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# Constructive Currency Signals

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**As in 2003-2004, emerging market forex indicates there are more than enough dollars.**

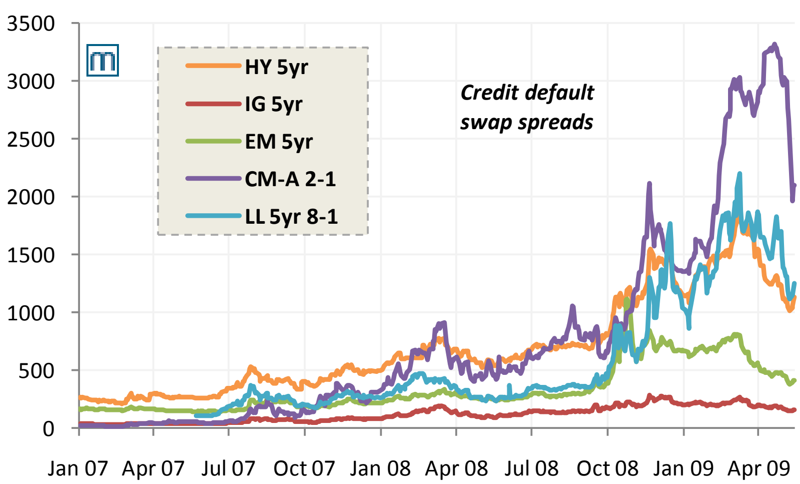
The easing of intense risk abhorrence and the associated relief from the deflationary surge in dollar demand that so roiled global markets last fall and earlier this year can be clearly seen in the rally now underway across the currency markets of the emerging market economies. The pounding these currencies absorbed in the panic raised fears of a potentially calamitous wave of defaults on dollar-denominated debt in many emerging markets (see "Emerging Relief" November 4, 2008). Now their recovery coincides with a dramatic drop in implied debt default rates -- leading the pack among all classes of risky debt (see the chart below) -- and must count as significantly assisting in the restoration of global financial and economic stability.

**Update to strategic view**

**US DOLLAR:** The rally of emerging market currencies stands as a solid indicator that the period of excess dollar demand being driven by extreme risk abhorrence has come to an end. Recovery of these currencies should continue, as the Fed remains in an ultra-easy policy stance, and shows no inclination to adjust its posture to changing conditions.

[see Investment Strategy Dashboard]

Among the most impressive performers, the Brazilian real has gained about 17% since early March, after losing more than 35% against the dollar in the panic beginning late last summer. The Indonesian rupiah lost more than 20% from last September through mid-February, but has picked up about 15% since. The Russian ruble, with its troubles compounded by the plummeting crude oil price, fell by more than 35% through early March. With an assist from the rally in oil prices, it has since gained about 12%. Both the Brazilian and Russian central banks conducted dollar-buying interventions last week to slow the rise in their currencies, but appear to have had little impact. Indeed, Russia's central bank is forecasting a continued rise for the ruble.

