GLOBAL INVESTING: Investors betting on the dollar's slide hope history repeats itself

By Christopher Swann in London
Financial Times; Jan 30, 2003

Investors and traders who failed to jump aboard the US dollar's recent move may be feeling they have missed the boat.

Since its turning point in February 2001, the dollar has fallen 26 per cent against the euro. With the US economy set to outpace rival economic blocs next year, it may be tempting to think that the dollar's fall has run its course.

Financial history, however, suggests the dollar's downward journey may be far from over.

Research by Deutsche Bank of the three most recent reversals in the dollar - the dollar's rise after 1980, its fall after 1985 and its resurgence after 1995 - provides a reminder that turns in the dollar have tended to be big and violent.

On average, the dollar moved by 30 per cent against the German mark in the first year and 12 per cent in the second year. If history repeats itself, this would leave the euro at $1.25 by February 2004.

Deutsche's research also showed that dollar moves are seldom just one-year affairs. Since 1972, cycles in the dollar have averaged seven years.

One reason the dollar's fall may be more sustained than many expect is the trend in the current account deficit. This is expected to have reached $500bn in 2002, requiring the US to attract a net $1.9bn of overseas capital every trading day. It looks possible that the current account deficit will widen to $600bn in 2003 - about 6 per cent of gross domestic product.

This is largely due to superior US growth relative to the eurozone or Japan this year, which should lead the US to take in large volumes of overseas goods.

But since this growth will be based on government spending and consumption rather than business investment, the US looks unlikely to produce enough compelling investment opportunities to suck in even larger quantities of foreign capital.

A much larger fall in the dollar will be necessary to remedy this problem. On the Fed's broad trade-weighted index, which includes fixed regimes such as China, the dollar has fallen just 5 per cent since last February.

According to Fed calculations, a 10 per cent trade-weighted fall in the dollar is needed to

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produce a fall in the current account deficit of 1 per cent of GDP. To bring the US deficit back to a sustainable level of about 3 per cent of GDP from the current 5 per cent of GDP may require a 20 per cent trade-weighted fall.

So what is the optimal strategy for US investors? Michael Lewis, senior currency strategist at Deutsche Bank, argues that US investors are best advised to build up their holdings in the eurozone, Britain, Scandinavia and Switzerland. "This is where the dollar's biggest decline looks likely," he says. The lion's share of the US trade deficit is with Asia, where there will be great resistance to the appreciation of their currencies.

"The area of least resistance is Europe," he adds.

For eurozone investors, there is now a compelling reason to hedge the currency risk on US assets. Over the past 12 months a European investor who had failed to hedge currency risk would have lost 38 per cent on the S&P 500, compared with a loss of just 24 per cent for a US investor.

The added bonus is that low relative US interest rates mean the cost of hedging the dollar is cheaper than in many years.

This is due to the fact that US interest rates are below eurozone rates and are now much closer to rates in Japan and Switzerland. Investors tend to hedge by buying dollars in the spot market, in order to buy the assets, and then selling dollars in the forward market. Since the forward price of the euro-dollar, for example, is calculated by taking the spot price and adding in the interest rate differential, the dollar forward is higher than the spot price.

For investors worldwide the fall in the dollar will continue to be both an opportunity and a risk.

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