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PROFIT & LOSS IN THE CURRENCY & DERIVATIVE MARKETS

A Contrarian Argument for a Stronger Dollar

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With so many calling for the long-awaited demise of the greenback, the short-US dollar trade has become increasingly crowded over recent months. Indeed, the case for further dollar declines is quite a valid one. Any number of potential pitfalls, not least of which include America's gaping deficits, central bank reserve diversification out of dollar assets and the Fed's monetisation of Treasury debt, could result in a precipitous decline in the US dollar. However, given that the US dollar remains the world's benchmark safe-haven asset, it will likely benefit in the coming months from the market's disappointment in the actual pace of global economic recovery versus its elevated expectations. Additionally, concerns about reserve diversification out of dollars will prove overblown as traditional surplus nations like China remain net buyers of US assets.

The third quarter of 2009 marked a continuation in the greenback's downward trend that was initiated by its steep declines in Q2. Moderating risk aversion over the past two quarters has fueled the broad unwinding of defensive long-USD positions that had been accumulated during the height of the market chaos between Q3 2008 and Q1 2009. Global investors, who were shell-shocked by the collapse of America's subprime mortgage market and subsequent crisis throughout global financial markets, flocked to the relative safety of dollar-denominated assets like Treasury bonds in droves. The massive spike in aversion to any asset with even the narrowest risk profile saw the US dollar index soar to its highest level in three years in early March. Since then however, mounting signs of stabilization in the global economy triggered a relief rally in risk assets on the notion that a worst-case "Great Depression" type scenario had been averted. The subsequent unwinding of dollar-denominated positions in favour of higher yielding instruments like stocks, commodities and emerging market assets pushed the US currency to a one-year low in mid-September.

Indeed, recent signs of stabilisation in the world's largest economy have been encouraging. Nearly all gauges of consumer and business confidence have rebounded sharply in recent months, with the University of Michigan's Consumer Sentiment Index currently near its highest level since February 2008. Manufacturing sector activity, as measured by the ISM, expanded for the first time since June 2008 in August, while the services sector put in its best performance since September 2008. Even the troubled housing market, suffering from its longest downturn since the 1930s, is showing signs of bottoming, with both new and existing home sales figures for July rising by 9.6%(m/m) and 7.2%(m/m), respectively. Employment remains a key area of concern for policymakers

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with the unemployment rate now at its highest level since June of 1983 and projected to continue rising even as the broader economy emerges from recession. However, the pace of job losses, which peaked at over 740,000 per month in January, has slowed markedly to just over 200,000 in August. These encouraging improvements have not been specific to the US. Both Germany and France, the euro zone's largest economies, surprisingly emerged from recession in the second quarter. China too, has shown surprising resilience, with its key manufacturing sector expanding at its fastest level in 12 months. Japan, the world's number two economy, recovered from an 11.7% annualised decline in the first quarter to grow by 2.3% annually in Q2.

While the relative strength of recent data from the world's largest economies has been a clear sign of stabilisation, it is not likely sustainable. To date, the US government has spent over $800 billion on a stimulus package aimed at infrastructure spending and aid to state and local governments. China spent roughly $600 billion on its stimulus package with the bulk of those monies earmarked for infrastructure projects and consumer assistance. Japan pumped $120 billion into its economy, Germany spent $100 billion and the UK and Canada anteed up $30 billion each. The countless billions of dollars in global fiscal spending are in addition to historic monetary easing, which has pushed global interest rates to record low levels. The average benchmark lending rate of the G7 nations is currently under 0.50%. Moreover, quantitative easing schemes in the US, the UK, the euro zone and Japan have added to the flood of cheap money sloshing throughout the global financial system. The short-term stimulus spending around the world aimed at avoiding a complete collapse of the global economy has been successful in providing a backstop for growth. However, rising unemployment will ultimately keep final demand in the industrialised world under significant pressure well into 2010. Household balance sheets have deleveraged significantly since the start of the recession and are expected to continue consolidating for the foreseeable future. The rising savings rate in the US combined with stagnant wage growth will keep consumers entrenched for the foreseeable future and will ultimately keep the pace of global recovery very subdued. As the "sugar high" of government spending fades over the coming months, aggregate demand is unlikely to have improved to levels that will be able to maintain the current elevated pace of global output. The resulting drop in production is likely to yield another dip, or a "W" shaped recovery.

The US dollar should benefit from the market's inevitable disappointment in the actual pace of recovery versus the elevated expectations that have been priced into many assets. Global financial markets are currently pricing in a "V" shaped, robust recovery. The Dow Jones Industrial Average is up over 46% from its March lows. Japan's Nikkei has rallied by 44% since March, London's FTSE is up 49% and China's main SSE share index is 70% higher than its lows in the winter. Commodities too have enjoyed a sharp rally on hopes of a near-term global rebound. The Commodity Research Bureau's Index is up 30% since its lows in the first quarter, with crude oil up almost $40/barrel in recent months. The pace of recovery currently being priced in by financial markets will ultimately prove overly optimistic, resulting in a pullback in investors' exposure to risk – an outlook that favors a broad return to safer assets like the USD.

The medium-term outlook for a stronger dollar is not, however, without considerable risk. The soaring levels of US government debt continue to seriously undermine the outlook for the greenback. A key concern for the dollar's longer-term outlook remains the threat of soaring government deficits and the Federal Reserve's monetisation of debt that could potentially result in a surge in inflation once a recovery begins to meaningfully gain traction. To allay market concerns, the Obama Administration has pledged to reign in government spending and reduce the deficit over time. The Federal Reserve has already begun to reduce the size of its balance sheet by allowing various credit easing facilities, including its $300 billion Treasury purchase program to run off (Fed purchases of mortgage and consumer loans will likely continue well into 2010). Worries about the US dollar's status as the world's reserve currency and reserve diversification remain an Achilles' heel for the greenback. However, key surplus nations like China and Japan remain net buyers of US Treasury assets, despite some of their recent rhetoric suggesting otherwise. Consequently, the dollar will rebound from its current oversold levels when investors begin to trim their exposure to risk assets as the pace of global recovery undershoots the market's overly optimistic expectations.

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