

## Where Now Greenback?

The US dollar had been buoyed by the easing of concerns that Fannie Mae and Freddie Mac would fail; a pullback in commodity prices, and weak European and Japanese economic data. However as the last full week in July drew to a close, the greenback lost its momentum as financial fears were rekindled and data shows that the US housing market has not yet bottomed. **While some consolidation may be seen, we look for the US dollar to be generally firm in the weeks ahead, though we recognize its sensitivity to developments outside the range of visibility that drives oil prices back up or heightens perceptions of systemic risk.**

One of the key factors that have contributed to the dollar's weakness has been the under-performance of the US economy and the rates cuts seen in response. We think that the news stream is improving in this regard. In fact, it is possible that the US economy was the best performer in the G7 in Q2, and could be doing it again here in Q3.

Toward the end of next week (July 31) the US will report its first estimate of Q2 GDP. In Q4 07, the US economy ground to a near halt. The 0.6% annualized pace of growth was less than population growth (estimated at 0.8%), indicating that GDP per capita probably contracted fractionally. In Q1 08 the economy grew slightly faster at a 1.0% annualized pace.

We had projected a 1.5% pace in Q2, but this seems too conservative. Indeed the US economy appears to have grown at around twice the pace of Q1. Recognizing that H1 08 growth has been significantly better than expected, both the IMF and the Federal Reserve have now revised higher their forecasts made in the spring.

This stands in stark contrast with what is happening in the other major industrialized countries. The UK was the first of the major countries to report an estimate for Q2 GDP. The economy expanded at a 0.3% quarter-over-quarter pace in Q1 and slowed to a 0.2% pace in Q2. This translates to less than 1% annualized. Moreover, the outlook for Q3 is for additional slowing.

Yet the world's second and third largest economies, Japan and Germany, do not appear to have fared even this well. It seems likely that both economies contracted in Q2, or at least stagnated. Japan's economy stands on three legs: government spending, exports, and capital spending. Each leg has been cut from under it. Surveys indicate weak capital spending plans. Japanese export growth has not simply slowed, but in June exports actually contracted for the first time in five years. At the same time, the purchasing power of Japanese households has been sapped, like those nearly everywhere, by higher food and energy prices.

The market is no longer confident that the Bank of Japan will even be able to raise rates once over the next twelve months, judging from the indicative pricing of derivatives and futures. Inflation is rising in Japan, with the June national index of consumer prices reaching a 10 year high of 2.0%. Unlike most other industrialized countries, Japan's price pressures are emanating from its core measure. The core measure is rose 1.9% in June from a year ago. Note that the yield on Japanese government's 10-year bond is about 1.56%, which is about 5 bp higher than it started the year. Overnight rates in Japan are set at 50 bp and are in real terms deeply negative.

Part of the issue is the metric itself. Japan's core measure excludes fruit, fish, and vegetables. If one were to exclude food and energy, as other countries like the US do, Japan's national inflation rose 0.1% from a year ago, up from -0.1% in May. That means that the rise in Japanese CPI is not truly inflation. It is not a general rise in prices, but a relative rise. Outside of food and energy, prices are for all practical purposes flat in Japan. And should the Japanese economy enter a recession, as is looking increasingly likely, the risk is that the deflationary forces have not really been defeated in Japan.

Germany's Economics Ministry has acknowledged that its economy may have contracted in Q2. The Irish economy contracted in Q1 in the first quarter, but a contraction of the German economy is more significant. The economy is larger and German has been much more successful than other European countries in containing unit labor costs and coping with the strength of the euro, the rise in food and energy prices, and other economic headwinds.

Investor, business and consumer confidence surveys in the euro-zone, including the flash readings on the July Purchasing Managers Surveys, suggest that the economic weakness will carry into Q3.

The economic cycle has peaked even if prices haven't. In addition, weaker economic growth, the fact that money supply growth has slowed and commodity prices have pulled back, suggest a budding optimism that current inflationary pressures may not be sustained. Money supply growth, measured by M3, slowed to a 9.5% pace in June from 10.5% in May and although still well above target, this is its slowest past in nearly two years. German states begin reporting July inflation figures in the coming days, and the year-over-year pace may stabilize around 3.4%.

ECB officials do not seem prepared yet to claim victory and some officials like the head of Austria's central bank Klaus Liebscher continues to threaten another rate hike. In June, the ECB revised up its forecast for this year's inflation for the second time this year. Still the weakness of recent economic data has prompted the market to reconsider its trajectory of ECB policy. In early June, the pricing of the overnight index swap market was consistent with 100 bp rate hikes by the ECB over the next year. The ECB did deliver a 25 bp rate hike in early July, but the market is now pricing in only about 16 bp of tightening over the next year, which is tantamount to a little more than a 50% chance of one more hike.

If the easing of oil prices, which are near six week lows, and food prices coming off the boil amid somewhat more favorable weather conditions can be sustained, and the upcoming European data as weak as early indications suggest, it would not be surprising to see the market expectations shift more toward a rate cut over the next several weeks.

This stands in stark contrast with US developments. Not only has US economic growth accelerated away from stagnation in H1 08, but inflation expectations arguably and ironically are better anchored than usually acknowledged. Consider that the University of Michigan's sentiment survey picked up an easing of inflation expectations. The five year outlook eased to 3.2% in July from 3.4% in June. Fed officials have cited this survey of inflation expectations as something they monitor. Fed officials also watch what the market calls the 5-year-5-year forward break-even, which is the 5-year-by 5-year forward inflation breakeven calculated from subtracting Treasury's Inflation Protected Securities (TIPS) from the US conventional Treasury forward. With some brief exceptions it remains mostly confined to a 10 bp range on either side of 2.50%. Over the past 200 sessions, it has averaged 2.55% and is currently quoted just below 2.6%.

The real Fed funds rate is, however, in negative territory and this setting is appropriate when an economy is contracting. A 25 bp rate hike would still keep the real rate negative, but less so and would help ease fears that the Fed is being too soft on inflation. At least three Fed officials in recent weeks have indicated a preference to hike rates even before the financial crisis is completely over. The Sept Fed funds futures implied about a 50% chance of a hike at the Sept 16 FOMC meeting, while the Dec contract is implying 100% confidence of a hike before the end of the year. Some participants have begun talking about an Oct rate hike, but all things being equal, we suspect the Federal Reserve would prefer not to hike rates so close to a national election, if it can be avoided.

We look for the dollar's base to broaden and deepen, but recognize that the market needs to become more convinced of the trajectory of monetary policy and needs to see greater evidence that the economic momentum in the US in Q2 carried into Q3. The euro and sterling tested their 100-day moving averages on July 24. The levels held on a close basis. The dollar remains above a similar average against the Swiss franc and the Japanese yen. We continue to advise medium- and long-term investors to take advantage of dollar declines to buy the greenback and/or reduce European currency exposure directly or through increasing hedges. Just like when the dollar was topping at the start of this decade, so too now, the process of carving out a cyclical extreme will take a prolonged period of time, and the rolling financial crisis makes underscores the protracted nature of this process.

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