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A Dollar Bottom?

Thursday, December 20, 2007
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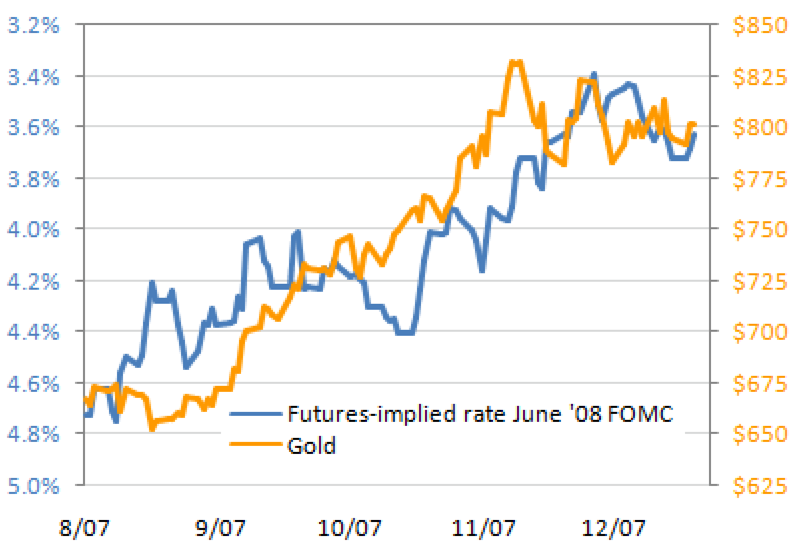
Not until the Fed takes inflation more seriously than it does the turmoil in credit markets.

Update to strategic view

US DOLLAR: Recent signs of renewed stability in the dollar's value as seen in gold and foreign exchange are not likely to be sustained. A spate of data pointing to worse than expected inflation and better than feared growth took some steam out of easing prospects going forward. But the Fed is likely to remain in a sub-equilibrium posture indefinitely, and the accumulation of surplus liquidity will take a further toll on the dollar's real value.

[see Investment Strategy Dashboard]

A series of unexpectedly disquieting inflation reports and surprisingly upbeat economic data has helped staunch the protracted erosion of dollar purchasing power for now. Bets on the extent of further Fed easing have come off their highest levels, and the possibility that the Fed might at some point have to shift course and at least roll back some of the 100 basis points in rate cuts effected thus far is no longer quite so universally viewed as preposterous speculation. But while this shifting market environment has had the immediate impact of somewhat firming forward-looking indicators of the dollar's value, whether this stabilization can be sustained remains open to considerable uncertainty. The Fed's open-armed generosity responding to the credit market's distress has put policy in a sharply sub-equilibrium posture, with at least one more 25 bp rate cut -- and probably two -- virtually assured. Unless and until policymakers signal that a redirection of the rate outlook is at hand, the surplus liquidity continuing to be supplied by the Fed likely will show through again in market price indicators such as the dollar, gold and other commodities, tracking with the eventual inflationary upshot of this outpouring of monetary largesse.



The response of the most sensitive of all monetary indicators, gold, to the expected path of Fed policy can be seen in the chart at left. Gold has

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tacked on nearly a quarter of its value since the outbreak of market turmoil in August upped the odds on the extent to which the Fed will be compelled to respond with rate reductions. It has been bound in a fairly wide range around $800 the past several weeks, as expectations have generally settled on the funds rate -- now at 4.25% -- moving to around 3.75% by June. The recent data has had the effect of marginally shifting the outlook against an open-ended course of Fed ease, with gold and the dollar's foreign exchange value late last week responding particularly to signs that the run of benign inflation data may be coming to an end.

One month, of course, does not make a trend, but we'd be cautious about hastily buying into assurances that the 0.3% core CPI print for November was only "noise." Were that the only sign of an inflation revival, we could see explaining it away with barely a shrug. That's hardly the case, however. The CPI release Friday was preceded a day earlier by the core producer price index showing a 0.4% jump. Moreover, the effect of easy money on the dollar's forex value is clearly showing up in import prices. Non-petroleum import prices last month were up 0.7%, and have risen at an annual rate of 4.6% the last three months. Finally, while most observers have been content to focus on core inflation so as to exclude what they see as a distortion caused by rising oil prices, consider that non-energy CPI is now running at a three-month annualized rate of 2.9%, up by a full percentage point just since May.

While a few regional reserve bank presidents have responded with some expression of concern about the inflation data, we're not looking for any quick change in tone coming from senior officials or the Fed itself. At this point, they have too much invested in the proposition that their first order task is to restore equanimity to the credit markets. And if that means the markets want and expect the Fed to continue bailing them out with lower rates, the central bankers are loath to risk disappointing them. Thus the Fed will remain in an excess liquidity posture for the foreseeable future, which also means that after a pause in the downward move of the dollar's real value, a resumption of the previous inflationary trends is likely to be seen in gold, the dollar and broader commodity indexes. That said, there could be some perturbations in forex depending on the actions of other central banks. The euro's recent weakening against the dollar reflects at least in part the massive liquidity injection operations undertaken by the European Central Bank. Paradoxically, though, to the extent such euro softness creates an impression of dollar firmness, it could also provide the Fed with what it perceives as additional leeway for further easing.

BOTTOM LINE: Recent signs of renewed stability in the dollar's value as seen in gold and foreign exchange are not likely to be sustained. A spate of data pointing to worse than expected inflation and better than feared growth took some steam out of easing prospects going forward. But the Fed is likely to remain in a sub-equilibrium posture indefinitely, and the accumulation of surplus liquidity will take a further toll on the dollar's real value. Eventually, the Fed will have to face the inflationary consequences of its monetary munificence. And when that day comes, we're likely to see the dark side of the Fed's current generosity.