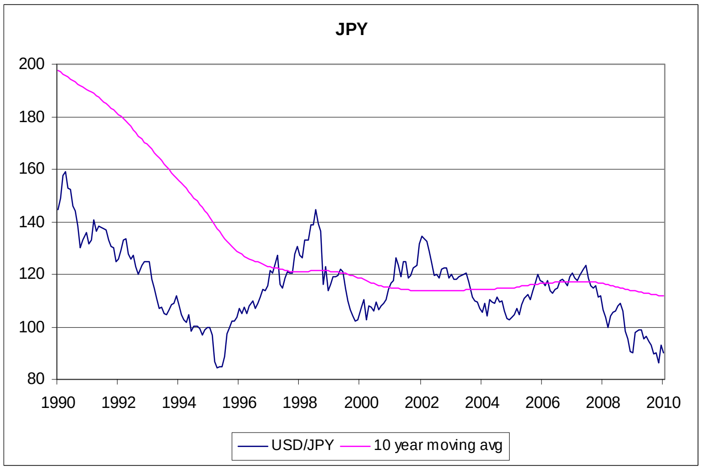
The Long Run Dollar Outlook



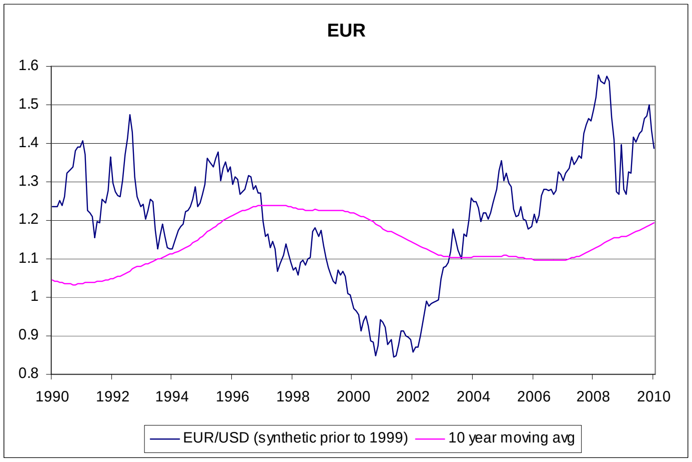
The great Lebanese poet Kahlil Gibran once wrote that sometimes the mountain is clearer from the plain than the summit. This insight may be applied to the foreign exchange market. Currencies in the modern era, not backed by gold or silver as was traditionally the case, have no intrinsic value. They are accepted because the governments have commanded it so; hence they are what economists call fiat money.

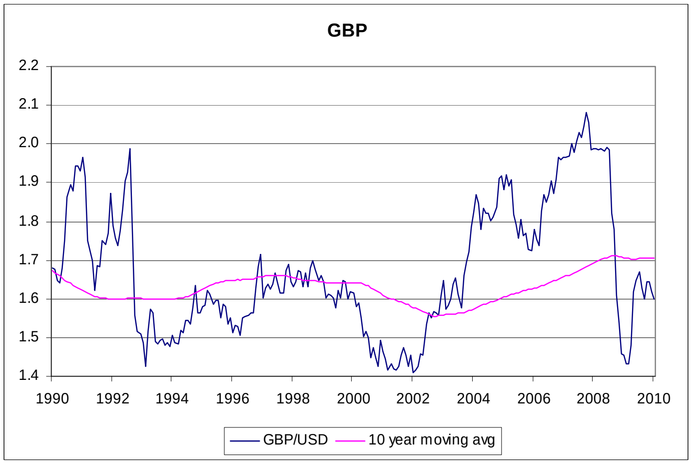
The day-to-day volatility is so great that it is difficult for even professionals to consistently forecast currency movement with any meaningful degree of accuracy. In addition the bulk of the turn-over in the $3.2 trillion a day market (BIS triennial survey 2007) is accounted for by short-term trading. Arguably, often the true signal of the market is lost in the noise and can only be seen by pulling back and looking at the bigger picture.

Long-Term Trends

Looking at the few currencies that have accounted for the vast majority of turn-over for the past twenty years, it becomes immediately evident that currencies trend for years at a time. Extreme readings were recorded between November 2007 (sterling and the Canadian dollar) and July 2008 (the euro), with the Swiss franc peak near the middle of the period. The dollar staged a dramatic rally from July 2008 through March 2009. As the crisis became acute, it was evident that far from the much foretold dollar overhang; there was really a shortage of dollars.

The dollar carry trade was not discovered last year. It had been building since nearly the start of the decade. The dollar had been used to finance the expansion of European bank balance sheets, by sovereigns and corporations who borrowed in dollars and swapped back into their own currencies, by hedge funds and speculators to finance purchases of emerging market assets and commodities. After the crisis passed the nadir in March 2009, many short-term traders returned to the tried and true cash register—using the dollar as a finance currency.





