SPECIAL FX

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Reviewing the Dollar's Outlook

The U.S. dollar appears to be stabilizing. We continue to believe that the main forces that have undermined it are largely cyclical rather than structural in nature. Several months ago we identified three indicators that would help investors time the dollar's bottom: short-term interest rate differentials, the status of the general risk-on/risk off trades, and technical factors. We review these indicators here.

Interest Rate Differentials

Interest rates help shape the incentive structure for many participants in the general global capital markets in addition to the currency markets. Short-term U.S. rates remain below similar euro zone rates. This means that one is paid to be short the U.S. dollar against the euro.

Not only are short-term U.S. rates still below those in the euro zone but the differential has moved further against the U.S. in the recent period. As a proxy for short-term rates, we looked at the Euribor and Eurodollar futures contracts. In early August, when first discussing the indicators that would allow investors to time the dollar's bottom, the December 2010 Eurodollar and Euribor futures contracts were at the same level. Now the Eurodollar contract yields 44 basis points (annualized) less than the Euribor contract, having set a 7- month peak in the first week of November.

Three months ago, the market was anticipating that 3-month Eurodollar rates would be well above (almost 50 basis points) Euribor at the end of 2011. Although the market had been reconsidering its assessment for some time, it was not until earlier this month that the U.S. rates were pushed back below the euro zone rates. A similar development is evident in the two-year swap rate. In August one could pick up about 25 basis points swapping out of dollars into euros. Now one earns about 40 basis points.

The take away point is that the interest rate story does not yet support a sustained dollar recovery. The most recent FOMC statement coupled with the unexpectedly large rise to 10.2% in the unemployment rate reinforces ideas that this general situation is unlikely to change substantially for several more months at least.

Positive Developments

Yet there have been a number of developments that under other circumstances would be understood as dollar positive. Could even the optimists have imagined as recently as the end of Q1 what has happened in the past eight months? The global economy is on the mend, with most countries returning to growth in the second or third quarters.

The financial crisis eased considerably with the assistance of unprecedented monetary and fiscal support. Numerous risk measures, perhaps best known of which are the TED spread (T-bills/Eurodollars) and the OIS-Libor spread have returned to pre-crisis levels.

If trend growth is associated with 2.5%-2.75% expansion of the U.S. GDP, then the world's biggest economy is likely to grow above trend not only in Q3 but on average over the next several quarters. Its current account deficit, which before the crisis was said by many to be the greatest risk to the world economy, has fallen another percentage point of GDP over the past year to stand at 3.8% of GDP, the smallest in seven years.

The U.S. has issued a record amount of debt, but this has been fairly easily absorbed by the market. At a 3.48% yield, the benchmark 10-year note yield is 21 basis points lower than the yield that prevailed a year ago. That yield is in between Germany and France, the euro zone anchors.

While the Federal Reserve bought $300 billion of Treasury bonds, foreign investors have not been shy; buying around 45% of the record issuance, up from about 28% at last year's smaller offering. It is not just debt securities that have done well, but the equity market too. In fact, here in the fourth quarter, (through November 12th) the S&P 500 is the best performing equity market in the G7. And the dollar has languished.

Risk On/Off

The pattern whereby the euro appreciates against the U.S. dollar while stocks rally is a key characteristic of the current market. That relationship, as measured by the correlation between the percent change in the euro and percent change in the S&P 500 and the Dow Jones Stoxx 600, has gotten tighter.

Using weekly data from 2005 through 2007, the euro and the S&P 500 were correlated 15.5%. The euro and the Dow Jones Stoxx 600 were inversely correlated. At -3.7%, this correlation is not statistically significant, but the negative sign is noteworthy.

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Year to date, using daily data, the correlations are 50.5% and 30.5% respectively. For the latest three month period, the correlations between the euro and the S&P 500 is almost 66% and with the Dow Jones Stoxx 600 almost 62%.

