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Dollar Wobbles

The US dollar has been beaten back in recent days and the perma-bears are taking to the airwaves. They attribute this decline to the Federal Reserve's decision to increase its balance sheet by \$1.15 trillion. While the dollar fell hard on the unexpected news, the fact that its decline began some time prior to the Fed's move, suggests a more nuanced understanding of the price action is necessary.

A look at the euro will illustrate this point. On March 4th it recorded year to date lows just under 1.2460. It then proceeded to recover strongly. For a run of seven sessions, it did not take out the previous day's low. That streak ended on March 16th, but then resumed.

Prior to the Fed meeting, the euro was trading at its best levels since early February, breaking out of a multi-week range. One useful measure to identify the near-term trend is the relationship between the 5- and 20-day moving averages. On March 12th, the 5-day average crossed above the 20-day average for the first time since January 6th. With some variation on the theme, the same general pattern holds whether one looks at the dollar-index, British pound, Japanese yen, Canadian dollar, and even many emerging market currencies. The dollar, which was firm for most of the first quarter, has generally trended lower over the past couple of weeks. The Fed's decision may have put the move on steroids, but the dollar's general near-term direction was clear.

Second Verse Same as the First

One of the least appreciated considerations behind the dollar's decline was the influence of the calendar. The end of the quarter is approaching. It is also the end of the fiscal year for some governments and companies. This is often a time when asset managers and corporate treasurers adjust investments and hedges.

Remember last December. The euro, which had sold off hard from its record high above \$1.60 in middle of the July to almost \$1.23 in late October, rallied 17.5% between December 4th and December 18th. Many people then pronounced the demise of the dollar. Hardly.

The portfolio adjustments and positioning of short-term speculative players can help account for that move then and this move now. The Commitment of Traders does show that non-commercial accounts (i.e., speculators) were reducing short foreign currency futures positions prior to the recent FOMC meeting. When the attempt to push the euro below \$1.25 and sterling back to \$1.35 failed, short-term momentum traders were forced to cover short currency positions.

Cautious Optimism

The dollar's decline occurred amid some budding optimism. Recall that in recent weeks, several global banks reported their businesses had improved in the first two months of the year. Purchasing manager surveys and some sentiment indicators appeared to be stabilizing. US retail sales suggest that the American consumer, often pronounced dead, may be contributing positively to first quarter GDP for the first time since the second quarter of last year.

This also coincided with a firmer tone in many equity markets after a dismal January-February. The MSCI World Index advanced nearly 17% between March 9th and this week's FOMC meeting. The S&P 500 largely matched the global performance. Commodity prices also rallied. The CRB index rose over 8.5% during roughly the same time. This is not simply a function of a 27% rally in oil. Industrial metals also rallied. Copper prices, for example, rose by nearly 20%.

Some observers talk about this in the context of less risk aversion, but often times the logic seems circular. These observers, including some in the media, draw this assessment purely from price action. Rising equities means the market is less risk averse. And the way we know there is less risk adversity is that the stocks have rallied. In the foreign exchange market, the dollar and yen were thought to benefit from risk aversion in a similar circular fashion.

Perhaps the kernel of truth is that the de-leveraging process revealed a shortage of dollars and yen. When markets are dropping like bricks, the de-leveraging pressures are more urgent. However, recent anecdotal evidence suggests dollar and yen scarcity has eased considerably. This is evident from the decline in usage of the currency swap lines made available by the Federal Reserve.. It is also apparent in the weekly Japanese portfolio flow data, which indicates that Japanese investors have stepped up their foreign bond purchases, while foreign investors have increased their sales of Japanese stocks.

QE or QED?

The dollar's decline clearly accelerated when the Federal Reserve announced that it would buy another \$750 billion of mortgage-backed securities, another \$100 billion of agency bonds, and, for the first time, \$300 billion of Treasuries. Other countries, such as the UK, Japan, and Switzerland, which have announced quantitative easing programs, have seen their currencies weaken as interest rates fall.

Yet in the larger picture, many seem to be exaggerating the negative dollar implications of Fed's decision. First, while inflation expectations of monetizing the US debt is a legitimate concern, dis-inflationary, if not deflationary forces, seem stronger than the inflationary. Not only for this year, but next year as well. Second, the five-year/five-year forward rate, which both the Fed and ECB have cited, shows that even after the adjustment following the FOMC meeting, expected inflation is higher in Europe than the US.

Third, the purchases of US Treasuries, which seemed to capture the market's imagination, is really quite modest, even though it can no doubt be scaled up. The \$300 billion is roughly 2% of US GDP and less than one fifth of the likely US budget deficit. The Bank of England has been authorized to purchase 100-150 billion pounds of gilts, though will begin smaller. This is tantamount to something on the magnitude of 7% of GDP and close to half of the public sector borrowing requirement. For its part the Bank of Japan will buy about 60% of this year's JGB issuance. Fourth, even though Europe does not have the institutional capability of the US, UK, or Japan, ECB President Trichet is correct that it too is engaged in unconventional easing. The ECB's balance sheet has expanded dramatically, and like the Fed's, it has eased back in first quarter, and is also likely to expand again, especially if it extends maturities of its refinance operations as some officials have hinted. As a percentage of GDP, the ECB's balance sheet increase is not much smaller than the Fed's.

The pessimist camp wants it both ways. The US is going down the same path as Japan, where the end of a real estate bubble led to a banking crisis and a deep economic contraction. And they want to caution that printing of money will boost interest rates, fuel inflation and debase the currency. Yet that was not the Japanese experience. Interest rates remained low. Deflation was not defeated. The currency was not debased.

We have argued that the leveraging-de-leveraging axis has been the key driver in the foreign exchange market. We expect a new driver, anticipated growth trajectories, to emerge and in the transition phase we expected the dollar to wobble. The Fed's decision does not change our view. Look for the dollar's uptrend to resume in the second quarter.

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