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A Dollar Rally?

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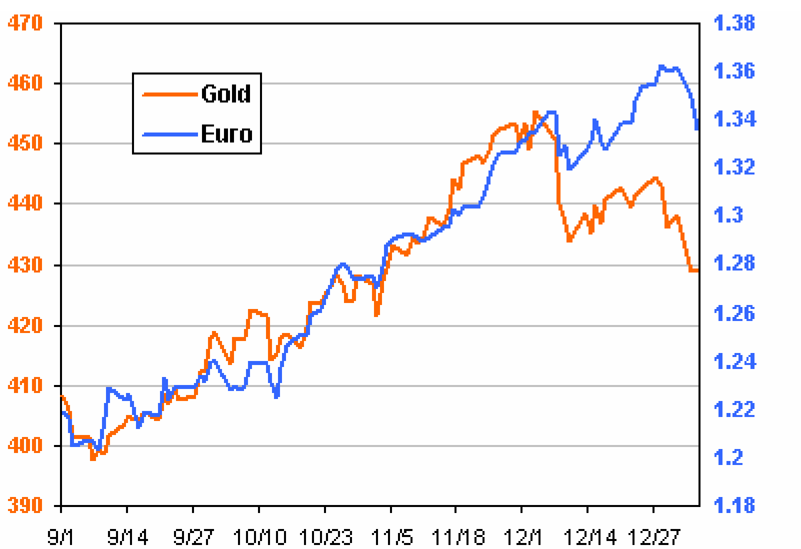
Surprise, surprise! Prospects for a reality-based Fed are helping firm up the dollar.

Don't look now, but amid all the unequivocal assurances from the analyst and media hordes that "there's only one way for the dollar to go, and that's down" -- due to the trade and budget deficits, of course -- the currency is showing signs of life, and could be poised for at least a short-run move higher.

At this point, the dollar has only recovered fractionally from its record lows last week around $1.36 against the euro, and the nine-year lows against its major currency counterparts encompassed by the G-6 trade-weighted index. But a more decided dollar firming has recently been reflected in a tumbling gold price, with gold closing below $430 the past two days for the first time in nearly two months. That's a 6% decline in the dollar price of gold since it reached a 16-year high above $455 early last month.



As the most sensitive indicator of supply and demand balance in the market for dollar liquidity, it's not unusual for the price of gold to lead shifts in foreign exchange rates at key inflection points in the trading environment. As seen in the chart at left, gold and the dollar/euro exchange rate moved virtually in lockstep during the period of intense dollar weakness beginning in September. After the price of gold peaked in early December, however, the dollar continued to fall, as momentum trading carried the day in the significantly higher volume forex markets.

Last month we noted that the price of gold moved off its highs when, within days of first crossing the $450 level, the ***Wall Street Journal*** reported that "Fed officials believe inflation risks are on the rise" (see "Slippery Slope" December 6, 2004). Soon after, we found a marginal shift toward a less generous liquidity posture had become apparent in **Fed** open market operations (see "Retro Maestro?" December 20, 2004). We suggested that these moves were intended to signal that the central bank is not incognizant of the inflationary implications of the currency's declining purchasing power and, presumably, would take action necessary to counter them. After being swamped for weeks by the can't-lose one-way bet against the dollar, the currency markets now appear to be catching on.

Although the chart above suggests the extent to which the momentum trade carried the dollar beyond real-value parameters, and appears to present an appealing near-term trading opportunity in the catch up, we are reluctant as yet to sound an "all clear" with regard to the currency's prospects. It's worth noting that the most recent **FOMC** meeting on December 14 saw policy makers stick with their boilerplate assessment that "upside and downside risks" to price stability remain "roughly equal." According to the Fed's official policy formulation, in other words, the risk of deflation remains as great as that of inflation, despite the dollar' decline of some 20% against foreign exchange, and 30% against gold, over the past two years, a period during which policy has maintained a degree of accommodation unseen in nearly half a century.

There has been speculation that the Fed is waiting for its early February meeting to revise its public stance and offer a more reality-based view of the current risk environment. Fed chief **Alan Greenspan's** semi-annual policy testimony on **Capitol Hill** customarily comes shortly after the February session, so the thinking is that he would prefer to time such a change for a meeting that would offer him the occasion to publicly explain it soon thereafter. The minutes of the December FOMC meeting released this afternoon portray an institution on the cusp of a potentially significant shift, but not quite there yet. "In their discussion of the outlook for prices, a number of participants cited developments that could pose upside inflation risks," the policy record says. It cites the decline in the dollar as a "potential source of upward pressure on prices that could get embedded in higher inflation under certain circumstances," and noted the recent widening of the spread between inflation-indexed Treasuries (TIPS) and their nominal counterparts. The widening of the TIPS spread "might be a warning sign that expectations were not as well anchored as they had been over the summer," the minutes acknowledge.

At the same time, though, the minutes capture policymakers maintaining a quite sanguine view of the inflation outlook. "Participants generally expected that inflation would remain low in the foreseeable future," the record relates. "Several participants cited factors that would likely continue to provide a counterweight to any upside risks," including such monetary non-factors as "wage and compensation growth," and "an economy still operating somewhat below its potential." In any case, though, the minutes offer scant support for any notion that the Fed is contemplating a near-term end to its rate-hiking cycle, which was enough to send the 10-year Treasury down by more than a half-point and contribute to a firmer tone for the dollar, which rallied today above $1.33 against the euro. Under "normal" circumstances prospects for a stable-to-stronger dollar, versus a continued decline of the currency, would be expected to support bond prices, but these are not normal times. Given the extent to which Treasuries, since the middle of last year, rallied in conjunction with the unwinding of out-month Fed tightening expectations, another reversal of those expectations, if sustained, can be expected to spell trouble for bonds. In that regard, following release of the FOMC minutes today, the implied yield on the December '05 Eurodollar futures jumped by 11 basis points, and for the first time since last summer is pricing for a funds rate approaching 3.5% by year-end. TM