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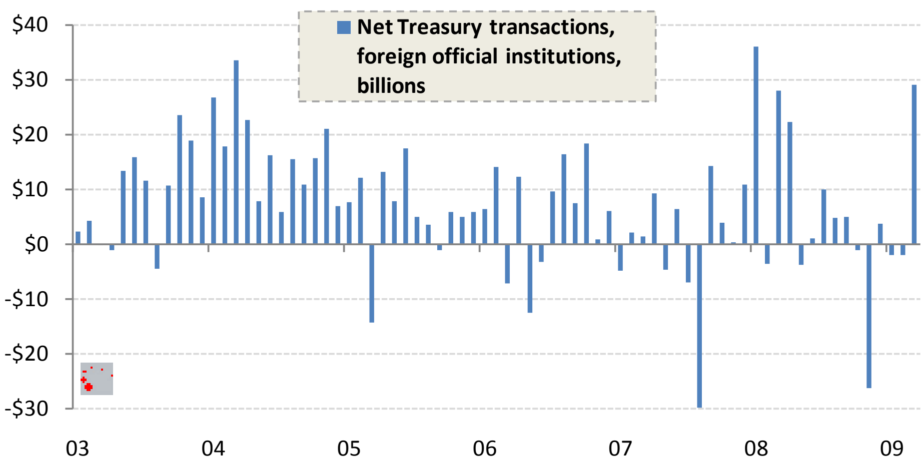
Absent a significant shift in factors now dominating the foreign exchange trading environment, the trend toward recovery in emerging market currencies seems likely to remain in place for the foreseeable future. Chief among those factors is the ultra-easy policy posture being pursued by the Fed, which we don't believe will be modified any time soon. Fed chairman Ben Bernanke told an audience last week that he sees the risk of deflation "receding," although he said the Fed must remain "very aggressive" to ensure against it. He also offered that the dollar will stay strong "because the U.S. economy is strong." Apparently, Bernanke hasn't been closely monitoring the foreign exchange market, because the dollar hasn't only been eroding against the emerging market currencies. While that movement has been most pronounced, the dollar is down nearly 8% against the G-6 trade-weighted dollar index, and 9% against the euro since early March. Virtually every developed economy's central bank is simultaneously easing, so the fact that the dollar has still broadly been losing ground is an indication of the extent to which the Fed's excess liquidity posture is outpacing all the others.

The Fed's bounteous liquidity posture was certainly appropriate to the extraordinary conditions of late last year when velocity collapsed as the economy essentially froze up in the face of a credit market implosion (see "Deflation Takes Center Stage" November 19, 2008). But while conditions have changed markedly, the Fed remains acutely sensitive to the potential for further market upheavals, and is unlikely to transition out of its current stance until it is confident that any lingering threat has passed. More likely than not, that will keep the Fed in its hyper-accommodative posture beyond the point at which a significant inflation breakout could still be avoided. Bernanke in his talk last week said policy makers are "committed to removing accommodation" in a timely way to maintain price stability, but he also said the Fed will face tough decisions when that time comes. In the Fed's balance-of-risks paradigm, courting inflation risk by keeping policy easy longer against the risk of a relapse of a market/economic blowup is likely to be the chosen course.




That was the same choice policymakers made in the 2003-04 cycle, maintaining an extremely easy stance against the perceived risk of a low-probability but potentially ruinous deflation outbreak. Not unlike the situation that seems to be developing now, dollar reserves were built up at a vigorous pace by foreign governments to keep their currencies from appreciating too rapidly against a dollar that was being kept in excess supply by the Fed. When the Fed finally began to lift the funds rate in mid-2004, long-term yields failed to follow short rates higher. This "conundrum" came to be identified by Alan Greenspan and other policymakers with a global "savings glut" that was supposedly supporting the Treasury market. But in reality, it was not a savings glut but a liquidity glut at work, as the dollar reserves accumulated by foreign governments found a home in Treasuries. Much the same dynamic may now play out again. TIC data released Friday showed foreign official purchases of Treasuries reached $29 billion in March, highest in more than a year and the second highest monthly total since March 2004, at the height of the Fed's last excess liquidity cycle.

While Bernanke and his cohorts would never acknowledge it publicly, it could well be that they regard some increase in inflation as the price that has to be paid in providing enough liquidity to re-establish market functionality and guard against any possibility of the economy falling into a deflationary spiral. If that's the case, there are signs that it's working. Not only are emerging market currencies rallying, but gold has resumed its rise, trading above $930 after falling below $900 last month. The counterparty solvency fears seizing the banking system have eased considerably, with the LIBOR-OIS spread at 62 bp, below levels seen prior to the outset of the most intense phase of the crisis late last summer. That's still well above the single-digit levels considered "normal" prior to the first credit crisis rumblings in the summer of 2007, but it's a long way off from the 360-plus bp seen at the height of the panic last October. That spread was still above 100 bp through mid March.

**BOTTOM LINE:** The rally of emerging market currencies stands as a solid indicator that the period of excess dollar demand being driven by extreme risk abhorrence has come to an end. Recovery of these currencies should continue, as the Fed remains in an ultra-easy policy stance, and shows no inclination to adjust its posture to changing conditions.