FOMC Preview and Dollar Outlook

A new factor has arisen that complicates the Federal Reserve's task as it prepares for its last meeting of the year. The broad outlines of the agreement between President Obama and the Republican leadership on fiscal policy is significant, even if the compromise is tweaked a bit now or passes retroactively early in the new year. Indeed, a new fiscal stimulus package will be agreed upon under the guise of tax cuts (although most are reluctant to call it that). In fact, one of the biggest surprises is the 2% payroll savings tax cut that replaces the "Make Work Pay" cut. The "Make Work Pay" cut was, after all, the largest single item in the 2009 stimulus package. As a result, economists are revising up their 2011 GDP forecasts by 0.5%-1.0%.

The Fed's resumption of its Treasury purchases was in large part aimed to improve financial conditions, which are seen as a harbinger for stronger growth prospects down the road. An improvement in financial conditions, as the theory goes, would lead to stronger output, which in turn would reduce unemployment and mitigate the risks of the deleveraging cycle from turning into persistent deflation. Arguably, though, the resumption of large scale assets purchases appeared to be predicated on the belief that there were no more bullets in the fiscal gun.

In spite of these policy actions, US yields have risen dramatically since the announcement of QEII. Partly the market had been caught wrong-footed. Some thought, for instance, in his "60-Minutes" interview Bernanke signaled that the Fed would extend the asset purchase plan beyond the $600bln initially suggested. In our view, he did no such thing. His interview was reportedly taped on November 30 and did not unveil a new policy initiative. At the same time, the Federal Reserve Chairman was simply trying to defend the Fed's current actions, going over the heads of his critics, and directly to the public to explain the controversial policy.

The FOMC statement clearly indicated the fuzzy nature of such policy action: It would be under constant review and that the purchases would be adjusted as the Fed saw fit based on the outlook for the economy, inflation, unemployment and the overall efficacy of the program. Meanwhile, long US Treasury positions were compelled to liquidate and the market had to discount the risks associated with the Obama-Republican compromise. Put differently, there are supply risks along with inflation risks. In addition, there are reputational risks in the sense that the credibility of US policy makers and the independence of the central bank were being called into question.

Initial estimates of the impact on the deficit may be somewhat elevated if the tax cuts do boost the economy to achieve what some economists have dubbed "escape velocity", which is to achieve the above trend growth. That in turn is necessary to bring the unemployment rate down and stoke a broad-based economic recovery. Stronger growth means higher government revenues and low counter-cyclical spending costs, thus improving the government's overall fiscal balance. On balance, these considerations should be taken into account when trying to assess the fiscal costs of the compromise.

FOMC Statement

How will the FOMC respond to the sharp backing up of US interest rates that has occurred? Some have suggested that Fed will announce an increase in the $600bln purchases program to protest to the higher rates. The risk of this is small. And ironically for the same reason that the majority of European finance officials do not support increasing the European Financial Stability Fund (EFSF) beyond initial guarantees. Officials in both countries are loath to act unless they have to and both the Federal Reserve's program and the EFSF have barely begun. But the Fed may assert its commitment to assets purchases, which may in turn cap further losses in Treasuries for the time being.

Equally important, there is nothing at this juncture for the Fed to gain by announcing a longer-term program and there is much for it to lose. On the one hand, increasing it could be more destabilizing because it would be seen as a commitment. Still, this would limit the Fed's existing options. On the other hand, the unexpected fiscal stimulus may strengthen the hand of the fifth column -- those Fed officials that oppose QEII. Unemployment is best addressed via fiscal policy and stronger growth reduces the risk of deflation. In other words, fiscal policy can take some of the pressure off extraordinary monetary policy.

In previous commentary we have expressed concern about how the Federal Reserve would exit from its program of long-term asset purchases as there may only be slow progress toward reaching its dual mandate: price stability and growth. This risk may be mitigated by another consideration: efficacy. In light of the new trajectory of fiscal policy, perhaps the ability of Federal Reserve to influence long-term interest rates through the use of its balance sheet has been compromised. At the same time, arguably there is, at least on the margins, a reduced need for extraordinary monetary policy as the economy begins to recover from the slowdown in deleveraging and resumption of consumer-driven growth.

New Dollar Driver, Same Direction

The rise in US interest rates and inflation expectations, of course, alter monetary conditions. The trajectory of such a policy mix, perhaps slightly more expansionary on the fiscal side, yet more restrictive on the monetary side, are generally associated with a rising currency.

Rising US interest rates, therefore, change the incentive structure of using the dollar as a financing currency and could shift the focus to other funding currencies such as the yen or Swiss franc. In addition, the attractiveness of emerging markets and commodities may have also been in part a function of the extremely low US interest rates. Nevertheless, this may be offset to a large degree by the improved global growth implications. Going forward, the positive impulses of this new fiscal policy, coupled with the potential for a higher interest environment, complement the existing trend of dollar strength. Overall, that trend has been driven by two main forces in recent weeks.

The first is the taking of profits on large short dollar positions established in September and October as investors discounted another bout of asset purchases by the Federal Reserve. The "sell the rumor, buy the fact" activity associated with Fed easing, including other unorthodox measures previously since the crisis began, was a catalyst for dollar weakness. Secondly, the US economic data, as it was coming out in real time, were showing a clear improvement in the economy after the soft Q2. Leaving aside the disappointing November non-farm payroll report, nearly all the other economic data have surprised on the upside.

Besides, the economy appears to be expanding faster than it did in Q3 and what appears to be the slowing of inventory accumulation does not seem to have as much of an impact on current production as expected. It lends credence to our previous suggestion that the surge in imports around mid-year (which may have been a function of the end of a Chinese export tariff rebate scheme) may have gone into inventory restocking rather than to meet current demand.

Europe, Your Rope

The second force that has helped strengthen the dollar is the intensification of the financial crisis in Europe. The smoldering fire burst into flames anew by the oxygen provided by German Chancellor Merkel's common sense suggestion that the private sector should be involved (that means take a haircut) in the resolution of debt problems. But it was precisely that belief that bondholders were special; so special, in fact, that of all the stakeholders they would be only ones spared from participating in the collective punishment for the poor decisions made mostly by the economic and political elite that has kept the teetering confidence game afloat in recent months.

European officials finish the year very much as they began it: finding it exceeding difficult to navigate the treacherous channel. Ironically, Obama and the Republicans have found a patch of common ground before Europe reconciled the conflicting demands. While there is a common understanding that there is no alternative to monetary union, there appears to be no meeting of the minds on how to ensure this. And there's the rub.

While the data are not very transparent, there will be a huge amount of European bonds that need to be sold next year. According to figures from Datalogic, euro-zone banks have around €600bln of debt coming due next year. Euro-zone bank issuance has been negative since May, and in the first ten months of 2010 is down 10% from the year ago period. In addition, sovereign debt issuance is estimated around €700bln. There seems to be some concentration of sovereign maturities in the first few months of 2011 and underscore euro's downside risks in the first part of 2011.

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