FED FIXES AND DOLLAR DEPRECIATION
© Leo Haviland, 646-295-8385 September 17, 2012

"And what costume shall the poor girl wear
To all tomorrow's parties?" Velvet Underground, "All Tomorrow's Parties"

CONCLUSION

The broad real trade-weighted United States dollar will depreciate. Over the next several months, its retreat probably will reach July 2011's record low around 80.6 (for the nearly four decades going back to 1973, monthly averages; March 1973=100) and break beneath it, with around 77.0 a reasonable target. Over the longer term, a descent to around 72.5 to 75.0 would not be surprising.

DOLOROUS DOLLAR DECLINE

Numerous intertwined factors intertwine to affect dollar levels and fluctuations. Marketplace wizards select between these variables, assess their interconnections, and debate their relative influence and consequences. The US obviously is not an island. Economic (and political) situations and policies of other nations influence the American scene. Other currency arenas (whether the Euro FX or others) as well as equity, debt, and commodity marketplaces entangle with dollar trends.

****

In any event, a survey of broad real trade-weighted dollar ("TWD") levels strongly suggests that the TWD has been suffering a long run decline. Note its major peak in February 1985 around 128.0. Even if 1985 seems like ancient history, a mournful dollar downtrend resumed with February 2002's 112.8 ceiling. Current levels not only reside well below this, but also are significantly below the noteworthy March 2009 top at 96.9, made during the depths of the ongoing worldwide economic crisis. Its last time over 100 was in August 2004.

Though the greenback made an important trough in July 2011 at 80.6, it managed only a relatively feeble seven percent rally to June 2012's 86.2. The June 2012 height is barely over the prior all time depths around 84.0 (October 1978, July 1995, and April 2008). In August 2012, not long before the Fed's marvelous third round of quantitative easing, the TWD stood at only 84.9.

Many nations would like a weak currency, or at least one that is not too strong (whatever that means). This admittedly mitigates TWD slumps, as well as dollar weakness for many currency cross rates.

DECLINE AND FALL…AND DEBT

Alongside the sustained weakness in the US dollar, note a couple of accompanying patterns.

The United States obviously is a very powerful nation on the world economic and political stage. However, most would agree that over the past twenty or thirty years, America has become less dominant.

In addition, over this extended time horizon, the United States increasingly has become a big debtor nation. The dollar obviously has had many twists and turns. Yet based on Federal Reserve

Board data (Z.1) data, total credit marketplace debt steadily has expanded over the past few decades. It was around 157 percent of nominal GDP in 1973. It jumped over 200 percent with 1985's 204 percent and leaped to about 300pc in 2002. It accelerated during the joyous Goldilocks Era, reaching a towering high over 380pc of nominal GDP in 2009. Though this credit debt has slipped to just over 350pc (as of first quarter 2012), US indebtedness remains massive. What is the remedy? And the nation continues to run a current account deficit. The International Monetary Fund forecasts America's current account deficit will be about $510 billion in 2012, $500bb in 2013, and $696 bb in 2017 ("World Economic Outlook", "Statistical Appendix", Table A10, April 2012).

****

We know that all else equal, debtors (and borrowers) want as low an interest rate as they can get.

The Fed's interest rate policy is (and has been for several years) geared toward aiding debtors (borrowers) at the relative expense of creditors (savers). Since debtors deserve special Fed help, surely the unemployed do.

****

We know that all else equal, debtors in a home currency (imagine the beloved US dollar) tend to enjoy some modest home currency depreciation. This makes their debt obligations less burdensome to pay off. This perspective assumes that these debtors can keep borrowing fairly easily, and at interest rates that not too high (overly punitive).

However, all else equal, foreign creditors are not enamored of such currency degradation. Foreigners hold an enormous amount of US Treasury securities, nearly $5.3 trillion (as of June 2012, US Treasury 8/15/12 TIC data, next release 9/18/12). Foreign official holdings account for nearly $3.9tr of the $5.3tr. TIC statistics do not separate official and private holdings by nation. Major foreign holders of US Treasury securities include Mainland China ($1.16 trillion; plus Hong Kong $136 billion), Japan ($1.12tr), oil exporters ($261bb), Brazil ($243bb), Caribbean banking centers ($240bb), and Russia ($158bb).

