Should We Fear A Stronger Dollar?

In markets, when you know what everyone else knows, you know nothing. And, at present, the consensus is the dollar will continue to weaken, and somehow this will create a problem for us in the indeterminate future. If we reverse this platitude, we should arrive at the opposite conclusion that a strengthening dollar will benefit the U.S. economy and financial markets.

Unsurprisingly, I beg to differ with this conventional wisdom. The biggest risk to the U.S. financial system will, incredibly, derive from what will seem like a normal and welcome firming of the dollar in response to the Federal Reserve acceding to the inevitable by raising the federal funds rate on May 4th.

First, I wish to make it clear, absolutely clear, I am not an advocate of a weaker dollar per se, nor am I falling back on the Reagan-era policy dubbed "benign neglect." I noted as far back as January 2001 that much of the stimulative effect of Federal Reserve rate cuts would derive from a weaker dollar. I began writing in May 2002 that the stock market would not be affected negatively by a weaker dollar. As a result, I fear being pigeonholed as a permanent advocate of a weak dollar. Perma-bulls and perma-bears are perma-useless.

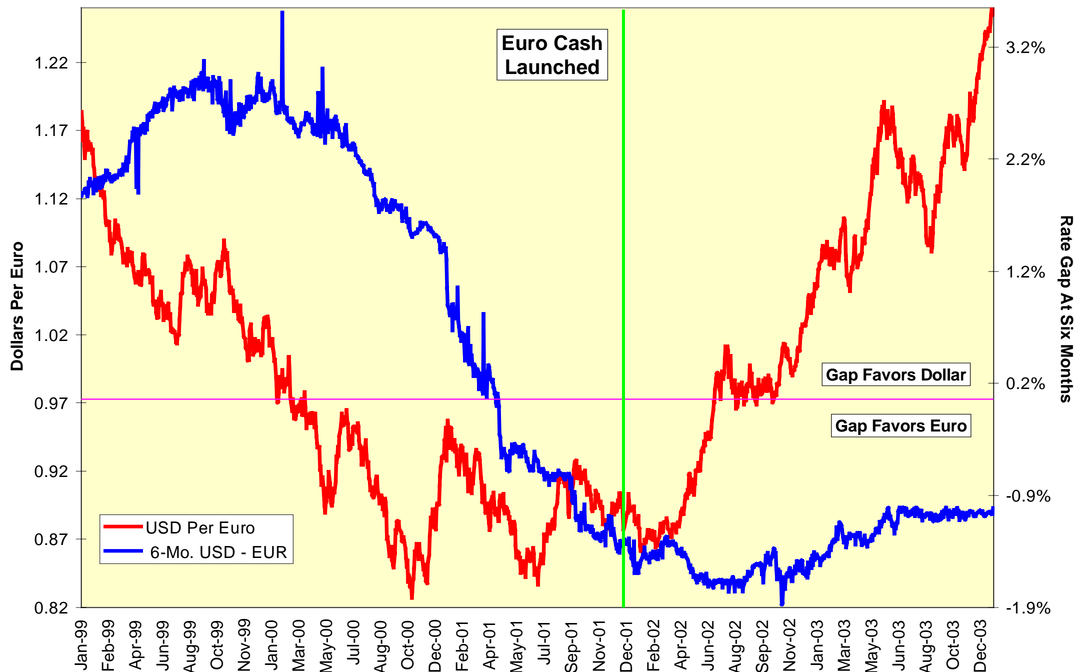
Nothing could be further from the truth; I have observed on numerous occasions that no country ever has devalued its way to prosperity and that a weaker dollar reduces the global purchasing power of Americans. A deliberate weakening of the dollar, one not the residual of defensible domestic fiscal and monetary policies, can wreak havoc on the allocation of resources within the economy.

One result of deliberate undervaluation of any currency is visible in the mercantilist imbalances of the East Asian exporters. The deal can be summed up as follows: We get the cheap goods and they get our bonds. Over the long-term, the quality of life gap continues to expand between the U.S. and these countries. Have you ever heard a traveler return from Japan and say, "Gee, I'd sure love to live there?"

The Interest Rate Gap

The dollar's weakness, particularly with respect to the euro, has been a function of nominal interest rate differentials and of special factors. At any maturity worldwide, there can be only one real rate of interest; otherwise, arbitrage would occur. As nominal interest rates are this real rate plus expected rates of inflation, relative currency strength should be a function of differences in expected inflation between any two zones.

