

MACROCSOM

The Unloved Buck

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With the Fed bowing to recession fears and market expectations, the dollar is collateral damage.

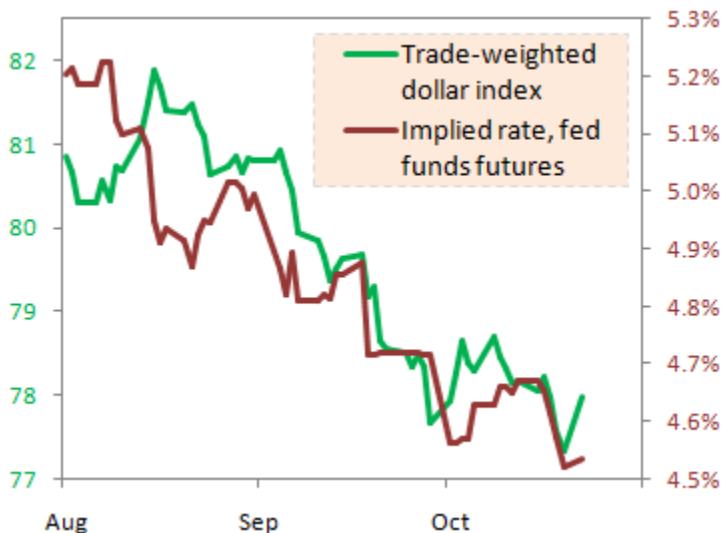
After a brief one-day reversal spurred by short-lived trading exigencies, the dollar today is resuming its move lower as gold again challenges \$760 and approaches 28-year highs. The snap-back yesterday was seen by some as a significant turn in the dollar's fortunes, but we view it as a brief technical trade tied to the weekend meeting of the G7 finance ministers. Having loaded up on dollar shorts and gold longs in anticipation of the G7's hands-off approach to the dollar, traders quickly booked profits and vacated their positions overnight yesterday once the dollar hit record lows against the euro at \$1.435 and gold jumped above \$770. But such short-run trading events don't mean much in the context of the larger fundamental forces pulling the dollar lower and supporting the ongoing rally in gold and other sensitive commodities.

Update to strategic view

FED FUNDS: Market expectations, the Fed's worries about housing and credit contagion, and its neglect of the falling dollar all point to the likelihood of another 25 bp cut to the funds rate at the October 31 FOMC meeting.

US DOLLAR: The Fed is choosing to ignore the inflationary implications of the falling dollar, and it is likely to push it lower when the FOMC cuts rates again at the October 31 meeting.

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Even had the G7 statement expressed concern about the sliding dollar -- as was reportedly championed by a few European ministers -- it would likely have had little lasting effect, given the monetary realities currently buffeting the US currency. But the silence of the industrial world grandees on the subject of the faltering dollar served to underscore the low priority its fate currently occupies on the policy agenda. That's despite the fact that, on a trade-weighted basis, the dollar is down nearly 5.5% just since the market turmoil that erupted in August

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and put the focus on the Fed's likely easing response. The Fed's long-standing easy- money posture has been taking its toll on the dollar for a lot longer than that, with the G6 dollar index down on net by some 22% in a little more than four years -- and down far more, were we to start the clock at the dollar's peak at the climax of the Fed's formerly deflationary posture.

It's certainly clear that the dollar's fortunes are not a primary preoccupation of the figure ostensibly assigned the task of safeguarding the purchasing power of the unit of account -- Fed chairman Ben Bernanke. In a Q&A session following his speech last week to the New York Economic Club, Bernanke was asked what he thought were the impacts of the dollar on inflation and what role the currency should play in monetary policy. Rather than directly answering the question, Bernanke gave an extended discourse on fixed exchange rates, maintaining that fixed rates are not a good system for a large economy because "you don't have independence of monetary policy to achieve domestic goals and objectives." This is the credo of the modern central banker, under which empowering the policymaker with the discretion to determine how best to achieve his "goals and objectives" is far superior to a system that would direct policy to the narrow task of stabilizing the value of the currency. It should be noted that price stability in the US was a practical reality until the late 1960s when the country began moving away from a fixed exchange rate system tied to gold. It was the abandonment of that system that gave rise to the inflationary era of the 1970s, as well as to the ever-present risk that central bankers -- with all their vaunted discretion -- will again stumble into creating a high inflation environment.

Bernanke finally acknowledged that "no central banker can be entirely indifferent to the exchange value of the currency," but he maintained that the inflationary impact of dollar depreciation "comes through the cost of imports," and claimed that "those effects are relatively small." Bernanke here is harking back to another error of the 1970s, a belief that the sharp decline of the currency would not have significant inflationary consequences because of the small share of imports in overall consumption. It seems this lesson of the 1970s still hasn't been learned by Bernanke -- specifically, that a weak currency is indicative of a lax monetary policy which eventually will leave a broad inflationary imprint regardless of the degree of import penetration in the economy.

The dollar's prospects, meanwhile, have not been aided in the past week as the combination of weak housing data, renewed credit market anxiety, soft earnings from some high-profile banks and a stock market correction re-intensified expectations for further Fed easing action, starting at next week's FOMC meeting. Fed funds futures started out last week showing a 30% chance of a 25 basis point cut next week, but are now pricing a probability of nearly 85% that the funds rate will be cut to 4.5%. And for the next meeting in December, futures show a 70% chance of another cut to 4.25%. Our reading is that a significant factor in the decision to cut rates by 50 bps last month was worry about the fallout in the currently tense financial market environment if easing expectations were to be disappointed. Those worries probably are still present, and unless the market backs away from its current odds-on bet, chances for a rate cut next week are good, which has been our expectations since the September 18 rate cut (see ["The Fed Gets the Yips"](#) September 19, 2007). But the December FOMC meeting comes six week later, allowing some time for intervening events to shift perceptions about prospects for another cut.

After a break of several weeks amid a stabilization of the markets and a run of good data, a sense of pessimism again is palpable. But our outlook remains upbeat and we find little that is either persuasive or new in the negativity of so many analysts and commentators. Outside of housing, the economy show few signs of significant deceleration, and as we have documented on a number of occasions, the 95% of the economy that is *not* housing has been well insulated from the housing downturn. We don't minimize the wounds to the credit markets being suffered as a consequence of the subprime mortgage meltdown. But the market shows little sign that its capacity to absorb risk and allocate credit has been seriously impaired. Yes, there has been a

repricing of risk from unsustainably low levels. But for the most part, this has entailed an adjustment to more rational levels, not a capital-extinguishing blowout. The Merrill high-yield spread is now running about 200 basis points above its unsustainably generous June lows. But at about 440 bp today, it remains below its long-term average around 500 bp. And the availability of bank credit to business borrowers is showing nothing less than spectacular growth, with commercial and industrial lending up at an annual rate of 43% the past 13 weeks -- up from an already healthy rate around 15% last summer. If the economy were facing the realistic prospect of a significant slowdown, such credit would be becoming more scarce, not less so.

BOTTOM LINE: The Fed has formulated a rationale that views the housing slump and related credit market upheaval as posing considerable downside economic risk. And market expectations for additional rate cuts are quite strong. That leaves the FOMC likely to effect another easing move next week, especially considering the lack of appreciation for indicators such as the dollar's forex value in its policy formulation. For the unloved buck, these figure to continue to be trying times. ▶