



Trend Macrolytics, LLC
 Donald Luskin, Chief Investment Officer
 David Gitlitz, Chief Economist
 Thomas Demas, Managing Director

MACROCOSM

Dollar/Euro, Fed/ECB, Gold/Oil: Keeping It All Straight

Monday, August 11, 2008

David Gitlitz

Apparent dollar strength is likely a trading aberration, not a sustainable trend.

Looking at the wild action in foreign exchange and gold late last week, one could conclude that the European Central Bank must have suddenly abandoned its inflation-fighting mandate, which must have been just as suddenly adopted by the Federal Reserve. In fact, neither is the case. That suggests that the dollar's gain, particularly against the euro, and the abrupt gold price decline could be a short-lived trading phenomenon, not reflecting a shift in the expectations environment pointing toward a relatively less inflationary outlook for the US.

The euro was hammered last week, falling from \$1.54 to \$1.50 after ECB president Jean-Claude Trichet's Thursday [press conference](#) following the central bank policy meeting, where he was widely interpreted as putting a dovish cast on the European policy outlook. Trichet said recent data point toward a "weakening of real GDP growth in mid-2008," which was instantly seized on as an indication that the ECB's rate-hiking exercise -- the policy rate was lifted from 4% to 4.25% last month -- is already over, and the next move might well be a rate cut. Somehow this instant analysis disregarded some very hawkish commentary, including Trichet's dispositive statement that "we have one needle in our compass and it is pointing to price stability." In other words, even amid indications of significant slowing in the economy, European policymakers remain focused on inflation. And the latest information available, Trichet said, "has confirmed that annual inflation rates are likely to remain well above levels consistent with price stability for a protracted period of time and that risks to price stability over the medium term remain on the upside." Fact is, the ECB is by law mandated to seek an inflation rate no higher than 2%, and with eurozone inflation now running at twice that -- at the highest rate in 16 years -- it has little choice but to maintain a bias toward higher rates.

But if the dollar's surge last week is to be explained by euro weakness, then how to explain the sharp decline in the dollar price of gold at the same time? The price of gold measured in any given currency is the purest indicator of that currency's expected real purchasing power. If the euro is weakening primarily as a consequence of an expectations shift toward more

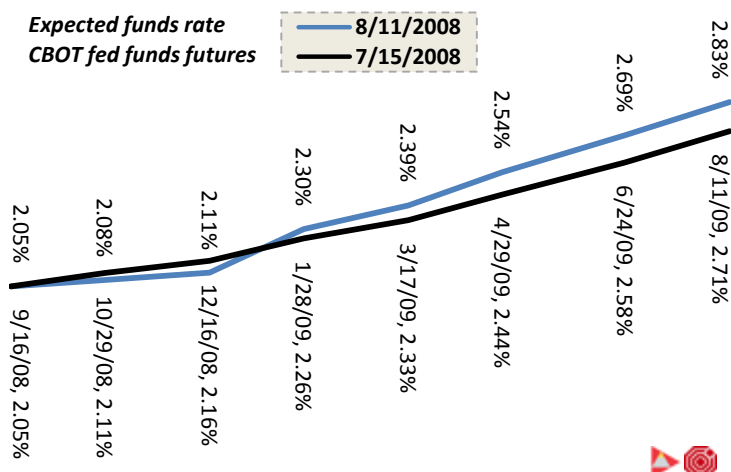
Update to strategic view
<p>US DOLLAR: The ECB has no scope to bail out the dollar by depreciating the euro, given the eurozone inflation level and the bank's single mandate for price stability. And the Fed is giving no indication that it intends to support the dollar by promptly beginning to normalize too-low interest rates. We conclude that last week's dollar surge is a speculative aberration likely to be reversed.</p>
<p>[see Investment Strategy Dashboard]</p>

<http://www.trendmacro.com>
 don@trendmacro.com
 dgitlitz@trendmacro.com
 tdemas@trendmacro.com

Offices:
 Menlo Park CA
 Parsippany NJ
 Charlotte NC

Phone:
 650 429 2112
 973 335 5079
 704 552 3625

accommodative *European* monetary policy, that should be affecting the *euro* gold price, not the dollar gold price. Yet gold has dropped by nearly \$25 in the recent days of euro weakening, but has hardly changed at all *in euro terms*. That suggests that the move in the dollar/euro exchange rate has been, in fact, a dollar event more than a euro event.



