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# A Stronger Dollar? Don't Be Fooled

Tuesday, February 12, 2008
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**The ECB is poised for excessive ease, weakening the euro but not strengthening the dollar.**

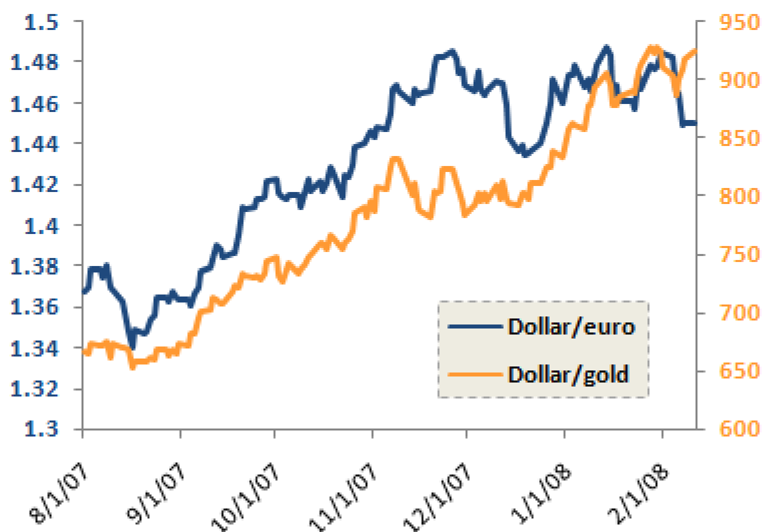
**Update to strategic view**

**US DOLLAR:** Recent stabilization of the dollar in forex markets, particularly against the euro, is a function primarily of speculation that the ECB's resistance to enter easing mode will soon come to an end. The marginally less weak dollar versus the euro does not signal any recovery in the dollar's real purchasing power, but rather that the impetus for excessive ease will soon be manifest in Europe.

[see Investment Strategy Dashboard]

Since the end of last month, the euro's retreat from near-record highs just below $1.49, has aroused some hope that the market has priced for the full extent of Fed accommodation -- both current and expected -- limiting the risk of further significant erosion of dollar purchasing power. Or, perhaps the market is sensing that cooler heads at the Fed might yet prevail and keep the central bank from continuing to pursue an apparently open-ended easing policy, avoiding the worst of the inflationary blowback that would otherwise be the likely consequence of this easy-money period.

But that would be a misreading of the dynamics currently at work in the forex market. The most sensitive indicators show no let-up in the market's pricing for a continued run of excess dollar liquidity. It should always be borne in mind when observing forex moves that they are a function of the influence of the two central banks of issuance in any currency pairing. What's been seen the last few weeks is not the strengthening of the dollar in any real sense. It is, rather, a reflection of the pressures bearing down on the European Central Bank, buffeted by some soft data and the initiation of an easing cycle by the Bank of England, to join in the Fed's rate-cut jamboree. For now, the long-euro/short-dollar play is being stymied by indications that the ECB may soon be compelled to bow to these pressures and

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shelve its inflation-first policy paradigm, at least for a time.

To filter out the interplay of competing central banks and get a direct read on the dollar's status, we assign the most weight to movements in the dollar price of gold, which has been shown over the years to maintain its role as a stable store of value. As can be seen in the accompanying chart, since last August the $/€ rate has for the most part moved in close congruence with gold. With a stable policy environment for the ECB, the euro's appreciation against the dollar was providing the same signal seen in gold -- first, a bet that the turmoil in US markets would soon be met with a return to policy easing by the Fed, which since September has been confirmed in spades, with 225 basis points in rate cuts, and significantly more likely still to come.

In the early part of this euro reversal to a range around $1.45, gold also turned lower, dropping from above $920 to below $890 over a three-session span. That was only a technical trading event, however, as short-dollar/long-gold positions were vacated with the euro's jump, rather than a reflection of real strength in the dollar. In short order, gold was rallying back above $920. In overnight trading yesterday, gold hit new highs above $928. It's selling off sharply today, possibly some kind of delayed reaction to reports of potential gold sales by the IMF. However, we would view that, too, as a trading event, as such ownership shifts have never been shown to long overwhelm the fundamentals determining the price of gold -- the balance of supply and demand in the market for monetary liquidity.

We would also note that gold is hardly alone in showing the effects of a continued surplus of dollar liquidity. The CRB spot index is at new all-time highs, up about 23% year-to-year and nearly 5% just in the last three weeks. CRB spot, by the way, does not include gold or crude oil.

At this point, we have little reason to doubt that the Fed will remain in easing mode for the foreseeable future, and believe it is highly likely to meet current expectations for the funds rate being brought down another 100 basis points -- to 2% -- by the summer. In recent weeks, a few Fed officials -- reserve bank presidents, not Fed governors -- have indicated that they may be having some second thoughts. In a speech last week, Philadelphia Fed president Charles Plosser said, "There are those who have expressed the view that in time of economic weakness, the Fed must not worry about inflation and should focus its entire effort on restoring economic growth by dramatically driving interest rates down as far and as rapidly as possible." Plosser said ignoring inflation risk during such times "risks undermining our ability to achieve economic growth over the long run," and noted, "All you have to do is recall the 1970s, when we experienced both high unemployment and high inflation to appreciate that slow economic growth and lower inflation do not necessarily go hand in hand." Plosser, though, said much the same thing prior to the last FOMC meeting, and it didn't keep him from joining his colleagues in voting for another 50 bp rate cut.

**BOTTOM LINE:** Recent stabilization of the dollar in forex markets, particularly against the euro, is a function primarily of speculation that the ECB's resistance to enter easing mode will soon come to an end. The marginally less weak dollar versus the euro does not signal any recovery in the dollar’s real purchasing power. If two central banks are each maintaining inflationary policy postures, their currencies can remain relatively stable against one another even as the upward pressure on their price levels intensifies. At this point, it's hardly implausible to posit that the impetus for excessive ease is now crossing the Atlantic and will soon be manifest in Europe.