# Turmoil *Causes* Dollar to Strengthen

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## Highlights

- The US dollar has been one of the few beneficiaries of the chaos since it is viewed as a safe haven currency in times of economic stress.
- Strong overseas demand for dollars was evident in the Federal Reserve's decision to increase its currency swap lines with the European Central Bank, the Bank of England, and the Swiss National Bank.
- Once financial markets eventually stabilize, the dollar may suffer a setback as the US currency no longer benefits from the flight to safety bid.

World financial markets have suffered their worst rout in decades after problems in the US subprime mortgage market morphed into an unwinding of leverage that has infected all asset classes. The US dollar has been one of the few beneficiaries of the chaos since it is viewed as a safe haven currency in times of economic stress.

Strong overseas demand for dollars was evident in the Federal Reserve's decision to increase its currency swap lines with the European Central Bank, the Bank of England, and the Swiss National Bank to more than $500 billion in October. The Fed's move was done to meet the demands of overseas institutional investors who borrowed dollars to purchase dollar-denominated assets and were forced to acquire more dollars in order to pay off their dollar loans.

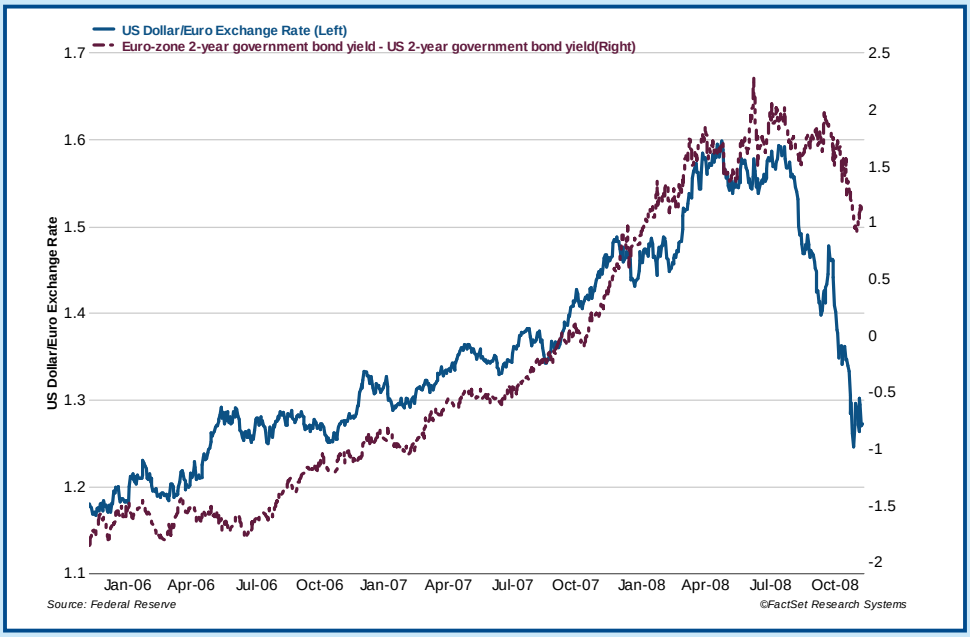
As a result, the US currency has experienced one of its most violent moves in the last two decades. Since late July, the dollar has surged more than 15% against a broad trade-weighted basket of currencies. The gains have been more dramatic on a bilateral basis, with the dollar up roughly 25% against the euro and British pound sterling during the same time period.

The question is whether the dollar's recent move is sustainable. Part of the answer lies in whether or not the forced deleveraging in global financial markets has run its course. Unfortunately, it is premature to draw any firm conclusions, but there are hopeful signs that the Fed's new credit facilities, such as the Term Security Lending Facility and the Commercial Paper Funding Facility, are improving conditions in overnight funding markets. Once financial markets eventually stabilize, the dollar may suffer a setback as the US currency no longer benefits from the flight to safety bid. At that point, investors will begin to focus back on the economic fundamentals. So what are these fundamentals telling us about the long-term value of the US dollar?

### Long-Term Dollar Strength

According to exchange rate theory, the best predictors of a currency's long-term equilibrium value are: the bilateral trade balance, net foreign investment, and inflation and interest rate differentials. Many exchange rate forecasters will also include measures of economic activity which can have a significant influence the

**Interest Rates Are the Key Driver of the Dollar/Euro Exchange Rate**



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- The euro-zone is the largest single trading partner for the United States and has a 17% weighting in the US trade weighted dollar as calculated by the Federal Reserve.
- The most important variable in determining the dollar's exchange value against the euro is the interest rate differential between 2-year government bonds in the US and Europe.
- Another factor that will be supportive of US dollar strength versus the euro is the shrinking US trade deficit with the euro-zone.

performance of the other variables contained in the model. Starting from this point, we have produced a simple currency model for the dollar-euro exchange rate, one which is similar to the model our currency analysts use in our global portfolios. We chose the euro-zone because the region is the largest single trading partner for the United States and has a 17% weighting in the US trade weighted dollar as calculated by the Federal Reserve.

The results suggest the most important variable in determining the dollar's exchange value against the euro is the interest rate differential between 2-year government bonds in the US and Europe. Historically, every nine basis point change in the spread between US and euro-zone 2-year rates leads to a one cent move in the dollar-euro exchange rate. The interest rate differential between the US and Europe has begun narrowing as policymakers at the European Central Bank play catch up on monetary policy with their counterparts at the US Federal Reserve. We expect this process to continue in the coming months providing a lift to the dollar.

Another factor that will be supportive of US dollar strength versus the euro is the shrinking US trade deficit with the euro-zone. The collapse of US demand suggests that the US trade deficit with Europe will continue to shrink in the coming months. The bilateral trade deficit between the US and Europe peaked at more than $122 billion in 2005 before dropping to roughly $85 billion this year. The less Americans import from Europe, the fewer euros they demand, and as a consequence, the stronger the US dollar becomes.

## 2008-2009 Dollar/Euro Forecast

### Three-month outlook:

Until financial market volatility subsides, the US dollar will receive a boost from the flight to safety bid from overseas investors and could retest recent highs in periods of extreme financial stress.

Trading range 1.25 to 1.35 with highs at 1.20

### Six-month outlook:

The dollar could suffer in the medium term as financial markets stabilize and the flight to safety bid evaporates. Economic fundamentals should prevent a retesting of the dollar's lows, but some weakness is likely.

Trading range 1.35 to 1.45 with lows at 1.50

### Twelve-month outlook:

Economic fundamentals will lead to an extended period of dollar strength. The ECB has been slow to reduce interest rates in response to the financial crisis and the euro-zone economy will suffer. Interest rate differentials between the US and Europe will narrow further, the trade gap will continue to shrink, and US economic growth will begin to outpace that in the euro-zone.

Trading range 1.20 to 1.35 with highs at 1.15