FX Crossroads

14 November 2007

Will the decline in USD become disorderly?

Summary and conclusions

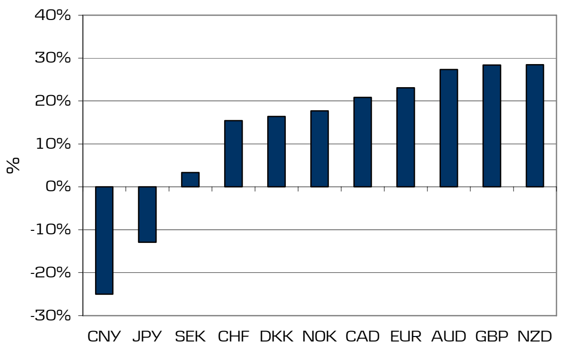
- Since 2000, the US dollar has fallen by 76% against the euro. The dollar index (DXY) has fallen by almost 40% since 2001. This decline has left the dollar undervalued against most – but not all – currencies. By and large, the decline has been orderly and most observers are sanguine about the outlook for USD. This week we consider the risk that not only will the dollar weaken in line with our forecasts (we have EUR/USD at 1.50 in Q2 08), but also that the decline will become disorderly and will eventually require some form of official intervention.

- In particular, we worry that 1) the US economy will be the source of dollar weakness in the coming months, 2) that a deepening of the financial crisis could put additional pressure on USD, and 3) that an accelerated pace of reserve diversification away from USD, a move by USD-peggers to abandon the dollar as anchor currency, or a decision by OPEC to price oil exports in other currencies than USD could inflict substantial damage on the dollar. On balance, we believe that the risk of a further drop in the dollar towards 1.60 (EUR) or 100 (JPY) in the coming six months is considerable. We recommend buying EUR/USD spot with a stop at 1.45.

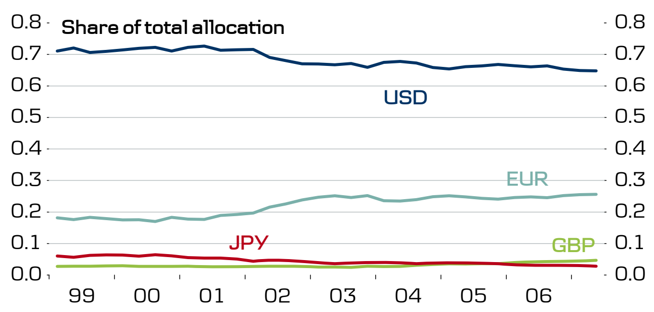
- Next publication date: November 27.

USD: deviation from PPP estimate

(positive number denotes USD undervaluation)



Total allocated FX reserves (IMF COFER)



USD: Will the decline become disorderly?

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What if?

Since 2000, the US dollar has fallen by 76% against the euro. The dollar index (DXY) has fallen by almost 40% since 2001. This decline has left the dollar undervalued against most – but not all – currencies (see chart on the first page). By and large, the decline has been orderly and most observers are sanguine about the outlook for USD.

In this article we consider the risk that not only will the dollar weaken in line with our forecasts (we have EUR/USD at 1.50 in Q2 08), but also that the decline will become disorderly and will eventually require some form of official intervention.

We conclude that:

- The US economy is likely to be the source of additional dollar weakness in the coming months
- A deepening of the financial crisis could very well put additional pressure on USD, particularly against the yen
- An accelerated pace of reserve diversification away from USD, a move by USD-peggers to abandon the dollar as anchor currency, or a decision by OPEC to price oil exports in EUR or a basket of currencies rather than USD could all inflict substantial damage on the dollar
- Currency intervention in favour of USD is unlikely until its decline becomes disorderly, threatening the functioning of capital markets overall.

On balance, we believe that the risk of a further drop in the dollar towards 1.60 (EUR) or 100 (JPY) in the coming six months is considerable.

