The Dollar Index Winning By Default

Excess Carry Returns Into Its Six Components Are Declining

The Fourth Great Lie over the years has been the Treasury's oft-repeated statement, "The U.S. has a strong dollar policy." This ranks right up there with, "I was only trying to make the market more efficient." Some things simply lose credibility when you give them forty years of reasons to do so.

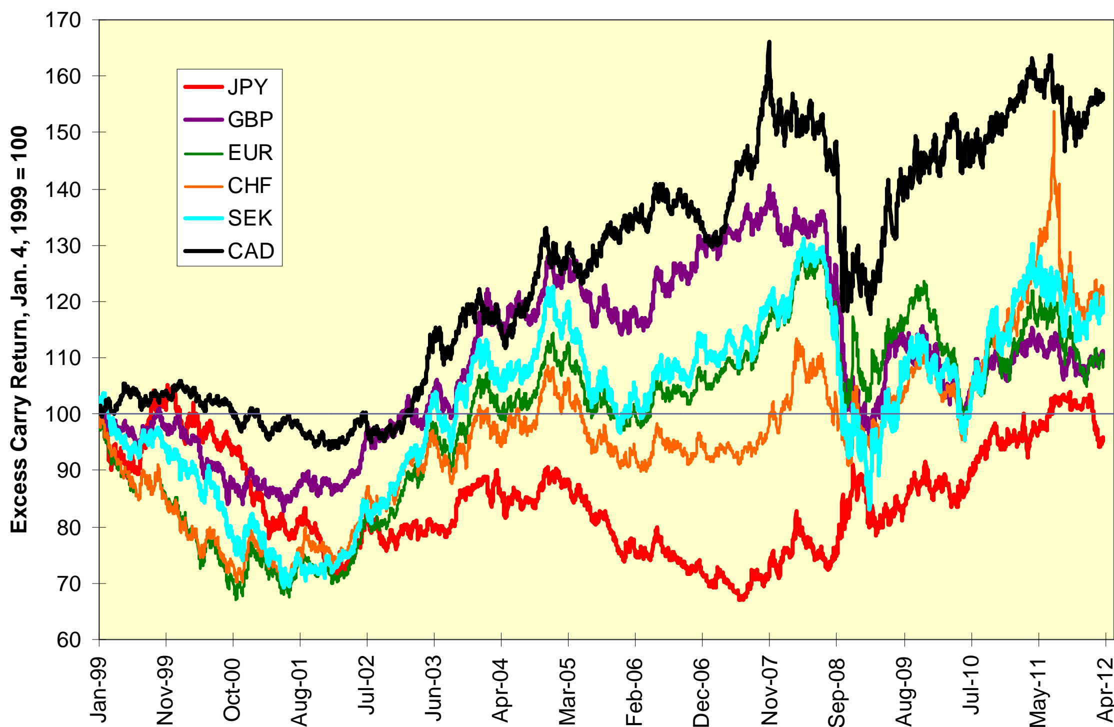
Of course, it takes two to tango, especially when the Argentine peso is involved; at least Buenos Aires has dropped the pretense of an independent central bank. The dollar as measured by the dollar index can gain on a relative basis when its sparring partners either cannot get out of their own way, as has been the case with the euro and British pound, or when the respective official managers declare war on their own currencies, as has been the case with the Japanese yen and Swiss franc.

As an aside, it is something of a theological exercise in establishing an absolute value for the greenback. If we want to use gold as a measure, the total return on the Dow Jones-UBS gold sub-index has been -13.4% since Labor Day in 2011. If we want to use any of the price indices, the dollar continues to lose domestic purchasing power. If we use rational expectations, the dollar should be avoided in favor of almost anything else as it can be created at near-zero cost and it yields less than expected inflation when lent back to its issuer.

