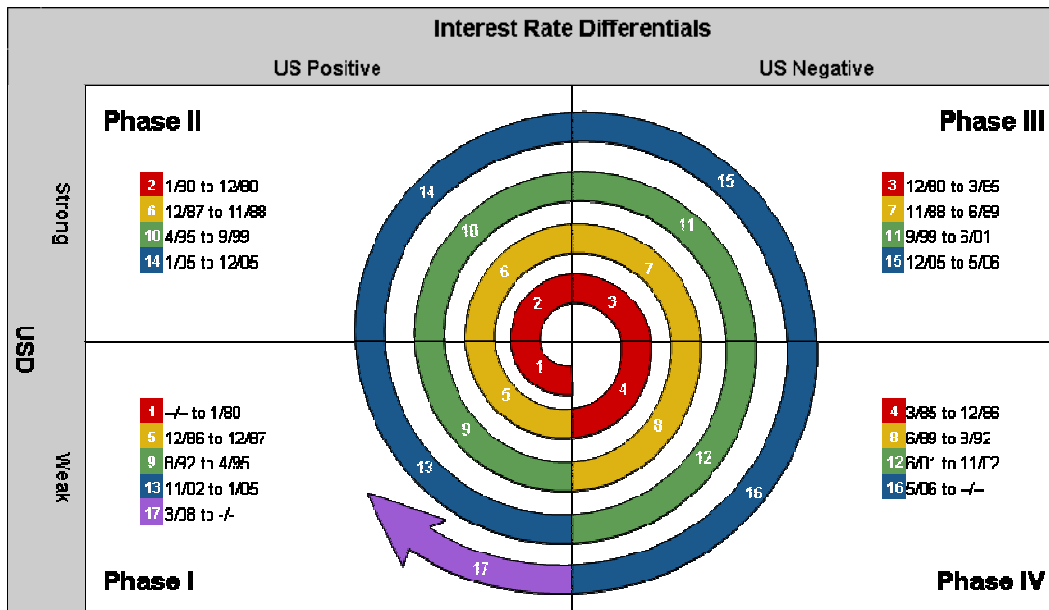


THE DOLLAR'S SUPER-CYCLE UPDATED

As we have presented before, we find that the US dollar moves in a large cycle against the euro and before that the Deutschemark relative to short-term interest rate differentials. Given the recent shifts in interest rate expectations and the somewhat firmer dollar, we thought it timely to review the dollar's super-cycle.

Recall that we are looking at two variables, the dollar's value and the direction of short-term interest rate differentials. With two variables there are four possibilities: There are times when there is a weak dollar while interest rate differentials move against the US, which has been the case in recent quarters. The dollar may remain weak as interest rate differentials begin moving in its favor. The dollar could strengthen as interest rate differentials continue to move in its favor and later the dollar could strengthen when interest rate differentials begin moving against the US.

Since the late 1970s, the dollar appears to be moving consistently and sequentially through the four different phases. We are not pretending to offer some kind of Holy Grail. The limitations of this conceptualization are stark. It says nothing about the duration; how long the dollar spends in any one phase. It also says nothing about magnitude; how much the dollar appreciates or depreciates in any phase.



Nevertheless, the dollar's location in its super-cycle helps identify the underlying trend and may be more useful for long-term traders than short-term speculators. In particular, recent developments lead us to believe that the dollar may be moving from what we have labeled Phase 4, where short-term interest rate differentials are moving against the US and the dollar is falling to Phase 1, where short-term differentials begin moving in the US favor, but the dollar remains soft against the euro.

As a proxy for short-term interest rate differentials we use Euribor and Eurodollar futures contracts. The spread for the June futures contract peaked almost 2 months ago on March 17<sup>th</sup> a little above 227 bp. It fell below 190 bp last month and recovered to about 215 bp now. The September spread peaked more recently—April 11<sup>th</sup>—near 208 bp fell to about 175 bp near the end of last month and is now trading near 197 bp. The difference between the Dec Euribor futures and the Dec Eurodollar futures contract peaked on March 31 just above 182 bp and dipped below 150 bp before recovering toward the mid-160s, where it currently is trading.

Admittedly the interbank market remains under stress, but the same general development of interest rate differentials no longer moving against the US and actually moving in its favor is also evident in the 2-year government sector. Over the past month, the US 2-year yield has risen about 56 bp, while a bond of similar duration in Germany has increased 44 bp. To be sure these are modest moves, but what is more important in our assessment is direction.

The economist's equivalent of Occam's Razor, the philosophical principle that the simple solution is preferable is that cyclical explanations ought to be given precedence over structural explanations and only when the former prove unsatisfactory should the latter be relied upon. We have maintained that the dollar's decline was largely a cyclical phenomenon, largely a function of growth differentials mediated by interest rate differentials and divergence in monetary policy between the Federal Reserve on one hand and the ECB on the other.

The structural reasons other observers cite, like diversification of reserves or the loss of the dollar's status as the numeraire in the world economy we find lacking much evidence. The most authoritative data, which comes from the IMF shows central banks hold more US dollars than ever before. The US does of course still run a large trade deficit, even if it has fallen in recent quarters. Nevertheless we have found that over half the trade deficit can be accounted for by the movement of goods within the same companies. These intra-firm movements of goods, as trade has been in effect in-sourced, often do not require countervailing capital flows but are rather book entries in corporate accounts. In addition, while the US is the world's largest exporter, its companies rely on local affiliate sales rather than exports as the chief method of servicing foreign demand. Sales by the majority owned affiliates of US multinational companies will sell something on the magnitude of four-times the amount the US will export this year.

The US dollar bottomed against half of the non-US G7 currencies, sterling and the Canadian dollar, last November. The dollar's location in its super-cycle does not preclude a marginal new low against the euro. It does support our view, however, that the dollar's multi-year downtrend is nearing an end. The shifting of interest rate differentials, which investors should continue to monitor, is another piece of the jigsaw puzzle falling into place for a broadening of the dollar's base in the period ahead.

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