Rise and rise of the mighty dollar

Dollar’s relentless rise is triggered by US economic strength and the ECB’s devaluation strategies

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One story has dominated global market coverage in 2015: the incessant rise of the dollar.

The scale and pace of the move has been remarkable. Last May, €1 was worth $1.39, compared to less than $1.05 – 12-year low – early last week. Although the dollar subsequently tumbled after dovish comments from Federal Reserve chief Janet Yellen regarding US interest rates, it’s been largely one-way traffic in 2015.

Currency markets rarely see such rapid movements. According to Nomura, the euro’s depreciation over the last three-, six-, nine- and 12-month periods has been almost unprecedented in each instance.

Not that the euro is the only currency to have tanked. The US dollar index, which measures the dollar relative to a basket of six major currencies, has risen by 25 per cent over the past year. Over the last eight months, Citigroup noted last week, the dollar has appreciated faster on a trade-weighted basis than at any time in the last 40 years and probably over a longer, much longer duration.

The dollar, Citi added, has already matched roughly two-thirds of the rally that occurred over the 1995-2002 period.

Many analysts envisage further euro declines against the dollar. Deutsche Bank predicts the euro will reach dollar parity by the end of 2015 and fall to 85 cents by the end of 2017. Goldman Sachs has cut its 12-month forecast to 95 cents from $1.08, and expects €1 to be worth just 80 cents by the end of 2017.

It’s a far cry from late 2007 and early 2008, when investors everywhere dissed the dollar.

“The dollar is collapsing,” said Jim Rogers, a sentiment echoed by then Pimco chief Bill Gross (“we’ve told all of our clients that if you only had one idea, one investment, it would be to buy an investment in a non-dollar currency,” he cautioned).

Even supermodel Gisele was aghast, demanding to be paid in euros rather than dollars. That turned out to be a classic market top indicator, with the euro peaking at $1.60 in July 2008.

Reasons for surge

The dollar has been in a multi-year uptrend ever since, but the bulk of the action has taken place over the last nine months.

Many attribute the initial surge in the dollar to the collapse in oil prices, although that thesis is not shared by all. Traditionally, there has been a strong correlation between oil and the dollar, with the dollar gaining when oil prices fall, and vice-versa. However, that correlation, Goldman Sachs noted late last year, has broken down in recent years, mainly because the shale oil revolution in the US has resulted in a big drop in oil imports.

For the most part, the dollar’s relentless rise has been triggered by relative US economic strength coupled with devaluation strategies adopted by the ECB and other central banks.

The improving US economy allowed the Federal Reserve to end its five-year quantitative easing programme last October; that same strength means that, this year, interest rate rises are finally in the offing.

The exact opposite is the case in Europe, where the ECB has finally launched its own QE programme in a bid to revitalise the fragile
European economy. Bond yields have plummeted in Europe, and are now “at the lowest they have been since the Black Death”, as Aberdeen Asset Management quipped last week. According to Merrill Lynch, yields are now less than 0 per cent on €1.8 trillion of European government debt.

With US government bonds yielding more than 2 per cent compared to infinitesimal rates almost everywhere else, investors have been busy selling euros to buy dollars.

That suits policymakers in Europe, where the falling euro means exports have suddenly become much more competitive. Recent European economic data has surprised to the upside, while the ECB has raised its 2015 GDP estimates from 1 per cent in December to 1.5 per cent.

“It makes things nice and clear”, said French president François Hollande recently. “One euro equals a dollar.”

The weak euro has also fuelled expectations for earnings growth, given approximately half of euro zone earnings come from outside the region. Fourth-quarter European earnings surged by 15.9 per cent, more than double the 6.8 per cent rise reported in the US.

With the single currency forecast to remain low for some time, analysts increasingly expect the earnings bounce will not be short-lived.

This growing euphoria has catalysed an eye-popping divergence between European and US equity markets. According to Merrill Lynch, US equities have suffered $47 billion in outflows this year, with $36 billion making its way into European equities.

The German Dax is up by 24 per cent in 2015, while the Euro Stoxx 600 has also soared, rising 17 per cent. In contrast, the S&P 500 is flat.

The latest Merrill Lynch monthly fund manager survey reveals bullishness towards European stocks “has reached uncharted territory”. A net 38 per cent expect double-digit earnings growth in Europe over the next 12 months, and a record 63 per cent say Europe is the region they most want to overweight. In contrast, a net 35 per cent want to underweight the US, the most bearish reading in almost 10 years. The spread between Europe and the US is at levels never seen before.

Danger
Therein lies potential danger. S&P 500 companies generate almost half their sales outside the US, and a stronger US dollar will hit those revenues. According to S&P Capital IQ, US earnings are expected to rise just 1.5 per cent this year, a sharp downgrade from the 12 per cent growth expected last October.

A recent Duke University survey of chief financial officers found two out of three big exporters have already been negatively impacted by the dollar’s appreciation. Survey founder Prof Campbell Harvey said there is now an “ugly contest to see whether the euro zone, Japan or Canada can depreciate the most against the US dollar”, one that would lead to “lower profits and less employment” in the US.

There is another concern, one recently flagged by Merrill Lynch: that the US dollar move “reflects a dislocation within the financial system”.

Capital flight to the US, says Merrill, “is a symptom of systemic risk in financial markets”. In the past, dollar shocks have been symptoms of “major financial events”, for example, the collapse of Lehman Brothers in 2008, Britain’s exit from the European Exchange Rate Mechanism (ERM) in 1992, and Federal Reserve chief Paul Volcker’s shock interest rate rises in 1981.

Little stress
Still, there is as yet little sign of systemic stress, Merrill admitting most global financial indicators appear “less stressed than normal”. Similarly, while US exporters may be concerned, most commentators believe the US economy will not be dragged down by the stron...
dollar, and that it’s largely a source of support for the global economy. That’s especially true for Europe, as evidenced by European stocks’ rip-roaring start to the year.

Still, the divergent monetary paths taken by the US and Europe has the potential to create tensions. Federal Reserve chief Janet Yellen last week diplomatically played down the threat of a stronger dollar but noted recent currency strength was probably weighing down US exports and inflation.

The Fed indicated it would raise rates slowly rather than hiking them too quickly, and strategists such as Citigroup’s Steven Englander believe the greenback’s strength gave them little choice but to take a more cautious approach. The ECB, adds Englander, is happy with the recent declines but may get nervous if the euro downtrend shows no signs of being arrested. Up last Wednesday’s reversal, it’s been one-way traffic, which is “normally not how currencies work”.

If the dollar does resume its rise, investors may eventually become edgy. The risk, says Deutsche Bank strategist Jim Reid, is that dollar strength may stop being “a sign of a relatively strong US economy, and start being a reason to doubt the continuation of that strength”.

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