The Dollar May Be Calling A Bottom

Past performance does not predict future results, but what else are you going to use? Yes, markets are discounting mechanisms, but we all know the future cannot be predicted with any satisfactory degree of accuracy. All we need to confirm this is a search for how many of the more cautious pundits, present company included, forecast the extent and duration of both the market's spectacular rise or precipitous fall. One or the other doesn't count: A broken clock or an overpaid "strategist" can do that.

Since past data are both more abundant and more accurate than their future cousins, and since our brains are hard-wired to recognize patterns even when they are simply random occurrences, we are forced into the rearview mirror while driving at breakneck speed. Of course, sometimes this proves useful.

Find Quality And Flee Thereto

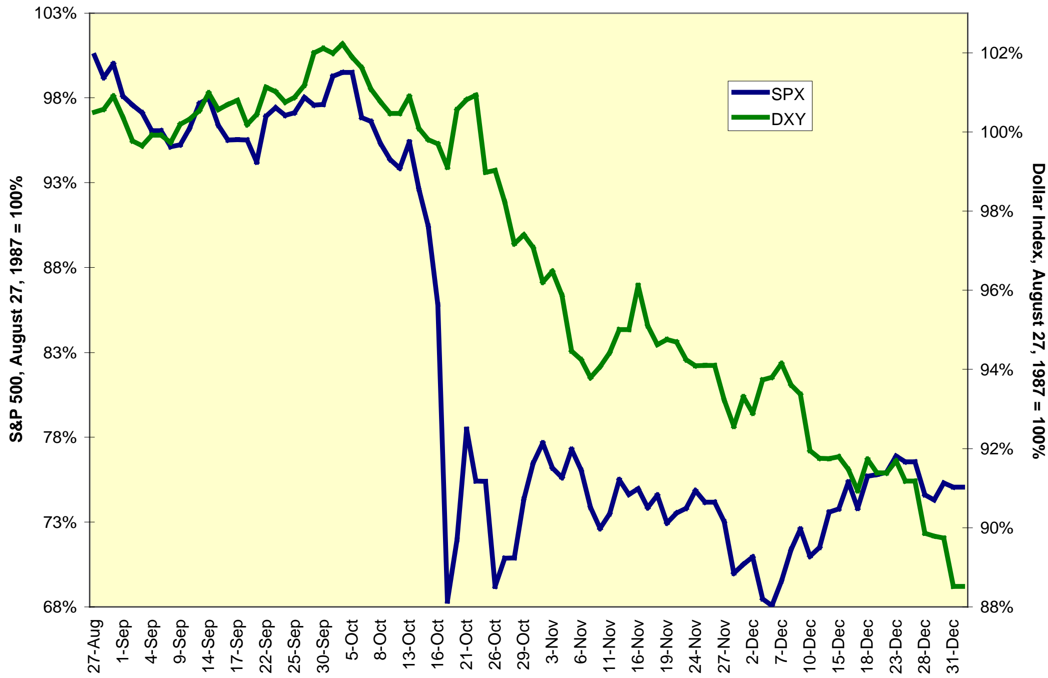
Ever since the advent of floating exchange rates in the early 1970s, a collapse in the U.S. stock market has produced a flight from the dollar. The reasons are simple and understandable. First, the massive U.S. trade deficit can be restated as an equally massive U.S. capital surplus. If foreign investors are large holders of U.S. securities – and nearly 37% of U.S. Treasury securities are held overseas – then selling of securities is likely to be accompanied by a repatriation of funds, at least in the short term.

Second, the notion the Federal Reserve is not targeting the stock market is starting to rank with "Of course I'll respect you!" in the dubious credibility category. The most colossal mistake in the Federal Reserve's history was its failure to provide sufficient liquidity after the 1929 Crash, and this failure is etched into the institution's memory. They must and will act in times of crisis to provide liquidity, not only to the U.S., but as we saw in 1997-1998, to the world as well. More dollars in circulation must mean each one is now worth less.

The third reason is more cultural than economic. Every nation has its equivalent of "Never Again." Germany will never allow hyperinflation to reappear, Japan never will permit another asset boom, and the U.S. will never allow a repetition of the Great Depression. Our social compact depends on it: The vast majority of ordinary Americans allow wealth and income disparities not seen elsewhere in the West since all Americans believe that we, too, shall be rich one day. This is reflected in our recent national politics: We felt so good about the economy that we allowed Bill Clinton to stay in office, while Al Gore's curious return to old-style populism was a contributing factor in his defeat. The rest of the world understands the Fed will err on the side of largesse, as it did in 1987, to prevent a repeat of 1930, and this raises the specter of dollar weakness and inflationary pressures down the road.

