Disinflation And The Dollar

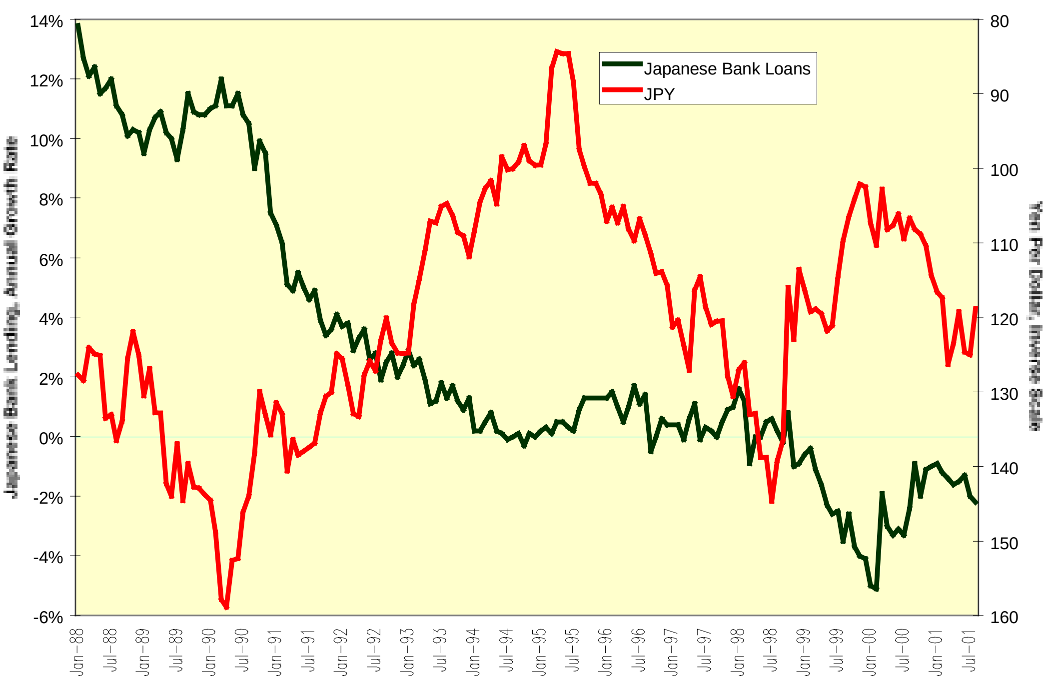
In this season of Thanksgiving, I can be thankful for the many RealMoney readers who have shared their thoughts, comments and concerns about the scribbling posted here. So, it is with a degree of apology that I offer two observations. First, I have learned angry e-mails spring from the pens of the more anxious among you; the more vociferously market positions are defended, the more wrong their authors are likely to be. The most recent example of this phenomenon came in June 2001, when I forecast a drop in petroleum prices based on a drop in tanker rates (see "Reading The Shipping News," June 15, 2001).

The second observation is that whenever readers ask when something is likely to occur, the opposite is more likely to materialize. Everyone, myself included, wanted to know where the top was in 1999, and everyone tried to call the bottom in 2001. That was a good use of mental capital, wasn't it? Recently, questions about deflation and the dollar's strength have been piling up, so I thought it might be useful to tackle these two simultaneously from the perspective of the ongoing debacle in Japan.

An Unexpected Twist

The notions that a currency's strength is a measure of global approval or reflects an economy's strength have a mixed basis in reality, but like most financial urban legends, they die hard. The Japanese economy has been in trouble since its combined equity and real estate bubble burst at the end of 1989, and nominal interest rates in Japan have fallen close to 0%, but the yen (JPY) has strengthened the most when bank lending has weakened the most.

Yen Strengthened As Bank Lending Stagnated



The reasons behind this inverse relationship are not that obscure. Bank lending in the U.S. is a lagging indicator of economic activity; it tends to peak after an expansion peaks as credit lines are drawn down in the face of declining profits to finance operations. Bank lending remains weak after an economic trough is reached, as borrowers are still reluctant to take on new financial risks.