Why is the dollar weak?
Perhaps the obvious starting point for our analysis is to ask why the dollar is weak. We think there are three main reasons behind the decline in the dollar in recent years:

- First, USD weakness can be explained by a **cyclical underperformance** relative to its peers. In our book, this argument explains the main part of the dollar's decline. As long as the US economy performs, or is expected to perform more poorly than comparative economies, then a fall in the dollar is a logical consequence.

- Second, we are currently in the midst of a global **financial crisis** that has at its epicentre US financial institutions and structured products on US financial instruments. Recent departures of senior executives from Citigroup and Merrill Lynch are obvious examples of this. The rise in risk premiums across financial markets can be seen also on the US dollar.

- Third, the dollar is under pressure from a structural change in the management of central banks' **FX reserves** and sovereign wealth funds. While we believe that the near-death of USD has been greatly exaggerated, we do find signs of a structural headwind against the dollar.

The three arguments are interrelated. A deepening of the financial crisis may be the cause of both capital flight as well as a US recession. A US recession would deepen the financial crisis. And though perhaps less likely, capital flight could drive the US economy over the cliff's edge.

Recession or just stagflation?
If we start by looking at the economy, our best guess is that **things will get worse before they get any better**. The risk of recession remains uncomfortably high and there is a good chance that the Fed will be forced to cut in excess of market pricing. At the same time, inflation will be under upward pressure from rising energy prices. A stagflationary scenario is normally bearish for the dollar, not least because the erosion of the Fed's credibility may damage the perception of the dollar as a store of value.
In short, **the performance of the US economy may weaken the dollar further in the coming six months.**

Ready for the next leg of the financial crisis?

The development of the financial crisis, and the net impact on currency markets, is not an easy one to untangle. To begin with, we can make two general observations:

First, a period of deleveraging will benefit currencies where positioning is short, mainly USD and JPY (see *FX Strategy: IMM positioning*, 12 November, 2007). The losers will be the currencies such as AUD, CAD, GBP and NZD, and to a lesser extent SEK.

Second, since currency markets have been leaning heavily towards carry trades in recent years, bouts of rising risk aversion will also tend to drive currencies toward their fair value. During the sell-offs in both February and July this year, the tendency for currencies to move towards their PPP estimates was clear.

That JPY will benefit from a rise in risk aversion is relatively straightforward. The response of USD is less obvious, seeing that the geographical location of the fault lines will be of importance. We feel that the fall-out from this crisis will continue to be felt the hardest in the US, making USD unlikely to benefit from safe haven flows. However, if this channel turns out to be the strongest one, then the euro will find it more difficult to rise.

Capital flight?

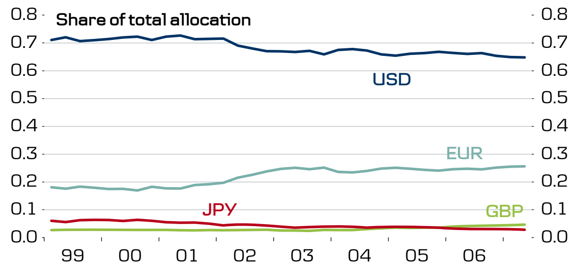
The third major dollar risk comes from outright capital flight triggered either by:

1. Aggressive diversification of FX reserves,
2. An announcement by one or several of the major dollar-peggers (eg, Saudi Arabia or China) to drop the dollar as the anchor currency, or
3. An announcement from OPEC that it would start pricing oil in a basket of currencies (or just EUR) rather than USD.

The story with currency reserve diversification is a complicated one. Perhaps the first point to make is that global FX reserves continue to rise rapidly and that particularly the BRIC (Brazil, Russia, India, China) reserves are rising strongly. The lion's share stems from currency intervention by central banks that are dollar-peggers to varying degrees. Normally, satellite currencies would tend to favour assets denominated in the anchor currency, but recent comments from China suggest that it is contemplating shifting into appreciating currencies such as the euro.