****

Currently, China is the largest trade weight in the TWD, at 19.8 percent. The Euro area is 16.4pc, with the United Kingdom 3.5pc. Canada represents 13.2pc, with Mexico 11.5pc and Japan 7.8pc. South Korea has 3.9pc, Taiwan 2.6pc, and Brazil 2.1pc.

****

Currently, depending on the time period on the US government yield curve, UST offer a negative or very low real return. Given the current Federal Reserve agenda, this mediocre return (yield) situation probably will persist at least for the next couple of years.

Because the US dollar is the key reserve currency, this induces ("forces") many to keep holding on to it and assets denominated in it. But this reserve aspect does not mandate they do so. Since overseas participants are not trapped in the dollar (or UST), they may elect to add fewer dollar-denominated assets (such as UST) to their holdings, or even to reduce their hoard.

How eager will foreigners be to own UST in a rock-bottom interest rate environment if the dollar slides significantly lower?

Some foreigners (and some Americans) find UST attractive in a "flight to quality" world. But suppose that at least for a while, such safe haven fears diminish. Aren't the Fed and other central banks finally and really and truly and definitely going to rescue the world and cure its economic

problems with their highly accommodative monetary policies? Yet how easily will America finance its budget deficit if foreigners do not ravenously desire UST?

****

Given America's election 2012 fever, nothing for the near term will be accomplished on the national fiscal frontier. Will massive federal deficit spending continue for the next few years? Not only has it been high during the recovery. In addition, many politicians and marketplace players worry about 2013's looming "fiscal cliff". When election 2012 passes and 2013 arrives, how much will US federal spending decline and how much will revenues climb (how much will taxes be raised)? Besides, the long run deficit problem has not evaporated.

Will the US devise antidotes to its fiscal ills? It arguably will take a renewed economic crisis to induce the competing political parties to engage in a grand agreement that would represent substantial progress on resolving the fiscal mess.

****

US general government gross debt as a percentage of nominal GDP at 106.7pc in 2012 and 110.7pc in 2013 decisively exceeds that of the Euro area's 91.4pc and 92.4pc ("Fiscal Monitor Update", International Monetary Fund, Table 1, 7/16/12).

The European Central Bank and European politicians in recent months have mounted a fierce defense of the Eurozone and the Euro FX. Note the ECB's 9/6/12 announcement of Outright Monetary Transactions as well as its ongoing Long-Term Refinancing Operations. Suppose confidence grows that the defense of the Eurozone and the Euro FX finally (eventually) will succeed. The Euro FX has rallied sharply from its 7/24/12 cross rate low of 1.2043 versus the dollar and now is over 1.30. To the extent the Eurozone as a whole appears less worrisome, America's dreadful troubles loom even larger.

MONEY PRINTING HISTORY: TWO FED FIXES

What happened to the US dollar after the Fed's prior two massive rounds of quantitative easing? The TWD depreciated.

The TWD rallied from its April 2008 low of 84.2 (monthly average). It reached 94.7 in November 2008, peaking in March 2009 at 96.9. The Fed unveiled QE1 in November 2008 with about $600 billion in debt securities purchases (mortgage bonds; Fannie Mae and Freddie Mac debt). In March 2009, to better repair the economy, it expanded this money printing program to a total of $1.3 trillion, including US Treasuries. The TWD plummeted (note also the S+P 500 low 667 on 3/6/09). It reached 87.3 in November 2009, moved sideways, and then slipped to 87.1 in April 2010. The Fed ended QE1 in March 2010. So for round one of money printing, the TWD bear move was 10.1 percent from the March 2009 summit.

Not long after the Fed ended its QE1 economic repair effort, the TWD advanced slightly, reaching 89.7 in June 2010. This rather tepid TWD rally hints at its underlying weakness.

Anyway, the S+P 500 made a high on 4/26/10 at 1220. It fell to 1011 on 7/1/10, with the 8/27/10 floor 1040. The Fed engineers, given their desire to sustain a recovery (and boost equities and thereby consumer net worth and overall economic confidence) reopened its trusty toolkit, unveiling QE2 in August/November 2010. It bought another $600bb in UST over the next several months. The TWD was 87.6 in August 2010, 84.2 in November 2010. QE2 ceased at end June

2011 (S+P 500 top 1371 5/2/11, with 7/7/11 1357). The TWD low was 80.6 in July 2011, about a 4.3pc fall from November 2010 and eight pc from August 2010.

