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Will the dollar fight back or take a dive?

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A weaker U.S. dollar may be about the only economic stimulus button the Administration has left, keeping the dollar on a long-term downside track. Bottom line: The outlook for the value of the dollar is a bet on economic growth.

Weak economy — weaker U.S. dollar

BY DARRELL JOBMAN

Currencies are generally considered to be among the best trending markets, according to trading experts. But just about the time you are ready to agree that the experts have it right, foreign exchange markets tend to zig or zag enough to shake the confidence of many traders trying to stick with the trend.

Such was the case again this summer as a rally in the U.S. Dollar Index had traders wondering whether the widely forecasted decline of the dollar was fizzling out and turning higher instead (see "Just another bear market rally" right). The reversal coincided with a similar move in U.S. stocks that inspired some investors and analysts to proclaim that the bear market in stocks also was over and that a new bull market had begun.

But experienced forex traders realize that trends tend to persist, despite significant counter-moves. That's what a number of analysts, for a variety of reasons, predict for the U.S. dollar as they look for a longer-term downtrend to continue, particularly against the euro. They base their opinions on basic fundamentals — in currencies, that often has a political connotation — on cycles and on technical analysis.

WEAKENING SCENARIO

The case for a weaker dollar and stronger euro boils down to this:

- U.S. interest rates have been at 40-year lows and may not see those levels again unless the Fed buys back Treasuries.
- Tax cuts have been implemented.
- Even with these unprecedented efforts to stimulate the economy, recovery has not been very robust as jobs remain scarce.
- The interest rate and tax cut cards have been played without producing a winning hand. What's left to revive the economy as a presidential election year approaches in 2004?
- The only solution may be more spending overseas for U.S. goods, meaning U.S. prices will have to be more competitive.
- The easiest way to accomplish that is with a cheaper dollar, talking a "strong dollar" policy while letting its value ease in an orderly decline.

"The main monetary safety valve is the dollar, and the focal point of its weakness remains the euro," analysts at BCA Research in Montreal summarize their outlook. "The Chinese won't budge on their currency. Other Asian nations are resisting as well. U.S. Treasury Secretary John Snow seems to have endorsed Japan's efforts to reflate through currency intervention (that is, the yen is being prevented from strengthening). This leaves Europe, where the European Central Bank (ECB) has dug in its heels against more stimulus, at least for now. Bottom line: The euro is poised for a test of its highs (see "New highs ahead," page 30) as U.S. policymakers maintain the push for growth."

Within that general framework lie many questions that prevent any currency outlook from being very clear at this point: Economic growth rates? Inflation or deflation? Consumer debt levels after the refinancing boom? Federal budget and current account deficits? Energy prices? China's plans for the yuan? Japan's resolve for the yen?

FALL CRISIS?

"I am forecasting a dollar crisis this fall that could result in the euro at 1.25 by year-end, based on the absence of strong U.S. economic growth and a crash in bond yields, which the bond boys call a rally," says Barbara Rockefeller of Rockefeller Treasury Services in Stamford, Conn. "If growth is high — and the window of opportunity to show that is small, to mid-October at the latest — the dollar will return to parity with the euro. I view this as the less likely scenario."

Rockefeller did expect the dollar to maintain a strong bias into September while investors and analysts worldwide tried to sort out the prospects for U.S.

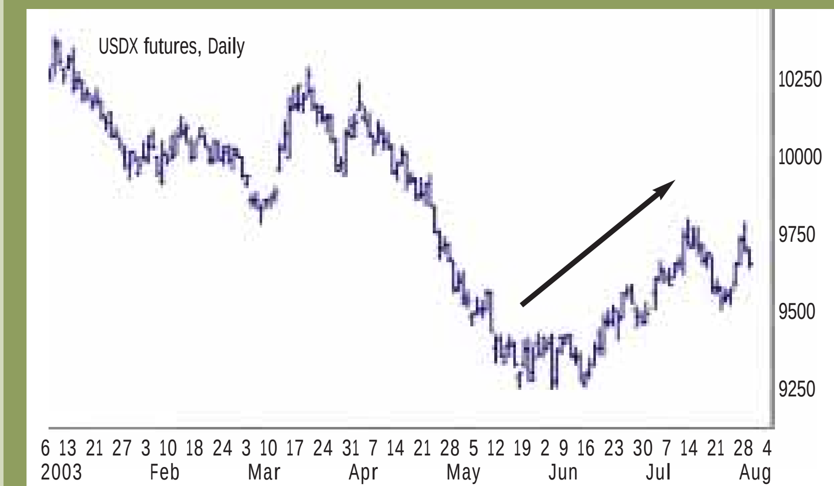
growth following this summer's rapid rise in interest rates and the surge in new Treasury issues to fund a rapidly mounting budget deficit. If the rise in interest rates reflects an expected increase in the rate of inflation, there will have to be an actual increase in broad-based growth to feed the inflation to justify the higher yields and stronger dollar.

