

Market Perspective

Dollar vs. Euro: What's Next?

Despite the recent rise in the dollar, the structural case for long-term weakness in the U.S. currency remains intact — the ballooning budget deficit still needs to get on a sustainable path before it can become less of a drag on the currency. Near- and medium-term dynamics, however, have shifted over the past three months and now appear to favor a stronger dollar.

The U.S. dollar experienced a short period of relative strength in the middle of the financial crisis; for several months beginning in October 2008 the dollar served as a safe haven for jittery investors worldwide. The strength began to dissipate in March 2009, however, as the Federal Reserve, in light of deterioration in the economic situation and outlook, announced the beginning of a large-scale quantitative easing program*. The Fed expanded its balance sheet considerably — the central bank purchased an additional \$750 billion of mortgage-backed securities to bring its total MBS holdings up to \$1.25 trillion, and it increased its purchases of agency debt to \$200 billion (both of these programs are to be completed by the end of first quarter 2010). An additional purchase of \$300 billion of longer-term Treasury securities — a bona fide quantitative easing measure on top of a federal funds rate of 0% to 0.25% — took place from March to October 2009.

As a result, the dollar weakened substantially versus the euro, from 1.25 in March to 1.50 at the end of October 2009. For a while it seemed that the dollar would replace the Japanese yen — the perennial favorite of carry traders — as a funding currency for all manner of risky trades. Currencies of states that engage in quantitative easing — as Japan has been doing for a long time — become the funding vehicles of choice for carry trades, as participants can borrow at low interest rates and invest in higher yielding currencies and securities elsewhere.

However, the Fed concluded its open-market purchases of longer-term Treasuries by the end of October 2009; in December the dollar began to stabilize and started to strengthen against its major trading partners — the dollar gained over 9% versus the euro in the three months that followed. The precipitous euro weakness during that time was exacerbated by weaker recovery prospects in the Eurozone as compared to the United States, as well as a perceived threat to the monetary union from sovereign solvency issues of some member-states, most notably Greece.

Concern about the possibility, however remote, of a Greek government default could soon dissipate — Greece needs to roll over only €16.8 billion of debt this year (though the principal of the maturing debt that needs to be paid back or rolled over in each of the next five years is much higher), and German officials recently

*Quantitative easing is an extreme form of monetary policy that occurs when interest rates have fallen to near zero and the central bank cannot stimulate the economy through its normal means of lowering rates further. In carrying out quantitative easing, the central bank floods the banking system with money via asset purchases, in the hope it will induce banks to increase lending and thereby stimulate real economic activity.

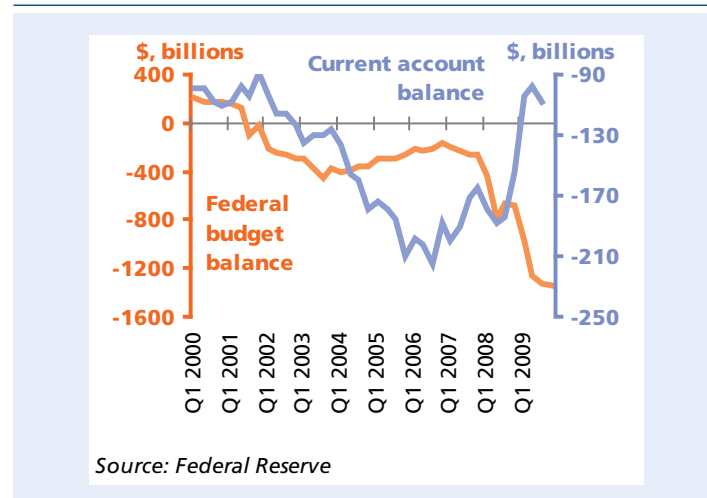
indicated that they are considering the purchase of Greek bonds through a state-owned lender. However, the recent issues faced by Greece and other European nations exposed a structural weakness of the monetary union: the dichotomy between a single monetary policy and multiple independent fiscal fiefdoms. This is likely to be a headwind for the euro going forward.

Short-term exchange rate determinants favor the dollar

Currently, several short- to medium-term exchange rate determinants are favoring the U.S. dollar vis-à-vis the euro.

First, the U.S. current account balance has improved substantially during the recent recession, reflecting reduced demand for imports from a weaker U.S. economy combined with stronger exports of its rebounding manufacturing sector. The trade and current account deficits are now at 2002 levels, the last year of dollar/euro parity (Figure 1).

