

## Market Insight

### Dollar Bears Beware

The US Dollar has been the weakest currency in the G7 over the past few months, reflecting not only weakness in the US recovery but also comparative strength in recoveries elsewhere around the globe. As the US labour market stagnates (the US has only posted 3 individual months of positive jobs growth in the last 3 years), domestic demand from both firms and individuals is likewise struggling to expand. Meanwhile, several G20 countries like Australia, Canada, China and India are pushing ahead with comparatively stronger recoveries. This is putting pressure on their central banks to tighten monetary policy and in turn raising interest rate expectations over the next 18 months. By contrast, the US is seeking to prolong loose monetary policy for the foreseeable future hence creating a negative outlook for US Dollar pairs. Against the Euro, the Dollar has given back almost all of its gains driven by the sovereign debt crisis which has seemingly come and gone as quickly as the banking/credit crisis in 2008.

A currently hot topic in the FX market is the diverging growth paths of Europe and the US. US growth estimates have been revised lower recently, not only by the Federal Reserve but also by independent financial institutions and think tanks. Meanwhile, European macro data/growth rates have improved markedly over the past couple of months, led by Germany's stunning 2.2% growth rate in Q2 2010. The effect on the Euro has been very positive with EUR/USD climbing from lows around 1.18 up to 1.31 over the course of June/July. This move was of course helped by substantial support and guarantees by the EU/ECB/IMF. It is more likely that the apparent divergence in actual growth rates (and their future expectations) is more a case of data lag between the US and Europe rather than decoupling. There is very little to suggest a decoupling scenario – rate expectations are similar with ultra-loose policy pencilled in for at least another 12 months on both sides of the Atlantic. It is also a struggle to find any concrete reason why European growth would necessarily help a divergence. Internal consumption and investment in the EU is likely to be driven solely by Germany and France but both nations aren't showing particularly exuberant rates of economic activity. If we assume that European macro data outperformance compared to the US continues, the next question is for how long? Historically, data lag between Europe and the US is rarely longer than 3 months. This implies that by the end of 2010 at the latest, a fresh downturn in European macro data should occur leading to calls for more state sponsored support – more or less what is currently happening in the US. Regarding Europe-wide fiscal tightening; for the time being, the downward effect on EU growth rates shouldn't be extensive enough to be significant because German fiscal expansion is helping to offset most of the fiscal contraction seen in the periphery.

Whenever the Dollar goes through a prolonged period of weakness, the same old questions are raised: the Dollar as the prime reserve currency and more importantly, whether mammoth Dollar based investments held by non-US investors will be unwound. However, the majority of the developed World has been saddled with immense public debt and consequently, savage deficit reduction programmes. This is creating a situation where investors are desperately searching for an alternative to the Dollar but are unable to find anything remotely suitable because of the homogenous, cheap money, environment engulfing all major currencies. Therefore, Dollar bears should beware because systematic shocks like sovereign default, large-scale commercial property losses and renewed economic contraction worldwide could still re-emerge as themes that drive the Dollar sharply higher. Despite a sharp bounce in equity, commodity and cyclical currencies



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