TrendMacrolytics

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Dollar Rally: What It Is, and What It Isn't

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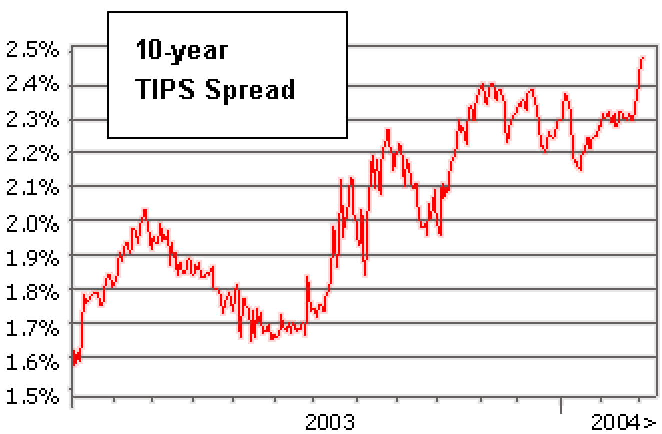
The dollar move suggests only that we might avoid the worst-case inflationary scenario.

The dollar's recent rally against gold and foreign exchange should be clearly understood for what it does -- and, even more important, does not -- represent. The comeback for the unit of account has closely corresponded with a shift in the expectations climate, moving forward the anticipated commencement of **Fed** tightening. These changing expectations primarily reflect a growing sense, buttressed by data releases such as this week's ISM manufacturing survey, that persuasive evidence of a labor market rebound will soon leave the Fed with little excuse to continue delaying the inevitable lifting of the funds rate from its current super-easy level of 1%.

To this point, however, we have seen few indications that the central bank itself perceives any reason to alter its stand-pat posture. If tomorrow's employment report is once again deemed "disappointing," the shift in policy expectations toward a more accelerated rate hiking schedule will likely be reversed, leaving the dollar and gold vulnerable to another reversal as well. Moreover, we would caution that the dollar's 4 to 5% recovery over the last two weeks -- with gold trading in ranges in the low $390s and the euro just below $1.22 -- still leaves it down more than 10% relative to the levels it held last summer prior to the inescapable evidence confirming that the Fed had remained too easy for too long. This suggests that, thus far, the dollar's move can be seen as a moderation of the forward inflation bet, but hardly represents an unwinding of expectations that significantly higher inflation lies ahead.



As if to underscore the point, the recent gains in the dollar have come against a surge in the spread between nominal 10-year Treasuries and their inflation-indexed (TIPS) counterparts. At nearly 250 basis points, the TIPS spread has jumped by about 20 bps just since last week, and now is at levels not seen since the months following the introduction of TIPS in 1997. It's worth noting, for comparison, that the spread was around 170 bps early last summer. With the nominal 10-year note holding in ranges just above 4%, the spread widening has been accounted for almost entirely by a rally in the inflation-indexed bonds, which are now yielding less than 1.6%. The seemingly quiescent inflation expectations indicated by such a low nominal yield, in other words, obscures the fact that the market increasingly is opting for inflation protection insurance, in the process effectively raising the inflation premium in nominal yields.

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Surely, we don't rule out the possibility that indications of a revitalized job market will mount in the coming months, and compel the Fed to finally face the task of normalizing its excess liquidity posture. Indeed, given the growing indications of robust business expenditures on capital goods and inventory accumulation, we'd be more surprised if the payroll data on which the Fed fixates doesn't soon take a decidedly positive turn. If so, the market's revised bet on the timing of the Fed entering rate-hiking mode -- with fed funds futures now priced odds-on for 25 bps in August and 50 bps by November -- could well come to pass. But the bulging of the TIPS spread even in the face of these more hawkish expectations reinforces our hunch that such a tightening schedule would be inadequate to preclude a run of markedly higher inflation than what has come to be regarded as the norm. Still, if the current expectations timetable proves correct -- with as much as 100 bps in rate hikes by next March -- our central bankers would still have a good chance to limit the damage to what we see as the low end of a range of possibilities. That would put core statistical inflation in the realm of 3% annualized within the next 12 to 24 months, versus an eventual rate of 5% or more if the Fed maintains its see-no-evil approach to inflation risk through this year, which many observers continue to expect. TM