Intelligence on global FX reserves gathered by the IMF (COFER) does not support the notion that a firesale of dollars is underway (see chart below), as the USD share of allocated reserves has remained constant at around 65% in the past five years. Unfortunately, the IMF does not account for the currency allocation from countries such as China.

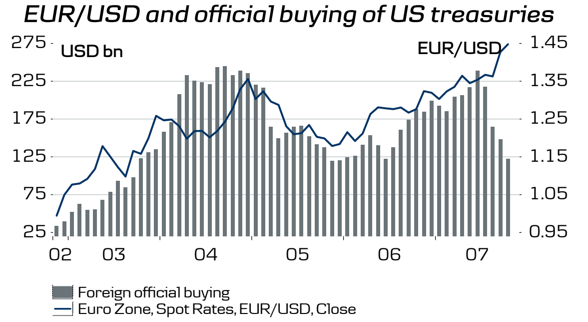
Total allocated FX reserves



Source: Danske Bank

As we also showed last week, however, what we do see is that central banks are no longer leaning against the wind by buying US treasuries when the dollar is falling. This change in behaviour has weighed on the dollar this year.

EUR/USD and official buying of US treasuries



Source: Danske Bank

Our general feeling is that in an environment of still rising FX reserves there will be a gentle shift away from USD. However, the risk is that such a shift takes place more rapidly.

A decision by a quasi dollar-pegger such as China to abandon the dollar as anchor currency could be a trigger of such a reserve shift. Equally, a move by Saudi Arabia to either abandon its peg or replace it with a basket reference could cause a more rapid portfolio unwinding.

Finally, a decision by OPEC to reprice oil exports from the US dollar to either a basket or simply into euros is likely to be highly negative for the dollar.

What we do not expect to see in the coming years is a rise in the use of the dollar as a reserve currency. The question then is whether we will see a slow or a rapid move out of USD.

What role the G7?

We have argued on many occasions that market conditions are yet to be supportive of G7 intervention. We still hold that view. However, should the dollar fall in a disorderly fashion, the G7 will be left with little choice but to engage.

The current stance of the major players can be summarised as follows:

US	Currencies should be set in a free market
	CNY is too weak
	A strong dollar is in the interests of the US
Japan	No strong view on FX currently
	No opposition to USD/JPY even above 120. A move below 100 may be resisted
Euro	The weakness of CNY and JPY is a key issue, but no formal line
	EUR appreciation consistent with ECB's policy (risk of inflation)
G7	Undervalued Asian currencies including CNY should rise
IMF	USD is overvalued. EUR strength not seen as a big problem.

As the table indicates, the current setting makes it difficult for intervention to be a realistic option:

- The **US** wants a stronger CNY (and JPY) and thus indirectly a weaker USD. Treasury Secretary Paulson claims that the strong dollar policy remains in place but also that FX rates should be set in the markets, a combination that is currently inconsistent. More problematic, a move to intervene in favour of USD will set back US attempts to persuade China to let its currency rise.

- **Japan** is genuinely pleased that its widening external surplus can counterbalance a soft domestic economy and, with deflation still an issue, does not seek a swift tightening of monetary conditions through currency appreciation. Recent comments from senior policy makers have highlighted that Japan will resist a rapid appreciation of the JPY, but the economic rationale is poor as long as the yen is undervalued.

- Parts of **Europe** want a weaker euro, but the ECB is still calling the shots and as long as higher inflation remains the key risk and exports are doing fine, then attempts to weaken the euro will not wash. Increasingly, European policy makers have come to realise that EUR/USD valuation is much less of a problem than EUR/Asia.

So, even within the G3, intervention is a complicated affair. The G7 will not be of much use either, since it has largely defaulted to the position that responsibility for action now lies outside of the G7 area (read China). Finally, the IMF currently sees the dollar as somewhat overvalued while at the same time maintaining that euro strength is not a problem. In summary, it probably requires a disorderly decline in the dollar to unite policy makers.

