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MACROCOSM

The Dollar: We're Not Buying It

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The Fed's easy posture simply doesn't support a sustained dollar rally.

How quickly the conventional wisdom turns. For at least two years the dominant narrative has been that housing and credit problems would drive the US into recession, but the rest of the world would perform well thanks to "decoupling." The US trade deficit would continue to build an insuperable mountain of debt owed to other nations. The dollar was destined to "collapse," we were to have a "dollar crisis." The last month's dollar rally has changed all that. The new conventional wisdom is exemplified by Goldman Sachs economists, who issued a report last week called "The Dollar Has Bottomed!" -- complete with exclamation point. The new narrative is that the US has emerged as a highly competitive global export player as the rest of the world's economies are slowing. "Decoupling" indeed, but in the opposite direction.

Update to strategic view

US DOLLAR: We reject on first principles the hypothesis that recent dollar strength is the result of a sea-change in relative performance of the US economy. The Fed is too loose, and dollar strength is only encouraging it to stay loose, so we expect that strength to be reversed.
FED FUNDS: Bernanke all but declared last week at Jackson Hole that inflation is not a high priority in the present policy debate. We expect the funds rate to remain at 2% as far as the eye can see, until a reversal in inflation-sensitive markets forces the Fed to again consider a long-overdue normalization of rates.

[see Investment Strategy Dashboard]

We're glad to see our fellow economists come around to our longstanding view that the US economy is not in recession. That view was strengthened quantitatively last week in an NBER Working Paper by Edward Leamer of UCLA's Anderson School of Management [click here to download it from our website]. The paper demonstrated that every post-war recession could be identified -- and the peaks and troughs of all but one (1974-5) pinpointed with near-perfect precision -- by tracking changes in just three simple variables: the unemployment rate, total payrolls and industrial production. So those variables effectively constitute the definition of an official recession. Currently none of the three variables point to recession. Indeed the change in the unemployment rate is the only one that is even close -- total payrolls and industrial production are very far from recession levels. One is free to define "recession" any way one wishes, and to declare based on that definition that we are in one, or predict we are about to enter one. But Leamer's paper shows conclusively that by any standard definition we are not in one, and not close to entering one -- nor have we been at any point over the last year of housing and credit turmoil.

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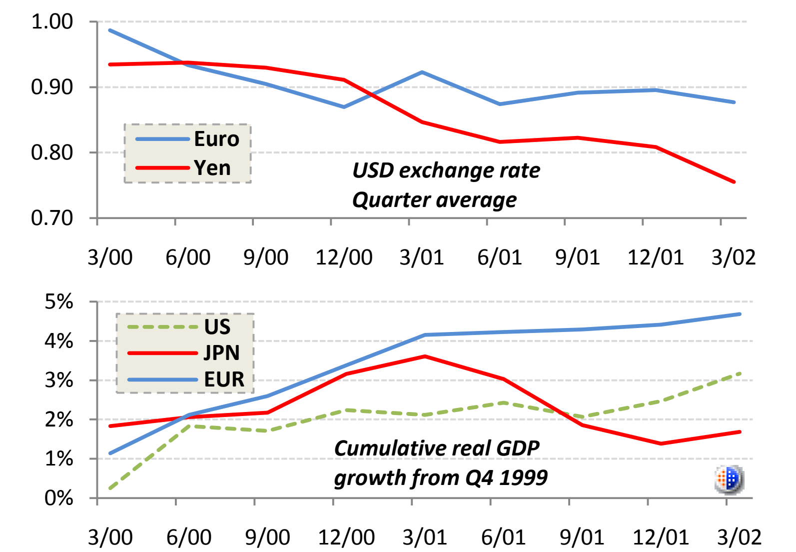

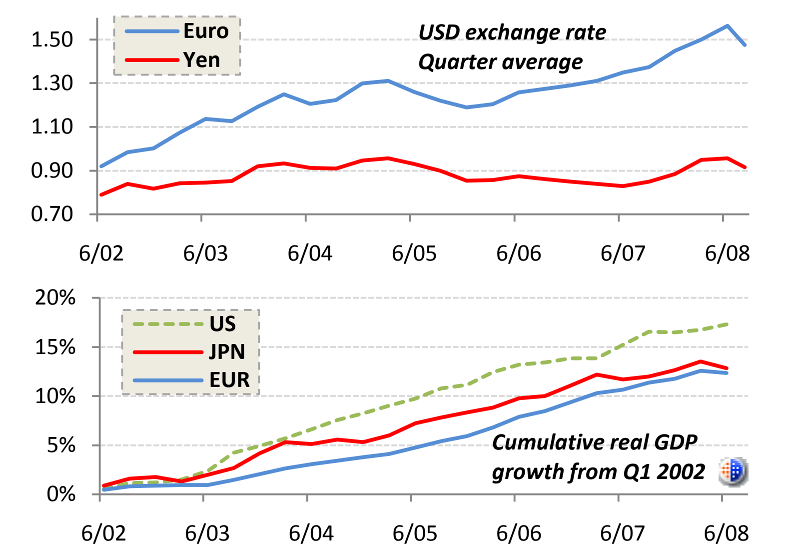

But as to the dollar, none of that matters, neither in absolute US terms nor relative to other world economies. The idea that exchange rates are determined by economic performance -- while utterly embedded in the conventional wisdom as though it were an unquestionable axiom -- is, in fact, completely false, and can easily be demonstrated to be so. From 2000 through the first quarter of 2002, the euro and the yen weakened consistently against the US dollar -- though the Eurozone economy consistently grew faster than the US economy, and the Japanese economy grew both faster and slower at different times. From the second quarter of 2002 to present, the euro and the yen have strengthened against the dollar -- the euro dramatically so -- though US growth has consistently stayed ahead of growth in the Eurozone and Japan. With that historical record -- which demonstrates that exchange rates have little to do with relative growth rates (indeed, if anything, it suggests they are negatively correlated) -- why attribute the last month's dollar rally to relative strength in the US economy?