MONEY PRINTING, ENCORE: THE CHARMING FED'S THIRD TRY

"Stop your train
Let a poor boy ride
Why can't she hear me cryin'?" "Smokestack Lightning", the Howlin' Wolf song, but with its lyrics varied by the Grateful Dead (in "History of the Grateful Dead, vol. 1 (Bear's Choice)")

****

After QE2 ended, we all recall the S+P 500's mournful crash to 1075 on 10/4/11. However, no money printing festival reappeared soon. Yet the Fed remained active, right? It generated Operation Twist in September 2011 (in June 2012, it extended this program to year end 2012). And not only did the Fed keep the Federal Funds rate depressed. This sentinel proclaimed it would maintain the Federal Funds rate at exceptionally low levels until late 2014.

The S+P 500 skyrocketed after October 2011, reaching a high on 4/2/12 at 1422. Though it slipped 10.9pc to 6/4/12's 1267 low, the S+P 500 resumed its advance. The economy continued to grow, though lamentably less than desired. The 1267 S+P 500 low stood above the April 2010 plateau. However, the Fed, increasingly and especially worried about unemployment (the labor marketplace), and via its ability to interpret and apply its mandate with great flexibility, decided to launch a third round of money printing.

****

Chairman Bernanke often speaks of the Fed's dual mandate of "maximum employment and price stability". (See his Jackson Hole, Wyoming speech, "Monetary Policy since the Onset of the Crisis", 8/31/12).

As "The Growth Game: US Unemployment and Federal Reserve Policies" (9/10/12) emphasizes, the Fed's ongoing worries about unemployment in particular (and economic strength in general) underline (reflect) its willingness to suppress policy rates.

The Chairman stresses in his Jackson Hole address: "The unemployment rate remains more than 2 percentage points above what most FOMC participants see as its longer run normal value, and other indicators- such as the labor force participation rate and the number of people working part time for economic reasons- confirm that labor force utilization remains at very low levels. Further, the rate of improvement in the labor market has been painfully slow." And "Over the past five years, the Federal Reserve has acted to support economic growth and foster job creation, and it is important to achieve further progress, particularly in the labor market."

Then on 9/13/12, seeking "sustained improvement in labor market conditions" (and also aiming for higher inflation to achieve its two percent medium term target), the Fed mechanics announced QE3. This money printing encore plans purchases of $40bb per month in agency mortgage-backed securities. This strategy is open ended in time and thus in quantity. It did not rule out "additional asset purchases", which presumably could include Treasuries. The Fed decided to extend the exceptionally low level for Federal Funds from end 2014 to at least mid-2015.

****

History may not repeat itself. The Fed's third money printing adventure does not necessarily have to end with further TWD weakness.

After all, the United States is not the only money printer. Japan, the United Kingdom, and Switzerland are money printers. What about the Euro area? The European Central Bank's Outright Monetary Transactions will involve purchasing Euro area sovereign bonds in secondary marketplaces. This is money printing, even if it is indirect and even if there is "sterilization" of such money creation. Its 9/6/12 policy on OMTs: "there are no ex-ante limits on the amount of Outright Monetary Transactions". Also, the LTRO policy arguably has consequences quite similar to money printing, especially if the LTROs are rolled over for an extended time period.

However, the ECB mandate is more focused on inflation fighting than the Fed's which also refers to employment. Moreover, the Eurozone at least has Germany and its Bundesbank, which will tend to temper the ECB's inflationary (including money printing) policies. The Fed does not seem nearly as resolute as the ECB on the inflation front.

****

Significantly, the Fed's determination to keep interest rates pinned to the floor (and thus offering pitiful returns on government debt relative to inflation) for an extended time period, say out to mid-2015, boosts the odds that its QE3 money flood will help to push the dollar down. In addition, recall that he TWD has been in a declining pattern over the past decade (or longer). So has America's relative international economic and political prominence. Remember that QE3 is occurring alongside substantial US indebtedness (with a potential federal deficit disaster lurking on the horizon), a noteworthy current account deficit, and only modest domestic savings (compare Japan).

Current levels and long run trends for various employment measures suggest that the Fed may be wrong in its assessment of the country's productive (GDP) potential (and in its view that the so-called output gap is substantial). See "The Growth Game: US Unemployment and Federal Reserve Policies" (9/10/12).