"Does the dollar drop if growth fails to materialize by, say, October? You bet," Rockefeller concludes. "Bonds would rally on the re-emergence of 'unconventional measure' talk, even if [Federal Reserve Chairman Alan] Greenspan put the kibosh on actual bond purchases. In fact, there would be a dollar crisis because slow U.S. growth would not fix the current account by reducing imports much, and slow growth everywhere else damages exports. If the U.S. economy fails to deliver a third quarter with growth over 3% — and preferably, at a 4.5%-5.5% pace — the dollar is toast, and we are back to wondering if foreigners will fund the deficits."

Jes Black, currency analyst at MG Financial Group in New York, gives growth a little more time to show up.

JUST ANOTHER BEAR MARKET RALLY

The early summer rally kindled a debate about whether the U.S dollar was returning to a position of strength or just creating a hiccup in an ongoing downtrend.



Source: eSignal

TECH TALK: Which way for the dollar?

BY JOSH LEVY

There has been a sharp increase in the volatility of the U.S. dollar recently, reflected by price action as well as a marked spike in trading activity.

The U.S. Dollar Index, which measures the value of the U.S. dollar against a basket of major world currencies, provides valuable insights into currency trends although the index itself is not a popular trading instrument. Instead, trading the U.S. dollar vs. the Japanese yen, Canadian dollar, euro or British pound (quoted in "inverse" terms) are popular ways to express an opinion about the direction of U.S. dollar.

The U.S. Dollar Index finally posted a near-term base in June and then staged a rally attributed to two primary reasons:

1. Heightened economic recovery expectations relative to Europe have buoyed the U.S. dollar as higher equity index levels and higher interest rates are already beginning to factor in a rosier outlook.

2. Investable funds are moving back into the United States as interest rate differentials diminish as longer-term U.S. rates move higher.

The extent of the dollar rebound will hinge on U.S. economic performance. This is paramount, given U.S. dependence on foreign capital inflows from China and Japan and concern over the rising budget deficit. The forex market remains skeptical. Although trading activity indicated that U.S. dollar shorts were being covered in July, it appeared that traders were unwilling to initiate new longs. The dollar rally has thus far been fairly unimpressive and reflects a greater propensity of investors and speculators to hedge their dollar exposures and seek alternative currency and capital market instruments.

To summarize, the dollar is in a corrective recovery phase as of early August, and that could eventually extend further. A recovery extension will be largely dictated by the extent of improved U.S. economic data. Either way, the technicals point to an eventual thrust down to new multi-year lows. This suggests that economic performance will not be robust enough to attract sufficient demand for U.S. assets at prevailing rates, amid increasing U.S. dependence on foreign capital.

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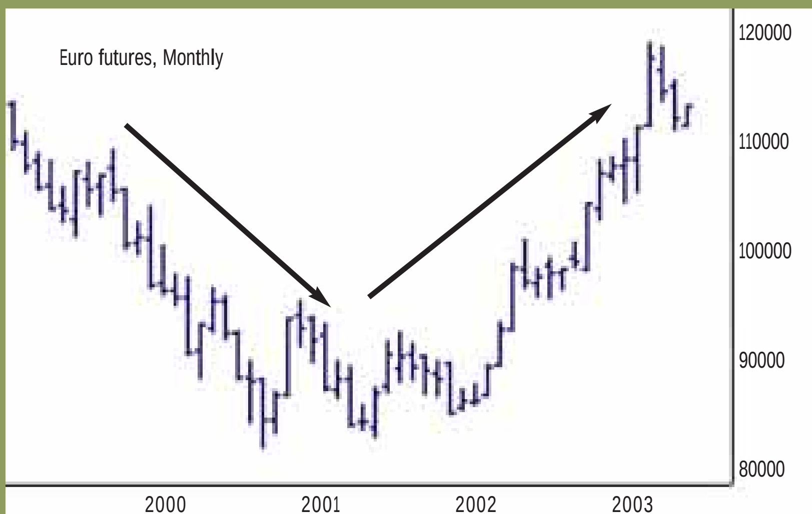
Source: www.CMCForex.com

