The euro is losing the relationship with riskier assets that underpinned the currency in 2011 as the deepening sovereign debt crisis reduces the creditworthiness of even the biggest economies in the region.

The 17-nation currency has fallen 8.7 percent against the dollar since October, while the Standard & Poor’s 500 Index has gained 3.4 percent, and the correlation between the two dropped to 58 percent from a record 91 percent in November, according to data compiled by Bloomberg. The euro had moved almost in lockstep with investments linked to growth, including stocks and the Australian dollar, since January 2011.

This decoupling is taking place as European Central Bank President Mario Draghi cuts interest rates and promises banks unlimited cash for three years to rein in soaring borrowing costs for governments ranging from Italy to Spain to France, which lost its AAA credit rating last week. The infusion drove the euro to a 20-month low of $1.2624 last week. UBS AG, which in mid-August advised selling the currency when it was at about $1.45, says fair value ranges from $1.15 to $1.20.

“In the latter part of last year you had the euro, the Aussie and the S&P 500 all trading in the same way, very highly correlated,” Andrew Cox, a currency strategist at Citigroup Inc. in New York, said in a Jan. 9 telephone interview. “Fundamentals once again matter.”

Worst Performer

Strategists also anticipate more losses as the U.S. economy improves while the euro zone shrinks, driving international investors away from the region’s assets. At the same time, European officials led by German Chancellor Angela Merkel are taking steps to contain the crisis and sovereign borrowing costs eased last week.

The euro is the worst performer this year among the 10 currencies tracked by the Bloomberg Correlation-Weighted Indexes, falling 1.7 percent. Major peers that have appreciated the most against the dollar are Brazil’s real, Mexico’s peso and New Zealand’s dollar, currencies with a traditionally high correlation to U.S. equities and the favorites of speculators seeking riskier bets, according to data compiled by Bloomberg.

Europe’s deepening debt crisis, which culminated in Standard & Poor’s cutting the ratings of France and eight other euro-zone nations on Jan. 13, caused the euro to weaken 0.2 percent to $1.2654 as of 8:45 a.m. in Tokyo, extending a drop from last week. It declined 0.2 percent to 97.34 yen after touching 97.17, the least since December 2000.

‘Short the Currency’

“Investors should be short the currency now and we’re concerned that Friday’s mass downgrades of euro-zone countries by S&P is not fully priced yet,” Mansoor Mohi-uddin, the Singapore-based chief foreign-exchange strategist at UBS, said in a Jan. 14 report.

The euro also reached a record low of 81.55 cents against the Australian dollar today. Currency forecasters reduced their fourth-quarter estimates by the most last month since January 2010, predicting it will end the
year at $1.30, from previous estimates of $1.38, Bloomberg data show. Cox said he expects it to drop to $1.20.

“The escalating euro zone sovereign debt crisis is both raising concerns over the long-run growth outlook for the euro zone, sustainability of the currency bloc, and solvency of some members,” Lee Hardman, a currency strategist at Bank of Tokyo- Mitsubishi UFJ Ltd. in London, said in a Jan. 11 e-mail.

Even with the declines, the euro remains above its average of $1.2054 since its inception in 1999 and signals that Europe’s leaders may stem the crisis that has led to bailouts of Greece, Portugal and Ireland.

**EU Summit**

The results of a Dec. 9 summit, at which 26 of the 27 European Union members agreed to sign up to or consider tighter deficit limits and sanctions against offenders, would have been “unthinkable” a few months ago and “can’t be overstated,” Merkel said in a Dec. 14 speech in Berlin.

The Stoxx Europe 600 Index of stocks is up 1.9 percent this year. Yields on Italian 10-year bonds fell to 6.64 percent last week from 2011’s high of 7.48 percent on Nov. 11. French notes of similar maturity are 3.08 percent, down from 3.82 percent.

That may change this week after S&P stripped France and Austria of their AAA ratings, cut those of Italy and Spain, while leaving Germany’s untouched. Before S&P made its move, Greece’s creditors said they had failed to agree how much money investors will lose by swapping the nation’s bonds, increasing the risk of the euro area’s first sovereign default.

**Crisis Shift**

“The problems in the euro zone have shifted from the periphery and are moving more into the core of Europe,” Ian Stannard, the head of European foreign-exchange strategy at Morgan Stanley in London, said in a Jan. 10 telephone interview.

A growing divergence between Europe and the rest of the world is driving away investors as ECB interest-rate cuts remove one of the euro’s pillars of support.

The currency appreciated as much as 6.6 percent between January and May 2011 as Jean-Claude Trichet, who stepped down as head of the ECB in October, raised the central bank’s main rate twice, to 1.5 percent from 1 percent.

Draghi has undone those increases, and foreign holders sold the greatest amount of euro zone assets in October since February 2000, according to ECB data released last month. He has signaled more cuts may come, saying at a Jan. 12 press conference in Frankfurt that there are “substantial downside risks” to the economy and policy makers stand “ready to act.”

The ECB’s decision to offer banks unlimited three-year loans and the central bank’s purchase of sovereign bonds helped balloon the central bank’s balance sheet to a record 2.73 trillion euros ($3.5 trillion) in December. The Federal Reserve’s balance sheet has averaged $2.86 trillion since the end of the central bank’s latest asset purchase program in June.

**Sovereign Bonds**

“It’s a different ECB than we’ve ever had before,” Sebastien Galv, a senior foreign-exchange strategist at Societe Generale SA in London, said in a Jan. 11 telephone interview. “That means that the euro is not going to
perform very well.”

By making loans to banks and purchasing sovereign bonds the ECB is flooding the market with euros, similar to the monetary policy called quantitative easing that the Fed conducted when it flooded the financial system with dollars through asset purchases.

A measure of the relationship between the value of the European currency and the Australian dollar against the greenback has dropped to 76 percent, after climbing to as high as 94 percent in November, according to the pair’s 20-day percent change correlation. The euro’s ties to the S&P 500 have fallen to the lowest since June.

**Recession Risk**

Germany may be on the brink of recession after its economy shrank “roughly” 0.25 percent in the fourth quarter from the third, the Federal Statistics Office said Jan. 11 in an unofficial estimate. A recession is defined as two consecutive quarters of declining gross domestic product.

Economists estimate the euro zone economy will contract 0.2 percent this year, according to the median estimate in a Bloomberg News survey. A separate survey shows the U.S.’s gross domestic product may expand 2.3 percent in 2012.

“In a world in which the ECB loosens policy and the better data in the U.S. is implying a lower probability for quantitative easing, we would expect euro-dollar to continue under pressure.” said Aroop Chatterjee, a currency strategist at Barclays Capital Inc. in New York.

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