Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

MARKET CALLS

Dollar Daze

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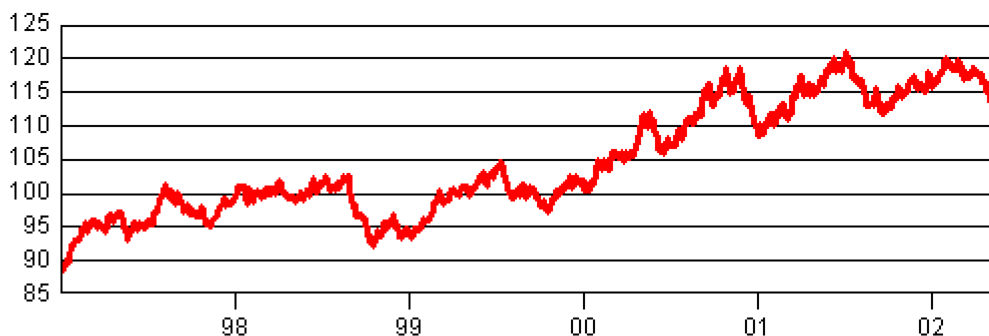
David Gitlitz

In meetings with clients in Boston and New York last week, questions about the dollar's strength relative to foreign exchange, gold and other commodities were at or near the top of the list of discussion topics. The dollar currently appears to be in transition from an excessive, deflationary scarcity to a more balanced but still-strong position. We differ both with those who see inflation risk lurking in recent behavior of the market price indicators, as well as those convinced that nothing of significance has occurred to relieve the deflationary dollar shortage. There is a risk, though, that incorrect interpretations of the recent movements could take on something of a self-fulfilling quality, leading to a potentially damaging bout of volatility that might in turn spur an equally damaging policy response. With the global financial press eager to seize on any opportunity to fan the flames of a "flight from the dollar," for example, **the Fed** could be faced with little choice but to tighten if only to reassure the markets that it remains steadfast in defending the currency. We don't view that as a high probability event at this point, but transitional phases are periods during which dynamic changes can give rise to risks that otherwise wouldn't rate mention.

The G-6 trade-weighted dollar index has fallen 5.5% from near 15-year highs in early January, and can only be considered "weak" by the deflationary standards of recent experience. At these levels, the dollar is still up 17% relative to its major-currency competitors over the last five years. Actually, we welcome the greenback's recent softening as indicating fundamental support for the deflation relief seen in the gold price rising from below $280 to above $310 so far this year. As we noted previously, gold price moves unconfirmed by changes in foreign exchange values tend not to be sustained. In fact, the trade-weighted dollar has only covered about half the depreciation indicated by the gold price increase, which suggests that further gradual weakening could be in store.

G-6 Trade-weighted Dollar Index



Some of the recent volatility in the dollar's forex value appeared to coincide with indications that U.S. economic recovery would be less robust than earlier thought. It would be a mistake, though, to view the dollar's performance as a straightforward barometer of U.S. growth prospects. Note that the dollar's highs over the past year were reached even as the economy

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016

fell into recession. That's because it was a *deflationary* recession, with the dollar's strength not an indication of robust health but of a staggering scarcity of monetary liquidity. In other words, to whatever extent the faltering economy may have marginally reduced transactions-based dollar demand, it was more than offset by the Fed's squeeze on liquidity. It's debatable, in fact, whether dollar demand was reduced in any real sense during this period. Interest-bearing money market accounts became an investment destination offering highly competitive risk-adjusted returns in deflationary times. It's worth noting that market-based indications of deflation relief have coincided with an abrupt plateauing in demand for these dollar deposits. After jumping by some 20% in 2001, MZM -- or Money Zero Maturity, the Fed's broadest classification of immediately available funds, the bulk of which is comprised of interest-bearing accounts -- has been decelerating all year, now growing at a 1.5% annual rate since late last year.

While the dollar's recent decline appears consistent with an easing of deflationary impulses, any concern that it could be a signal of rising inflation expectations seems highly premature. One can get a sense of the global market's confidence in the strength of dollar purchasing power in the movement of spreads between U.S. Treasuries and other government bonds of similar maturities. If, for example, the recent strengthening of the euro against the dollar were seen as a measure of rising inflation risk in dollar-denominated assets, we would expect to find benchmark European issues -- such as the 10-year German Bund -- gaining relative to their U.S. counterparts in spread terms. In fact, just the opposite has been the case. Since mid-April, as the euro has appreciated from about $.88 to more than $.91, the 10-year Treasury/Bund spread has shifted by about 10 basis points in the Treasury's favor. In a relatively rare event by the standards of recent history, the Treasury's yield is now a few basis points less than that of the Bund. As opposed to the dollar's recent decline suggesting any hint of inflation risk in dollar-based instruments, the spread move could well be an indication that the marginal bet is for some reversal of the recent action in euro/dollar forex.

Nor do we see much hint of a potential inflation outbreak in the shape of the Treasury yield curve. Yes, at 240 basis points, the 30-year/2-year curve remains steep by the standards of the latter half of last decade, when the curve ranged below 100 bps almost without exception. It's also the case, though, that shifting expectations of Fed action can dominate movements along the curve, distorting the inflation-risk signals that one would otherwise expect to glean from the term structure. Since early last month, for example, the curve has steepened by about 30 bps as the short end, as one would expect, has had the fastest and largest response to the rollback of Fed tightening expectations, with the yield on the two-year note falling from above 3.7% to below 3.15%. It's difficult to see that steepening as representing a rising inflation risk premium, especially considering the nearly 30 bp rally in the long bond over the same period. Our hunch is that the rally in short maturities has come close to running its course, but the long end could still have considerable upside. Even at a nominal yield just above 5.5%, real yields in a virtual zero-inflation environment remain highly appealing. With the Fed today signaling that the first round of rate hikes has become a fairly distant proposition, we see conditions ripening for a bullish curve-flattening trade. TM