NEW HIGHS AHEAD

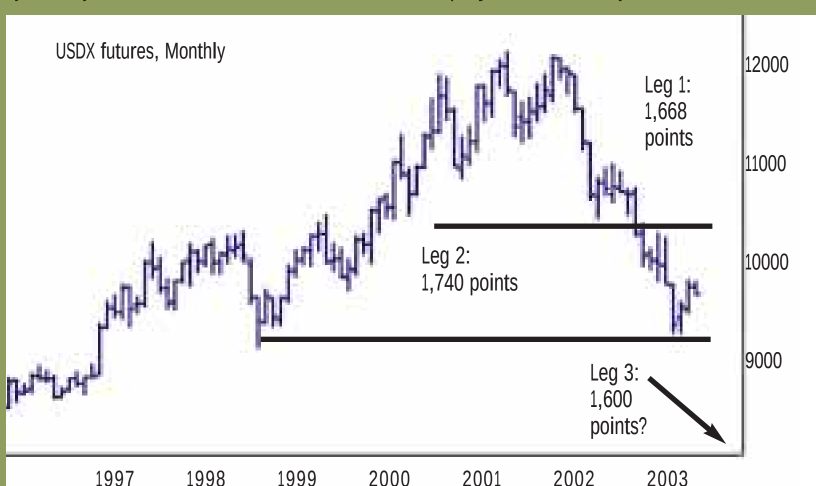
More than four years after its inception, the Euro made a run to record highs in 2003, and many analysts expect another rally will take it above 1.20.



Source: eSignal

A TREND IN PLACE...

Trends tend to persist, according to a market axiom, and that could extend the decline in the U.S. dollar that has been unfolding since late 2001. A possible target is the 1995 low at 80 (not shown), which would be another leg down of about 1,600 points, in line with two previous downlegs, notes Steve Briese, editor of *Market Revolutions*. "This type of symmetry is common and adds confidence to our projections," he says.



Source: eSignal

"The Fed will find itself in a quandary if the housing market slides and the economy does not reach a sustainable recovery by next year," he says. "Moreover, without credible assurances from Greenspan that more credit is forthcoming, a deflationary contraction in money supply could occur alongside an inflationary cycle if money flows out of bonds and other paper assets into 'things' we need, thereby driving up the cost of living."

"The core of the economic concerns surrounding the dollar remains the jobs and yields story," adds Ashraf Laidi, MG's chief currency analyst. "With 10-year yields testing the 5% level and job losses showing no signs of abating, the Fed's task of easing policy at the longer end or the yield curve remains challenging. Going forward, the duality of higher anticipated growth vs. the continued job losses will be the underlying factor shaping the dollar's route."

WHAT STIMULUS?

Stimulus efforts may not be that successful domestically. For example, some of the increase in defense spending, which accounts for most of the expected increase in gross domestic product, will occur overseas and has no long-term economic value. And whatever might have been gained by federal tax cuts is being offset by tax increases at the state and local level. "So that stimulus is out the window," observes Gerhard Isele, managing director of Emcor Securities Inc. in New York, who is among those looking for a weak dollar and no rebound until 10-year rates rise to 5.5% and 30-year rates to 6.5%.

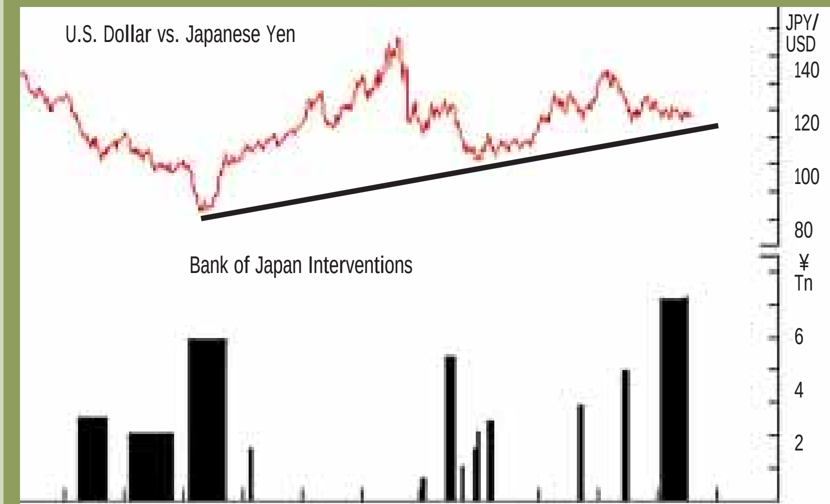
"Over the next three to six months, all of the recent dollar lows (except the USD/JPY rate) will be retested and then eventually shattered," says Tim O'Sullivan, trading manager at GAIN Capital, who believes the Bush Administration accepts a weaker dollar as long as the pace isn't frantic and doesn't cause a freefall in U.S. Treasuries. "However, it remains unlikely that the ECB will tolerate a 1.25 EUR/USD or 150 EUR/JPY rate, so expect heavy intervention at those levels. Six months down the road we can expect to see EUR/USD reach new highs to 1.23, with USD/CAD at 1.27, USD/CHF hovering near 1.25 and USD/JPY up to 123 with tremendous volatility in between."