But *what* dollar event? For moves in the dollar and gold to appear sustainable, we'd be looking for some indication that the Fed is prepared to begin reversing the rate-cutting frenzy begun last September, and sooner rather than later. There are no such indications in evidence -- quite the contrary. The fed funds futures markets now assign less than a 50/50 probability to even a single rate-hike by year-end. In fact, the futures expectation curve now looks substantially identical to its posture on July 15,

the day of the worst of the Fannie/Freddie crisis (see ["Stocks are Cheap, But the Fed's Asleep"](#) July 15, 2008), even though equity and credit markets have improved considerably since then.

The dovish tilt of last week's post-meeting FOMC [statement](#), in fact, suggests that the Fed is now marginally less inclined to initiate the rate-normalization process than it was at the previous meeting in late June. The dollar's recent upturn, in fact, could perversely leave the Fed more comfortable delaying a rate-hiking exercise, as persistent dollar weakness was a key factor inspiring more hawkish noises for a time from Fed chair Ben Bernanke in early June (see ["The Bernanke Awakening"](#) June 5, 2008). While gold is the most reliable of the monetary indicators, there are occasions when it can be distorted by short-run trading exigencies, and this appears to be one of them. With the dollar having been under selling pressure for so long, a popular position in the market was to pair a bet against the dollar with a long gold position -- or probably more on point in this episode, a long oil position. With oil's upside momentum since April suddenly reversed, that trade is being vacated (see ["No Get Out of Inflation Free Card"](#) August 6, 2008).

At the same time, we don't entirely rule out the possibility that the dollar might have received some support from an unlikely source: Democratic presidential candidate Barack Obama. Reuters reported [Tuesday](#) in a brief story that Obama told a forum in Ohio that if "we had a strengthening of the dollar, that would help" reduce oil prices. The story was picked up by the *Wall Street Journal's* editorial page on [Friday](#), noting that this put Obama "pointedly at odds with the Bush Administration and Federal Reserve, both of which blame high commodity prices on supply and demand, despite falling demand due to slower global growth. Fed officials -- in particular, Vice Chairman Donald Kohn -- have expressly rejected any strong link between the dollar's collapse and the oil price surge since last August."

Indeed, there's no question that Fed-induced dollar weakness was important impetus for the soaring oil price the past year. But the last \$30 or so of the crude price escalation to just below \$150 from April into early July came after the dollar bottomed. This suggests that the reversal in oil to current levels around \$115 has largely been a response to easing geopolitical risks, an improving regulatory environment, and the correction of overbought conditions (again, see ["No Get Out of Inflation Free Card"](#)) -- not the result of the strengthening dollar. If anything, in the

strange logic of short-term speculative trends, it is more likely the case that the reversal in oil is driving the strengthening of the dollar. That's a slender reed for the dollar to lean on -- just as the climactic ramp-up of oil prices took on the character of a buying panic, the roll back could also prove highly volatile and overdone. But long-term, it is the Fed that drives the purchasing power of the dollar, which in turn drives the oil price, not the other way around -- and the Fed is doing nothing at this point to carry out its indispensable role.

BOTTOM LINE: The sudden appreciation of the dollar and decline in the price of gold appear to represent some significant shift in the inflation and monetary policy expectations framework. But we don't think they do. Despite much speculation surrounding the euro's decline, the ECB does not have the freedom to abandon its inflation mandate, even if it wanted to. And the Fed is providing no assurance that it is poised to begin the process of restoring monetary equilibrium any time soon. The market moves of the past few days will likely end up being recorded as a short-run trading event without lasting implications. ▶