For the dollar to rally one of two conditions likely will have to be met. First, the pattern can break down. It is not unreasonable. For most of the 1993 through 2004 period the euro (both the actual and the pre-EMU synthetic) was negatively correlated with the S&P 500. The strength of the current correlation is without precedent over the last two decades and is nearly as positive as the 2003 inverse correlation was negative.

The second condition for a dollar rally is a sharp drop in equities. As risk assets are liquidated, the financing leg of many of the trades, short dollar has to be bought back: Shades of H2 2008 and Q1 2009. It is conceivable that after this year's dramatic equity rally, investors lock in some profits. Most recently, the late-October 6.8% pullback in the S&P 500 corresponded to a 3% pullback in the euro.

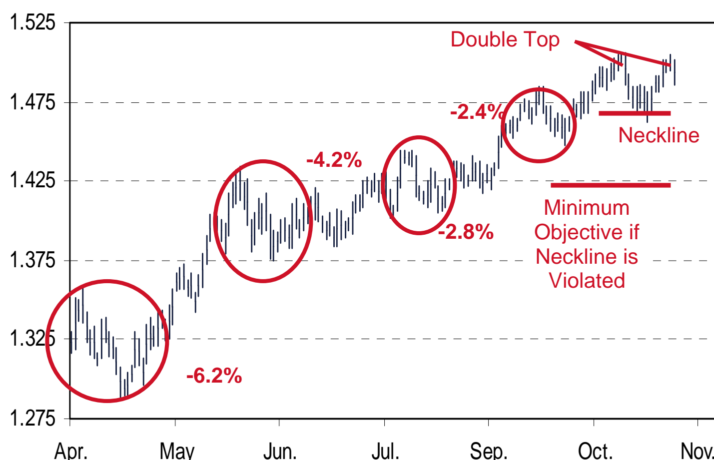
Since the S&P 500 bottomed in March, declines have been short and shallow. The largest was the 9.5% decline in the mid-June through early July. The other four "corrections" since have varied in size from about 3.8% to about 6.8%.

The dollar has tended to appreciate during those down drafts, as the correlation figures would suggest. However, euro corrections appear to have been largely limited to about 2.5-3.0% since the end of the first quarter.

Technical Considerations
Sometimes the price action itself may show the market is getting tired or has the news already priced in before more considered opinion shifts. The technical condition for the dollar may be in the process of becoming somewhat more supportive.

Sentiment readings are excessive, but this has been the case for some time. It is warning that when the dollar does turn, it could be dramatic as most will not be positioned for it. At the same time we have noted that in the options markets, investors are paying among the largest premiums of the year for euro puts (the right but not the obligation to sell euros) over calls, suggesting to us the perceived need for insurance. That said, speculative market positioning, judging from the futures market and from some of the currency ETFs, does not look particularly extreme.

Momentum indicators are not over-extended, but there are dollar bullish divergences appearing. The 14-day relative strength index made its high near 73.5 in the middle of September. The subsequent highs in the euro have not been confirmed by the RSI, suggesting downside risks may be growing.



More immediately, the euro is currently struggling to rise above $1.5050. A convincing break could trigger a move to $1.5300. It takes a break of $1.4600 to be significant. That level is of such importance that its violation would likely signal a top of some note. The area could also serve as a good location to structure options. A break of that area would likely be seen as confirming a topping pattern that would project toward $1.42 at a minimum.

The liquidity officials flooded the market with to quench the financial and economic meltdown, is the key driver of the currency and asset markets. It lies at the root of the risk-on trades. It is as if there had not been a crisis since Charlie Prince's notorious aphorism that "As long as the music is playing, you've got to get up and dance." This liquidity has provided the new music, but the dance remains the same. It is all about carry and momentum now, but numerous measures of valuation, including the IMF/OECD's measure of purchasing power parity, warn that the euro and most of the major foreign currencies are getting stretched.

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