

The Dollar Road Map

The first leg of the dollar's recovery appears to be ending. The dramatic trend of the past several weeks is likely to morph into more of a range trading affair, even if it takes time for such a range to become clear. We can anticipate a stream of fundamental news that will also temper some of the recent enthusiasm for the greenback.

The dollar's rally appears vulnerable to a shift in the pendulum of market expectations about Fed policy. The December Fed Fund futures contract is pricing in an almost 87% chance of a rate **cut** at the December 16 FOMC meeting. Fair value of the Dec contract if the Fed would not cut would be 98.00 (2%) and, given the date of the meeting, fair value assuming a 25 bp rate cut would be 98.12 (1.88%). Contract is currently trading at 98.105 (1.895%). This apparent shift in expectations is palpable. The Dec contract has rallied 90 points since bottoming in mid-June.

There is an important caveat. The Fed funds futures contracts do not settle at the Fed funds target rate, but at the effective weighted average. More often than not the effective Fed funds rate has been below the target rate for the past several weeks. While this technical factor might help explain why Dec Fed funds futures contract may be exaggerating the risk of a Fed rate cut, it does not explain, in a satisfying way, why the implied yield of the Fed funds futures strip through April is below the current Fed funds target. It does appear then that with the price of oil and commodities falling, the US economy weakening, and financial tensions running high, many market participants suspect the Fed may be more sympathetic to a rate cut.

To be clear, we do not think a Fed rate cut is a likely scenario. On one hand, the decline in commodity prices, if anything, speaks to the headline measure of inflation, not the core measure, which still seems elevated. Some measures of inflation expectations have eased. This is what was picked up by the September University of Michigan's consumer confidence survey. The five-year inflation expectations came in at 2.9% compared to 3.2% in August.

At times, some Fed officials have cited this survey. It has begun to converge with another measure, which has also been cited by Fed (and ECB officials) and that is the 5-year/5-year forward. This is a measure that looks at the 5-year by 5-year forward inflation break even, which is the difference between the corresponding TIPS forward and the forward of a conventional Treasury forward. The decline in commodities has not changed the picture. Inflation expectations remains stable, with the current reading of 2.57% the same as the 100-day moving average, which is also essentially unchanged from the middle of July (when both the euro and oil peaked).

The rise in energy and food prices was understood as similar to a tax on businesses and households. In a similar fashion, then, the sharp decline in commodity prices should be seen as a tax cut. Yet the damage is done, and part of the dramatic decline in commodities reflects weaker demand and expectations of more of the same. Indeed, after growing by an incredible 3.3% pace in Q2 (faster than all the other G7 countries combined), the US economy is slowing markedly in Q3, with little improvement seen in Q4. Even if the US economy does not contract outright, growth may be slower than population growth (roughly 1% a year) and that means that regardless of whether a recession is "officially" recognized, the economy may still contract on a per capita basis.

These fundamental developments, coupled with a strong conviction that the ECB and BOJ are on hold for many more months, and that much of their bad news stream is now fully digested, will likely see the US dollar set back in the period ahead. Do not misunderstand: on a longer-term basis, our favorable outlook for the dollar remains intact. Our point here is that the first leg of it looks to be over and the fundamental news will provide a favorable backdrop for the much needed backing and filling and consolidating one of the sharpest dollar advances in years. While short-term speculators and momentum traders may want to trade the dollar from the short side, medium and longer term investors may want to use this anticipated dollar decline to reduce foreign currency hedges and short dollar exposure in general.

What kind of levels should be anticipated for the euro? The first target is in the \$1.4300-60 area, but given the magnitude of the euro's drop, this will likely prove too conservative. A more likely target comes in near \$1.49-\$1.50. That said, the \$1.5285-\$1.5300, which corresponds to the spring low and the lower end of the four month consolidative topping pattern that the euro appeared to have carved out. Similarly, this more constructive outlook for the euro is also predicated on the \$1.40 level now marking the lower end new range.

Sterling has been fairly resilient in recent sessions despite a negative news stream. A move now above \$1.80 would confirm the corrective phase as opposed to simple consolidation. Initially then sterling can advance toward \$1.8200-\$1.8300. A move likely target comes in near \$1.8500, but it is unlikely to move above the late August high near \$1.8800. While there may be some speculation of a rate cut by the BOE next month, we are more inclined to see November as a more likely time frame and that would give sterling some time to correct.

The yen has been largely flat against the dollar, but has soared on a cross rate basis. The risk is that during the downside correction in the dollar envisaged here, that the yen weakens on the crosses and may sport a heavier profile against the dollar, though still remaining largely range bound.

The recovery of the dollar had coincided with the decline in commodities and emerging markets. If the argument outlined here is valid, it would not be surprising to see the commodities and emerging markets trade better. Among emerging market currencies, the Czech koruna and Iceland krona were hit the hardest since the dollar bottomed against the euro. Both lost a little more than 14%. The Polish zloty and Hungarian forint and the Colombian peso each lost more than 13%. The Brazilian real lost about 10.5% and the South Korean won lost about 9%. This handful of currencies that were hit the hardest in the latest period would appear to be the most likely candidate to have the largest bounce in this corrective phase.

If the first leg up in the dollar was essentially a short-covering rally, which broadly understood, including the unwinding of large structural positions of long emerging markets and commodities, then after this correction phase, we anticipate another leg up for the dollar, this time fueled by a more positive stance toward the US economy and the trajectory of Fed policy. At the present, this still seems several months away.

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