

## Market Insight

### As economic recovery expectations diverge, the outlook for the US Dollar looks increasingly uncertain

The US Dollar has been on a rollercoaster ride over the past two years as the financial crisis infiltrated the dynamics of all asset classes. The effect on the Dollar has been positive until the economic recovery theory began gaining traction in March of this year – between December 2007 and March 2009 the Dollar rose against every currency except the Yen as capital invested overseas was repatriated back to the US in search of security and liquidity. Since March however the Dollar has gone the opposite way as risk tolerance climbed higher in line with unprecedented stimulus packages and softening in macro deterioration around the globe. The risk-rally has also boosted equity and commodity markets which have helped to suppress upward Dollar momentum because investors who were stung by the unravelling of the economic crisis decided to remain sidelined in safe-havens such as USD and JPY – these positions have begun to be liquidated and re-invested over recent months as investors search for higher yields and better returns.

Exactly how US Dollar price action develops from here is highly dependent on the validity of the economic recovery; macroeconomic indicators continue to send mixed signals as to whether the tentative recovery is a prelude to a tangible improvement. Housing and labour market deterioration continues at a record pace whereas credit, banking and sentiment indicators are pointing to a rebuilding of trust, confidence and risk taking. The divergence of opinion regarding the recovery has induced consolidation in most asset classes and expectations are being re-evaluated on a regular basis.

Several key themes threaten both USD bulls and bears over the next 12 months. The upside will have to negotiate the overhanging effect of quantitative easing (QE) which for some is the biggest threat to USD value because medium-long term inflation effects are likely if the added stimulus proves too effective. The current QE policy framework will undoubtedly influence inflation expectations especially if extra stimulus is added or existing stimulus is removed. Fiscal easing is also important because excessive internal and external debt burdens tend to weigh on currency values. The rapid increases in government debt have buffeted bond markets, sending yields towards pre-crisis levels despite record low benchmark rates and bond purchases that are designed to suppress long-term rates. One other key theme is the Dollar's status as the world's reserve currency; severe doubts remain whether reserve managers will continue to trust the Dollar given the risk of credit rating downgrades and investors demanding higher risk premiums on long-term debt which threatens to stall recovery in the housing market.



#### Market Research

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From a more pragmatic perspective, USD positives are there too. Given the risk-negative status of the Dollar over the course of the financial crisis and assuming FX stays risk sensitive, we may only be able to see a higher Dollar if economic conditions deteriorate again. Fears of being caught in illiquid, unprofitable investments would reduce risk-tolerance and encourage risk-haven capital flows. A stronger Dollar alongside an improving US economy looks unlikely at the moment because the risk theme is predominating i.e. improving economic conditions in the US have so far pushed USD lower. A break from this trade logic is possible via interest rate expectations. The same way USD dynamics were changed as a result of unprecedented conditions, so too could traditional dynamics return as higher interest rates draw nearer. The Dollar could stand to benefit greatly if the US becomes a clear recovery case because interest rates will be used to guide sustainable economic growth. In this scenario, the Dollar would benefit from being one of the first currencies to experience recovery compared to nations who lagged in their policy responses.

In broad terms, the US Dollar is surrounded by potential risks that threaten to drive it in either direction depending on developments in the monetary policy framework, the rate of economic recovery worldwide and the severity of new regulation in the financial sector. Plans to re-regulate the financial markets will be pivotal for all asset classes if they prove restrictive for market participants. Investors are likely to remain risk-sensitive so negative macroeconomic indicators could support the Dollar although continued deterioration in US fundamentals could tip the Greenback into the doomsday scenario of facing a crisis in confidence. Regardless of how USD price action develops from here, we are likely to see more uncertainty in USD pairs.



Source: Reuters

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