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The ECB and the Fed

If there is a single factor that was the main driver of US dollar in the first quarter, it would be the divergence between the trajectory of US and European monetary policy. The Federal Reserve is still engaged in easing monetary policy through unconventional purchase of Treasuries.

On its current path, QEII is worth something on the magnitude of 20-30 bp of easing in Q2. The European Central Bank has since early January steadily increased its commitment to tightening monetary policy through hiking interest rates and raising the decibel and frequency of its anti-inflation rhetoric.

Anticipation

A wonderfully frustrating aspect of the capital markets is that the cause often happens after the effect. The market has bought euros, sold dollars and sold European debt instruments because it expects the ECB to hike its main rate by 25 bp on April 7th.

The euro appreciated 5.8% against the dollar in Q1, second only to the Swedish krona in the G10 (6.2%). The December 2011 Euribor futures contract finished last year with an implied yield of 1.28%. It reached a high of 2.21% in early March and is now near 2.12%. The 2-year German note tells essentially the same story. It finished 2010 yielding about 86 bp. It now yields just above 1.80%. The market appears to be pricing in, with strong confidence, at least three hikes this year.

The biggest risk to this view is that ECB President Trichet dampens such expectations, or encourages traders to push them further out in time. The rise in the flash March euro zone CPI reading of 2.6% year-over-year from 2.4% in February was consistent with ECB expectations that inflation had not yet peaked, which is part of the reason it will hike rates.

Indeed, if Trichet uses the signaling phrase “rates are appropriate”, it would seem to reduce the likelihood of another step in Q2. Arguably, this type of language would indicate the ECB is not yet embarking on the beginning of an extended normalization cycle. On the other hand, the use of the “monitor closely” phrase has historically been paired with extended tightening cycles.

Cautious

There are good reasons to expect a more cautious approach than the market appears to have discounted. Consider three. First, the euro has appreciated about 6.5% on a trade-weighted basis since early January. This is tantamount to some degree of tightening. Using a moving average to smooth the more likely impact on businesses and investors, the broad appreciation of the euro is worth 25-50 bp of tightening.

Second, the ECB has indicated there are two pillars of its monetary policy: inflation and money supply. The focus has been nearly exclusively on inflation. The other pillar is indicating something completely different. Money supply grew 2% year-over-year in February. The ECB's reference rate is 4.5%. Money supply is growing at less than half the pace the ECB says is consistent with price stability. When using a 3-month annualized rate, which the ECB used to smooth out the time series, the rate of growth slows to 1.7%. Money supply growth and the velocity of money are not going to provide the fuel that inflation needs to burn.

Third, growth in the euro zone is likely to moderate in the coming quarters. This may discourage secondary impacts from higher commodity prices and thus dampen inflation expectations. Indeed some of the increase in administered prices, including taxes and tuitions, that boost measures of inflation will actually reduce aggregate demand. This also means that that the core CPI rate of 1% might itself overstate the inflation pressures in the euro zone.

Sell the Fact

Short-term market participants and medium term investors seem to be well positioned for the April 7th rate hike. The net long speculative euro position at the IMM is at the upper end of market positioning for the past three years. The persistent uptrend of the euro gave plenty of opportunity to jump aboard. Funds that invest in European equities, for example, reportedly experienced inflows consistently throughout the quarter.

The risk, then, is not only that Trichet's remarks ease interest rate expectations in some fashion, but also that the market that bought the euro on "rumors" of a hike, will sell it on the "fact". Indicative pricing in the options market suggests euro longs are a bit nervous as the market pays a premium for euro puts over calls.

The premium was its lowest most of the year in mid-January near 1.16%. The most recent low was recorded in on March 8th near 1.28%. Now, the market pays 1.7% more for euro puts than calls equidistant from the three-month forward. The euro has not closed below its 20-day moving average since mid-Feb. It currently comes in around $1.4050 and a break of this general area, perhaps extending toward $1.40, would likely signal the end of the nearly quarter long euro advance.

An important caveat is that other technical indicators and chart patterns are not as compelling as early last November, when we also thought the market was vulnerable to "sell the rumor buy fact" after the dollar lost more than 10% in anticipation of QEII.

Therefore, prudent investors should also consider what is potentially on the euro's upside. An initial barrier is seen in the $1.4280-$1.4300 area. A break could signal another 1-2% euro rise to the $1.4450 and possibly $1.4600. To be sure, we suspect further euro appreciation in the face of tightening of monetary and fiscal policies will exacerbate the pressure in the periphery and act as further headwinds to European growth.

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Fed

At the same, we are concerned that the market has been exaggerating the ultimate significance of some of the recent comments by a couple of the more hawkish members at the Federal Reserve. Comments by New York Fed President (always a voting member of the FOMC) who is perceived as speaking for the leadership at the Fed helped return the market's focus to the real signal. While there is difference of opinion at the Fed, there have been no dissents at this year's FOMC meetings.

Going forward, there very well may be dissents. Dissents are a healthy part of a deliberative process. To be sure, though, dissents do not set policy. The esteemed Mr. Hoenig, for example, dissented from the decision to resume buying Treasuries (QEII) but to have attached too much significance to it one confuses the minority view with the majority.

Investors need to focus on the likely policies backed by the majority. We think that this message has been clear. The minutes to the March 15 FOMC meeting will be released on April 3. They will indicate that the Treasury purchase program has been reviewed and will continue. We expect the Federal Reserve will complete its $600 bln of purchases first outlined last November.

At one point on April 1, following the jobs report which confirmed the greater quarterly job gain since 2004, the December Fed funds futures contract had nearly fully priced in a rate hike by the end of the year. The March 2012 contract is implying an average effective Fed funds rate of over 50 bp, while the June 2012 contract is implying a rate of more than 75 bp. We think this is too aggressive.

While we recognize the recovery is more solid, the headwinds created by de-leveraging pressure and a banking system that remains fragile, coupled with the lack of a fully functioning transmission mechanism of monetary policy, cautions against a quick reversal of the Fed's extremely accommodative stance. Moreover, it does not appear that the US economy has reached what economists call its "escape velocity" by which is meant a self-sustaining recovery.

Rising headline inflation has been generally greeted with the FOMC statement and official comments discussing it more. The key take away, in effect, is that the majority at the Fed understood the rise in food and energy prices as having a transitory impact on inflation. Core inflation is below 1%.

Hourly earnings, which have risen at 1.7% pace over the past year, have lagged behind headline inflation. Consumption, which contributed strongly to Q4 10 GDP, is not repeating itself this quarter. While corporate America appears strong, households seem decidedly more fragile.

In conclusion, our argument is two-fold. First, in Europe, we suspect the market is ahead of itself on the likely pace of ECB tightening. The market appears ripe for buy (the euro) on the "rumor" of an ECB rate hike and

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sells on the fact type of action. Second, similarly, the market appears too aggressive in pricing in Fed tightening after QEII is finished. The pendulum of market sentiment has swung too hard and we expect it to adjust in the weeks ahead.

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