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A MORE SANGUINE VIEW AS THE DUST SETTLES

The doom and gloom directed toward the US seems exaggerated. Warnings that the Fed has lost its credibility, that the dollar was losing its status as a reserve currency and that the US economy was stagnating here in Q4 all seem to be misplaced.

There is little doubt that the Fed's communication tactics could be enhanced, but the substance of this week's moves seem to be quite reasonable, even if the stock market has been unable to recover from the sell-off after Tuesday's rate moves. At the time, many of us were flummoxed and yet within a couple of days, the Fed's logic seems clearer and more compelling.

Some observers were disappointed that in the Fed's statement there was still a recognition of the upside risks to inflation. Why should that be the case if the risk was that the US is headed for a recession? Some thought the Fed should have cut the Fed funds rate 50 bps. Do Fed officials not appreciate the urgency and risks to the highly leveraged US economy?

Yet look at the news stream since the FOMC meeting. Import prices jumped by 2.7% m/m in November after a revised 1.4% m/m rise in October. The y/y rate stands at 11.4%, up from 9%. Producer prices leapt by 3.2% m/m in November, more than twice what the market expected and the y/y rate stands at 7.2%. Consumer prices rose 0.8% m/m in November after a 0.3% m/m rise in October, lifting the y/y rate to 4.3% from 3.5%. If the Fed had satisfied its critics on Tuesday, it would have exposed the other flank to more criticism that it was becoming soft on inflation.

There was also some disappointment that the Federal Reserve chose not to cut the discount rate more and lower the punitive spread over the Fed funds target. Yet discount window borrowings have risen over the past two weeks as one month libor (and alternative source of some funding) rates moved well above the discount rate. Apparently the attractive cost of funding offsets or blunts the stigma associated with the discount facility. In fact, the outstanding discount window borrowings stood a little above $4.5 bln on December 12, which is slightly higher than the amount borrowed in the middle of September, when in a high profile operations several large banks made a gesture to support the Fed's attempt to revive the largely dormant facility.

It is too early to judge the success of the new liquidity provisions the Fed announced. The effect on interbank offered rates seems quite modest at best, but next week's auctions will help assess the effectiveness of the new steps. However, the size of the each auction is less than what the Federal Reserve might provide in their regular daily operations, especially this time of year.

Ultimately, the Fed and other central bank may be trying to address the access to capital, even if in a modest way, there is little they can do to revive the willingness to lend and the desire to borrow. We argue that the key ratio to be watching is the one between the estimated potential loss created by imprudent mortgage lending and financial engineering and the amount of write downs and losses that large institutions are recognizing. Estimates of the magnitude of the problem, including by the OECD, suggest that as much as $300 bln will be lost. Thus far, the large institutions have taken about $80 bln in write downs and losses.

The fact that some large banks are putting their affiliated SIVs back onto their balance sheet will help make it easier to service those investments and prevent or at least delay more sales of the distressed assets. It also makes the super-SIV strategy somewhat less urgent.

Two weeks ago many people were talking about the possibility that several oil producers who pegged their currencies to the dollar would abandon the peg. Speculation was rampant and especially focused on the UAE. The regional meetings were held and nothing came of them. Indeed, after the Fed cut rates, all the members of the Gulf Cooperation Council except Kuwait matched the Fed's move. Moreover, the head of UAE's central bank was crystal clear: it would not change its currency regime unilaterally and there is not strong interest to do so.

The reason that speculation picked up regarding a change in the GCC's currency regime was due in part to the fact that these countries are experiencing strong inflation pressures, which some observers linked to the pegs to the weak dollar. However, regional officials are making the argument that the source of inflation is not the foreign exchange market, but their real estate markets. UAE's central banker was emphatic about this, and suggests a repeg would do little to address higher inflation.

Moreover, there continues to be little hard evidence that central banks as a whole are diversifying reserves away from the US dollar. Rarely has the ink spilled been in such disproportion with the evidence. The shift in valuations rather than quantity of holdings account for the bulk of the changes that might appear to be taking place in the currency allocation of reserves.

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Another worry that has been expressed is that the US economy is stagnating in the fourth quarter. Yet the most recent string of economic data suggests this is not the case, even though the economy is indeed slowing down from the heady and well above trend growth of near 5% in Q3. Retail sales rose twice what the pessimistic consensus had expected in November and excluding autos retail sales jumped 1.8% rather than the 0.6% the consensus forecast. And the October data were revised higher. The real US trade deficit was also a bit smaller than expected. Lastly, government spending, especially defense spending, appears to have risen sharply. Our back-of-the-envelop guesstimate of 1.0% Q4 GDP is probably a bit conservative. One of the headwinds on the US economy, slower inventory accumulation, might turn into a tailwind again later in Q1 08 or early Q2.

Lastly, when trying to assess the US fundamentals, they need to be understood not only in terms of what is happening domestically, but also how they compare on a relative basis with other countries. The slowdown the US is experiencing now will still produce a growth rate on a two-quarter average that much of Europe and Japan can only dream of. Much is made of the fact that Canada is the only G7 country that boasts both a budget and current account surplus. Yet, long-term well-being is determined by productivity growth, and US productivity grew more in Q3 alone than Canada has in the first three quarters combined.

The combination of a weak US dollar and relatively cheap US assets will encourage direct investment and increase use of the US for sourcing and production by foreign companies. Unit labor costs in the US look downright attractive when converted to euros, or sterling or Canadian dollars, for that matter.

In the short-term, the US is punished for the pro-growth policies of the Federal Reserve in being able to act quickly and preemptively. In the intermediate and longer term, the US will be rewarded by returning to trend growth earlier after a potentially shorter and shallower economic slowdown. As other countries are forced to pursue pro-growth policies, their currency overshoots should end and the US dollar recover.

Dollar extremes against the euro or previously the Deutschemark seem to be often seen twice and so if the dollar has bottomed against the euro, there will likely be another run at the $1.48-$1.50 area. However, a better case can be made for the US dollar having already bottomed against the British pound and the Canadian dollar, where the central banks have already begun their own easing cycles.

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