The Dollar Index and the Twin Deficits

The Long, Strange Trip Could Get Even Stranger

Go saunter over to your local library and dig into some business magazines from the late 1980s. You will see all sorts of stories telling you why the U.S. should be more like Japan. Here I am happy to report Mission Accomplished: We, too, have had a Lost Decade, massive public deficits and near-0% interest rates for years. It is too bad the actual 1980s suggestions were for the U.S. worker to consider business as war and do silly things like morning calisthenics with colleagues and (shudder) sing the company song.

That era also was characterized by nonstop fretting over the twin deficits of the federal government and the current account trade balance. Never mind the federal deficit then was trivial compared to today's levels or the current account deficit has proven to be easily financed, the concern by the frowny-face crowd was U.S. interest rates would have to soar to attract foreign capital. The idea ten-year rates would have punched below 2% by 2011 after Congress punted on a debt ceiling measure and after Standard & Poor's downgraded the U.S. would have seemed like science fiction.

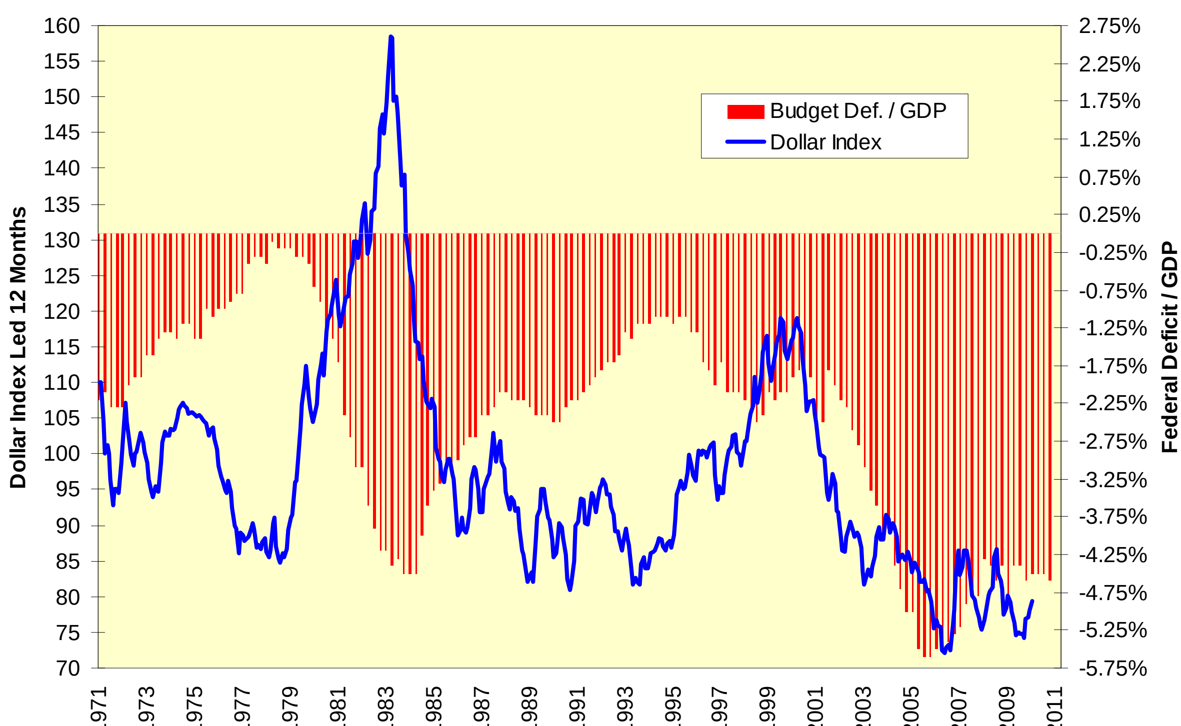
OK; it still does.

The Dollar And Deficits

A second fear was the dollar was going to get trashed by all of this deficit abuse; the Federal Reserve would turn on the printing press and leave it on, leading to a flood of increasingly worthless greenbacks. That has proven true on an absolute scale, as evidence by gold's long bull market, but was not true on a relative scale as other countries have turned on their printing presses, too.

