

The Long and Short of It: Outlook for the Dollar

The US multi-year down trend is over. The process we described as “carving out a bottom” has been completed. Recent days have been a watershed, but it has been a long time in the making. The dollar bottomed against the British pound and Canadian dollar (half of the G7 currencies) last November, as the Federal Reserve expanded its lending facilities and these countries prepared to cut rates. The dollar bottomed against the Japanese yen and the Swiss franc in late March, around the time that the Federal Reserve made a stand to protect what it perceived as potential systemic risk from the demise of Bears Stearns. The dollar recorded its low against the euro in early July as the US Treasury and Federal Reserve made it clear that the failure of government-sponsored agencies Fannie Mae and Freddie Mac would not be permitted.

The proximate cause of the sharp dollar advance in recent days is, however, not a new found optimism about the US or its macro-economic conditions. Instead, the dramatic adjustment was sparked by the growing realization that most of the apparent de-coupling was a mirage, and that Japan and large parts of Europe are experiencing recessionary conditions. Moreover, the lack of an early and flexible response by European and Japanese policy makers increases the likelihood that those downturns are deeper and more protracted.

A related development, even if reasonable people differ on what that relationship really is, many commodities, but especially oil, have pulled back sufficiently from their highs to encourage ideas that a top of some significance may be in place. This in turn has led to an unwinding of longer-term positions that were essentially long commodities and short US dollars.

Those countries, whose exports are weighted toward commodities, like Australia, New Zealand, Canada, South Africa and Brazil (to include majors and emerging market currencies) have come under strong downside pressure. Those dollar-bloc currencies have their own problems as well of course, with Australia's central bank signaling a rate cut as early as next month, New Zealand officials indicating that they will cut rates again, and Canadian data, like recent GDP figures for May and July and employment figures, point to continued economic weakness.

There has also been an important shift in interest rate expectations, even though the RBA, Fed, ECB and BOE left rates unchanged at policy making meetings in recent days. In essence, indicative pricing from the interest rate derivatives show expectations that the Federal Reserve raises rates over the next several quarters, while most of the other major countries are expected to cut rates. Just like the narrowing of interest rate differentials weighed on the dollar, anticipation of the widening is supportive of the greenback.

While these interest rate considerations are a factor, it is important not to exaggerate the roles of interest rates in the current environment. Countries do not offer high yields because they are generous. Instead high yields are demanded by investors to compensate for some risk, like inflation, currency vulnerability, threatening politics or even past policy mistakes. High yields can protect a currency under certain circumstances, as we have seen recently. However, high yields are generally a sign of weakness not strength.

Nearly all foreign exchange strategies can be bucketed into one of three categories: carry trades, momentum trades and value or mean-reverting trades. Carry trades in the foreign exchange market involve the selling of a low yielding currency and buying of a higher yielding currency. Generally speaking, given the usual volatility in the currency market, the carry-trade must be held for some time to make the “carry” a significant part of the return. The heightened volatility currently of both interest rate expectations and the currencies themselves, make carry trades for the most part, unattractive at the present.

The yen's weakness (the dollar traded above JPY110 for the first time since very early this year) does not carry strategies as much as momentum trades. In momentum strategies, one buys what is going up and sells what is going down. This strategy tends to be for speculators and short-term operators. Speculators, in the currency futures, and possibly in some of the Currencys share ETFs, had begun playing for the short-side and as momentum built, others joined either on their discretion or through the virtue of stops being triggered.

This momentum that has been established has inflicted serious technical damage to the foreign currencies. We have argued that the technical case for dollar bears had weakened considerably as the dollar's decline was increasingly on a narrow base, but the price action in recent days dealt the coup de grace. The euro was pushed through the spring lows in the \$1.5285-\$1.5300 area. And the euro was sold through its 200-day moving average (~\$1.5220). The dollar moved above its 200-day moving average against the Swiss franc (~CHF1.6040). The yen and sterling had previously fallen below their respective 200-day moving averages. Levels in the major currencies that should have limited profit-taking corrections were cut through like a hot knife through butter.

Valuation is often elusive in the foreign exchange market and economists have created valuation models based on either the relative price of a similar basket of goods (purchasing power parity) or combined with a function for external balances (fundamental equilibrium exchange rates). Value strategies in the currencies involve buying currencies that are cheap and selling those that are expensive. In effect, value plays are means reverting strategies, anticipating weak currencies recover and strong currencies depreciate. By many measures of valuation, the US dollar has rarely, if ever, been as cheap as it has become recently.

By the very nature of these strategies, they are for medium and long-term investors, not short-term speculators. These investors do not necessarily act quickly, but they do act decisively. The point here is that short-term speculators and longer term investors are on the same side of the market now.

Just like we can look back with awe and wonderment at the ridiculous heights some technology shares reached in the late 1990s and early 2000, we are going to look back with a similar bemusement at the pound trading about \$2.10 and the euro above \$1.60 and the Australian dollar near parity with the US dollar.

The market stance has moved from a sell dollar rally mode to a buy dollar dips. The forecasts in our last quarterly publication called for the euro to finish the year near \$1.47 and sterling to be near \$1.89. We have the dollar ending the year near JPY110. These forecasts seem conservative now, but weren't when we were among the few looking for a dollar recovery. More important than the precise levels is the signal that we are trying to convey. The dollar's multi-year bear market is over and given the trending nature of the currency market, a new bull market has begun.

Marc Chandler
Global Head of Currency Strategy