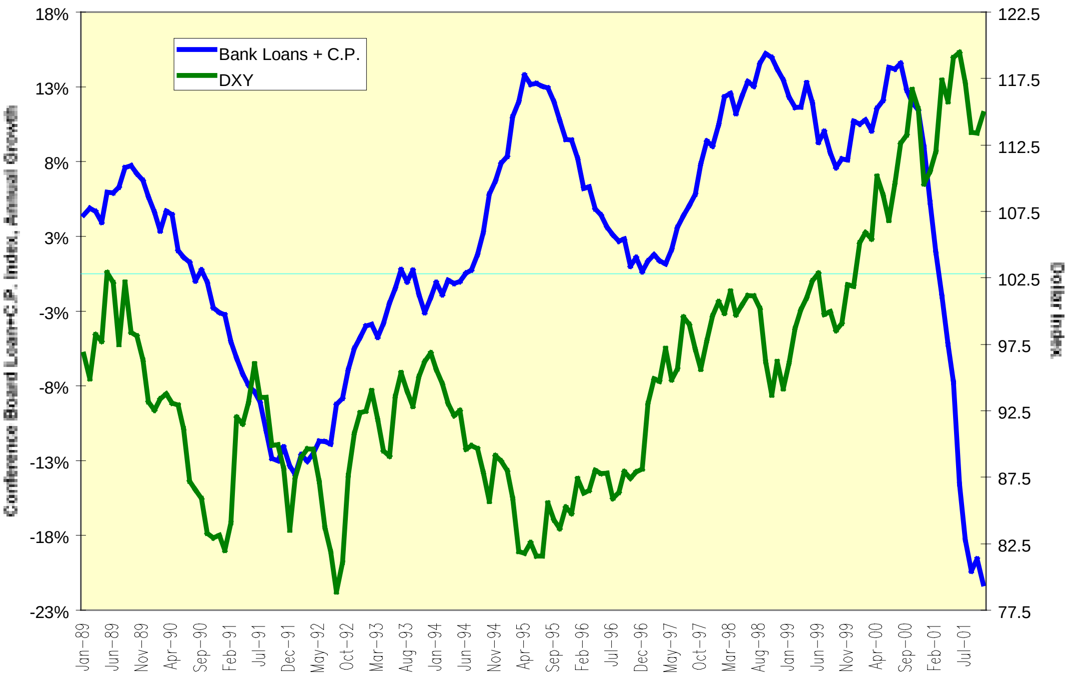
Bank lending in both Japan and the EU is more important than corporate bond and equity markets, which means bank lending is more of a coincident economic indicator in these economies. As business activity in Japan slows, Japanese exporters and creditors repatriate funds in lieu of bank borrowing, and this creates a high demand for JPY.

More important, however, is the impact of lower lending on total money supply. Even as the Bank of Japan has driven nominal rates lower and has engaged in quantitative easing policies, total credit expansion has been lackluster. Bank balance sheets are still staggering under the weight of non-performing loans, and banks prefer to lend surplus funds in the government bond market rather than extend new loans. Corporate borrowers, awash in surplus capacity, have little need to borrow. The weak bank loan market refuses to transmit the central bank's policies into the total credit market, and the result is a persistent deflation. If a currency is expected to become more valuable over time as a function of negative inflation, it rises in the foreign exchange market. This is the cycle noted in the chart above.

What About The U.S.?

Now, let's construct a similar picture for the American economy. Since many American corporate borrowers use the commercial paper market instead of the bank loan market, we'll use the Conference Board's index of bank loans plus commercial paper issued by non-financial corporations. The trade-weighted dollar index (DXY) will be used as a measure of the dollar's strength.

Can It Happen Here?



Credit demand fell during the recession of the early 1990s; this was to be expected. While credit demand turned higher in February 1992, the DXY remained under pressure until October 1992. The DXY then weakened in the face of growing credit demands until August 1995. But, the DXY has continued to move higher since regardless of a credit demand cycle as global investors sought it both as a refuge and as the currency representing the highest-returning assets.

The recent plunge in credit demand began in September 2000, and is the most precipitous in the history of the Conference Board data. It has continued in the face of ten Federal Reserve rate cuts and stands as testimony to 1) the Fed's complete mismanagement of monetary policy in 2000 and early 2001, and 2) the severity of the present recession.

What is in store for the greenback? Since credit demand is a lagging indicator of economic activity, and since plummeting credit demands will offset central bank policies here as they did in Japan. We should expect, therefore, a continuation of negative inflation and thus a strengthening dollar for several months into a new economic expansion, whenever that will be. Once an economic recovery is in place, rising credit demands will lead to an abrupt expansion of total credit within the banking system. That will send out re-inflation signals and produce a weakening, and perhaps a catastrophic weakening, of the dollar.

How shall we best play such an impending move? First, we'll have to make sure the economy is strengthening. Next, look to achieve non-dollar diversification by value stocks in East Asian and European markets. Finally, watch out for a prolonged bear market in U.S. bonds.