Time to consider the USD end-game

To conclude: fundamentals, the financial crisis, as well as the management of sovereign assets could all be the cause of additional dollar weakness in the coming months. If sustained, the orderly decline seen in recent years could become disorderly. If that happens, EUR/USD could easily trade up to 1.60 and USD/JPY could fall below 100 before policy makers are called to the rescue. We think the risk of this happening is high enough to be worth considering.

Trade idea: Buy EUR/USD

We recommend buying EUR/USD spot at 1.4676, target 1.50, stop at 1.45.

G10: The Week Ahead

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Perhaps not a week to remember

There are no central bank policy meetings scheduled for the coming period and data releases are mostly in the second-tier category. Hence, markets will be left to ponder an uncertain future and refine the forecasts for the FOMC meeting on 11 December. It is not that we are short of things to consider, however: how much risk will you carry on your books for the rest of the year and how will you place your bets in 2008?

Currency markets are tied closely to overall risk-seeking these days and the daily correlation with equity markets remains very high (USD/JPY 50-day correlation with S&P500 is above 70%). By contrast, the correlation with interest rate markets is relatively low and has trended lower. At the same time, the day-to-day volatility is picking up, with broader carry measures showing unusually high price swings. While underlying fundamentals for high yielders such as AUD and NZD are still supportive, we feel that elevated volatility levels will present a barrier to carry trades in the rest of the year that will be difficult to overcome. As the previous article shows, we believe that dollar weakness remains a key trend for the weeks ahead.

In the **US**, the key issue for the coming weeks is how the Fed will address current market expectations in favour of a rate cut on 11 December. Futures pricing implies an 82% probability, whereas Fed officials have been more cautious. This game of 'chicken' may well have two losers. Data-wise, CPI is released tomorrow (Thursday) and will highlight rising pressure on headline inflation from energy (consensus expects CPI to rise to 3.5% y/y from 2.8%). Fortunately, core inflation is well behaved and is helping to anchor break-even inflation. On Friday, it is time for another update on the monthly TICS flow-of-funds report. The last month gave markets a scare, with a record net outflow of USD 69bn. Further, there was clear evidence of foreign central banks dumping Treasuries despite widespread dollar weakness. Presumably, we are in for a reversal of the outflow but another disappointment could hit dollar sentiment badly. Next week, it is time for a round of housing indicators, with the NAHB, building permits and housing starts all due, as are the minutes from the last FOMC meeting.

In **Canada**, CPI is on offer next Tuesday. Despite market expectations of a rate cut, we still expect the BoC to leave rates unchanged on 4 December.

In **Europe**, the euro area has little to offer until the monthly round of PMIs is released next Friday (23 November). Manufacturing sentiment has been deteriorating recently and further weakness is likely to influence the ECB's rate-setting despite rising inflationary pressures. In the **UK**, the key event is likely to be the release of the BoE minutes on Wednesday 21 November.

In **Sweden**, the calendar is equally light, dominated by a number of Riksbank speeches. Unemployment will be released tomorrow (15 November). **Norway** sees the release of third quarter GDP on 23 November. Both central banks meet again only in the middle of December.