Note what the Fed's opinions on what the unemployment rate should be in the context of its September 2012 unemployment rate forecast. This underlines not merely that QE3 probably will remain firmly entrenched for many months. The generous Fed therefore probably will print a mountain of money to achieve its employment target.

Start with headline unemployment at approximately eight percent for early September. Recall Chairman Bernanke's faith- the unemployment rate now is over two percent more than what the majority of the FOMC views "as its longer run normal value". One does not need a Ph.D in mathematics to surmise that the Fed's current headline unemployment target thus is around six percent. Maybe it would slow down or eliminate quantitative easing as this target neared, but maybe it wouldn't.

The Fed's economic projections give the central tendency for unemployment rate as about 7.7pc in 2013, 7.0pc in 2014, and 6.4pc in 2015, with the "Longer run" level 5.6pc. The Fed's decided: "If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in the context of price stability." Thus, when looking at the six percent benchmark, there is incentive for QE3 to print money for the rest of 2012, all of 2013 and 2014, and maybe even some of 2015. Suppose

there are 30 months at $40 billion a month. That $1.2 trillion is a river of cash. It represents about 7.7 percent of second quarter nominal GDP of $15.6 trillion (annualized).

The Fed presumably is aware that the TWD declined after the QE1 and QE2 episodes. So apparently the Fed will tolerate dollar weakness to achieve its employment objectives.

****

Ask a few closing questions. Why doesn't the Fed, if it has faith that money printing genuinely will remedy unemployment (and boost real GDP significantly and more than temporarily), buy $400 billion in securities each month rather than $40 billion? To what extent is the Fed selling (promoting) confidence as an important element in its quest to bolster economic recovery? To what extent will TWD weakness boost US exports (or reduce imports)?

How bad "really" is the US (and world) economy since Fed doctors feel compelled to engage in a third round of money printing with Federal Funds having been close to zero for nearly four years (and with the S+P 500 far above its March 2009 abyss)? Why won't the Fed raise the Federal Funds rate at least to around its forecast inflation levels? To what extent will dogged refusal to raise policy rates increase the downward pressure on the dollar?

The chant that "a weak dollar equals strong US stocks (S+P 500), and a strong dollar equals weak stocks" has been popular for many years. But this pattern is not inevitable. Suppose the dollar depreciates "dramatically"? Will the current guideline relationship between the TWD and US equities remain unchanged? Maybe a falling dollar at some point will encourage stock marketplace price slumps.

The intraday low on the UST 10 year note was 1.38 percent on 7/25/12. Why endure very low yields relative to inflation (and especially if flight to quality fears become less widespread)? What happens to US equities if notable interest rate rises accompany at least modest dollar depreciation?

****

Declines of five or ten percent in the TWD, given what happened after QE1 and QE2, provide yardsticks to estimate TWD support levels. Suppose the TWD falls five percent from 85.5, about the average of the June 2012 and August 2012 levels. That gives 81.2, close to July 2011's record depth of 80.6. However, given the Fed's determination to manufacture a significant decline in unemployment and given its prediction that it will take another two years or so to accomplish this task, more dollar depreciation than this probably will occur. A ten percent slump from 85.5 gives 77.0. A twenty percent fall from the March 2009 peak of 96.9 gives 77.5, a five pc move under the July 2011 low is 76.6, and a 33pc fall from the February 2002 major high is 75.2. If the TWD breaches the July 2011 bottom by ten pc, that makes 72.5.

****

This essay is furnished on an "as is" basis. Leo Haviland does not warrant the accuracy or correctness of this essay or the information contained therein. Leo Haviland makes no warranty, express or implied, as to the use of any information contained in this essay in connection with the trading of equities, interest rates, currencies, or commodities, or for any other use. Leo Haviland makes no express or implied warranties and expressly disclaims all warranties of merchantability or fitness for a particular purpose. In no event shall Leo Haviland be liable for any direct, indirect, special, incidental, or consequential damages (including but not limited to trading losses or lost profits) arising out of or related to the accuracy or correctness of this essay or the information contained therein, whether based on contract, warranty, tort, or any other legal theory.

All content copyright © 2012 Leo Haviland. All Rights Reserved.