All Quiet On The Greenback Front

The Greek Chorus was a great dramatic device; it allowed the playwright to cue the audience into what might not have been obvious otherwise. Financial commentators hopefully provide a similar service today; we can stand off to the side and out of harm's way while chanting ominous warnings, some of which may eventually prove correct.

The year 2004 has seen greater action to-date by the Greek Chorus than by the *dramatis personae* we paid good money to see. Total returns for the major asset classes have been pretty soggy to say the least, as we can see from the table below, copied and pasted from the only working copy of the 1972 version of Microsoft Excel in existence.

2004 Returns In USD Terms

	Price Return	Total Return
Stock		
Russell 3000	1.47%	2.67%
Nikkei 225	0.97%	1.51%
FTSE 100	3.04%	6.30%
MSCI Euro	-1.05%	1.54%
Bond		
ML Treasury Master	-0.21%	2.97%
ML Pan-European	-2.56%	0.80%
S&P Real Estate	11.02%	15.70%
DJ-AIG Commodity	7.13%	NM

Only the S&P real estate index has provided a double-digit return, and as anyone who lived through the REIT selloff in April can attest, some real excitement. In fairness, the energy-heavy Goldman Sachs Commodity index would have provided double-digit returns had it, and not the more-balanced Dow Jones-AIG indexed been used.

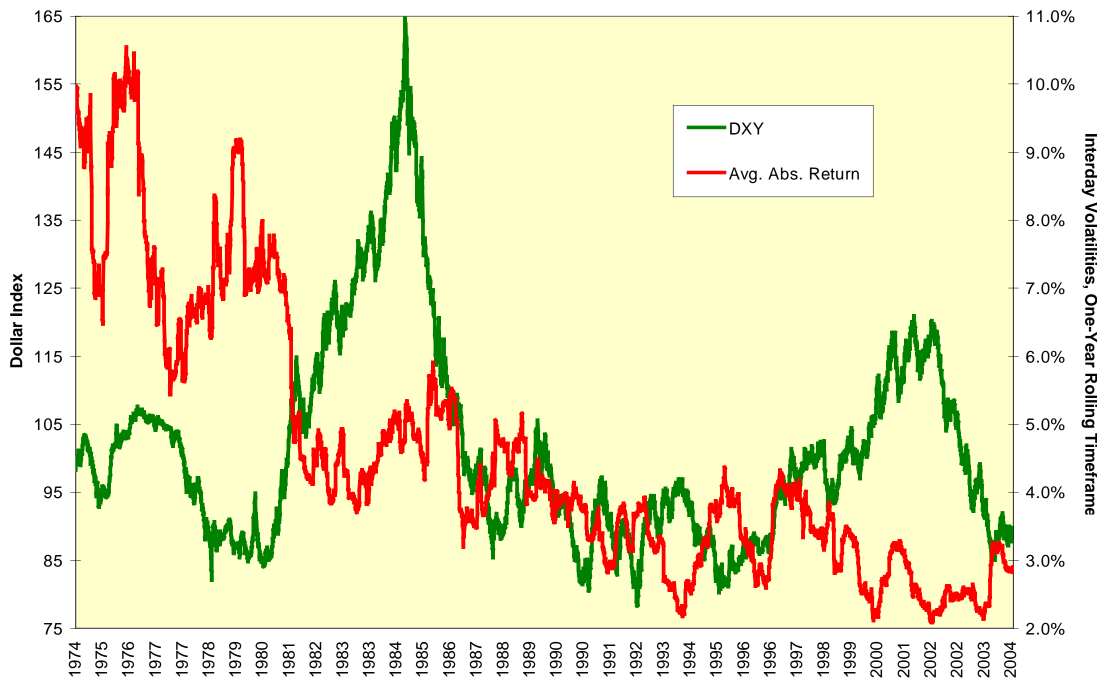
So, after all of the upwards-pointing excitement of the late 1990s, the brutal bear market of 2000-2002 and 2003's anything-worked rally, why can't any of these markets get out of their own way? Even the VIX, one of the favorites of the Greek Chorus when it wished to forewarn of an impending trip to Hades when its level became "too low," has dipped below 14 on occasion. How would Euripides translate "cruising for a bruising?"

Between Scylla And Charybdis

The Greek Chorus has had plenty to warble about this year. The list includes oil, terrorism, higher interest rates, uncertain economic growth, the impending election, the Olympics, record budget and trade deficits. But a simpler reason for why the wheels are stuck in the muddy ruts may be the dollar.