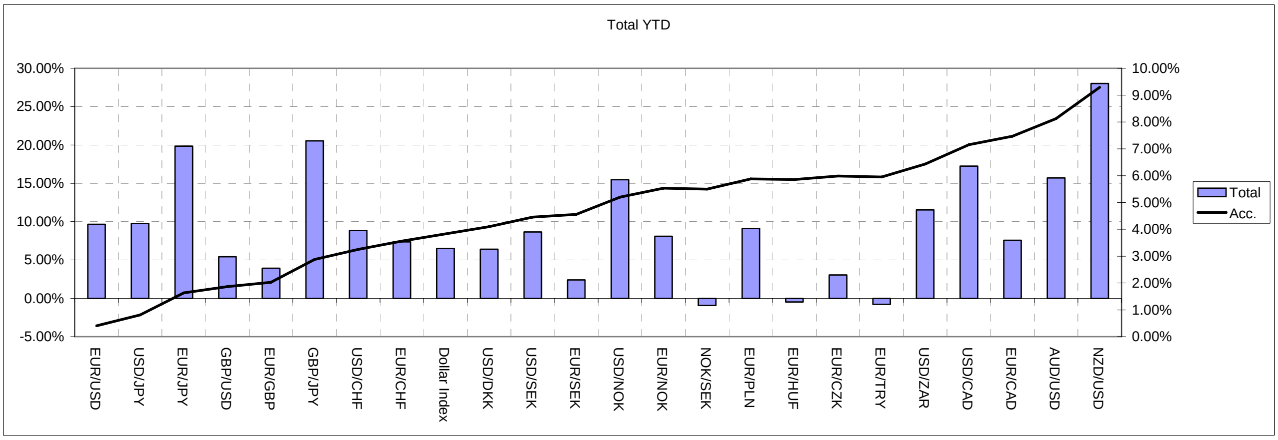
Finally, the **Bank for International Settlements** (BIS) gathers G20 central bankers and finance ministers in South Africa on 18–19 November, with the possibility of a fresh take on world events. The **OPEC** summit takes place on 17–18 November, but recent comments do not suggest that a production increase is likely at this stage. While talked about, we would also be surprised to see comments to the effect that a re-pricing of oil exports from USD to a basket of currencies was underway.

Trading Points

14-11-2007 9:35 (CET)

Strategy (Short- Medium Term)

MARKET	LAST	Trend	5DCHG	Strategy	Stop/Entry	1st Target	2nd Target	Stop/Reverse	New Target	Total P/L YTD
CURRENCIES - Majors										
EUR/USD	1.4652	↘	0.11%	Go Long>	1.4678	1.4823	Go Short<	1.4521	1.4367	9.65%
USD/JPY	111.36	↓	-1.13%	LONG		112.15		110.24	107.67	9.76%
EUR/JPY	163.17	↓	-1.02%	LONG		164.23	165.16	161.84	156.88	19.85%
GBP/USD	2.0776	↘	-1.18%	Go Long>	2.0842	2.0916	Go Short<	2.0705	2.0622	5.42%
EUR/GBP	0.7053	↓	0.00%	Go Long>	0.7079	0.7148	Go Short<	0.7008	0.6959	3.92%
GBP/JPY	231.35	↓	-2.30%	LONG		233.37	234.83	229.54	226.67	20.55%
USD/CHF	1.1248	↘	-0.77%	Go Long>	1.1300	1.1397	Go Short<	1.1214	1.1147	8.86%
EUR/CHF	1.6481	↘	-0.67%	Go Long>	1.6490	1.6632	Go Short<	1.6379	1.6309	7.37%
Dollar Index	75.658	↗	0.003	Go Long>	76.1530	76.969	Go Short<	75.419	74.852	6.52%
CURRENCIES - Scandies										
USD/DKK	5.0854	↓	-0.15%	SHORT		5.0722	5.0533	5.1042	5.1333	6.41%
USD/SEK	6.3075	↓	-0.23%	SHORT		6.2840		6.3336	6.3600	8.66%
EUR/SEK	9.2423	↓	-0.12%	SHORT		9.1751		9.2801	9.3250	2.40%
USD/NOK	5.3864	↗	1.53%	Go Long>	5.4492	5.5035	Go Short<	5.3454	5.2973	15.48%
EUR/NOK	7.8917	↗	1.62%	LONG		7.9820		7.8848	7.8518	8.10%
NOK/SEK	1.1711	↘	-1.70%	Go Long>	1.1773	1.1850	Go Short<	1.1639	1.1582	-0.94%
CURRENCIES - Non Majors										
EUR/PLN	3.6347	↓	-0.22%	Go Long>	3.6564	3.6685	Go Short<	3.6126	3.5601	9.11%
EUR/HUF	253.45	↓	-0.35%	Go Long>	255.04	256.27	Go Short<	251.87	248.34	-0.47%
EUR/CZK	26.621	↘	-1.32%	Go Long>	26.721	26.859	Go Short<	26.524	26.327	3.04%
EUR/TRY	1.7323	↓	-0.56%	SHORT		1.7106		1.7433	1.7579	-0.78%
USD/ZAR	6.6668	↗	2.22%	Go Long>	6.7365	6.8090	Go Short<	6.5765	6.3315	11.52%
USD/CAD	0.9555	↗	2.68%	Go Long>	0.9725	0.9824	Go Short<	0.9433	0.9228	17.24%
EUR/CAD	1.4001	↗	2.78%	Go Long>	1.4129	1.4385	Go Short<	1.3820	1.3578	7.58%
AUD/USD	0.9039	↘	-2.60%	LONG		0.9081	0.9145	0.8947	0.8755	15.70%
NZD/USD	0.7647	↘	-1.32%	LONG		0.7718		0.7529	0.7470	28.03%