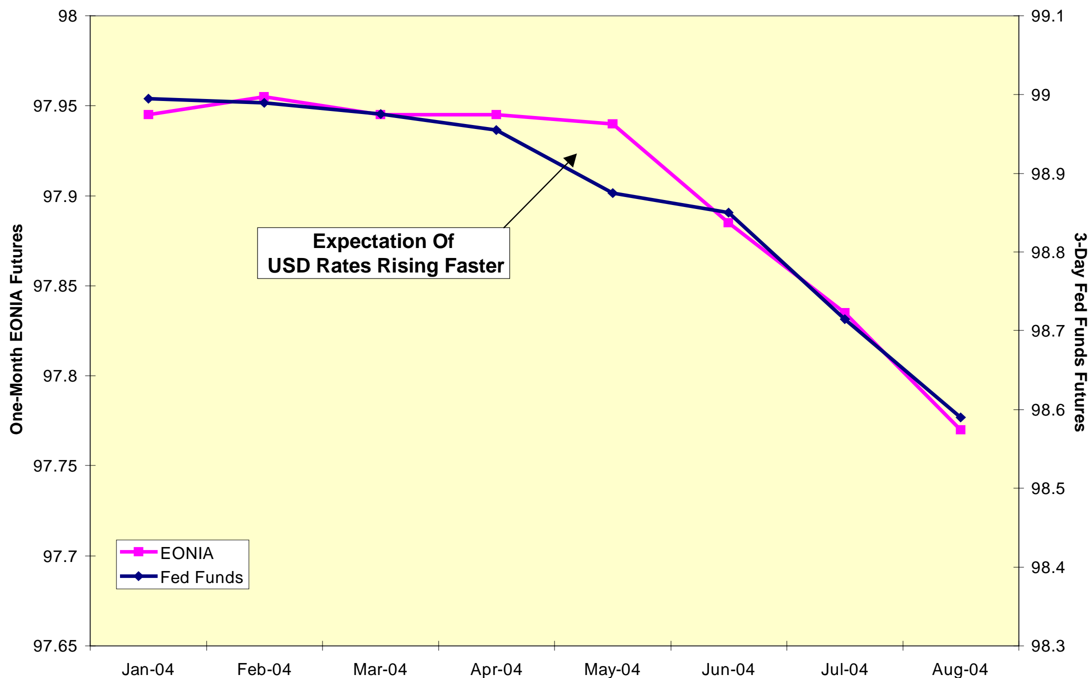
The Transatlantic Rate Gap And The Euro



This is a wonderful theory, but it tends to get knocked around quite a bit in the real world. Prior to the introduction of the euro five years ago this week, the dollar and Deutsche mark traded quite closely to their interest rate parity values. Since the advent of the euro, the rate gap and the currency have followed very different paths. Six-month rates in the U.S. started to narrow relative to their European counterparts in the summer of 2000, but the euro continued to weaken and remained on the ropes even as the rate gap moved in favor of euro deposits. Much of that weakness is thought to be due to various forms of national cash that had been hidden from the continent's tax collectors being sold surreptitiously for dollars prior to the introduction of euro cash at the start of 2002.

The nominal interest rate gap has not changed much since last June, but the euro continues to dance as if the band were still playing. The 16.4% run the currency has put on since the beginning of September can be justified if the market could see higher expected inflation in the U.S. than in Europe, but with nominal ten-year note yields virtually identical in the two zones, that is a difficult argument to make. One could propose the euro is responding to higher growth prospects in Europe than in the U.S., but that argument is inconsistent with virtually all reported macroeconomic data and forecasts.

Well, then, is the market expecting the rate gap to resume moving in favor of the euro? No, the forward curves of fed funds futures in the U.S. and EONIA (**E**uro **O**ver-**N**ight **I**ndex **A**verage) futures in Europe are sending the opposite message.



The fed funds market is expecting the Fed to start rescinding its rate cuts in May, and that should begin narrowing the rate gap. The euro's rise will be stemmed thereby, if not beforehand.

The Other Ocean

The story across the Pacific has been quite different. The dollar and Japanese yen almost never traded at interest rate parity. Why? Regardless of where the interest rate differential was with Japan, the permanent trade imbalance between the two countries meant that U.S. importers eventually had to buy (lend) the yen to pay their bills.

Japanese investors seeking higher returns and the Bank of Japan both sold yen and bought dollars, the latter agency still doing so in massive amounts - more than $100 billion by official scorekeeping - to keep the yen from strengthening further against the dollar. My concern is what will happen to U.S. bond yields and by extension to both the stock and real estate markets once this artificial source of stimulus for the American economy, the almost-reckless purchase of Treasury coupons by the Bank of Japan, is removed? If they no longer fear a plummeting dollar, will they cease their interventions on its behalf and inadvertently trigger a financial selloff once the dollar appears stable?

One of the lessons from 1994, repeated in July-August of 2003, is that only small changes in either the actual fed funds rate or expectations therefor can produce big changes in other markets as leveraged positions, particularly in mortgages, are unwound. The huge carry trade in Treasuries is dependent on both the low level of fed funds themselves and on the buying of foreign central banks to keep yields at the long end relatively low. Should the dollar start to rise in anticipation of the first wave of Federal Reserve tightening, a scenario for a massive repricing of long-dated bonds - and of all financial markets - could result.

The conventional wisdom sees the dollar and its present course as a problem by itself. The conventional wisdom, by definition, knows what everyone knows and therefore knows nothing. If technical analysis teaches us anything, it is that markets move most violently when "everyone" was wrong.