A Different Dollar Decline

Every now and then you get caught up in the excitement of something on your left and get blindsided on your right. The bruise on the starboard side belongs to yours truly in reference to the U.S. dollar. As the poet and songwriter Shel Silverstein noted in another context long ago, sometimes you just miss things.

The greenback as measured by the dollar index (DXY) had been meandering in a trading range between 87.90 and 92.60 for more than six months, and it became easy to ignore. Nearly all of its movements could be lain at the doorstep of either the Federal Reserve or the European Central Bank and their various on-again / off-again indications about their respective courses of monetary policy. After all, the euro together with the closely related Swiss franc, Swedish krona and British pound account for 77.3% of the DXY.

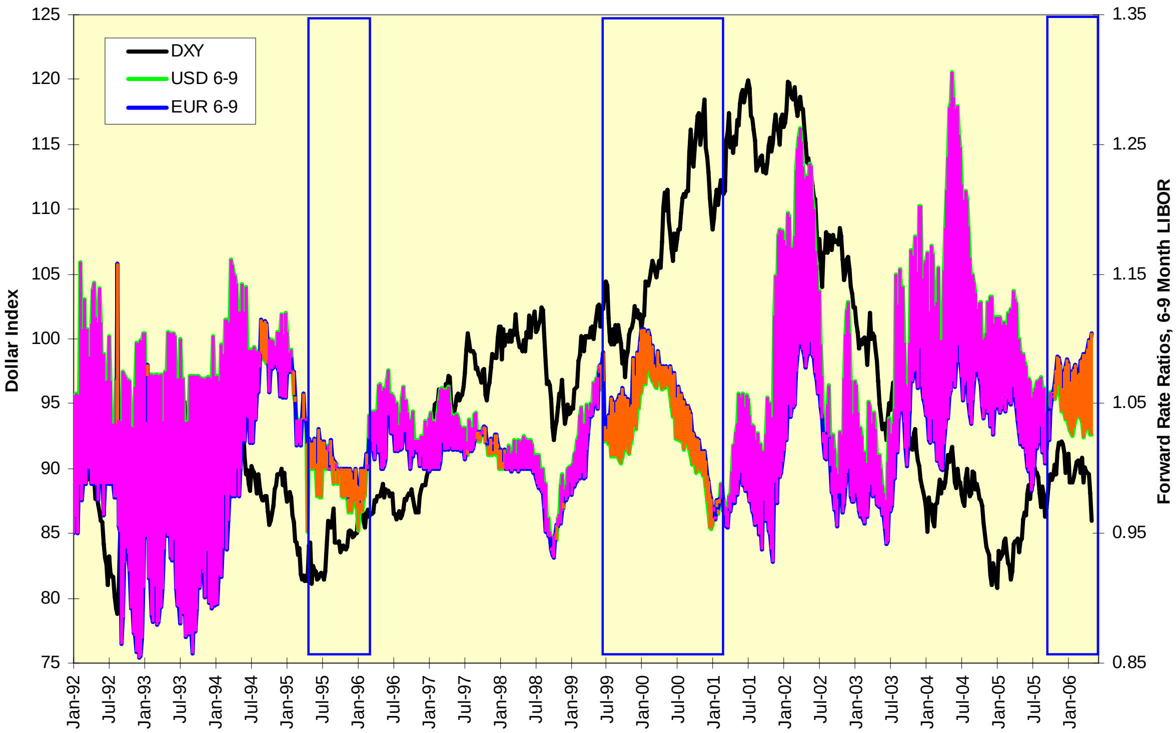
The last time I took a look at the subject, November 2005, I noted you could throw out all the histrionics about the U.S. twin deficits, those of the federal budget and the current account, and simply compare short-term monetary expectations between the U.S. and Europe:

> Currency markets are not morality plays.
>
> The spot exchange rate reflects, among certain other factors, the relative returns between borrowing in one currency and lending in another. In the money market horizon, the most important for currency traders, these return differentials are determined first and foremost by expected changes in monetary policy between the two countries. We can summarize these expected changes by measuring the shape of the LIBOR curves between six and nine months; three months from now when the typical three-month forward transaction is unwound, today's six-nine month curve will reflect the then-prevailing three-six month conditions.
>
> We can measure the shape of these curves by taking the forward rate between six and nine months -- the rate at which you can lock in borrowing for three months starting six months from now -- and dividing it by the nine-month rate. The more this ratio exceeds 1.00, the looser the monetary policy is expected to be. Critically, these forward-rate ratios are comparable across economies and across interest rate levels.
> If we compare these forward rate ratios for the dollar and for the euro as reconstructed back to 1992, we see how U.S. monetary policy was significantly looser than Eurozone monetary policy over that period, as depicted in the pink shaded areas. This included the periods of 1992-1994 and 2001-2005, both of which saw a declining dollar. The periods wherein U.S. monetary policy was tighter, highlighted in orange and with blue rectangles, include late 1995, 1999-2000 and -- you guessed it -- today. All of these periods coincide with dollar strength.
>
> Given the Federal Reserve's rate-hiking stance and the unwillingness of *les poulets* at the European Central Bank to follow suit, we have every reason to expect dollar strength to continue.