Trading recommendations and G10 central bank overview

Directional trades

	Date	Start	Now	Target	Stop	P/L (incl carry)
Open						
Buy EUR/USD	*14/11/07*	*1.4676*	*1.4687*	*1.5000*	*1.4500*	*0.07*
Recently closed						
Sell EUR/SEK	*06/11/07*	*08/11/07*	*9.2*	*9.2*	*9.31*	*0.42*
Buy EUR/CHF	*10/10/07*	*08/11/07*	*1.66*	*1.7*	*1.659*	*-0.54*
Sell EUR/NOK	06/11/2007	*12/11/07*	*7.86*	*7.65*	*7.86*	*-1.00*
P/L 2007	**18.8%**	**Open**	**0.07%**	**Closed**	**18.8%**	
# of trades *	**82**	**# of trades 2007**		**30**		
- average net gain	**0.39%**	**- average net gain**		**0.63%**		
- batting average	**0.52**	**- batting average**		**0.60**		

* Since 17 November 2005

G10 central bank overview

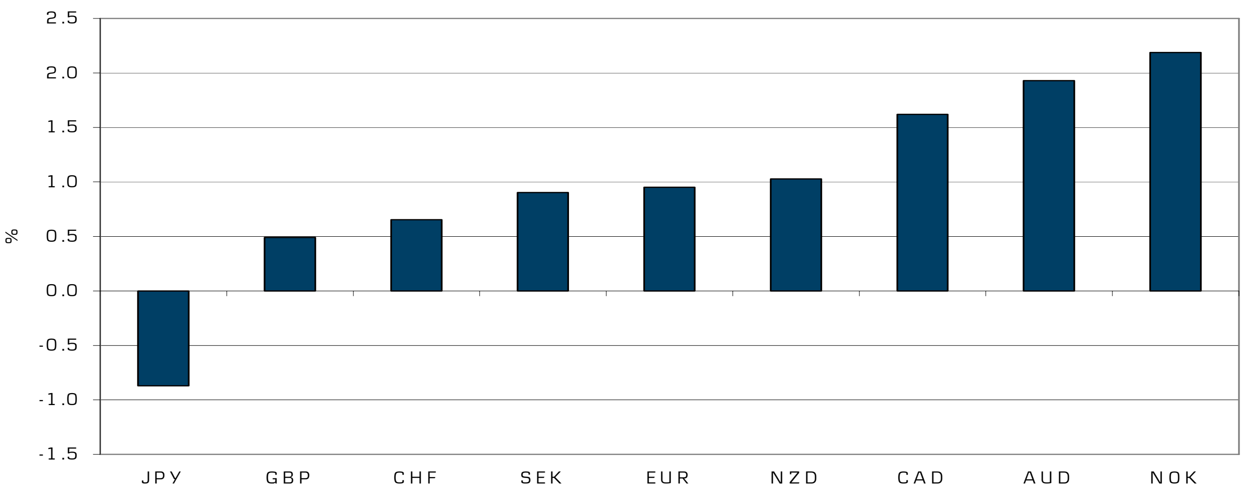
Country	Official interest rate	Policy rate	Next decision*	Last change
United States	Federal funds rate	4.50	11 Dec (Unch)	31 Oct (-25bp)
Euroland	Minimum bid rate	4.00	6 Dec (unch)	6 June (+25bp)
Japan	Overnight call rate	0.50	20 Dec (unch)	21 Feb (+25bp)
United Kingdom	Base rate	5.75	6 Dec (unch)	5 July (+25bp)
Switzerland	3-month Libor	2.75	13 Dec (unch)	13 Sep (+25bp)
Canada	Overnight rate	4.50	4 Dec (unch)	10 July (+25bp)
Australia	Cash rate	6.75	5 Dec (Unch)	7 Nov (+25bp)
New Zealand	Cash rate	8.25	5 Dec (unch)	25 July (+25bp)
Sweden	Repo rate	4.00	19 Dec (unch)	30 Oct (+25bp)
Norway	Sight deposit rate	5.00	12 Dec (+25bp)	26 Sep (+25bp)

