

Is the Dollar Turn at Hand

The US dollar sold off in recent weeks. While we recognized the fundamental considerations behind its decline, we disagreed with them. Prudence and financial discipline warned against fighting the market. Now, however, a crack in the dollar bear case has crystallized and there is a potential opportunity here for medium term investors to reduce short dollar exposure or increase hedges on non-dollar exposures.

To understand the dollar's decline in recent weeks, one must appreciate market positioning. The active trading market had built an apparently sizeable long dollar position. In discussions with clients and other market participants, the position was not so much based on a constructive view of the dollar, but more a case of a stronger negative view of the euro and sterling.

The greenback rallied strongly in the first week of the year. The euro made new lows since last year's high was recorded in early November and it approached a key retracement of the euro's rally from last June. For its part, sterling retested, and held, the lows from December. Position squaring ensured.

Swing Low

However, what transformed the move from one of simple profit-taking to the downdraft of recent weeks were two fundamental considerations. The first was the dramatic swing in market expectations of monetary policy at both the Bank of England and the European Central Bank. A combination of data and official comments prompted the market to price in one hundred percent certainty that these two central banks would hike rates, and fairly aggressively at that.

The implied yield on the December Euribor futures contract rose nearly 70 bp over the past month. The implied yield on the December short-sterling futures contract rose by nearly 60 bp and that is on top of the roughly 40 bp in the Oct-Nov period. After all, UK inflation was rising and officials seemed to be increasingly troubled by it. And as Trichet explicitly reminded the market, the ECB hiked rates in July 2008, even though the euro zone economy had begun contracting and a financial storm was gathering. While we recognized that the risk of a policy response was above zero, we thought the market was well ahead of itself.

The second consideration was a dramatic swing in the market's psychology about the European debt crisis. In the Sept-Oct period last year, the dollar was declining as the market was pricing in the implications of QEII. However, what cautioned us against chasing the dollar lower was that after a summer lull, the interest rates spreads and credit default swap prices were widening and rising. The debt crisis was smoldering, and as it burst into flames, it took down the firewall that officials had erected, and forced Ireland to seek assistance.

While there may have been some position squaring ahead of yearend, the situation looked bleak as 2011 began. It seemed like Portugal would be next, and pressure was building on Spain and Italy. European rhetoric changed. Various and conflicting proposals surfaced, followed by denials and affirmations.

Comprehensive Plan

It was not certainty of strong European official action that triggered a massive position adjustment, but the heightened uncertainty. The idea, for example, that either the European Financial Stability Facility could buy European bonds, ostensibly in larger scale than the reluctant ECB, or that the EFSF could loan money to Greece (and Ireland) to buy back their bonds at discounts in the market saw bond prices bid up.

There has also been some suggestion that European officials are considering a Brady Plan type of operation that would offer a voluntary swap for current bonds at market prices for EFSF triple-A bonds with a longer maturity. Previously circulating talk that the EU and IMF would extend the maturities of Greek and Irish loans was coupled with ideas that the interest rates could also be lowered. Recall, for example, that the EFSF raised 5-year money at about 2.85% and was going to charge Ireland 5.85%, apparently at the insistence of some of the large creditor countries as a punitive measure.

Taken individually and collectively, the measures pointed to a restructuring that would provide a reasonable chance of closure for investors. Yet we were and remain skeptical. We worry that the basis of a truly comprehensive agreement will remain elusive and that market expectations will be disappointed. Given the position adjusting in recent weeks, the risk is that the leveraged community re-establishes short positions, leading to a potential rout in short order.

Healthy Skepticism

The political situation in Germany, where 7 of the 16 states hold elections this year in the run-up to next year's national contest, makes a solution particularly difficult. Perhaps more assistance can be sold to German tax payers in exchange for some iron-clad agreements that prevent recurrence. This has moved Germany toward the French position of greater political governance, though of course on German terms. The direction it may be moving, such as changes in national laws or even constitutional changes that enshrine fiscal rectitude, and an EU-wide corporate tax rate and minimum retirement age, are unlikely to prove acceptable.

We think the market is under estimating the risks involved with Germany's brinksmanship tactics. There is a misunderstanding of cause and effect. The budgetary positions were not the cause of the crisis. On the contrary, the crisis caused the deficits and debts to explode. Greece is an exception, and it is still not clear how much EU officials knew and how much they wanted to know. Ireland's problem was guaranteeing a large part of the banking system that was several times bigger than the country. That guarantee incidentally seemed to have been required in origin and continuation by EU officials and the ECB, among others. Germany is not so much guilty of closing the barn door after the horses have bolted as some imply, but misdiagnosis of the ailment.

There is another misunderstanding. Under what charade are Greece and Ireland getting bailed out? Greece and Ireland are incurring more debt. They are not being bailed out. Follow the money. What will the funds loaned to them by the EU, EFSF and IMF being used for? To pay their creditors. The creditors, as we all know, are primarily private sector banks in Europe. The creditor Northern European countries want, nay, need a resolution arguably even more than the southern debtor countries. Those that think Germany, as the main creditor nation, holds all the cards in this high stake poker game may be surprised at the power of a sufficiently large or well placed debtor.

Implications

The pendulum of market expectations toward ECB and BOE tightening appears to have crested. Evidence of fundamental disagreements between policy makers in Europe, even at this late stage, will likely be offered in the form of an absence of any concrete developments from the EU Summit (Feb 4).

The disappointment may see peripheral countries come under pressure again, and safe haven flows push short-term German rates off their two-year highs. This in turn will narrow the premium it offers over the US and weigh on the euro. There are signs from the options market that we have been monitoring that also warn that euro longs have been come increasing nervous, especially during its latest advance.

For three days the euro tried to rise convincingly above the \$1.3840 area, a technical area we had been monitoring. Provided this is indeed a failure, the euro could fall back into the \$1.3250-\$1.3350 range in the near-term. Sterling neared \$1.62 and appeared also to run out of gas. Yet given the rebound in UK data and the prospects of heightened tensions in the euro zone, sterling can outperform the euro. Sterling may encounter support in front of \$1.60, but there appears to be potential toward \$1.58.

Steeper euro and sterling losses may be difficult because 1) market positioning does not appear extreme, 2) the easing of US monetary conditions, as the Fed continues its Treasury purchases, 3) expectations for an EU resolution can pushed back into late March, and 4) skepticism about the US fiscal discipline may intensify as the debt ceiling approaches. It will be lifted and the key question is really at what cost, and that debate is bound to be messy.

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