# U.S. Dollar: Hitting Bottom?

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After sliding 15% since March 2009 on waning concerns about the credit crisis and mounting worries about the budget deficit, the U.S. dollar is showing signs of bottoming, rising 2% since early December to three-month highs on a broad trade-weighted basis. Support has stemmed from year-end repatriation of foreign earnings by American firms, as well as improved sentiment, with net long dollar positions swinging to record highs (*Chart 1*). In addition, the currency has been rallying on "good" economic news in anticipation of Fed tightening, a sign that interest rate spreads, rather than investor risk appetite, are starting to drive its movement. After a schizophrenic two years, the dollar has come full circle to pre-credit crisis levels.

**We still look for a modest 4% trade-weighted depreciation of the dollar this year, as fiscal worries will continue to weigh**. The dollar's decline should be greater against currencies of resource-based countries, where interest rates are already on the rise (Australia, Norway) or likely to climb sooner than in the U.S. (Canada, New Zealand).

CHART 1

GOING LONG

United States (000s of contracts)

U.S. Dollar Net Futures Positions

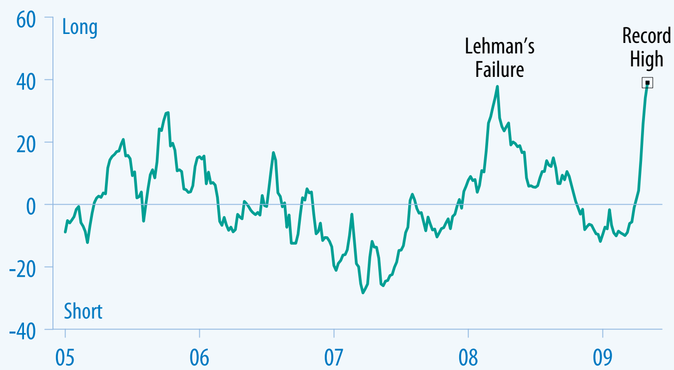



TABLE 1

WE'RE NUMBER 1

(y/y % chng)

| Real GDP | 2009 | 2010 | 2011 | 3-year Cumulative (2009-11) |
|---|---|---|---|---|
| **United States** | **-2.5** | **2.6** | **3.2** | **3.2** |
| Euro area | -3.9 | 1.5 | 2.6 | 0.1 |
| United Kingdom | -4.8 | 1.3 | 2.4 | -1.2 |
| Japan | -5.3 | 1.6 | 2.2 | -1.7 |

**Still, we don't expect the greenback to revisit record lows against the major currencies, as further downside should be limited by several factors. First**, a recovering economy will likely spur the Fed to tighten by the fall, possibly ahead of European and Japanese central banks given expected softer recoveries abroad (*Table 1*).

**Second**, higher U.S. interest rates will trigger an unwinding of dollar carry-trade positions, especially against high-yielding currencies like the Brazilian real. Meantime, the yen should weaken as investors flock back to the yen-funded carry trade.

**Third**, while debt concerns will linger until the Obama Administration crafts a meaningful deficit-reduction plan (the upcoming State of the Union Address will provide an opportunity to outline his intentions), a strengthening economy should at least mollify the worst fears.

**Fourth**, other developed countries aren't exactly paragons of fiscal probity. Greece's credit-rating downgrade, coupled with rating warnings for Ireland, Spain and Portugal, have fanned sovereign debt fears in the EU. Some countries, struggling to emerge from recession, could balk at future ECB tightening or mandated fiscal retrenchment, possibly destabilizing the euro. Meantime, Japan's deflation-prone economy faces a public debt burden that is more than twice that of America's, with a rapidly aging workforce to boot.

**Fifth**, after sliding 22% since 2002, the dollar is likely undervalued, at least against major currencies. The real trade-

CHART 2

READY FOR LIFT-OFF?