* Expected decision in brackets

Exchange rate forecasts

	Forecast Spot	+1m	+3m	+6m	+12m	Forecast vs forward outright, % +1m	+3m	+6m	+12m
Exchange rates vs EUR									
USD	1.465	1.48	1.48	1.50	1.38	1.0	0.9	2.2	-5.9
JPY	163.23	166	169	173	163	1.9	4.3	7.5	3.2
GBP	0.706	0.710	0.710	0.720	0.720	0.5	0.2	1.2	0.6
CHF	1.648	1.65	1.69	1.70	1.68	0.3	3.1	4.1	3.6
DKK	7.45	7.46	7.46	7.46	7.46	0.1	0.1	0.1	0.0
NOK	7.89	7.80	7.70	7.75	7.75	-1.3	-2.7	-2.4	-3.0
SEK	9.24	9.25	9.25	9.20	9.30	0.0	0.0	-0.5	0.4
PLN	3.64	3.60	3.60	3.60	3.70	-1.1	-1.2	-1.4	0.6
CZK	26.62	27.20	27.30	27.40	27.10	2.3	2.8	3.3	2.3
HUF	253	250	260	265	270	-1.6	1.9	3.2	3.9
TRY	1.73	1.70	1.80	1.90	1.90	-2.9	0.9	3.9	-1.6
Exchange rates vs USD									
JPY	111.4	112	114	115	118	0.9	3.4	5.1	9.4
GBP	2.08	2.08	2.08	2.08	1.92	0.5	0.7	1.0	-6.4
CHF	1.12	1.11	1.14	1.13	1.22	-0.7	2.1	1.8	9.9
DKK	5.09	5.04	5.04	4.97	5.41	-0.9	-0.8	-2.1	6.2
NOK	5.38	5.27	5.20	5.17	5.62	-2.2	-3.6	-4.5	3.1
SEK	6.31	6.25	6.25	6.13	6.74	-0.9	-0.9	-2.7	6.7
CAD	0.96	0.94	0.92	0.94	0.98	-1.6	-3.7	-1.7	2.4
AUD	0.90	0.92	0.94	0.95	0.92	1.9	4.5	6.3	4.6
NZD	0.76	0.77	0.76	0.76	0.72	1.0	0.4	1.4	-1.6
ZAR	6.66	6.60	6.70	6.80	7.00	-1.5	-1.1	-1.1	-1.8
BRL	1.75	1.70	1.65	1.70	1.75	-3.5	-7.2	-5.4	-5.7
MXN	10.86	10.60	10.50	10.55	10.60	-2.6	-4.0	-4.4	-5.8
CNY	7.44	7.47	7.37	7.25	6.90	1.2	1.4	1.7	0.5

Expected change in USD vs forwards, 1m



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FX Crossroads is updated every week.

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