



Currency wars => dollar strength

2013 could see virtuous circle for dollar & US assets

Talk of currency wars has increased recently. M Juncker, until this week President of the euro group, laments the euro's 'dangerous strength'; the Prime Minister of Japan tries to push the yen down; the Bank of England's Monetary Policy Committee is worried that the level of the pound is impeding the rebalancing of the economy; and the Swiss National Bank seems to have defeated speculators, leaving the world not only with a falling franc, but also with an example to other central banks that may wish to pursue the road to a weaker currency.

Obviously, all currencies cannot simultaneously weaken. Someone has to be the one they weaken against (this is true even if you bring in gold into the equation and all currencies weaken against gold; in the subgroup non-gold currencies, there still has to be at least one currency that strengthens.) Looking beyond the immediate future and day-to-day movements, the most likely major candidate for that strength in 2013 is the US dollar.

This may sound counterintuitive. Why the dollar, when the US is facing repeated disruptive fiscal negotiations about spending cuts, tax hikes and the debt ceiling, possibly culminating in another downgrade of American creditworthiness? Would not the euro, which has held up well against the dollar and where the sovereign debt crises seem to have gone into abeyance, be a better candidate? Or sterling, or – with commodity prices picking up – the Australian or Canadian dollars?

The latter two are certainly possible candidates, not least if the Chinese economy is now beginning to pick up again. Less so sterling, which is likely to suffer from the British austerity debate (ie, is it time for a Plan B?) and from British economic weakness, and possibly also from the intensifying debate about Britain's EU membership. As for the euro, the case against euro strength is that the euro remains overvalued, but, more importantly, that the crises remain. Markets have been tamed by the ECB's lure/threat of Outright Monetary Transactions, by successful bond auctions in some countries and, above all, by the absence of a crisis flare-up. The value of the OMT may diminish if it is never used (that is not certain; if it is never used because there really is no perceived need, its credibility could remain); but a more worrying prospect is the return of the debt crises, with a flare-up in some country - Cyprus, Greece, Spain or any other. The seeming strength of the euro thus masks continued underlying weakness.

By contrast, in the case of the dollar, the concentration on public finances masks an underlying strength. This is notably the case with the monetary data (to be discussed in a comment in the near future) which show a pick-up in broad money growth (5.1% in the year to December, but 10.4% on a six-month annualised basis, which is a better guide to recent trends; that is by far the fastest rate since early 2008) and a rise in household borrowing; but also in other indicators, eg car sales or the housing market. While some regional Fed surveys have shown weaker activity, the latest Beige Book also shows reasonable growth continuing across the country.

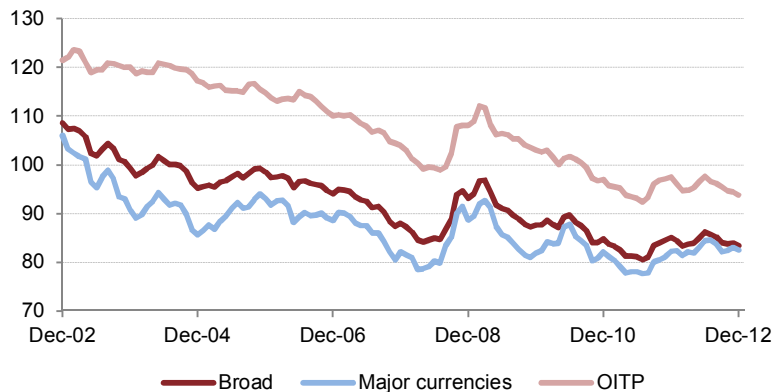
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Add to this a number of other factors which should be dollar-positive. Judging by the FOMC minutes, the Fed should sometime this year cease its asset purchases. By next year, subject to labour market developments, the Fed Funds rate may begin to rise. Further, it is rare for the Americans to try to push down their currency. In a world where everyone else – the UK, the euro area, Japan, China, other emerging markets – are trying to weaken their exchange rates, a policy of neglect means dollar strength.

Dollar strength could of course impact on US exports. But the dollar has space to rise. On the Fed's real effective exchange rate indices, the dollar has not only weakened over the past ten years; but on all indices, whether total, against major currencies and against the OITP (Other Important Trading Partners) currencies.¹ Perhaps more importantly, the dollar has weakened against the OITP group over the past two years as well as the US has recaptured competitiveness.

**US Federal Reserve real effective exchange rates,
index March 1973=100**



Moreover, if – as seems likely – US risk assets will do well in 2013, there should be a positive feedback from flows into US assets translating into dollar strength, increasing the attraction of those assets, further feeding dollar strength.

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¹ Major currencies are those of Canada, Australia, the Euro Area, Sweden, Switzerland, Japan and the UK. OITP are Mexico, Argentina, Colombia, Venezuela, Brazil, Russia, China, Taiwan, Hong Kong, Singapore, Malaysia, Thailand, Indonesia, the Philippines, India, Saudi Arabia and Israel.

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