Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Strong Enough, Thank You

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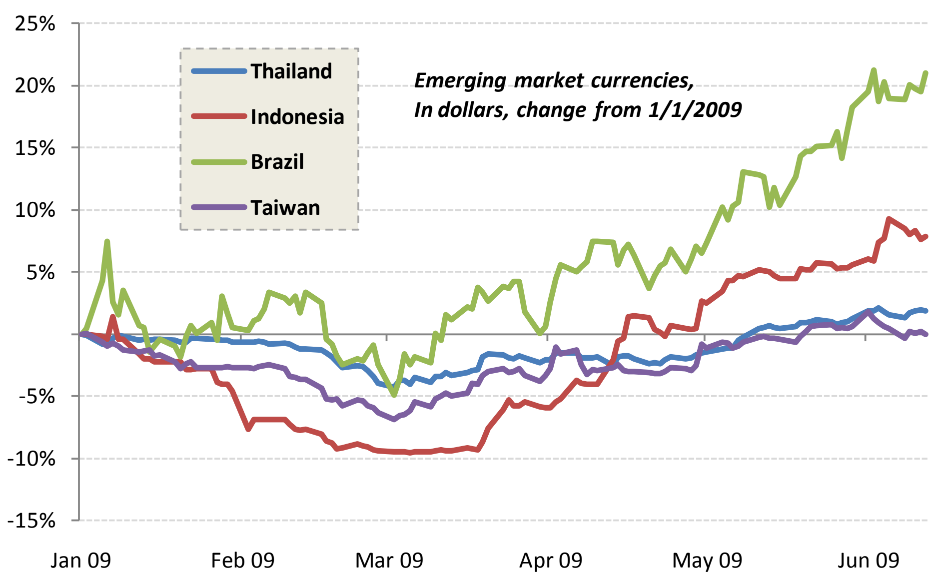
David Gitlitz

Emerging markets currencies are re-linking to the dollar -- and that way lies inflation.

Update to strategic view
US DOLLAR, EMERGING MARKETS MACRO: The currency rally in emerging market economies appears to have stalled out, as authorities have intervened to keep their currencies from continuing to rise against the dollar. With their export markets already devastated, it's unlikely many of these countries will want to risk having their currencies strengthen again until growth is restored. But with their exchange rates now re-linking with a depreciating dollar, the emerging markets are running another significant risk: the importation of dollar inflation.
[see Investment Strategy Dashboard]

The rally in emerging market currencies that we noted last month (see "Constructive Currency Signals" May 18, 2009) has stalled out since then, although that does not appear to reflect any real trend toward dollar stabilization. We characterized the recovery in emerging market forex from the pummeling absorbed late last year into the early part of this as reflecting relief from the deflationary surge in dollar demand spurred by intense risk abhorrence, with that relief supported by the Fed's ultra-accommodative policy posture. But we think it would be a mistake to interpret the leveling off of that uptrend in the developing country currencies as indicating any departure from the real weakening of the dollar's purchasing power being caused by an exceedingly easy Fed.



Rather, it appears that the cessation of the move higher in emerging markets currencies has been brought about by what we forecasted last month (again, see "Constructive Currency Signals") -- the forceful intervention by the central banks in a number of these countries to keep

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

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their currencies from continuing to appreciate against the dollar. With their export growth crushed by crumbling import demand in the industrialized economies (US imports fell by 48% at an annual rate from last October through April), tolerating continued currency appreciation is simply too much to ask for many of the emerging markets. From the end of February through early this month, a Bloomberg-JP Morgan index of the 10 most actively traded non-yen Asian currencies had risen by more than 7% against the dollar. It has since fallen off by about 1.5%.

The extent of the dollar-buying intervention is captured in the amount of securities held by the Fed in custody for foreign official institutions. Essentially, these are the dollar reserves of foreign central banks, funneled into Treasury and agency securities at the Fed. In the past four weeks, the custody account has expanded by nearly 40% at an annual rate, up from about 7% at the end of the first quarter. It's probably a safe bet that the growth in reserve assets can be attributed to the emerging markets, since intervention by any industrialized central bank would have been widely publicized. Asian emerging market central banks intervene routinely without public announcement.

For the most part, inflation has remained tame in the emerging market economies up to this point. If, however, the authorities in these countries will now be seeking to maintain stability against a dollar riding on the Fed's extraordinarily bounteous stance, the results could get unpleasant. Certainly, we see no indication that the Fed is itself contemplating a shift. In fact, two FOMC members who are usually counted on the more hawkish side have recently made comments indicating they are quite comfortable with present policy. Richmond Fed President Jeffrey Lacker said last week, "I think growth is likely to warrant rates as low as they are now for some time. We'll just have to wait to see how the growth process unfolds for some time." Dallas Fed president Richard Fisher, for his part, said the Fed was still primarily concerned not with inflation, but with deflation. "We just want to make sure we don't repeat the mistakes made in the 1930s and mistakes made by the others like the Japanese in the 1990s, and we don't withdraw too early."

A major pre-FOMC "round-up" in Friday's *Wall Street Journal*, meanwhile, described the "crosscurrents" currently affecting the policy environment. The story was framed around the question of whether the Fed would expand its bond purchasing program in an attempt to bring yields back down. But it's clear resolving that issue also has deeper implications -- more bond acquisitions would mean an even more aggressive policy stance, while avoiding such a move would at least represent recognition of the potential inflationary implications of its ultra-easy stance and balance sheet expansion. "Divisions are brewing within the Fed over whether it should do more to speed the healing, pause, or start pulling back to avoid an outbreak of inflation," according to the story. It cited officials who "worry that buying more government bonds could signal the Fed's willingness to accommodate large budget deficits." But it also referred to others who "believe that even if growth resumes, the economy will need more stimulus from the central bank because the unemployment rate is likely to remain above 9% for years and factories are still running far below capacity." Based on the recent remarks of Ben Bernanke and other policymakers, it seems a good bet that the views of those who believe the "economy will need more stimulus" even if growth resumes are still holding sway (see "On the May Jobs Report" June 5, 2009).

BOTTOM LINE: The currency rally in emerging market economies appears to have stalled out, as authorities have intervened to keep their currencies from continuing to rise against the dollar. With their export markets already devastated, it's unlikely many of these countries will want to risk having their currencies strengthen again until growth is restored. But with their exchange rates now re-linking with a depreciating dollar, the emerging markets are running another significant risk: the importation of dollar inflation.