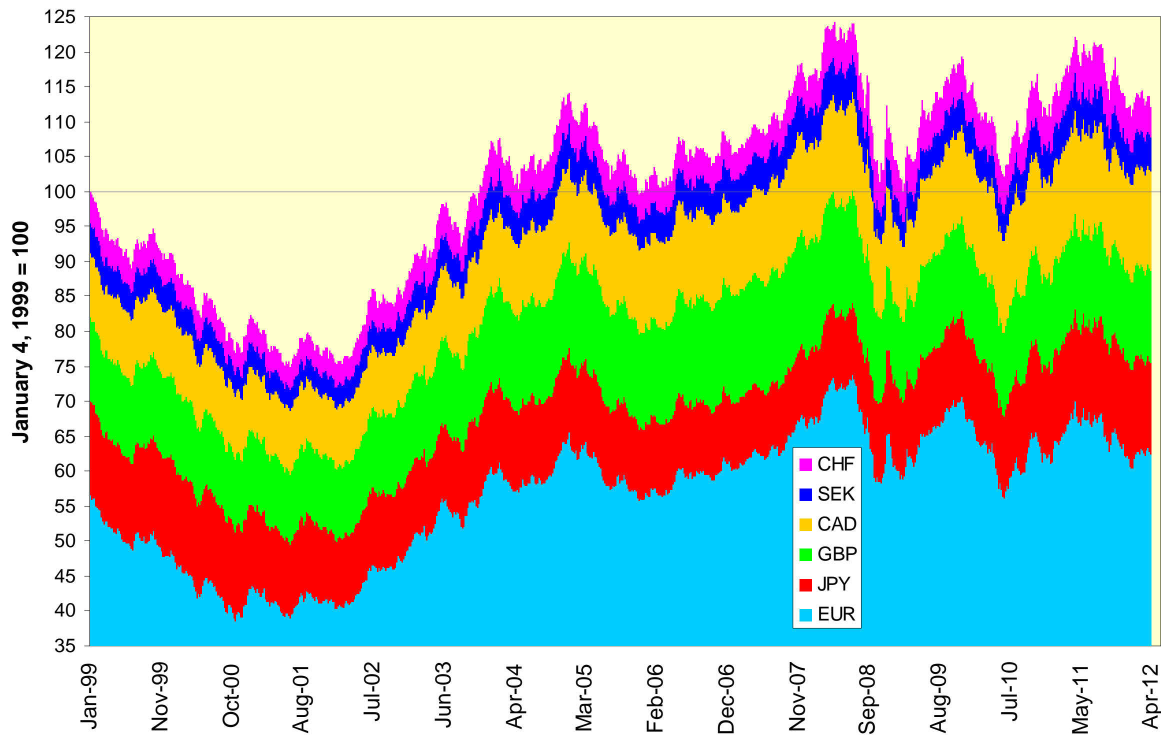
A Market of Currencies

If we take a look at the excess carry returns from borrowing the dollar and lending into the six component currencies of the dollar index, the engineered declines in the JPY and CHF are very clear. To be fair, the panic buying of the CHF in 2011 as a result of the never-ending European sovereign credit crisis was just as spectacular.

Unweighted Excess Carry Returns For Dollar Index Components



If we weight the six excess carry returns in accordance with the index, the overall trend becomes much clearer along with some surprises. First, the excess carry return peaked on April 22, 2008, almost four years ago. Neither QE1 nor QE2 nor hints of QE3 pushed it over the edge. Second, the weighted sum has been declining since August 29, 2011; we have to ask ourselves if the dollar has been in a bull market for six months why it has not felt like one.



As the EUR accounts for 57.6% of the dollar index by weight, it will drive the index. Its excess carry return peaked on July 11, 2008, the Friday before the Treasury backstopped Fannie Mae and Freddie Mac (FNM and FRE) and the very weekend when the Chinese yuan was re-pegged without further ado (What further ado would have sounded like, I do not know).

As the U.S. has done everything in its power to drive the USD lower and the European Central Bank et al still have some ammunition left to kneecap their own currency, I will have to lean toward supporting the dollar index. You can trade this directly via instruments such as the PowerShares Dollar Bearish fund (UDN). Oh, and send Treasury Secretary Geithner a postcard congratulating him on the strong dollar. He will be happy to hear from you.