SPECIAL FX

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Macro Forces and Dollar Outlook

Now that the new year and decade are under way, it may be timely to consider the forces that are buffeting the dollar. Of course, just because the calendar changes, it does not mean that the forces do. Just as the first quarter of 2009 felt a great deal like the latter part of 2008, with the shock waves of Lehman's collapse still reverberating intensely, we expect the first quarter of this year to seem a great deal like the last few quarters of 2009.

Unwinding Year-End Dollar Rally

Recall that the dollar generally trended lower against most of the major and developing countries' currencies from April through November. In December the dollar rallied across the board. Some attributed the greenback's recovery to the better than expected November employment and retail sales reports. U.S. interest rates rose dramatically, as the market began anticipating a more robust economy and several measures of inflation expectations increased, went the explanation.

We were inclined to believe a more benign interpretation: year-end profit-taking and position squaring. After having been short the greenback for six months, without significant corrections, there was a strong desire to realize profits, which in this case meant dollar purchasing.

A similar pattern, was seen at the end of 2008, though in the opposite direction. The dollar had rallied sharply beginning in July and there was a counter-trend sell-off into the end of the year; from which, it is interesting to note, the dollar recovered in the first quarter of 2009, and approached its 2008 highs on several bilateral currency pairs.

Interest Rate Support Dissolves

Our hypothesis is that as the new year gets under way, the dollar will surrender its year-end gains. However, following the disappointing December employment and retail sales reports, even those who argued that the dollar's strength had been a reflection of the stronger economy would not be surprised to see the dollar pullback now.

Whatever fundamental support the dollar had derived from the backing up of short-term U.S. interest rates has been removed over the last couple of weeks. The overnight index swap rate that corresponds to the June FOMC meeting has fallen almost 25 basis points since the start of the year, nearly retracing in full the rise from late November.

The June Fed funds contract tells an even more dramatic story. The day before the November jobs data was reported on December 4th, the June Fed funds futures contract implied a yield of 28.5 basis points at close. It closed last year implying a 34.5 basis points effective Fed funds rate. Following the unexpected decline in December retail sales, the contract was 20 basis points.

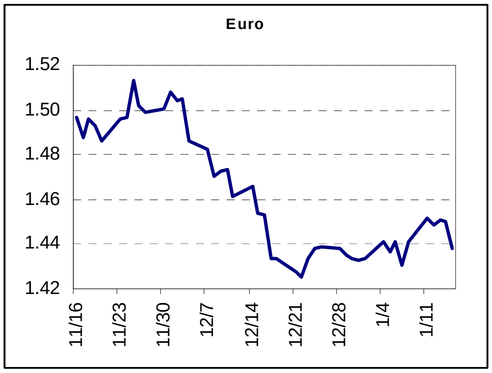
U.S. Treasuries have also retracing their year-end declines that saw U.S. 2-year and 10-year yields increase roughly 60 basis points. The 2-year yield has fallen almost 25 basis points and the 10-year yield has fallen more 10 basis points. U.S. debt managers seeking to lengthen maturities and supply concerns may be weighing on the long term rates.

The deluge is not just due to U.S. Treasury supply (and without being even partially absorbed by the Fed as was the case last year.) Corporate America has begun the year with heavy issuance too. There have also been a number of foreign countries and companies that have also issued dollar denominated bonds. It is not uncommon for institutional investors to sell Treasuries against those other dollar denominated debt instruments.

A Few New Wrinkles

Two new developments argue for the euro not to lead the foreign currency recovery against the dollar. First, recent data for the euro zone, and particularly Germany, suggest a loss of momentum in the fourth quarter and inhospitable weather may put a damper on the first quarter of 2010. Second, deficit and debt challenges of southern European members (Spain, Portugal, Italy, and Greece) as well as Ireland have cast a pall over the area.

On the other hand, according to the Commitment of Traders report as of January 5th, the net speculative position was short nearly a record number of euro contracts.