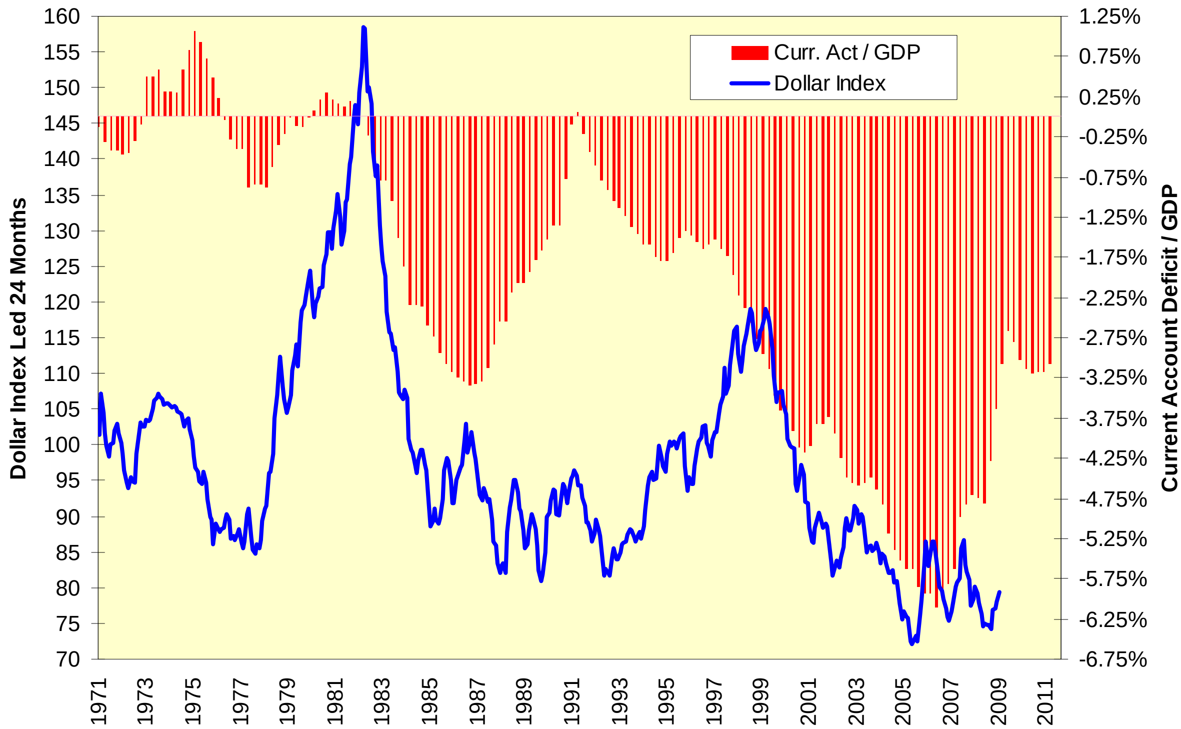
The net result here has been the dollar index' ability to hold long-term support in the upper 70's even as federal red ink continues to flow. A measure of the federal deficit normalized to GDP show the deficit measure leading the dollar index by 12 months on average; tellingly, the two previous moves to narrow the deficit in the late 1970s and late 1990s did in fact lead to rallies in the dollar index.

The Dollar Index And The Federal Deficit



The lead time between the normalized current account deficit and the dollar index is twenty-four months. As the current account deficit narrows, generally a recessionary phenomenon, the dollar index strengthens. This pattern is likely to repeat, especially if the euro remains under pressure. The common currency accounts for 57.6% of the dollar index.

The Dollar Index And The Current Account Deficit



Neither deficit is likely to disappear in 2012. Given the euro's troubles, money-printing in Japan, the U.K. and Switzerland, all components of the dollar index, we should see some upward pressure on the greenback even as we continue to abuse our creditors, yesterday's caveats about China and Japan duly noted. It might behoove you, therefore, to start looking at one of the many long ETFs available for the U.S. dollar, such as the PowerShares DB Dollar Bullish Fund (UUP) or simply to trade the dollar index futures from the long side.

As far as those nonstop complaints about the dollar's weakness over the years, I cite Huey Long: "One of these days the people of Louisiana are going to get good government – and they aren't going to like it."