Fundamentals, Huh! What Are They Good For?

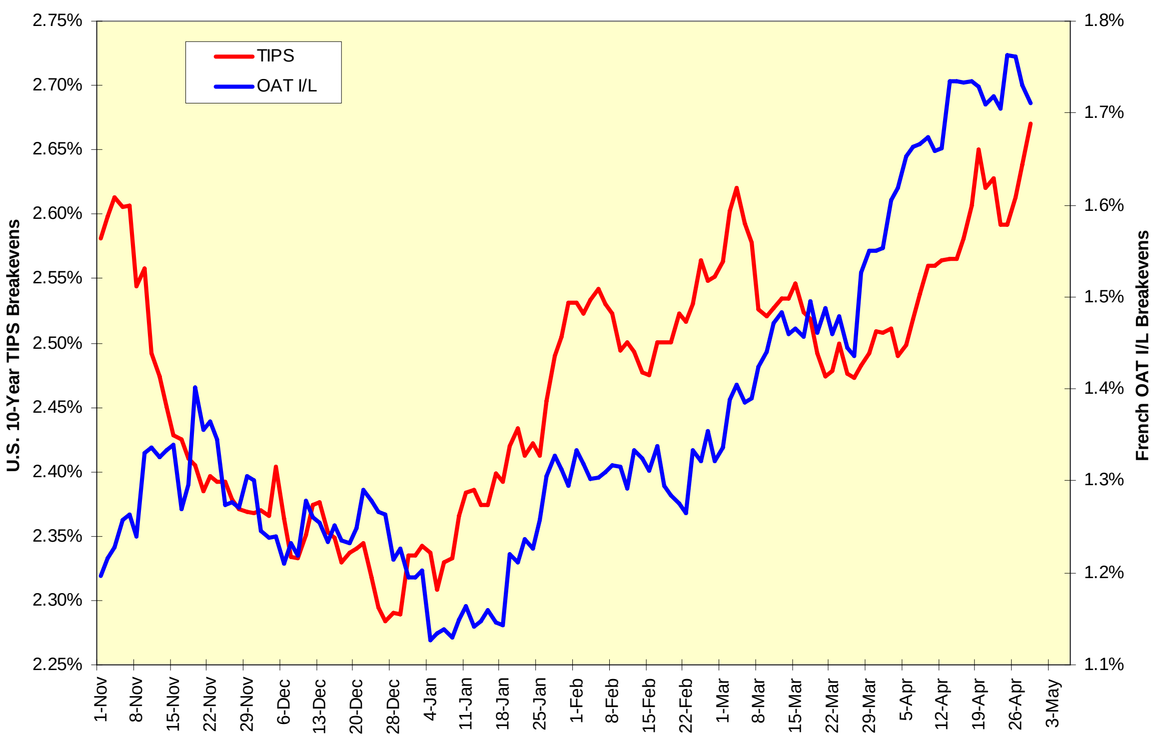
So what happened when I decided to pay attention and update the chart referenced above? The expected monetary policy advantage of the U.S. vis-à-vis Europe has increased since last November. By logic and experience, the DXY should be firming.

Steepness of Money Market Curves Drove Dollar Until Recently



Can we account for the broken relationship by comparing differential inflation expectations at the ten-year horizon? It is a nice theory, but it breaks down on the data: If we compare the inflation expectations in U.S. TIPS and in French OAT inflation-linked bonds, we see their relative growth rates have not been all that different since November.

Differential Inflation Expectations



If all of the reasons given by the dollar permabears were in force during the dollar's 2005 rally, and if the normally reliable interest rate fundamentals are wrong, we should be ready to accept structural reasons for the dollar's burst of weakness. One is the central banks of our creditors, chiefly the Banks of Japan and China, are unlikely to increase their relative holdings of dollars. We should be happy if they maintain those holdings. Another is the U.S. political bias, one apparently accepted by Federal Reserve Chairman Bernanke, to risk inflation over recession.

These are topics for another day. Which U.S. stock groups are helped and hurt by a weaker dollar vis-à-vis the Canadian dollar, Japanese yen and euro? Using the same technique first introduced here in February 2005, let's sort S&P 500 industry groups by their currency sensitivities. The groups in the top cells are those expected to underperform if the dollar weakens further, while the groups in the top cells are those expected to outperform in a weaker dollar environment.