The dollar proceeded to sell off for the next eight months, generally speaking. The first part of the dollar's recovery seemed to be related to year-end position adjusting, just like what happened at the end of 2008, when the near-term trend was reversed. However, two new forces emerged at the start of the year that have extended the dollar's gains.

First, the Chinese responded to an explosion of new bank loans in early January by allowing bill rates to rise and hiking reserve requirements. This sparked a wave of profit-taking on commodities and emerging market equities, which in turn required investors and speculators to buy back the financing currency, the dollar.

Marc Chandler	212.493.8800
Win Thin	212.493.8361
Meg Browne	212.493.8744
Audrey Childe-Freeman	44.207.614.8791

Second, although Greece's problems first emerged following the election in early October, it largely seemed a localized phenomenon into the early part of this year. It has since exploded and exposed a fissure in the foundation of European Economic and Monetary Union. This has weighed on the euro and helped spur the dollar higher.

It is important to recognize that the low the dollar recorded in the second half of last year was not below the cyclical low recorded in the late 2007 through mid-2009 period. This successful test further underscores the likelihood that a multi-year bear market for the dollar has ended and a new bull market has begun.

Over the coming years, as the bull market for the dollar unfolds it is reasonable to expect the euro to return to its birth rate, just below $1.20, which roughly coincides with its 10-year moving average, though a move to parity cannot be ruled out. The ten-year moving average is also a good approximation of purchasing power parity—which many economists suggest currencies gravitate around in the long run. Sterling will likely continue to trade well below its 10-year moving average as it copes with the ruinous crisis. A move toward $1.20 seems like a reasonable scenario in the coming years.

The Japanese yen does not fit as neatly under this framework. But if this is a new bull market for the dollar, the yen is likely to weaken as well. Japan is the only major economy that continues to be plagued by deflation. With poor productivity growth, an aging population and a shrinking workforce, over time the yen needs to weaken. On a multi-year view, the dollar may rise toward JPY120.

Medium Term View

In addition to trending, another point gleaned from the price action over the past couple decades is that the dollar's extremes—highs and lows—are probably best thought of as a process rather than a point in time. The dollar seems to cascade—not recording extremes at the same time against all the currencies. Often times, it appears that sterling leads the euro in a new direction and the Swiss franc often confirms it.

Many investors who can take a long term view of the currencies often look at moving averages. One set of relevant moving averages now are the 50-day and 200-day moving averages. When the 50-day moving average falls below the 200-day moving average, it is called a 'dead man's cross' (when the 50-day crosses above the 200-day it is called a 'golden cross').

The 50-day average crossed below the 200-day average for sterling on February 1st. The moving averages crossed for the euro on February 9th. The moving averages have not yet crossed in the Swiss franc, but could before the end of the month. Looking at the Dollar Index, its 50-day average is poised to move above the 200-day average imminently. These developments indicate that in addition to the dollar's long term trend, the medium term trend is also higher.

Macro-Fundamentals

This may all sound too technical for some investors. What is the fundamental case for a medium and long term U.S. dollar appreciation? The most honest answer is that it is still developing. The dollar is cheap relative to measures like purchasing power parity. The US economy appears to be emerging from the crisis more robustly than Europe or Japan. The Federal Reserve appears likely to raise interest rates before the Bank of England, the European Central Bank and the Bank of Japan.

Contrary to the rumors of its demise, the US is still the world's largest economy and, whether number two is Japan or China, the US GDP is roughly three times larger. Productivity has surged in recent quarters. The gap between the US per capita GDP and Europe's has grown since the advent of the euro.

The US of course faces serious fundamental challenges in terms of its deficits and debt. It needs to demonstrate resolve in addressing this and poor policy decisions could cut short the bull market for the dollar envisioned here. Foreign exchange prices are relative and Europe and Japan face not only these problems but additional ones as well. Moreover, the sheer size of the US economy and its political institutions appear to be both more flexible and stronger than in Europe or Japan.

Americans are the marginal global equity investors. They have been diversifying their portfolios so now some reports suggest that as much as 20-25% of US equity investments are foreign. Perhaps one source of fuel for a stronger dollar will be provided by Americans keeping more of their increasing savings at home.

Of course, long-term foreign exchange prognostications, like all long-term forecasts are notoriously unreliable. Currency prices seem path dependent, which means that a modest perturbation can put the dollar on a different trajectory. The dollar's demise has been long foretold and around the time that sentiment reaches a fever-pitch is when its inexorable ascent has often begun. This time may not be different. So, while the exercise is fraught with the risk of appearing foolish in hindsight, a multi-year dollar bull market may have begun.

Forewarned is to be forearmed.

Marc Chandler
Global Head of Currency Strategy

(All charts use monthly data from Bloomberg)

Marc Chandler	212-493-8800
Win Thin	212 493-8361
Meg Browne	212-493-8744
Audrey Childe-Freeman	44 207 614 8791