United States (March 1973 = 100)

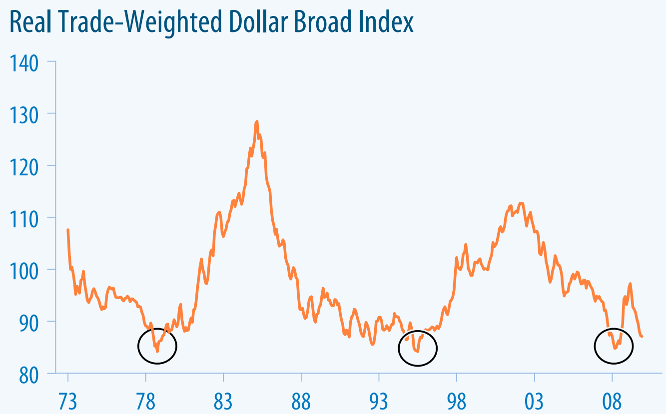



CHART 3

U.S. EXPORTERS NOT RESTING ON DOLLAR CRUTCH

(y/y % chng)

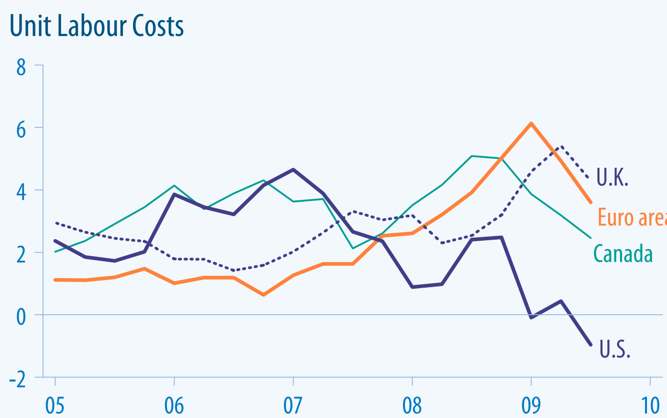
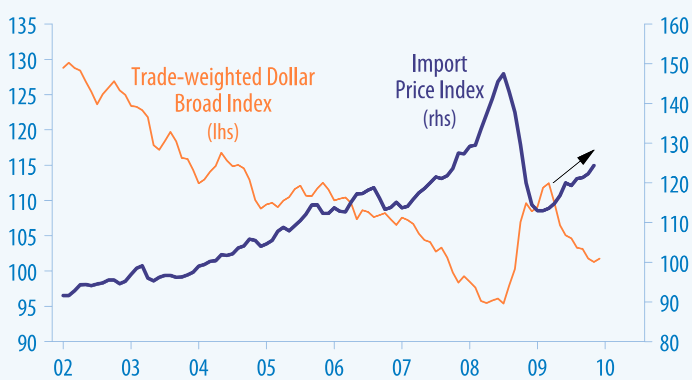



CHART 4

YES VIRGINIA, THERE IS SOME INFLATION

United States




Trade-weighted Dollar Broad Index = (Jan 1997 = 100) Import Price Index = (2000 = 100)

weighted exchange rate now hovers near the lows set on three previous occasions since the mid-1970s, all of which launched sharp rebounds (*Chart 2*).

**Sixth**, the cheap dollar and lower unit labour costs have improved America's trade position (*Chart 3*). Except for the yen, the dollar is the only major currency that hasn't risen against the yuan in the past year (because it's fixed!). And, a possible revaluation of the yuan would only help shrink the U.S. trade gap further. (As an aside, a yuan revaluation would likely spur appreciations of other developing nations' currencies, and facilitate global trade rebalancing, while easing the upward pressure on major currencies.) The U.S. current account shortfall could narrow towards 2% of GDP from 3% currently and a record 6% in 2006—a ratio small enough to keep the external debt on a manageable course.

**Seventh**, fears over possible debt monetization and hyper-inflation should dissipate once the Fed moves to renormalize policy. The central bank has the proper tools (including its new Term Deposit Facility) to drain reserves from the banking system and to tighten policy (including its new ability to raise rates on excess reserves held at the Fed). Bernanke will likely address the threat of higher inflation with the same boldness he showed in tackling the Great Recession.

Although these seven factors may not prevent the dollar from slipping further, they should act to cushion any fall. **A steadier greenback would have positive implications for the U.S. economy and investors**. Inflation pressures arising from higher import prices would subside, thus tempering the pace of Fed tightening (*Chart 4*). Foreign investors would be less squeamish about purchasing U.S. assets, possibly extending the rally in equity and corporate debt markets. And, commodity prices could lose some steam (though they should remain well supported by firming global demand). All in, slower increases in interest rates and resource prices (notably oil) would be positive for U.S. growth. Gold, however, could lose its lustre as fears of a dollar collapse recede.

**The Bottom Line:** Although it may yet to have bottomed, the bulk of the greenback's depreciation, at least against the major currencies, is likely behind it—with favourable implications for the economy and financial markets.