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MACROCOSM

Dollar Glut, Continued

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The fall of the dollar to 15-year lows isn't because there are too many subprime defaults -- it's because there are too many dollars.

The subprime mortgage meltdown may be the latest exogenous calamity supposedly posing a threat to financial stability and economic well being, but despite the narrative being retailed by the Wall Street/financial media consortium, it's not the driving force behind the dollar's continued slide on foreign exchange markets.

It's understandable that a market which had no compunction about assigning an untenably low price for risk-bearing -- which gave birth to the subprime phenomenon in the first place -- would suffer a few shudders when the consequences of that carelessness are now being exposed to the light of day. But after the latest round of subprime panic earlier this week, equities and Treasuries regained their balance, with stocks impressively making new highs and the 10-year Treasury note yield backing up to well above 5%.

But the dollar continued its descent, with the euro at all-time highs near $1.38, the trade-weighted forex index at 15-year lows and gold approaching $670, up more than $25 in little more than two weeks. The sight of the dollar selling off as subprime angst intensified created a convenient coincidence for attempts to link cause and effect. At a few points, it could perhaps be plausibly argued that the subprime crisis was feeding into speculation that the Fed would be forced to cut rates and that that was contributing to dollar weakness. On Tuesday, when subprime fear reached its high, Eurodollar futures priced for as much as a 70% chance of a rate cut one year out, up from just a 14% chance last Friday. But the dollar continued to drop even as futures reversed much of the additional rate cut bet, with June '08 futures now showing odds of less than 40% for a rate cut.

Update to strategic view
US MACRO: The drop in the dollar to 15-year lows on a trade-weighted basis is evidence of a worldwide glut of dollar liquidity. This will lead to higher dollar inflation, despite seeming relief from official inflation measures over the last several months. **INFLATION PLAYS (US DOLLAR, US RESOURCE STOCKS, GOLD, OIL, COMMODITIES):** The dollar will continue to fall, and inflation-sensitive commodities and equity sectors will continue to rise, as long as the Fed continues its present accommodative posture. These trends will not end until the Fed signals it is ready to move rates up to equilibrium levels.
[see Investment Strategy Dashboard]

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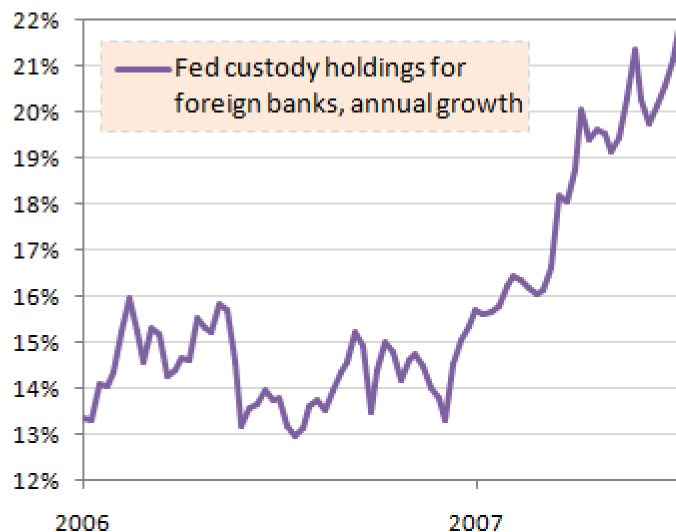
For the most part, conventional wisdom is seeking such rationales for the dollar's plight because it has failed to recognize the underlying monetary reality explaining the currency's eroding purchasing power: the Fed remains in a surplus liquidity posture. The trend toward dollar weakness has been unmistakable since early last year, when the euro was around $1.20 and gold below $550. The currency had a brief respite following the May 9 FOMC meeting when the Fed dashed hopes that it would at least give a nod to prospects for forthcoming rate cuts. Over the next five weeks, the dollar strengthened from about $1.36 to $1.33 versus the euro, and gold dropped from $685 to below $650. But while the central bank's resistance to entreaties for rate cuts at this point may take out the potential worst case scenario for inflationary policy error, it doesn't alter the fact that the Fed's stance is still accommodative. The bias toward further dollar weakness remains in place.



One of the more compelling illustrations of the extent of the continued dollar liquidity glut is provided by the Fed's holdings of securities in custody for foreign central banks. This is essentially a measure of the dollar reserves being accumulated by central banks as a consequence of their intervention in foreign exchange markets to keep their currencies from appreciating against a weak dollar. On a 52-week basis, the Fed's custody holdings are now growing at a rate of about 22%, highest since early 2005, when the Fed was still in the early stages of normalizing policy from the ultra-easy 1% funds rate target in place from mid-2003 to mid-2004. Year-on-year growth in custody holdings peaked at about 35% in summer 2004. The path of the growth of these holdings seen in the chart above offers quantitative support for our contention that the 5.25% target funds rate reached a little more than a year ago remains below equilibrium. The chart also helps illustrate that the effects of policy moving in one direction or the other accumulate over time. Even though the Fed's stance has ostensibly been steady for the past year, by remaining on the accommodative side of neutral, the liquidity excess continues to build.

BOTTOM LINE: The subprime mortgage blow-up is the most recent in a string of apparent disasters that purportedly spell doom, offering a handy rationale to explain the dollar's weakened condition. But it doesn't distract us from the real culprit behind the currency's sustained slide: a still-easy Fed. For now, the official price indexes are presenting a benign portrait of the inflation environment. Inevitably, though, this extended period of eroding real dollar purchasing power will be manifest in a renewed uptrend in statistical inflation, leaving the Fed no choice but to return to rate-hiking mode.