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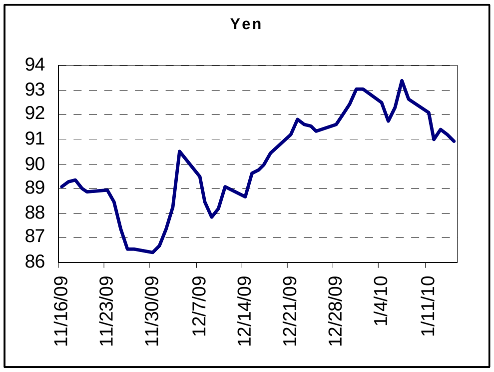
We would anticipate that in the coming weeks, these positions will be covered and that short-term speculators will again choose to run net long euro positions. We expect these forces to help lift the euro back toward $1.50.



Turning to Japan, a new finance minister seems to be reversing his predecessor's predilection for a strong yen and his recognition of limits on fiscal policy. To be sure, of all the myriad of factors that can and often do influence the foreign exchange rates, the desire of politicians is frequently not very salient. However, it does reflect a genuine concern about the outlook for the Japanese economy. Deflationary forces remain strong and it is possible that the Bank of Japan capitulates to political pressure and agrees to buy more government bonds.

From late November through last week, the U.S. dollar appreciated a little more than 10% against the Japanese yen. Although Japanese fundamentals remain poor, the yen itself is likely to recoup some of that lost ground. Like the euro, it probably will not lead the move against dollar, but that is the direction. The speculators in the futures market have a larger net short yen position, as of January 5th, than they held at any time last year. We anticipate these yen shorts will be covered and long positions will be re-established with the dollar returning toward ¥88.

Leadership

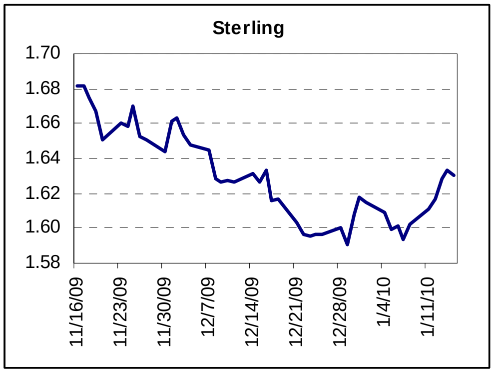
Currency leadership among the major countries is unlikely to shift significantly from last year during at least the first quarter 2010. Two currency blocs continue to look well supported: the dollar bloc and the Scandis.

Within the dollar bloc, the Canadian dollar was the star performer from early November through late December. However, we look for the Australian dollar to provide the leadership in the coming weeks. Australia benefits from relatively high interest rates, the commodity story and the robust Chinese economy (if that is not double counting). Australian data has generally surprised on the upside in recent weeks and a rate hike in Feb, after three moves in the second half of 2009, cannot be ruled out as the market seemed to last month.

Swedish krona and the Norwegian krone outperformed the other G10 currencies. This is likely to be the case through at least the first quarter. While they generally move in the euro's orbit, they do not have the challenges of the euro zone and the other benefits, such as oil in Norway's case. A year ago, we were concerned about Swedish exposure to the Baltic's, but more recently it has waned as a key factor.

We'll conclude with a brief word about the Swiss franc and sterling. Real or imagined intervention by the Swiss National Bank or its agents helped keep the euro-franc exchange rate in narrow trading ranges for the most of last year. The Swiss franc appreciated markedly against the euro in December and the Swiss officials have not voiced much protest.

Like the German economy, the Swiss economy may also have lost some momentum as 2009 drew to a close. Poor economic data coupled with a return to deflationary conditions could bring the SNB on stage. Consistent with our view that year-end trends are reversed; we would expect the euro to recoup some ground against the Swiss franc.



Given the financial and political backdrop, it is difficult to buy sterling. In fact the speculators in the futures market have not had a net long position in sterling for nearly a year and a half. However, as the euro zone slows, the U.K. appears to have gained some momentum and is likely to post positive GDP growth in the fourth quarter of 2009, which it has not done since the first quarter of 2008. So far in 2010, sterling, has nearly retraced in full its decline since mid-December, but needs to take out the cap near $1.64 to signal another 2-3 cent advance.

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Source for All Graphs: Bloomberg