SPECIAL FX

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Is the Dollar Really King?

The US dollar recovery over the past several weeks has been simply breath-taking. Consider for example that it took the euro the better part of six months to move from around $1.44 to its record high of almost $1.6050. It took a little more than six weeks to retrace that gain and then some. The violence and persistence of the dollar's advance since the middle of July has been of historic proportions and reflects a powerful pent-up demand for the greenback.

The pace and magnitude of the move is extreme and technical indicators continue to warn of the risk of a technical correction. However, such signals have in recent weeks been common and have encouraged medium and long-term investors and hedgers to wait for a better level to buy dollars. Yet such opportunities have been brief and much shallower than desired.

The driving force has not been technical in nature but a function of market positioning. For several years, real and leveraged players have amassed huge short dollar, long foreign currencies (especially European currencies and emerging market currencies) and long emerging market equities and commodities. Some high frequency traders and speculators have been able to adjust their positions and some have been forced by risk-management (stops) to reduce their short dollar exposure. Others, including many real money and leveraged accounts have been considerably slower to adjust or have been resisting the sharp reversal, thinking it is simply another counter-trend dollar bounce. What took several years to build has not been unwound in a few weeks.

We have consistently argued since the end of last year that the dollar's cyclical decline was nearing an end. Until late July or even early August, it was not unequivocally clear that our analysis was correct. The critical development seems to be a confluence of three factors: the de-leveraging process continued to unfold, the de-coupling story fell flat on its face, and the ECB acknowledged that the downside economic risks that it had warned of were in fact materializing.

This is important: the dollar's recovery has little to do with what is happening in the US. It is true that a number of economic reports in recent days have been a bit better than expected and Q2 growth was revised sharply higher to a mind-boggling 3.3% annualized pace. Yet that pace of growth is widely recognized as unsustainable and economic growth is likely to slow back toward 1% in Q3 and Q4. Moreover, the dollar's rally has taken place alongside scaling back of Fed rate hike expectations.

As recently as late July, the December Fed funds contract was implying 100% confidence of at least a 25 bp rate hike before the end of the year and leaning toward two such hikes. Now it is just as confident of no move. Taking a look at the overnight swap index, the day the euro peaked against the dollar, indicative prices suggested the market was looking for about 32 bp of hikes by the Fed over the next 12 months. That is where it is today after having moved up to about 85 bp in the first part of August.

An even bigger shift has occurred in expectations for the ECB. Through most of Q1, our expectation for an ECB rate cut was shared by many if not most in the market. The OIS shifted to a rate hike by mid-April and proceeded by early June to price in 100 bp of tightening over the next 12 months.

The ECB hiked its repo rate 25 bp in early July but, with the contraction of Q2 euro-zone GDP and signs of further weakness in Q3, by late July the OIS shifted back in favor of a cut and now, despite official concern about the second round impact of higher commodity prices and IG Metall (the largest union in the euro-zone) demanding a 7-8% wage increase, there are 50 bp of rate cuts priced in. The euro has declined a little more than 10% since its peak in mid-July.

The OIS for the UK tells a somewhat similar story. Between mid-May and mid-July, the OIS was biased toward a UK rate hike. It peaked in mid-June pricing in 75 bp worth of hikes. It is now pricing in almost 100 bp of cuts. Since the middle of July, sterling has fallen nearly 12% against the US dollar.

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Of course neither the ECB nor the BOE have cuts rates in recent months. But it is as if the market has said: We think you should ease policy and because you refuse, we will do it for you. This has been accomplished through the sharp depreciation of their currencies. The BOE's trade weighted index for sterling has fallen by almost 6% since mid-July (and now stands near its lowest level in a dozen years). For its part, on a trade-weighted basis, the euro has declined about 5% in the same time. Economists may differ over the magnitude of the effective ease, but at a bare minimum, it is probably tantamount to at least a 50 bp easing in monetary conditions in both economies.

The dollar is the inverse. The BOE's trade-weighted index of the greenback has risen about 7.5% since mid-July. This is tantamount to at least 50 bp of tightening of monetary conditions, even though the Fed shows no inclination to do so.

The first leg of what we expect to be a cyclical advance for the dollar was not predicated on new positive developments in the US. This is not a unique development. The euro was bought earlier this year more as a function of pessimism about the US than euphoria over Europe, but few suggested the euro was rallying by default. The next phase of the dollar's advance, which still might be several months off, may be fueled by a recovery in the US economy.

It is not just that the US was the first to slow down, so it should be the first one back up. It is also that the US was able to pursue more flexible policies that will likely ensure an earlier recovery. Consider a small example. The Federal Reserve liberalized its collateral rules, but the ECB allowed a wider range of collateral, including instruments that were as much as 5 notches below triple-A. This has resulted in massive borrowing from the ECB (467 bln euros last week) as some participants reportedly create instruments for the sole purpose of using them as collateral.

The ECB has objected to this gaming of the system and announced yesterday that the cost of such activity would go up sharply. The amount that it is willing to lend relative to the notional value is called a "haircut". It has been as low as 2%, but the ECB announced it will go up to as much as 12%. While perhaps prudent from a policy point of view, if anything it will retard the healing of European bank balance sheets. This is on top of the very flat yield curve which also tends to slow the repair of balance sheets.

The move in the dollar, emerging markets and commodities does not appear complete. Counter-trend moves still are brief and shallow. The real economic impact of the dollar's recovery on exports, a major support for the economy, will take a while as the price of goods take much longer to adjust than the price of money (see J-curve effect). The bigger threat to US exports comes from the slowing of the world economy. Recall that US exports were strong in the second half of the 1990s, when the dollar was strong because demand was strong.

The dollar may not be king, but it is still in ascendancy.

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