S&P Industry Group Sensitivity To Currencies

Canadian Dollar		Japanese Yen		Euro	
Group	Beta	Group	Beta	Group	Beta
Airlines	(0.426)	Wireless Services	(0.243)	Drug Retailers	(0.299)
Home Ent. Software	(0.317)	Motorcycle Mfg.	(0.236)	Food Distributors	(0.280)
Drug Retailers	(0.285)	Drug Retailers	(0.218)	Casinos	(0.201)
Food Distributors	(0.236)	Photo Products	(0.208)	Computer Storage	(0.186)
Wireless Services	(0.224)	Publishing & Printing	(0.205)	Dept. Stores	(0.177)
Environmental Services	(0.216)	Food Distributors	(0.184)	Apparel & Access.	(0.176)
Tobacco	(0.212)	Hypercenters	(0.181)	Environmental Services	(0.166)
Air Freight	(0.203)	Household Products	(0.168)	General Merch.	(0.166)
Pharmaceuticals	(0.201)	Apparel & Access.	(0.156)	Advertising	(0.161)
Household Products	(0.192)	Biotech	(0.147)	Specialty Stores	(0.156)
Brewers	(0.179)	Leisure Products	(0.125)	Tobacco	(0.140)
Distributors	(0.178)	Food Retailers	(0.117)	Leisure Products	(0.134)
Publishing & Printing	(0.172)	Data Processing	(0.117)	Food Retailers	(0.133)
Food Retailers	(0.169)	Pharmaceuticals	(0.108)	Data Processing	(0.132)
General Merch.	(0.149)	Healthcare Equip.	(0.107)	Healthcare Services	(0.122)
Multiline Insurance	(0.147)	Air Freight	(0.096)	Household Products	(0.119)
Advertising	(0.146)	Office Services	(0.093)	Publishing & Printing	(0.118)
Healthcare Equip.	(0.137)	Integrated Telecom	(0.091)	Computer Hardware	(0.109)
Restaurants	(0.136)	Packaged Foods	(0.086)	Pharmaceuticals	(0.093)
Data Processing	(0.132)			Packaged Foods	(0.082)
Integrated Telecom	(0.129)			Office Services	(0.082)
Systems Software	(0.114)				
Packaged Foods	(0.112)				
Soft Drinks	(0.107)				
Other Div. Finance	(0.105)				
Electric Utilitiles	0.135	Divers. Banks	0.082	Divers. Banks	0.085
Specialized Finance	0.135	Other Div. Finance	0.090	Asset Mgmt.	0.112
Industrial Gases	0.137	Thrifts & Mortgages	0.096	Electric Utilitiles	0.112
Building Products	0.145	Indus. Machinery	0.096	Fertilizers	0.274
Construction Mach.	0.151	Commun. Equip.	0.130	Aluminum	0.302
Diversified Chem.	0.175	Trading Comp.	0.139	Integ. Oil & Gas	0.324
Paper Packaging	0.176	Building Products	0.157	Oil & Gas Explor.	0.363
Metal & Glass Cont.	0.218	Specialized Finance	0.165	Steel	0.384
Integ. Oil & Gas	0.443	Household Appliances	0.167	Oil & Gas Equip	0.387
Homebuilding	0.460	Asset Mgmt.	0.171	Oil & Gas Drilling	0.397
Aluminum	0.477	Home Furnishings	0.206	Homebuilding	0.399
Oil & Gas Equip	0.569	Computers & Elect.	0.226	Oil & Gas Refng.	0.488
Steel	0.700	Aluminum	0.232	Divers. Metals	0.856
Oil & Gas Explor.	0.721	Steel	0.311	Gold	1.478
Oil & Gas Drilling	0.730	Internet Retailing	0.344		
Oil & Gas Refng.	0.864	Homebuilding	0.410		
Divers. Metals	1.332	Divers. Metals	0.502		
Gold	1.426	Gold	0.925		

The clear winners are in the Energy and Basic Materials groups: Oil, Steel, Aluminum and Gold. Electric utilities and the homebuilders should outperform as well. Many of the groups expected to underperform include those part and parcel of our everyday lives: Retailers of various descriptions: Household Products, Apparel, Advertising, Pharmaceuticals, Restaurants, Packaged Foods, Tobacco, Casinos and Brewers.

One macroeconomic implications of a weaker dollar is a relative loss of discretionary consumer purchasing power. If the hairshirt crowd finally gets its way, we are going to be slaves to gasoline and not enjoy shopping, clothing, advertising, drugs, food, cigarettes, a roll of the dice or a couple of cold ones.

If you were lacking a reason to root for the dollar before, I hope I have given you several here today.