

Market Insight

Why is the US Dollar doing so well?

Economic figures made available this week have shown that US inter-bank lending, consumer spending, manufacturing activity and employment numbers are all much worse than first thought for the period October-November 2008. Media headlines in the US and around the world have been showing the largest US car manufactures such as Ford, GM and Chrysler making their case to congress for a bailout of the automotive sector estimated to be worth 50 billion USD. Events such as this underline the severity of the problems facing many businesses not only in the US but also elsewhere. The USD has managed to find support partly due to US authorities launching huge rescue packages designed to boost confidence and to reduce job losses. So far, market participants have taken the news of bailouts for the US banking, housing (and now potentially the automotive sector) as good news that will help the US as whole and encourage capital inflows that are crucial to support the US dollar's value.

The US dollar has been benefiting greatly from the persistently high LIBOR levels. Real interest rates that market participants receive for holding USD have remained high despite the aggressive interest rate reductions by the Fed and the potentially inflationary Troubled Assets Relief Program (TARP) that plans to support the US economy with over \$800 billion of public sector funds. LIBOR levels that show the real rates that economic agents pay and receive have not fallen by the same amount as the official US interest rate because large financial institutions have been very sheepish in passing on interest rate cuts to their clients. Widespread fear that counterparties may not meet their obligations have led to many banks hoarding cash reserves and only lending funds to counterparties and clients at significant risk premiums. The added cost (manifested out of risk aversion and fear) incorporated into USD LIBOR rates has led to a dislocation of official policy conducted by central banks and the actual effect of that policy on the everyday lives of businesses and consumers. The net effect is that although the amount of USD lending has fallen, the compensation for holding USD has remained high leading to its upward trend against most currencies over the course of the last few months.



Market Research

George Tchetvertakov
Head of Market Research
gtchetvertakov@alpari.co.uk

Another very important yet underestimated factor helping the US dollar is the sophistication of US based investors in comparison to non-US based investors. US based investors are usually very quick to reposition and adjust their exposures following market changing events. This effect could be attributed to many different factors although market commentators tend to favour the theory that market access and access to market information is most efficient in the US compared to other nations.

Many analysts are in agreement that many of the world's currencies are still catching up in their digestion of bad news coming out from the retail, banking, housing and manufacturing sectors in their respective countries. Approximately a year ago the USD was only one of a few currencies that saw consistently negative sentiment and poor economic figures as the credit crisis took hold. Now, as the effects of the credit crisis are spreading to other countries we are seeing an equalisation of sentiment between the world's major FX pairs as bad news is priced into previously lesser affected currencies.

Nothing stays up forever

Historically, the US dollar has tended to pare back substantial gains by making significant losses soon afterwards; an example of which is the strong gains made by the USD in the late 1990's only to give it all back and more between 1998 and 2001. Some would also argue that repatriation of US dollars will subside once risk appetite returns to the fore once again. Sophisticated investors are quick to reduce risks but they are also quick to explore new opportunities and take advantage of high marginal value that is likely to come from the emerging markets in the years to come. Other factors are also worrying many investors; the US budget deficit combined with the world's largest national debt is making it difficult for even the staunchest US dollar bull to defend the US dollars' chances in the long term. There are significant worries amongst FX traders that the US sovereign AAA rating on its government bonds may be downgraded at some stage due to the astronomic levels of debt being taken on by the US authorities each year in addition to the huge levels of debt already being serviced each year.

The demand for gold has been strong but because of its strong negative correlation to the US dollar, gold prices have been slow to push higher. If the upward momentum in gold prices seen in late 2007 – mid 2008 returns, the US dollar could be on track to retrace some, if not all, its strong gains made in 2008.

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