

Another Voice on the Dollar vs. Yen and Euro Discussion

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Recently, I spoke with Ray Farris, Head of Asia Pacific Macro Products Research at Credit Suisse, about his outlook for the major currencies against the U.S. dollar. Here are some highlights of our discussion: • At this stage in the cycle, the foreign central banks—the Bank of Japan (BOJ) and the European Central Bank (ECB)—have more sway in determining the direction of the dollar than the Federal Reserve does. • The current account surplus in Europe, without action from the ECB, puts upward pressure on the euro (implies a weaker U.S. dollar). • The current account deficit trend in Japan is supportive of a weaker yen (stronger dollar). **Ray, what do you think will be the main drivers of the U.S. dollar against the yen and euro over the coming months?** Historically, we are not yet at a part of the Fed cycle which would generally argue for a strong U.S. dollar. That is because the front end of the U.S. interest rate curve is very low and the interest rate yield curve is very steep. For the dollar that matters in two ways: First, the cost of hedging is extremely low. Think about the Japanese pension funds and life insurance companies; they buy U.S. fixed income. The cost for them of running a rolling hedge of their currency exposure is essentially nothing because of where short-term rates are in the United States. That means they can earn all the higher interest rates from holding longer-duration fixed income securities while fully hedging currency risk on a short-term basis. That is a great trade, so hedge ratios are very high. One of the more empirically robust observations in currency strategy research, in the [G10](#) space especially, is to sell currencies with proportionally steep yield curves and buy currencies with proportionally flat yield curves. **Given that the current interest rate environment is a headwind and not supportive for the U.S. dollar, what is the case for being bullish on the dollar?** You must think countries on the other side of the U.S. dollar pair are going to do something to actively depreciate their currencies. The expectation at the beginning of this year is that we would see more stimulus from the BOJ aimed at recognition that the momentum in the Japanese economy was beginning to slow, the beneficial impact of the yen on both inflation and economy was waning. But that's not happened. The head of the BOJ, Kuroda, commented recently that the BOJ thinks Japan's economy is still on course for recovery, and the underlying implication was they don't need to do anything meaningful anytime soon. I think the BOJ will end up doing something, but it needs more compelling data that the momentum in the economy has turned over, that the rise in inflation has stopped and that something needs to be done. When will they do that? The earliest opportunity, we think, is July, when they had the economic assessment report and can see the impact of the consumption tax hike, summer bonuses and summer wage negotiations. Quite simply, if the BOJ does not do anything new in the next three to six months, then the dollar–yen trades at a frustrating range. We still believe the dollar goes higher against the yen this year for three reasons: The current account deficit keeps pressure on

the yen. We think U.S. yields will rise in the middle of the year. The last time the 10-Year U.S. Treasury was 3%, the yen was at 105.5. At some time in next 12 months, I think we will get more stimulus from the BOJ to give another bout for inflation expectations. **What about your views on the euro area?** Absent any actions from the ECB, the dynamics are more positive for the euro. The euro area has the largest current account surplus in its history. Emerging markets—China in particular—are buying euro foreign exchange reserves. With the improvement in credit quality in peripheral sovereigns (Spain, Italy, Portugal), the euro has become more investable. If the ECB doesn't do anything to shock the system—such as creating punitive disincentive to hold euros—the euro is more likely to grind higher on the current account surplus and reserve manager flows. **What factors impact the timing of when you think the ECB would take action?** Draghi probably wants to do more. Unfortunately, the Governing Council, which dictates ECB policy, is not quite like the Fed, where the chairman dominates decisions if he wants to. The ECB has very significant political constraints. I liken the euro area under Draghi's leadership to Japan's under the former head of its central bank. Before Kuroda came in, the BOJ was led by Shirakawa. Shirakawa increased the size of asset purchases a number of times. But he never really thought it would work—he never raised the BOJ's own inflation forecast. He never came across as signaling a true regime change. Along came Kuroda this past April. He announced a huge program. He changed the BOJ's inflation target. The size of his QE program was the signal—he said he would do whatever it takes to get 2% inflation, something Shirakawa never did. The ECB as a central bank does not look and sound like Kuroda leading you to expect it will announce a new higher inflation target, a massive QE program, a signal to the market that the regime has changed, that it is here to play ball and win in a fight against deflationary forces. They sound more like Shirakawa—we don't really have a problem, inflation will remain low for a long time, maybe we cut the deposit rate to -10 basis points, while saying early on it won't have a big effect on the system. If the ECB came out and said we are going to tax you to hold the euro at -150 basis points that would be a big move and change my mind. But you have all these political forces at work on the Governing Council and different opinions on the cost of inflation. The Bundesbank, the Austrian central bank, the Netherlands prefer price stability, and undershooting the inflation target is not so unattractive to them. For the weaker southern European central banks—more rightly in my opinion—with as much debt as the euro area has, a faster rate of inflation that keeps nominal gross domestic product (GDP) higher is beneficial. The message we are getting now is there is no consensus in the Governing Council that something needs to be done. And macro data from the euro area has been coming in OK. Some euro economic indicators are looking outright strong. My sense is, the heart of the Governing Council is not in it for fighting deflation. To change their view, they would need to see collapse in inflation or feel dangerously close to deflation. The only way to get that is if real economic data starts to roll over. Then maybe the ECB starts to sound more Kuroda-esque by the middle of the year. **Conclusion** In summary, Ray's views are that it is still too early in the U.S. interest rate cycle for the Fed to be a primary determinant of the dollar's moves—the foreign central banks' moves are more important today. In that regard, Ray believes it is easier to maintain a bullish dollar position (i.e., assume a weak yen) because of the current account dynamics in Japan and the BOJ's strong political stance to fight deflation. The ECB is less committed in its effort to promote higher inflation, and the current account dynamics in the euro region make the euro a stronger currency in the absence of more aggressive ECB actions.

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