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MARKET CALLS

A "Real" Dollar Rally? Don't Bank On It

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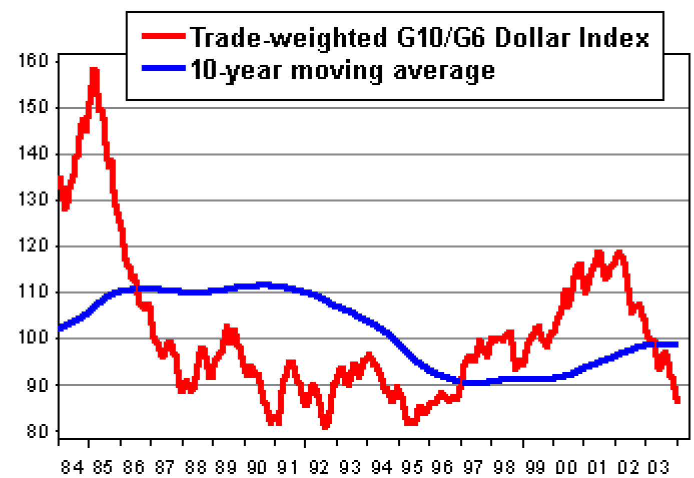
Until the Fed reverses its inflationary course, the dollar is headed nowhere but lower.

Having absorbed the euro's rally to new lifetime highs above $1.29/€ in early trading, the dollar took a startling turn yesterday to close more than two cents higher against the **European** common currency. Gold also reflected some apparently new-found dollar strength, falling below $409 after climbing above $417 in accord with the dollar's early Wednesday weakness. In some influential quarters, the abrupt move was seen as a welcome indication that an "oversold" dollar was finally set for a long-overdue correction.

Not likely. In fact, any hope that this trading action might reflect an emerging turn in the dollar's fortunes was already cast in doubt by late morning today, with the euro poking back above $1.27 and gold regaining the $410 level. Market crosstalk yesterday focused on speculation about potential central bank intervention, spurred by the ruminations of various European functionaries bemoaning the heightened currency market volatility. Rather than indicating a sustainable reversal in the dollar's decline, however, the sudden market whipsaw in response to this chatter was more a reflection of the degree to which the currency and commodity markets are positioned for continued softening in the **US** unit of account. With the market's bets strongly favoring a weaker dollar and higher gold, the reports were enough to cause some speculative positions to be vacated and profit booked. But absent a change in the fundamental conditions driving the dollar lower both in real commodity-based terms and against competing currencies -- namely, a too-easy **Fed** -- the dollar's most likely course points to further weakness.

Indeed, the dollar's forex descent earlier this week came on the heels of **ECB President Jean-Claude Trichet** making clear that the stewards of the still-young continental currency have no intention of following **Alan Greenspan's** inflationary lead. Much of the European economic elite has deep trepidation about the threat to export competitiveness caused by the euro's rise *vis-à-vis* the dollar, and as yesterday's response suggested, the market remains keenly attuned to the risk of monetary authorities stepping in to staunch the euro's rise. Trichet appears to recognize, however, that the exchange rate is indicative of real dollar depreciation, not real euro appreciation, and that chasing a weak dollar would extract an unacceptable price in terms of inflation. By telling the **European Parliament** that the central bank's target rate -- double the Fed's 1% -- is "appropriate," the markets understood that Trichet was drawing an



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unmistakable contrast with his US counterpart. Last week Greenspan reiterated the Fed's pledge to remain "patient" before moving to rein in its ultra-accommodative posture, effectively insuring that the dollar would continue to fall against currencies governed by less-easy central banks.

While dollar/euro has received the bulk of recent press and market attention, it's worth noting that the dollar has continued to fall against nearly all of its major-country counterparts. The notable recent exception has been the **Japanese** yen, with authorities using massive, repeated rounds of sterilized intervention to deter speculative long yen positions. In any case, with the trade-weighted dollar now at eight-year lows, the casual nonchalance toward the currency's continued decline expressed by Greenspan last week rings hollow. On a trade-weighted basis the dollar is now at a level below its 10-year moving average last seen in early 1987 (see chart on previous page). The Fed's indifference to the mounting signs of liquidity excess at that time foreshadowed the inflation breakout of 1987 to 91, the last time core CPI inflation exceeded 4.5%.

As was the case in early '87, the Fed currently seems entirely oblivious to these realities, and nearly appears brazen in courting the same error. At this point, we see the odds strongly favoring further depreciation of real dollar purchasing power, and view this as an opportune time to capitalize on what are likely to be short-lived moves in the opposite direction. Today, we are establishing speculative **Model Positions short the trade-weighted dollar index and long gold**. TM