SPECIAL FX

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Of Cycles and Structures

As the third quarter draws to a close, the U.S. dollar is under pressure, falling to the lowest level in a year against a wide swathe of major and emerging market currencies alike. After putting in a strong performance from the middle of 2008 through the first quarter of 2009, the greenback has surrendered a significant proportion of those gains.

Structures

At first many attributed the dollar's decline to structural forces. Numerous observers emphasized diversification of reserves. There is little factual evidence this is actually taking place. The dollar's share of reserves has remained amazingly steady and, if anything, has increased slightly in recent quarters.

China, the most vocal in advocating an alternative to the dollar, holds the most reserves, twice as much as second place Japan. In June of last year, U.S. Treasuries accounted for 29.6% of Chinese reserves (Treasury holdings of $535 billion on total reserves of $1.808 trillion). In June of this year, U.S. Treasuries accounted for 36.4% of China's reserves (Treasury holdings of $776 billion on total reserves of $2.132 trillion).

While there still are those observers who talk about the diversification of reserves as a major weight on the dollar, lack evidence is spurring many to offer another explanatory model.

The second attempt at a structural explanation for the dollar's decline focused on the indisputable that the U.S. government is taking on a great deal of debt and the Federal Reserve is creating reserves. The debate about U.S. health care reform and the skepticism greeting the Obama Administration's claim of will not increasing the deficit plays into these fears. Inflation is seen as a political expedite to lighten the debt burden. A depreciating dollar is at once and simultaneously a cause and effect of perceived inflation risks.

Yet, inflation would seem to be more a sin of omission (failing to bring spending back under control, for example) than a sin of commission (intentional actions to spur inflation). Also, various market-based measures of inflation, the absolute level of long-term interest rates, the break-even in Treasury Inflation Protected Securities (TIPS), and the 5-year/5-year forward suggest inflation expectations, are what the ECB's Trichet would call anchored. Surveys of economists and the public, such as the University of Michigan's survey, which the Fed has sometimes cited, also suggest inflation expectations are innocuous. Moreover, inflation expectations appear higher in the euro zone and the UK than the U.S.

Cycles

If such structural explanations for the dollar's weakness fail, why is it falling? Market participants often seem inclined to exaggerate structural variables and under-estimate the saliency of cyclical variables.

Indeed, even articles in the Financial Times, which often has argued that the structural current account deficit is the main source of the dollar's decline, seem to suggest a more cyclical factor—low interest rates in the United States—with the dollar becoming the dominant funding currency.

The Federal Reserve has in the past and will likely repeat at the September 23rd FOMC meeting that the Fed funds target will likely remain at "exceptionally low levels" for an "extended period of time". A substantive change in this wording may very well trigger a sharp short-covering rally in the dollar.

And that it is the point. The main weight on the dollar is not the U.S. debt. It is not the diversification of reserves. It is not the end of the so-called U.S. model of capitalism. It is not because the reform of health care seems beyond the capability of the factious political system. The dollar is falling because U.S. interest rates are low.

Data Mining

Some reporters and analysts who recently have recognized the superiority of this explanatory narrative for the dollar's decline seem to be exaggerating it, perhaps like the observation that often it is the convert that sings loudest in choir. A number of recent press reports have noted that the London Interbank Offered Rate (LIBOR) for the dollar is below what it is for the Japanese yen.

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What they are referring to is the LIBOR fixings, not to real market rates. Specifically, this is what it means. The forward currency rate is a function of interest rate differentials. If dollar rates were below Japan's, like they are for the euro zone, then we would say that the [forward] points are at a premium. But the fact of the matter is that they are not. As far as I can tell, market makers continue to quote the forward rates as if U.S. rates remain slightly higher than Japans.

In addition, such analysis, as it were, is cherry-picking the evidence in another way. LIBOR fixings cover periods of one week to one year. Dollar LIBOR fixings are below Japan's for 2, 3, and 4 month tenors, but the rest of the curve is above Japan's, let alone that the entire TIBOR (Tokyo Interbank Offered Rate) term structure is below the U.S.

A more compelling explanation for the yen's recent gains is that Japanese investors were repatriating earnings and window-dressing their books ahead of the fiscal half year end at the end of the month, encouraged by a Japanese version of the U.S. Homeland Investment Act, which allows companies to repatriate earnings without paying the customary 40% tax.

In addition, the new DPJ-led government seems more relaxed about the strength of the yen than prior LDP governments. Even BOJ Governor Masaaki Shirakwa has recently seen some virtues in a strong yen, which if truth be told.

This explanation also suggests the conditions under which the dollar will stabilize and recover against the yen. It will happen before U.S. rates rise. It will happen as the fiscal year end machinations cease. We may already be seeing the early signs of this.

In the most recent weekly Ministry of Finance portfolio flow report, in the week ending September 12th, Japanese investors bought the most foreign bonds (~$18 billion) in four years. The dollar appears tentatively to be finding a floor just above JPY90 and the euro near JPY131-JPY132. And the new Japanese government is likely to learn how to communicate with the markets better. After all there has been no official intervention on dollar-yen for more than 5-years. It need not encourage long yen positions.

Liquidity

Low U.S. interest rates are a necessary, but are insufficient to fully explain the dollar's decline. Two other conditions seem to interest with the low interest rates to encourage the dollar's use as a funding currency.

First is liquidity. The greenback remains the most liquid currency in the world and the priority given to liquidity since the economic and financial crisis is difficult to over-estimate. Moreover, a number of central banks continue to auction dollars. Demand at the long-dated (84 day) dollar auction by the ECB, for example, has dried up, but there is still strong (~$40 billion+) demand for the short-dated (7-day) dollar auctions.

Second is the appetite for risk, those often unquantifiable "animal spirits". Over the last six months, the pendulum of market psychology has swung from capital preservation to rates of return—from risk-off to risk-on.

Therein lays an under-appreciated irony. If the U.S. is as flawed as many of its critics suggest and that the U.S. is quickly going down the path blazed by Argentina, then why are dollar sales associated with taking on risk?

The dollar's role as a funding currency will not last for a decade or more, as has been the case for Japan. The consensus has emerged on news wire surveys of various banks and research groups that the first Fed rate hike is likely near the middle of next year. This view seems to be reflected as well in the Fed funds futures strip.

In our explanation of the dollar's decline, we would emphasize cyclical influences over structural considerations. It means the dollar's decline is not terminal. The role of the dollar as the go-to funding currency will cease when the incentives shift.

But rest assured, carry trades has been the graveyard of many investors over the years, and this time in unlikely to prove different. After falling victim to a powerful short-squeeze in the second half of last year, pity the dollar short that gets bitten by the same dog twice.

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