Although the euro gets the most votes as the strongest currency going into 2004, the expanding eurozone community is still "dysfunctional" and unlikely to realize its dream of overtaking the United States as a top economic and reserve-money power any time soon, according to Rockefeller. Europe's unemployment rate of nearly 9% is the highest in three years, and retail sales and other economic indicators remain sluggish, not offering a lot of support for the euro. However, Europe is making some structural reforms, albeit very slowly, Isele points out, and some analysts believe the ECB will be forced to go the Fed route and reduce interest rates in September to spark growth, something it has been reluctant to do in stubbornly maintaining an anti-inflation stance.

"If I wanted to get provocative, I could say that the weakest currency against the dollar is the Swiss franc," Isele adds. "The Swiss franc is becoming sort of irrelevant as the country is turning into a theme park within Euroland with its own play money."

HOLDING THE LINE

As the yen threatens the uptrend line around 115 yen to the dollar, the Bank of Japan has been selling record amounts of yen to stop the currency from rising. A stronger yen could hurt Japan's export edge and abort the country's fragile economic recovery.



Note: Bars denote periods when the bank of Japan sold Yen for U.S. Dollars. Data for 2003 includes official MOF numbers plus an estimate for Yen sold during the months of April through June.

Source: BCA Research

LEGGING IT OUT

Steve Briese, editor of the *Market Revolutions* newsletter in Gulf Breeze, Fla. notes that "Two completed down-legs are clearly visible on the U.S. Dollar Index futures chart (see "A trend in place . . ." left). The second leg was completed in classic fashion, with increasing downward momentum. Major trends are usually comprised of three legs, and a potential target for the final leg is the 1995 low near 80."

Instead of the euro or other European currencies, Briese favors the "commodity currencies," including the South African rand, noting, "The situations in the Canadian and Australian dollars are more explosive (than for other currencies) in that only the first of three potential uplegs are complete" after consolidating substantial gains at the end of July.

Money managers, who were underweight Japanese stocks when the Nikkei Average began to rise as Japan's financial system stabilized, have poured more funds into Japan, strengthening the yen. That inward flow has put pressure on the Bank of Japan to keep the yen above 115 to the dollar to preserve Japan's export business and economic recovery, resulting in record intervention (see "Holding the line" above). Many analysts see no change in this attitude and look for the yen to stay in a 115-125 range.

China remains a question mark and could produce the most turbulence in the forex world in the next year. Getting most of the blame for exporting deflation due to its low labor costs and a huge expansion in exports, China is under increasing pressure to devalue the yuan, which has its value pegged to the U.S. dollar. As the value of the dollar sinks, so does the value of the yuan, giving China a competitive advantage in export markets and allowing China to take in billions of dollars that it can then invest in U.S. Treasuries.

The United States needs that money to fund its budget deficits. A number of U.S. firms also have established bases in China and depend on buying Chinese goods, and officials are pushing to increase exports of U.S. agricultural products to China. Further, the United States needs China to serve as a mediator with North Korea's upstart leaders, and then there's still the sensitive issue of Taiwan. So any U.S. pressure on China will proceed slowly and carefully.

If China does decide to become a bigger player in international trade policy and makes some adjustments in the yuan, the effects on forex as well as commodity markets are difficult to predict. For example, a devalued yuan could make U.S. grain prices look very cheap to Chinese importers and spark the upward move that cycle analysts have been predicting for commodities.

For many traders the ramifications of a shift in currency values on their markets may be more important than what happens in the forex market itself. The weaker dollar has already had an impact on commodity prices. Gold prices, for example, have risen about $100 an ounce in the last two years. Part of that is due to the uncertainty of geopolitical issues and expectations for inflation.

But the key factor is what hard-money advocates term the debasing of the dollar, and they are looking for more of the same. The price of gold in euros looks somewhat different than it does in dollars or on a global currency basis (when priced in special drawing rights), according to BCA analysts. FM