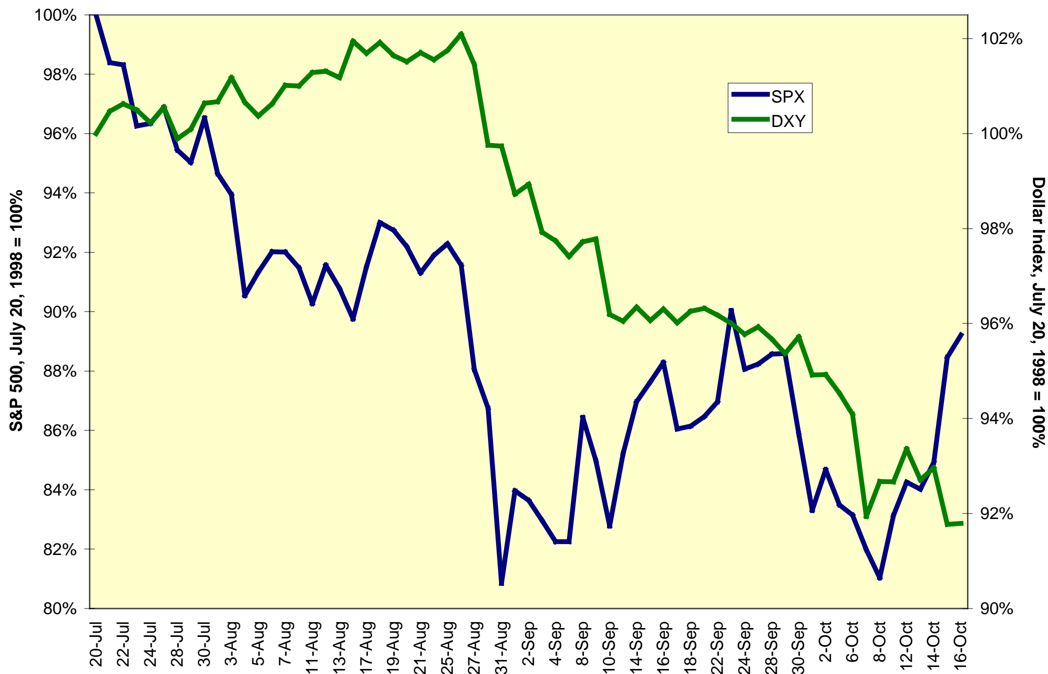
We can see this relationship in the aftermath of two different market crashes, October 1987 and August 1998. In 1987, the USD had been in trouble all year; indeed, the market's belief that the U.S. would defend the unit through higher short-term interest rates was a proximate cause of the October crash. Once the stock market fell and U.S. interest rates were cut in response, the USD continued to slide into the start of 1988.

The Dollar Index And S&P 500 After 1987 Crash



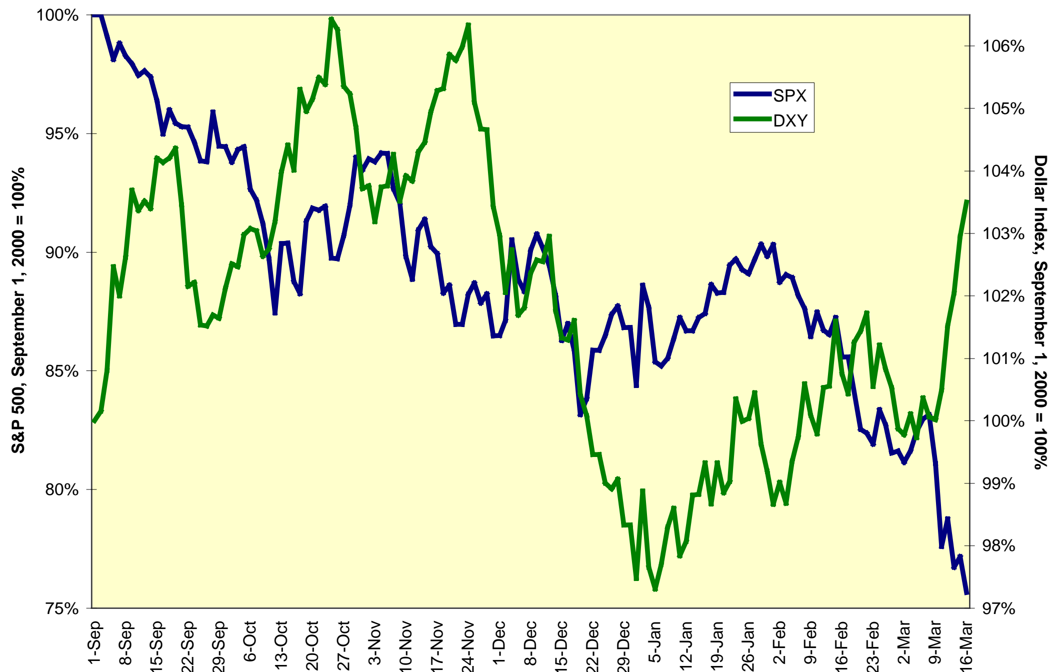
In 1998, the situation was quite different, but the outcome was similar. The USD remained firm in the early stages of the global equity selloff. It started to fall and fall sharply during the last week of August in anticipation of the Fed's rate cuts. It continued falling into the second rate cut in mid-October.

The Dollar Index And S&P 500 After 1998 Crash



The Present Situation

The ongoing bear market has an USD-SPX relationship completely different from the previous market crashes; the current market has not had a true "crash" yet. The USD hit a double-top peak in late November 2000, fell precipitously into the surprise rate cut at the beginning of January, but then reversed. The USD rallied into a widely anticipated rate cut at the end of January, and its rally accelerated in the horrible stock market week of March 12-16, 2001, a time in which all agreed further interest rate cuts were to be expected.



In the words of the Bard, what gives? Two lines of reasoning are suggested. First, the U.S. may be doing poorly, but the rest of the world, Japan in particular, is doing much worse. This would suggest a global round of rate cuts is in the offing.

The second, and more intriguing, possibility is the U.S. downturn is far more a stock market phenomenon than a macroeconomic phenomenon. The strength of the USD may be the currency market's way of saying that the ongoing rate cuts and possible tax cuts are going to have a very stimulative effect on the U.S. economy, that aggregate credit demands are not going to fall, and that profit growth may not implode.

If either aggressive global rate cutting or an impending economic recovery is bearish for U.S. stocks, that would indeed be a first. So, there is light at the end of the tunnel, and if the above analysis is wrong, that light will be attached to the front of a moving train.