Three Things to Look for to Know When it is Time to Buy Dollars

We retain a favorable medium term outlook for the US dollar, its recent fall to new lows for the year against a broad swath of currencies. However, we are not prepared to call a dollar bottom now and issue a strategic buy recommendation. Here is a brief discussion of three factors than can help fine-tine the timing a dollar bottom.

Interest Rate Differentials

While U.S. 5 and 10 year bond yields are above those for German bunds, the proxy for the euro-zone, short-term rates, which appear more important in the foreign exchange market, are below similar German rates. Those interest rate differentials mean that one is still paid to be short dollars.

This has to and will change, but it will take some more time. Currently the U.S. 2-year yield is about 25 basis points below the German 2-year yield, but the spread has narrowed by about 16 basis points over the past month. Given the strong likelihood of a relatively robust third quarter GDP in the U.S. (the consensus is rising from 0.8%; Greenspan talked about the possibility of 2.5%; a couple of former investment banks are on the record calling for 3%) the 2-year yield may rise above Germany's by early in the forth quarter.

We can use the Eurodollar and Euribor futures to review short-term rates. For the December contracts of 2010, three-month Eurodollar yields are essentially at par with Euribor yields. The June contracts of 2010 show three-month Eurodollar yields almost 10 basis points below Euribor yields. The December 2009 three-month Eurodollar yield is about 25 basis points more than Euribor.

The dollar's relationship to interest rate differentials is not linear, but rather cyclical. At this point in the dollar's cycle, widening interest rate differentials are a pre-condition for a sustained advance. But to be clear, the day the U.S. short-term interest rates rise above those in the euro zone will not necessarily signal an immediate commencement of a dollar rally. It often happens with a bit of a lag.

Shifting Drivers

The pattern over the past year has been for the dollar to benefit on poor news and suffer from good. The dollar generally appreciated as the financial and economic crisis became acute in the beginning of the second half of 2008 and remained firm through most of the first quarter of 2009. But as the policy global policy response took effect, the dollar generally trended lower, falling to new lows for the year in early August as equity markets reached their highs for 2009.

For the dollar to sustain a rally, one of two things has to happen. Either the pattern breaks or the news stream turns decidedly negative. The latter is surely possible, but in the near-term, unlikely. After the recent string of economic news, especially the stabilization of a number of housing reports and the unexpectedly large inventory decline estimated in the first look at Q2 GDP, many observers are revising higher their GDP forecasts, though many haven't yet some, as mentioned earlier, have.

If the market's bias is to see the proverbial glass as half full rather than half empty, then the only way for the pattern must break down for the dollar to rally. One day a trend does not make. Remember that even an 80% correlation allows for the pattern not to be evident one day a week and the inter-market correlations we are discussing rarely reach that level. Running the calculations on percent changes, the euro and S&P 500 have moved in the same direction a little less than 50% of the time since the start of the second quarter of 2009. The Australian dollar and the Brazilian reai have been correlated with the S&P 500 74.5% and 76.4% respectively in the same period.

Investors who think that the dollar's weakness has been exaggerated should monitor how the greenback responds to news and economic developments. Our hypothesis that the dollar's push lower is nearing an end is predicated on the dollar responding better to good news and retreating on the bad. This has not happened yet, but could towards the end of the third quarter as forward looking economic data possibly leads many to revise up their forecasts for forth quarter GDP, which the Bloomberg survey found, remained steady at 1.9% in June and July even as estimates for the third quarter were doubled from 0.5% to 1.0%.

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Technicals

Timing is an important part of risk management. Even rudimentary technical analysis can help investors fine-tune entering of an investment and help quantify the risk. Monitoring the price action itself will likely reveal a higher probability of opportunities to buy the dollar.

It is important to keep in mind Keynes' insight that the markets are like a beauty contest. The trick is not to pick who you think is the prettiest, but to pick who you think others will think is the prettiest. In this context, it means to understand the market is bearish the dollar and using common technical tools like Fibonacci retracements and traditional pattern recognition to try and identify their objectives as these could be possible turning points as positions are adjusted.

Specifically, a number of these technical tools suggest the euro could rise to $1.46-$1.4850. This of course is close to what would seem to be psychologically important level of $1.50. Drawing on similar tools, the $1.73-$1.75 area is a reasonable for sterling. As these areas are entered, one should be sensitive to the emergence of reversal patterns or price action that suggests exhaustion, including bearish divergence in momentum indicators. This will help identify lower risk opportunities to implement bullish dollar strategies.

The yen is a different kettle of fish, as it were. Two years ago, on a trade-weighted basis the yen, which had been depreciating for the better part of eight years, troughed, and since the middle of 2007 has appreciated, through early this year, by nearly 45%. Against the dollar, it gained by almost a third.

The dollar appears to have bottomed in mid-December 2008 just above JPY86. In late January the dollar re-tested that area, but did not really make it past JPY88. And then in mid-July, the dollar dipped briefly below JPY92 before rebounding. Many traders have drawn a line connecting these three lows. This "trend line" will come in around JPY92.50 at the end of the month and JPY93.25 at the end of September. Provided this trend line holds, the dollar has bottomed against the yen.

Many market participants would have also drawn a line off the early April dollar highs near JPY101.50 and off the June highs near JPY99. It comes in now around JY96.75 and JPY96.00 at the end of the month. A convincing break of that trend line would likely been seen as a signal of the dollar's recovery has begun, back toward the year's highs.

Conclusion

Although we expect the dollar to bottom, we have identified three factors investors should monitor to help anticipate the turn. First, watch interest rate differentials, especially short-term interest rate differentials. U.S. rates need to rise relative to Europe's to change the incentive structure.

Second, the pattern by which the dollar appears to be better amid bad new and does worse as the news improves, has to break. We think it will and the dollar will be rewarded as the economy recovers and U.S. rates rise. Many investors are underweight U.S. assets and a return to benchmark weightings, coupled with renewed foreign direct investment, to take advantage of the relatively low cheap unit labors costs and to get inside the potential protectionist walls (see "Buy America").

Third look for potential reversal chart patterns and divergences to help identify low risk entry time and levels to establish long dollar positions or reduce short dollar hedges. The dollar looks to have already bottomed against the Japanese yen. The price action reaction to the U.S. Jobs data is a small, preliminary taste of what we expect to materialize later this year

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