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The Dollar: The Tallest Pygmy

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If the dollar is so strong, why is gold even stronger?

Since early last month, the price of gold has risen by more than $90 to around $920 against a backdrop of conflicting deflationary and inflationary forces. The credit market panic which had been driving up cash demand persists, but has notably moderated, while the Fed maintains and expands its extraordinarily bounteous liquidity posture (see "What is Gold Trying to Tell Us?" February 3, 2009). Over this period, the dollar has rallied, up about 8% against the euro and 5% against its G-6 counterparts on a trade-weighted basis.

This is a highly unusual pattern. Since the floating exchange rate regime was established in 1971, there have only been two other brief occasions when a significant gold price escalation corresponded with a strengthening forex value for the dollar -- once in the early 1970s and once in the early 1980s. A rising gold price is indicative of a surplus supply of liquidity relative to demand, which typically is consistent with a weaker currency. What's going on?

Update to strategic view

US DOLLAR: The dollar's strength on forex markets is an illusion. Declining sharply in real terms as measured against gold, the dollar is merely less weak than most other currencies.
US BONDS: With the 10-year yield creeping back up to near 3%, and with the dollar exchange rate complicit in signaling false comfort about inflation risk, the Fed grows increasingly likely to intervene to cap yields, by buying long term Treasuries.

[see Investment Strategy Dashboard]

Viewing a currency's value strictly from the perspective of its price relative to another currency can be misleading. The exchange rate is a bilateral function of how the policy environment and risk factors impacting *two* sovereign governments affect the value of their currencies *relative to each other*. Looking at any given exchange rate movement in isolation, it's impossible to say whether one currency is rising against another because its value is appreciating in real terms or because the other currency's value is eroding. That's why we use gold, the most monetary of all commodities, to serve as a common measuring stick in assessing the changes in the real value of currencies.

In the present situation, what we find is that while the rise in dollar gold indicates a real weakening of the US unit of account, the purchasing power of competing currencies has fallen even further. For example, while gold priced in dollar terms is up about 11% since the beginning of the second full week of January, euro gold is up 17%, and sterling gold is up about 14%. The

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dollar cannot be said to be strengthening in real terms. In real terms, measured against gold, it's just *less weak* than the other currencies.

Going forward, we think the forces at work point to further dollar erosion relative to gold, with the Fed giving every indication of maintaining its generous liquidity posture indefinitely. But how the dollar performs relative to other currencies, will depend on the actions of monetary authorities in the individual countries. In the euro-zone, the European Central Bank today refrained from cutting its target rate -- currently at 2% -- but the euro fell on indications that it remains inclined to ease further, perhaps substantially. The European response to the banking crisis is hobbled by the fact that there is no mechanism for euro-zone debt issuance and other Treasury-type rescue functions. So more of the burden for relieving the distress may unavoidably be assigned to monetary policy, with an inflationary outcome being the least bad option.

The Bank of England today cut rates to an all-time low of 1%, but sterling rallied on signs that it may be preparing to at least pause in its rate-cutting exercise. But the UK faces other critical issues that could have highly negative consequences for the currency. Its quasi-nationalization of RBS is sowing worry that such action could be undertaken on an even broader scale, potentially leading to default or its functional equivalent, hyperinflation.

That potential for an inflation surge certainly cannot be ruled out in the US either, looking ahead through today's seemingly deflation-dominated statistics. With Treasury bond yields on the rise, partly a result of relief from the deflation risks that had been infecting the market, the Fed's announced preparedness to purchase long-term government debt might soon be operationalized. While at about 2.9% the 10-year yield cannot be viewed as high in any absolute sense, it's more than 80 bp higher than it was at its lows in December, soon after the Fed first broached the possibility of acquiring debt. The pop in yields cannot be comforting to policymakers seeking to revive private credit markets by keeping government bond yields at rock-bottom lows. Under current conditions, with the economy in a sharp downturn and inflation risk widely considered a non-factor -- in part, no doubt, thanks to the dollar's illusory strength on forex markets -- Fed purchases would likely have the desired short-term effect of pulling yields lower. But depending on the volume of the purchases, the longer-term effect of the liquidity added to the system could have significant inflationary consequences, particularly in combination with the array of other liquidity injecting programs that the Fed is now operating. Moreover, with the massive borrowing requirements now being incurred by the federal government, investor resistance to accepting debt at such low yields could also compel the Fed to intervene, seeking to keep yields in check. That would be a course of outright debt monetization, with obvious inflationary implications.

BOTTOM LINE: The dollar's strength on forex markets is an illusion. Declining sharply in real terms as measured against gold, the dollar is merely less weak than most other currencies. With the 10-year yield creeping back up to near 3%, and with the dollar exchange rate complicit in signaling false comfort about inflation risk, the Fed grows increasingly likely to intervene to cap yields, by buying long term Treasuries.