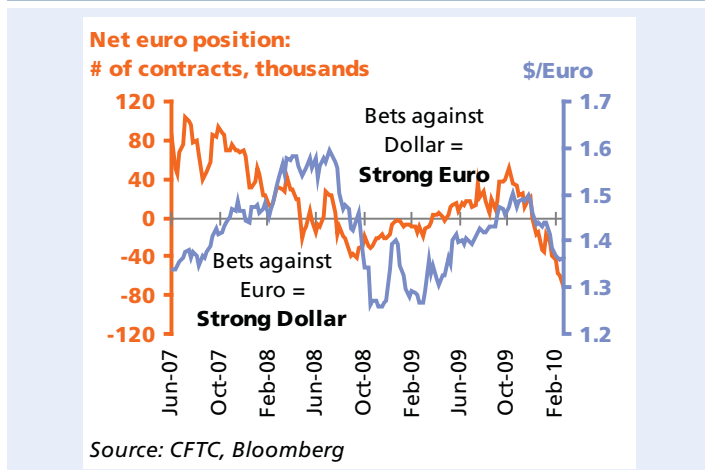
Figure 1: Ballooning fiscal deficit remains the single structural case for dollar weakness



Meanwhile, data from the Commodity Futures Trading Commission show that currency traders started betting on the decline in the euro versus the dollar in December 2009 and gradually increased the net number of speculative bets against the euro to a record high 72,000 in the week of February 23 (Figure 2). Speculative bets usually lead currency trends by several months; as such, the current speculative positioning implies that euro weakness may persist in the near term.

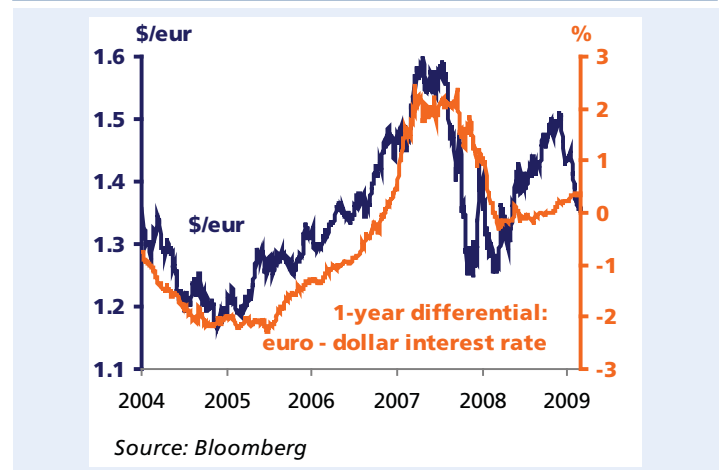
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Figure 2: Speculators have put sizable bets on euro weakness versus the dollar



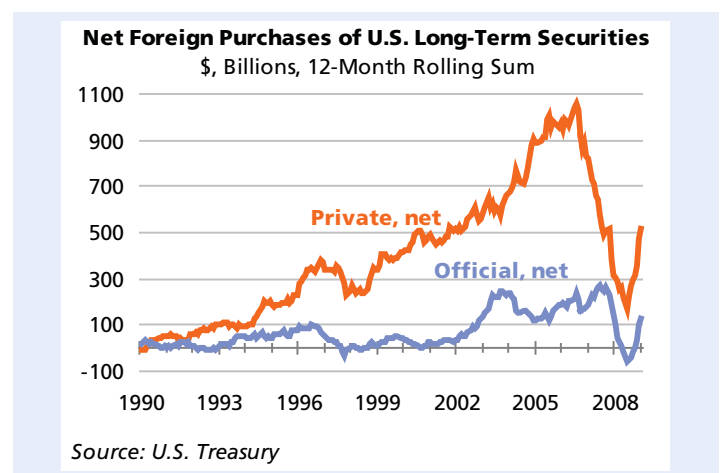
In addition, the interest-rate differential between the Eurozone and the United States, another short- to medium-term determinant of the exchange rate, is currently neutral and should be supportive of the dollar going forward (see Figure 3). Growth prospects in the euro zone are likely to remain weak, as several European countries (such as Greece, Portugal, Ireland, Spain and Italy) must implement fiscal austerity measures or remain fiscally conservative at the worst possible point of the economic cycle – in the middle of nascent recovery. As a result, it is unlikely the European Central Bank will start removing its monetary stimulus ahead of the Fed.

Figure 3: Interest rate differential remains neutral and supportive of the dollar



Finally, international capital flows recently changed direction once again and are now increasingly favoring the dollar. Both private and official net purchases of long-term U.S. securities increased in the last quarter of 2009 (Figure 4).

Figure 4: Foreign capital is returning to the U.S.



Taken together, these developments suggest that the U.S. dollar should find firmer footing in 2010. ■



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