

The Dollar: On Script

The outcome of the US midterm elections and Federal Reserve Open Market Committee meeting, coupled with the various economic reports, strengthens our base case scenario in which we expect the US dollar to generally trade higher as the 2010 winds down. Many expect the dollar to decline in the wake of the \$600 bln Treasury buying program of the Federal Reserve. In contrast, we emphasize the anticipatory nature of investors. The dollar's relentless decline in September and October was in fact the market pricing in QEII.

As it became clear the Federal Reserve was going to provide more monetary stimulus, we anticipated roughly a 10% decline in the dollar that would carry the euro toward \$1.40 and sterling toward \$1.60. At the same time, we suspected that the dollar would not gain much traction until uncertainty around US fiscal and monetary policy would be lifted by the outcome of the US election and the FOMC meeting.

Election

In the most immediate sense, the significance of the election is that it will allow for the resolution of key issues for businesses and households: marginal tax rate in 2011. At the same time, the Republican victory increases the odds that the 2001 and 2003 so-called Bush tax cuts get wholly extended. And finally, there appears to be a reasonably good chance that the unemployment benefits program that is set to expire at the end of this month are extended as well.

However, it is important to keep in mind that these measures will only temper and not reverse the fiscal headwinds the US economy faces in the coming quarters. At this point there seems little political appetite of renewing the payroll tax credit (Making Work Pay), which was the single biggest program in last year's stimulus program. Indeed, the impact of this could be most severe in the start of 2011.

It is difficult for nonpartisans to divine a clear message from the Republican victory. Exit polls suggest that less than 1 in 5 thought health care was a top issue and voters appeared split (48%-47%) between favoring repeal of national health care and expanding it. A little less than 40% thought reducing the deficit was the top priority, while a statistically identical 37% wanted to spend more money to create jobs, a full third of whom identified as Republicans. If it is clear what was voted against, it is not clear what was voted for.

It is also difficult to extrapolate the terms of 2012 presidential election from the midterm results, which President Obama called a "shellacking". However, the Republican victory extended to the state houses and governors and this will have important implications for congressional redistricting based on the 2010 census.

FOMC

The fact that the consensus nearly got the size and pace of QEII correctly means that the Federal Reserve's signaling channel is functioning fine. NY Fed President Dudley had indicated that \$500 bln of Treasury purchases would have the impact of 50-75 bp of easing depending the holding period. For the \$600 bln amount this would naturally be shielded a bit higher, but the \$75 bln a month means the pace of the drip feed of monetary stimulus (worth ~7.5-10 bp a month) was as expected and largely discounted.

One of the most striking aspects of QEII is that it is happening at all. The consensus forecast for US growth next year is around 2.5% with a 1.5% CPI. Most high income countries would regard this as quite a favorable outcome and surely not one in need of extraordinary monetary stimulus. Yet the Bernanke Fed says that it is not satisfactory because its legal mandate of full employment and price stability will not be achieved in a reasonable time.

Nevertheless, the idea that the money that the Fed creates to buy those billions of dollars of Treasuries will flow out of the US and into emerging markets is mistaken. The US current account deficit means the US runs a capital account surplus. This means the US is a net importer of capital, not an exporter.

In fact, the US TIC data records not only foreign purchases of US financial assets, but also US purchases of foreign financial asset with the most recent data from the month of August. Over the first 8 months of 2010, for example, Americans bought \$80 bln of foreign stocks and bonds. In the last three months, the purchases slowed to total of \$10 bln. By comparison in the first 8 months in 2009, Americans had bought almost \$100 bln of foreign bonds and stocks and in the three-month period through August bought \$64 bln. If emerging markets are being inundated with capital, it is not coming from the US.

Economic Entrails

A better series of US economic data would be difficult to envision; all better-than-expected. This included both ISM reports, auto sales and the US employment data (with 103k upward revisions in Aug and Sept). The details were also encouraging. In the ISM reports, not only did production/activity measures gain, but the forward-looking orders components were also stronger. The 12.3 annualized pace of auto sales represents a new high since the cash-for-clunker program ended. Industry reports suggest that households rather than fleets were responsible.

With the revisions, October was the fourth consecutive month in which the private sector created more than 100k jobs. During these four months, the US posted its best job creating record since early 2007. May and June stand out as particularly weak with a combined total of 112k jobs compared to the average monthly gain since of 131.5k.

Moreover the work week increased by 0.1%. This sounds meager, but given that there are roughly 131.5 mln workers, working 6 minutes more is relative to income and output of another 380k workers.¹ Hourly earnings have been trending lower, but the pace has slowed. In particular, hourly earnings rose 0.2% in Oct and the Sept series was revised higher to show a 0.1% increase.

This improvement in the high frequency economic data is reinforced by the improvement in a host of financial variables. These include money supply growth, easing of credit conditions (as picked up in the most recent senior loan officer survey) and reflected in better consumer credit and commercial and industry loans. Namely, one credit rating agency reported that credit card defaults and delinquencies have begun slowing.

¹ This can be calculated by multiplying the 131.5 mln workers by 6 minutes. Divide that product by 60 to convert into hours. The quotient is then divided by 34.3, the number of hours in the current work week to find full-time equivalent.

None of this denies the structural constraints on the economy. Increasingly, however, and at a heavy cost, the current and ongoing recovery is on par with, and in many ways superior to, the (jobless) recoveries seen after the last two recessions.

Europe

Our expectation for a dollar recovery was not only predicated on the market having discounted all the bad news and being vulnerable to a better string of economic data, but also that the situation in Europe is not as good as some are inferring from the euro's appreciation over the past few months.

The unresolved debt dynamics are resurfacing. Greece, for one, (which has its own EU/IMF program separate from the EFSF) is the worst performing bond market in the euro zone (10-year yield is up 133 bp in the past month and the 2-year yield is up a little more than 200 bp) followed by Ireland, which has sufficient funds on hand to last toward the middle of 2011 (10-year yield is up 113 bp in the past month and the 2-year yield is up almost 45 bp).

Germany is insisting that after the EFSF expires in 2013, there will be no more bailouts. The cost of leaving the monetary union is prohibitively great. That would seem to leave only one option to resolving the intractable debt situation. Germany calls it burden-sharing with the private sector, created to minimize the taxpayer's exposure, while forcing creditors to accept larger haircuts. But, overall, it is debt restructuring plain and simple.

The investment implications are driving funds into Germany and driving down interest rates. The US-German 2-year interest rate differential snapped a five week trend in Germany's favor on November 5 and at 55 bp, the premium Germany offers is smaller than its 4-week moving average for the first time since early September.

The lifting of the political and economic uncertainty that hung over the US, coupled with the somewhat better economic momentum, may allow the devolution of the situation in Europe to move into ascendancy. This was the basis of our call for the dollar to recover in the second half of the fourth quarter. While we are constantly monitoring developments, the script is thus far unfolding largely in line with our base case.

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