The Demise Of The Dollar Is Greatly Exaggerated

This is the latest piece by Anatole kaletsky, which was recently featured in the Times.

Mortgage your house, sell your car, pawn your wife's jewellery and buy dollars ! But don't do it just yet. On Friday the pound closed only two cents below the $2 level, which has provided a sure-fire signal for buying dollars and selling sterling for 25 years. The euro, though not quite as strong as the pound, is less than 3 per cent away from the record high that it hit at the end of 2004, a peak that was followed immediately by a 20 per cent plunge ? and a corresponding gain for the dollar.

Most telling, newspaper headlines are screaming that the dollar is becoming worthless, while market leaders, central bankers and politicians seem to be in unanimous agreement that there is only one way for the US economy and currency to move from now on, and that that is down.

The cover story of The Economist this week, for example, is titled The ShrinkingDollar. The Financial Times has been publishing leaders or analyses almost daily to explain why the fall of the dollar is inevitable and why it should be welcomed, not resisted, provided that it does not get out of hand.

Such media excitement ? and especially magazine cover stories ? are usually reliable contrary indicators of a change in trend. Once the whole world believes that a currency will keep on falling, there is nobody left to sell it ? and, therefore, the trend is likely to reverse.

The big question today, not only for currency speculators but also for businessmen and politicians whose fortunes depend on the global economic outlook, is whether the dollar and the American economy have reached such a pivotal point. Rarely in living memory has an important currency, or any financial asset, been as friendless as the dollar is today.

So, on the tried-and-tested contrarian principle that the best time to buy is when everyone else is selling, the dollar and other US assets probably offer extraordinary bargains today. This is especially true because most of the supposedly fundamental reasons why the dollar is falling appear to be bogus.

For example, the idea that higher interest-rate movements offer stronger support to the euro than the dollar is simply untrue, since the gap of two percentage points between US and European rates today is wider than it was in 2005, when the dollar was rising, and there is almost no chance of this gap disappearing —or even narrowing substantially— in the next two years.

Nor is it true that prospects for economic growth point to a lower dollar.

Although growth in the United States is slowing, so is growth in Europe and Japan ? and there is more likelihood of a reacceleration in America by the second half of next year. In fact, the eurozone and British economies are likely to suffer a severe slowdown if the euro and the pound remain at anywhere near present levels against the dollar and the Asian currencies, which is why I believe that a big change of direction in the currency markets is probable very soon.

But what about global trade imbalances? Surely, America's huge trade deficit explains why the dollar is so weak. This may seem to be a plausible argument for the weakness of the dollar, but can trade imbalances possibly explain the extraordinary strength of the euro and the pound? The answer is «no». If exchange
rates were still driven by trade, as they were in the 1970s, then the only tradable currency going up against the dollar would be the yen, since Japan has by far the world's largest trade surplus and is the only leading economy whose surplus is steadily growing.

Yet the yen is the only significant currency that has not risen against the dollar this year. This is not the time to explain in detail why trade balances are almost irrelevant to currency levels in a world of globalisation and deregulated financial markets, but suffice it to say that there has been a certain inconsistency, to put it

mildly, between the theory that currencies are driven by trade performance and the empirical experience of the past decade.

After all, the dollar, which is supposed to be driven by the world's biggest trade deficit, has fallen by exactly the same amount this year as the yen, which is supposedly driven by the world's biggest surplus.

Now let us juxtapose the fundamental arguments, which are, if anything, rather favourable to the dollar, at least in comparison with sterling and the euro, against the hugely lopsided balance of market opinion.

This is unanimously bearish about the dollar and wildly enthusiastic about the euro and, to a lesser extent, the pound. This contrast suggests that the dollar is about to turn, perhaps in a very big way.

The irrational bias in market sentiment does not, however, tell us when the trend will turn —or at what price. And until the trend does turn, investors who try to fight it risk losing their shirts. And how do we know when the trend has turned ? Some years ago Brian Marber, one of the City's best-known and most-respected currency analysts, devised a rule for assessing trend changes that has, on the whole, withstood the test of time. Marber's law states that when a currency reaches within 1 per cent of a previous important high, it enters a «twilight zone» from which it could easily emerge in either direction —and as soon as it does emerge, with a move of 2 per cent or more, that establishes the new trend.

Last week the dollar entered the twilight zone against sterling. If the pound now rises above $2.06, it will keep moving upwards. If it falls below $1.95, it has nowhere to go but down.

So what should the investor do? Hedge your bets until it is clear whether the pound decisively breaks through the $2 barrier. If it does, it could well go a lot higher in the short term. But if the pound tests the $2 barrier and then falters, it will be time to take a flutter, if not mortgage your house.