In our economic model, exchange rates between nations' currencies are determined by the respective nations' central banks' monetary policies. Currencies issued by loose (inflationary) central banks will be weak relative to those issued by tight (deflationary) central banks. This model perfectly explains the two periods just discussed. In the 2000-2002 period, the Fed was extremely tight -- in fact, it would subsequently give itself quite a fright by coming to realize that its posture during this period risked a monetary deflation. So the dollar appreciated versus other currencies issued by central banks that had not been so tight. In the 2002-present period, the Fed has been extremely loose, first to combat the risk of deflation, and now to combat the effects of the housing slowdown and the credit crisis. So the dollar has depreciated versus currencies of central banks that have not been so loose.

Admittedly, that leaves our model at a bit of a loss to explain the dollar's strength over the last month. After all, over the last month the Fed has allowed events to cement it into maintaining an extremely loose policy posture (see "Fannie and Freddie Fan Inflation Fire" July 11, 2008). We could potentially explain this by noting that the dollar bottomed -- as we predicted at the time -- in the midst of the collapse of Bear Stearns, when the Fed introduced new non-monetary tools to deal with the crisis (see "Three Quarter Profile In Courage" March 19, 2008). Dollar strength since then could be seen as relief that the Fed found ways to avoid being *even looser*, perhaps having to resort to a Japan-style zero-rate. In that context, the July GSE crisis -- which marked the starting point for latest move higher in the dollar -- could be seen as a reaffirmation that, while the Fed may not move to tighten any time soon, at least it doesn't intend to ease further (see "Deflation? Surely You're Joking" August 21, 2008). That makes more sense to us than the conventional wisdom's current argument -- in the face of substantial historical contradiction -- that the dollar's latest move is due to relative strength in the US economy.

What makes most sense to us is to think that the last month's dollar strength is overdone -- most probably a speculative spillover from the sharp drop in the oil price -- and likely to be substantially reversed. The monetary fundamentals simply do not support a sustained dollar strengthening. At a funds rate at 2% as far as the eye can see, the printing press is very much stuck in high gear. We note that in Ben Bernanke's speech last week at Jackson Hole he characterized the Fed as being "committed to achieving medium-term price stability." By inserting the expression "medium-term" -- a qualification that appears nowhere in the Fed's statutory mandate -- Bernanke has effectively declared that, for the time being, inflation is not a high priority in policymaking.

We should not be surprised -- Bernanke gave us fair warning that he would relegate price stability to the "medium term." In his 2005 Senate hearing for confirmation as Fed chairman, when asked how he would respond to a hypothetical situation very much like today's actual one -- in which there are threats to growth that militate for low interest rates, but at the same time inflation is running well above target -- Bernanke said, "The inflation objective is explicitly a long-term or medium-term objective… I would certainly not try to return inflation to a target within a short period of time. I would simply try to assure the markets that over a long period of time that the Federal Reserve was committed to price stability as a central part of its monetary strategy."

Though Bernanke has long advocated "inflation targeting" as a policy framework, he has never advocated that price stability be the Fed's *sole* mandate. He stated in that same hearing, "I disagree with it entirely." For Bernanke, "inflation targeting" is only a communications strategy -- more to the point, a public relations strategy -- a way of maintaining market confidence in the Fed's commitment to price stability even when that commitment is being ignored, as it is today. In his 2002 Senate hearing for confirmation as a Fed governor, he said, "an inflation target actually increases the flexibility…of a central bank… by maintaining low and stable inflation expectations, the Central Bank actually releases itself to have more ability to respond to short-run economic disturbances."

Sadly, the last month's strength in the dollar has only served to encourage Bernanke in this dangerous gambit. He said at Jackson Hole, "well-anchored inflation expectations and increased slack in resource utilization, would foster a return to price stability… In this regard, the recent…increased stability of the dollar, has been encouraging." If dollar strength itself contributes to the very thing that creates dollar weakness -- that is, a loose Fed -- then we think that today's dollar strength won't be very long-lived.

BOTTOM LINE: We reject on first principles the hypothesis that recent dollar strength is the result of a sea-change in relative performance of the US economy. The Fed is too loose, and dollar strength is only encouraging it to stay loose, so we expect that strength to be reversed. Bernanke all but declared last week at Jackson Hole that inflation is not a high priority in the present policy debate. We expect the funds rate to remain at 2% as far as the eye can see, until a reversal in inflation-sensitive markets forces the Fed to again consider a long-overdue normalization of rates.