

LOST IN TRANSLATION: THE DOLLAR IS A GOOD BUY, NOT A GOODBYE

Much foreign exchange commentary these days reads like eulogies for the US dollar. Central banks are diversifying reserves away from the dollar. OPEC countries are increasingly worried about the decline of the dollar and the inflationary implications and may break the pegs and possibly even begin benchmarking their black gold in euros rather than dollars. The aggressive US policy easing and the financial crisis, which none less than former Federal Reserve Chairman Alan Greenspan has said is the worst since the Great Depression, contributes to the lack of attractiveness of US assets. The low rates of return in the US will make it increasingly difficult to fund its large current account deficit, which in turn will continue to undermine the dollar.

This pessimism is exaggerated and ignores evidence to the contrary. Moreover, the very fact that sentiment is so poor and short dollar positions so extensive may be more symptomatic of a market extreme than the beginning of a trend.

One of the weights on the US dollar has been the belief that foreign central banks have a clear alternative to the debt-ridden greenback as a reserve asset. Yet the evidence for this is sketchy at best and depends on when one wants to begin counting from. The IMF recently reported the allocation of reserves for Q4 07, which of note excludes China as China does not provide a break down of its reserves. The share of allocated reserves accounted for by the dollar actually rose slightly to 63.9% vs 63.8%. Given the dollar's depreciation in the quarter, the fact that its share actually rose suggests, contrary to conventional wisdom, that reserve managers are reluctant to sell dollars at these levels.

That is clearly the message coming from foreign officials. On March 12, speaking at an ECB conference, the head of the Saudi Arabian Monetary Authority, Hamad Saud al Sayari, explicitly stated that the dollar was a "good buy", as the rout looks overdone and the dollar under-valued. Less than two weeks later the head of Kuwait's Investment Authority, thought to be one of the largest sovereign wealth funds, indicated that he was going to boost investments in the US because the weaker dollar made US assets more attractive.

The Middle East is not alone. At the end of March, press reports quoted Russia's Finance Minister Alexei Kudrin indicating a comfort level with its current reserve diversification (~49% US dollars, 40% euros, 10% pounds and 1% yen) and that "the dollar has potential to strengthen against other currencies in the medium-term."

The Federal Reserve offers foreign central banks some plain vanilla custody services for their Treasury and Agency holdings. Contrary to what passes for conventional wisdom, foreign central banks have been on a buying spree in recent months. The Fed's custody holdings have jumped \$145 bln in Q1, which alone will cover the lion's share of the Q1 current account deficit (quarterly average over the past year was \$184.7 bln) and is just shy of the total of the previous three quarters combined.

We would recast the debate over if and when the US dollar will bottom. We argue that it is already bottoming. Not including the dollar, there are four other currencies in the G7 and the dollar appears to have bottomed against two of them, the British pound and the Canadian dollar. If it has not bottomed against the other two, the euro and Japanese yen, we suspect it has come close to what will likely be the cyclical low. The Australian and New Zealand dollars may find it difficult to rise through the Q1 highs set near \$0.9500 and \$0.8215 respectively. We also believe the US dollar has bottomed against several of the major emerging market currencies as well, like the South African rand and Turkish lira.

It is of course difficult to pick the precise time and level that the dollar will record its low against the yen and euro, but that is the game for short-term speculators. For medium and long-term investors who look at value, the dollar is historically cheap, especially against the European currencies and its cheapness has begun to impact the behavior of businesses and investors. In order to compete in a weak US dollar environment (and given perceptions that the risk of US protectionism may increase), foreign companies are locating more sourcing and production in the US. Foreign direct investment in the US in the second half of 2007 roughly matched the direct investment inflows for the previous four quarters combined (\$141 bln vs \$152 bln).

With some observers claiming that the Federal Reserve has gone too far to insulate the financial system from the consequences of investor behavior and others thinking the government has not gone far enough, judging from the behavior of the markets, the official action has gone far enough. Although there still are parts of the capital markets under stress, the liquidity crisis appears to have been alleviated or at least mitigated by the various facilities created by the Federal Reserve and the liberalization of the lending capability of Fannie Mae, Freddie Mac and FHLB. Some measures of credit-quality concerns, like the TED-spread (compares the rate the US government pays with the rate that the private sector pays) has narrowed. This is not to say that the 07-08 crisis is over, just that the situation has stabilized, even if not turned a significant corner.

Meanwhile, the notion that this crisis will somehow be limited to the US is being undermined almost daily. The economic expansion cycles in Europe, Japan, Canada, Australia and New Zealand were already getting long in the tooth, leaving them vulnerable to the credit crunch, higher oil prices and currency strength. These economies have lost considerable momentum and although price pressures remain troublesome, we suspect that the divergence in monetary policies have already peaked or will peak here in Q2.

The fissures in Europe have been partly concealed by looking at the region in aggregate. The size and prowess of Germany may distort the divergence taking place within the area. Italy, Ireland and Spain for example appear to be slowing dramatically and some warn that at least the former two may stagnate or even contract before the year is over. Relative to Europe, US unit labor costs have fallen by more than 30% since the early part of the decade and this undermines the competitiveness of producers in the area.

This more positive outlook for the dollar is not predicated on the coordinated intervention by the central banks. Indeed, despite the number of observers who claim to be on intervention watch, we think the risks are minimal at best. Last September the IMF indicated that the dollar was still over-valued and more recently that it was strong compared to the underlying fundamentals. The Bush Administration appears ideologically opposed to intervention and, as we have pointed out previously, is likely to be the first US administration since at least the break up of Bretton Woods not to authorize foreign exchange intervention.

Those who think intervention is likely do not appear to have thought out the logistic difficulties, given the role of sovereign wealth funds. In the past, intervention often was tantamount to a transfer from tax payers (via central banks) to speculators. However, in the current setting, intervention might provide some sovereign wealth funds or central banks with a better level to sell dollars, so that the intervention adds to the wealth transfer from the G7 (in coordinated intervention) to the Middle East or Asia, where sovereign wealth funds are mostly based. Nor do most of those watching for intervention think out the kind of signal it sends to countries like China which has been browbeaten in nearly every international forum to let the market determine the yuan's value.

Instead of intervention, our more positive dollar argument is based on its relative cheapness, the changing behavior of investors and businesses, and the fact that the bad news from the US is widely known while the magnitude of the challenges faced elsewhere do not appear to be generally appreciated. The dollar has already bottomed against half of the G7 currencies and several key emerging markets. We expect that bottom to broaden out in the period ahead.

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