Threats Cloud Euro's Flight
With Europe's Economy Still Hobbled, the Currency's Surge Could Soon Stall

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The euro, once on death's door, is on a monthslong tear, rising Wednesday to its highest level since November 2011.

But even some investors who helped propel the currency above $1.3560 Wednesday say it can't fly much further. Europe's economy is still in the doldrums, they say, and a stronger euro could make the situation worse. And with central banks elsewhere racing to push down their own currencies, boosting the relative value of the euro, the European Central Bank eventually could be compelled to join them.

A pedestrian walks past an ad showing euro notes in Athens.

"I could imagine another 2-3% for the euro, but I don't expect a continuous rally," said Joe Corbach, head of commodities and currencies at Swiss Global Asset Management, which had 87.4 billion francs ($94.5 billion) in assets under management as of the end of September 2012. "We do not expect the euro to go beyond $1.40."

Mr. Corbach has been overweight on the currency since November, and is considering returning to a neutral position.

The euro has come a long way in a short time. Last year, in the throes of the euro-zone crisis, companies were making emergency plans for the common currency's demise.

The turning point for the euro came last summer, when the European Central Bank pledged to prop up troubled areas of the government-bond market and keep the euro-zone intact. Since late July, when ECB President Mario Draghi outlined his support, the euro has climbed by some 12% against the dollar.
Several factors have bolstered the ascent. The relaxation of concerns about calamity in the euro zone has ended the capital flight that hurt the euro during the peak of the crisis. Investors no longer are selling the euro and buying the dollar out of fear. The surprising report Wednesday of a contraction of the U.S. economy at the end of 2012 pushed the euro higher against the dollar. Some months ago, that might have spurred the opposite reaction.

But the actions of central banks are looming particularly large. The U.S. Federal Reserve has pledged to keep short-term interest rates low. The Bank of England and the Fed are running massive quantitative-easing programs. The Bank of Japan has moved to hold down the yen.

The ECB is going the other way. A year ago, it flooded banks with inexpensive loans. It now is withdrawing that liquidity by accepting repayment of those loans.

That adds to upward pressure on the euro. Wednesday, European banks were set to repay €137 billion out of the €1 trillion they borrowed. In coming weeks, more of these funds are likely to be repaid.

That puts the ECB in a tight spot. It would like to unwind its extraordinary easing, but the possibility that the rising currency could hit growth at a fragile time is deeply unpleasant for many—especially in the euro-zone's southern tier.

"From an economic point of view, Europe is not in a better place now than it was six months ago," said Reto Feller, head of spot foreign-exchange trading in London for Westpac Bank WBC.AU -0.46% . "We are reaching a level where officials may start
becoming outspoken in the next few weeks" about the currency's strength. He expects the euro to reach around $1.37 before starting to weaken.

A strong currency makes exports appear relatively more expensive to trading partners and reduces the attractiveness of foreign investment. The 17-country bloc is forecast to contract 0.3% in 2013, according to the latest ECB staff projections.

ECB officials haven't described the euro as overvalued in recent weeks, allowing it to continue its rise. Earlier this month, the ECB's Mr. Draghi said that "so far, both the real and the effective exchange rate of the euro are at their long-term average."

But the pain in Europe is steep, and many expect pressure to mount on the ECB to ease policy again, denting the euro. Spain's unemployment rate keeps rising and its economy is shrinking.

"That's the next step, for them to do something about the economy," says John Hardy, head of foreign-exchange strategy at Saxo Bank in London. "I think we'll see a violent pivot at some point."

Philippe Bonnefoy, founder of Eleuthera Capital, based in Switzerland, believes the euro's rise soon will be halted by profit-taking and increasingly negative data coming out of the euro zone. "People will soon start to contemplate whether they want to be long the euro on the eve of a European recession," he said.

This week he went from being long the euro to a neutral position, and is looking to short the currency between $1.35 and $1.37, he said.

Other investors also are looking to pounce on weakness, though many who bet on a declining euro were badly burned by the reversal in sentiment sparked by Mr. Draghi last summer.

Still, Philippe Gougenheim, who runs the $60 million Gougenheim Investments hedge fund, plans to wait for the euro to appreciate further, then employ an options strategy that would allow him to sell euros and profit if, as he expects, the currency hits $1.30 in the next three to six months.

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