TrendMacrolytics

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Strong Dollar?

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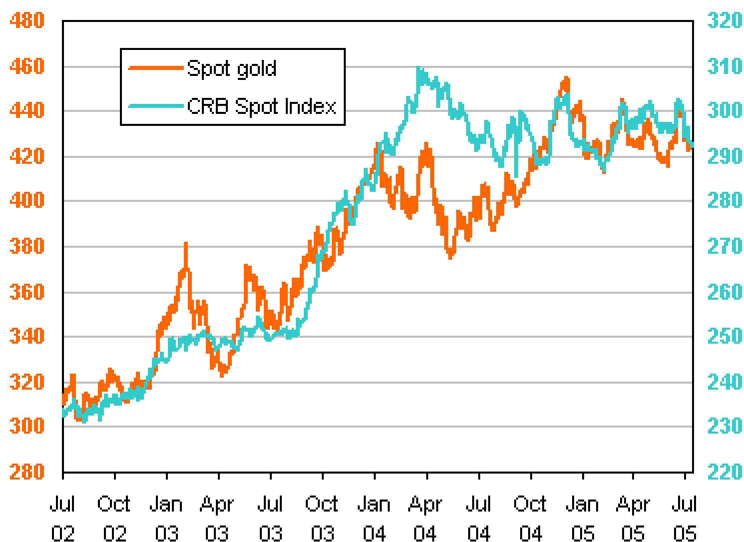
Don't be fooled -- signals from the dollar and the CPI only *seem* benign.

The recent meanderings of the **US dollar** against its major foreign counterparts underscores the care one should exercise in interpreting the change in **relative value of currencies** in a **floating rate**, **fiat money** world. Since mid May, for example, the dollar has strengthened, on net, by 5% against the **euro**, with the **European** common currency today buying $1.21, versus about $1.27 two months ago. The **G-6 Trade-Weighted Dollar Index**, the largest component of which is the euro, has risen about 4% during this time. Over the same period, however, the dollar's real value as indicated by **gold** and other **commodity prices** has been flat. The dollar price of gold is trading in a range around the $420 levels seen then, while the **CRB Spot Index** -- which excludes **oil** -- is slightly lower.

From this perspective, it becomes apparent that the ostensible dollar **strength** is more properly seen as a **real weakening** of other currencies, chiefly the euro. This is borne out by the fact that the euro has fallen by proportionately the same amount against gold as the dollar has risen against the euro, with euro gold rising from €332 to about €349. The **European Central Bank** has established an admirable record in maintaining the euro's real value against a steadily weakening dollar over the bulk of the past few years. But confidence that it will have the authority to continue to do so has eroded significantly in the wake of voter rejection of the **EU constitution** and the subsequent political buffeting it has taken to use monetary means to enliven the continent's chronically moribund economies. This highlights the vulnerability of the common currency project seen by many of its skeptics in the pre-launch phase. Given the realities of constituencies wedded to Europe's rigid labor market regulations and welfare state guarantees, monetary policy becomes a natural target for political elites seeking to boost **growth** but unable or unwilling to undertake the needed market-based reforms.



With this political risk unlikely to abate anytime soon, the euro could continue to weaken and the dollar appear to strengthen against the common currency, which will push it higher as well in terms of the broader G6 index. In some circles, the dollar's recent forex performance is already being taken as a sign that **the Fed** is **tight** enough, and that further action would risk another bout of **deflation.** But this overlooks that in terms of **real purchasing**

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power, the dollar remains weak. As seen in the chart on the previous page, gold and the CRB Spot Index have followed largely corresponding paths during recent years. The period from mid-2002 through early 2003 -- with gold having recovered from its lows below $280 to trade largely in a range around $325 to $350 -- was the salutary **reflation** phase of the Fed's **policy cycle**, correcting for the deflationary error of the previous five years. Stating in mid '03, the Fed entered **hyper-accommodative** mode, and while these indicators have come off their weakest levels, they remain in ranges indicative of a **still-easy policy stance**, pointing to rising future **inflation**.

It's simple enough, on a day when the **CPI** prints with an innocuous **core rate** of 0.1%, to dismiss such concerns. But we believe that would be short-sighted. In a massive data aggregate like CPI, ephemeral influences can at times produce anomalous short-run results. It appears, for example, that a significant factor holding down the core measure in recent months has been **apparel prices**, which dropped by 5.2% at an annual rate in the second quarter. Such a decline, however, is unlikely to persist. In the past three months, the year-on-year core rate has dropped from 2.3% to 2.1%, which at first glance might appear to break the trend line pointing higher, which began after the rate bottomed at 1.1% in December '03. Such seeming departures from trend are not terribly unusual, however. We note that in the last inflation breakout, the year-on-year core rate fell from 4.5% to 4.1% during a three-month period in 1989. After that brief pause, the rate reaccelerated, and did not top out until reaching 5.6% in early 1992.

Avoiding a repeat of that experience may require that the Fed maintain its current course even longer than we had anticipated. Our supposition has been that getting the **overnight rate target** to 4% or 4.25% would probably be sufficient to reach an **equilibrium posture** implying a balance in supply and demand for **dollar liquidity**. In recent weeks, however, **interest rate futures** have moved toward pricing for a greater probability of at least a 4% rate by year end. **December '05 Eurodollar futures** are now priced for a better-than-even chance of a 4% target rate. Three weeks ago, they were 50/50 between 3.5% and 3.75%. Today, gold fell below $420 for the first time since early last month, but in a highly volatile market suggesting a relatively low level of confidence that the move will be sustained. When there is a decisive break to levels below $400, we'll know the market is signaling that the Fed is poised to establish an equilibrium stance. Until then, the task facing the Fed will remain incomplete.

Bottom Line: The dollar's recent strength on foreign exchange markets cannot conceal that in real purchasing power terms, the currency remains weak, pointing to the need for continued Fed action to forestall a worst-case inflationary breakout. In the past few weeks, the benchmark **10-year Treasury yield** has risen by about 30 bps in keeping with a recalibration of Fed **rate-hike expectations**. At some point, however, the **bond market** will also face the need to reprice for a significant recalibration of its totally benign inflation outlook. TM