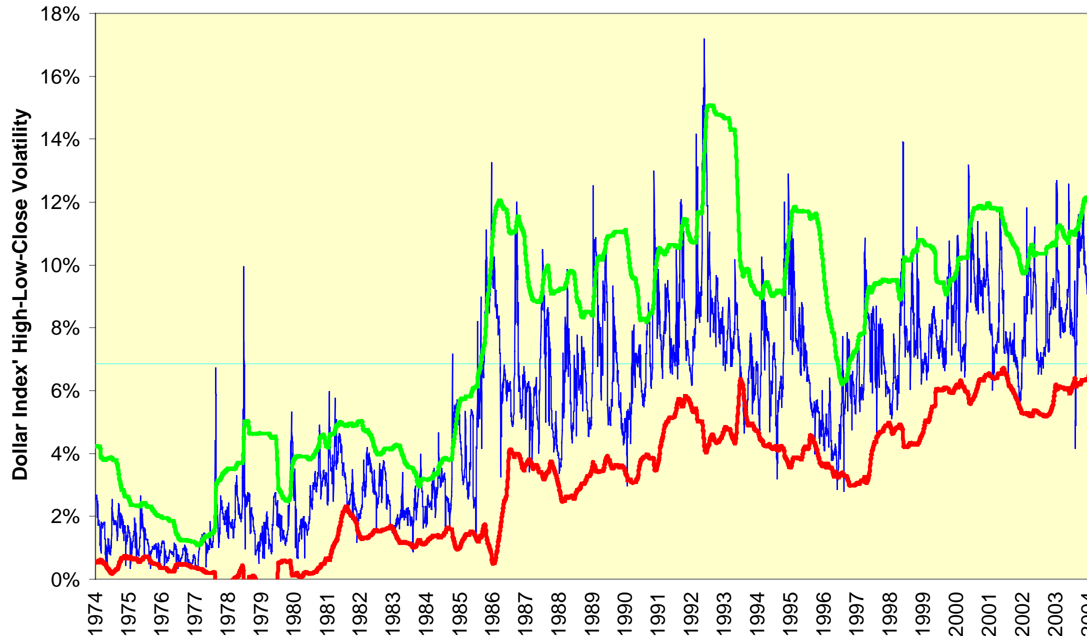
Yes, that is a cause, and not simply another symptom of little happening. The exchange value of the dollar is the one price that affects all others, not only in our $11.6 trillion GDP, but globally as well given the dollar's role as the world's only reserve currency. Each time the dollar moves, the relative advantages of importer to exporter, debtor to creditor, saver to spender, etc., change. It is these changes in relative economic advantage and the capital flows associated with the resulting reallocation of resources that produce so many of the changes in our financial asset prices.

Two ways to judge the stability of the dollar are its average interday price changes and its high-low-close volatility, a measure that takes intraday range into account. The first method depicts an average absolute daily return for the dollar index over the rolling one-year timeframe that is well within the normal bounds seen during the past decade while the dollar index itself has traded in a very narrow range since the start of 2004. This volatility measure is higher than it was for many time periods during the dollar's 1995-2002 rally and its subsequent decline, which is consistent with the feeling we have been bouncing up and down within a trading range.



The high-low-close volatility measure tends to expand when intraday price range dominates interday price change. The logic of this may appear counterintuitive at first, but if volatility is viewed as the price of uncertainty, then a market moving with great directional certainty should have a lower volatility than a market bouncing up and down within a range.

A depiction of this volatility measure and its 95% confidence interval shows the current 6.15% high-low-close volatility to be on the low side of the range prevailing since the 1987 Louvre Accord designed to stabilize the dollar, but nothing unusual. We can interpret this odd combination of low high-low-close volatility and a flat market as comfort with the fact we are going nowhere fast. Actually, this is the best interpretation I can offer these days for the low level of the VIX: Investors are ignoring the market and feeling good in the process.



Getting Off Dead Center
Currencies move for three reasons. The first and most important economically are the interest rate differentials between it and other currencies; such an analysis allowed me to call a top in the euro this past January. The second factor is an assessment by the market of greater inflation-adjusted returns on assets in one currency than in another; this is why so many high-rate currencies are also weak currencies. The third reason is special factors, such as the need for importers of Japanese goods to buy yen regardless of interest rates or asset returns to pay their exporters. Note how the trade deficit, however defined, is absent from this analysis. The next person to model foreign exchange rates from trade flows successfully will be the first to do so.

So which one of these factors will move the dollar off dead center? The Federal Reserve's careful communications policy has taken the mystery out of our short-term rate policies, and it appears as if other central banks are starting to prepare the markets for their next moves, too. What about greater returns on one nation's assets than on another's? This, if anything, has been moving in the other direction in recent years, and has prompted many to question the value of international diversification.

This leaves special factors such as wars, commodity shocks and unilateral changes in fiscal policies as movers of the dollar. The first two fall into the category of event risk, and my opinion is no better or worse than anyone else's in this regard.

Fiscal policies are another matter. If Washington starts to address the deficit by moving toward higher taxes and reduced spending in 2005, regardless of who wins the election, we will start to see a weaker dollar just as we did in the mid-1980s and mid-1990s. Nobel Laureate Robert Mundell noted this mechanism and how it would be compounded if the Federal Reserve started to loosen monetary policy in conjunction.

Such a move toward a weaker dollar, which could happen as soon as we get more electoral clarity, would lead to a global repricing of assets and a strong surge in volatility of returns. So rest up and get ready.