# Weak economic 'shadow' dims currency outlook

**The U.S. engine that pulled the world through the Asia and hedge fund crises in 1997 and 1998 is chugging along in a different environment today, but the dollar remains a leader in the foreign exchange market.**

By Darrell Jobman

The outlook for the U.S. economy has changed dramatically since last fall, a fact heralded by almost every economic report released during the last six months. What does not appear to have changed significantly, however, is the outlook for the U.S. dollar against the other major currencies, even as the U.S. economy was becoming unglued more quickly and more sharply than ever before.

In general, analysts contacted by *Futures* continue to see a strong U.S. dollar relative to the other currencies. Although the U.S. economy shows all the signs of weakness that should put pressure on the value of its currency, other countries aren't doing much better and, in some cases, their prospects for growth are even dimmer in the global economy.

"At the center of this global economic universe is the U.S. economy," says Tim O'Sullivan, trading manager at Gain Capital. "As the United States goes, so goes the rest of the globe."

Adds Bert Dohmen, editor of the *Wellington Letter* in Honolulu: "This is the year when money goes to safety. That means the dollar once again."

So, warts and all, the U.S. economy casts a long shadow over the foreign exchange market. Consequently, that puts the direction of the U.S. stock market at the center of attention because it has played such a prominent role in perceptions about consumer confidence and economic health.

The forecasts for currencies, while generally favoring the dollar, are as varied as the prospects for the stock market and the economy. For example, while analysts generally conclude the Japanese yen will be around 120 to the dollar (about 0.83¢ in futures terms) by the end of the year, a sampling of opinion on the euro ranges from 0.80 to 1.05 and for the British pound from 1.36 to 1.65 by Jan. 1, 2002.

With the U.S. economy in such a dominant position in the global foreign exchange market, affecting investor psychology and capital flows, the first step in any currency analysis is finding out how currency analysts see the U.S. economic scenario unfolding.

**U.S. outlook: 'Relatively' good** No one questions the softness in the U.S. economy over the last six months. However, the debate still rages over "recession" or "no recession," "hard landing" or "soft landing," "V bottom" or "extended bottom." Discussion about a recovery seems to exceed talk about the decline.

"First, we need to determine the bottom and then we can think about a recovery," says David Ethridge, director of global market strategy at Standard & Poor's Corp. "The bottoms in the 1970s and 1980s were not V-shaped, and this one won't be either."

Ethridge admits he's a little more bearish than most but sees a landing somewhere between "hard" and "soft," with the odds of an official recession — two quarters of negative gross domestic product (GDP) growth — at about 40%.

"By about May, people will realize there will be no V-shaped recovery and will really begin to unwind the excesses of the last year, especially in the technology sector," he says.

One difficulty in trying to analyze the current economic downturn is that there is no history for the key area, technology. Is the decline in almost everything related to com-



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puters and the internet cyclical or is it a permanent setback? It's still an unknown new territory.

However, "it will take more than one or two quarters to dissipate the bubble in the Nasdaq Index," Ethridge declares. "Every high-tech firm has issued similar warning messages about missing earnings and not knowing what the second half of the year will bring. There is more inventory on the shelves than expected and more reductions in orders than anticipated. This process is not over, by any means."

He thinks it may take a year. High energy prices could contribute to the negative slump, he adds, noting that the energy demand squeeze is not limited to California.

Ken Bercuson, chief financial officer and market strategist at Hotspot FX Inc., has a different slant on what has happened.

"The U.S. economy is better maintained than most expect. There is no recession on the way," he says. He thinks Federal Reserve Chairman Alan Greenspan is correct in expressing concern about the sharp decline in consumer confidence figures and other data but also is correct in not responding in a panicky manner because key numbers actually remain rather strong. "The reports suggest we will work through the inventory and capital stock quicker than expected. I look for (GDP) growth to be 3½% to 4% in the second half, compared to the revised figure of 1.1% for the fourth quarter of 2000."

That is in line with the most widely held outlook for the U.S. economy: a weak first half, strong second half. Analysts holding this view usually point to three main factors: (1) Stocks have already been hit hard, with the Nasdaq Index posting two of the worst months in its history in the last five months and wiping out much of the "irrational exuberance" Greenspan talked about a few years ago. At much lower levels, can stocks go anywhere but up? (2) The Fed's interest rate cuts suggest an aggressive policy that will stimulate the economy and not let a recession take place. (3) A tax cut — maybe not the "Bush tax cut" but some form of a tax "refund" — is likely to be enacted this year and could rekindle consumer spending or at least consumer optimism.

O'Sullivan is one who expects major stock indexes to begin to bottom out during the second quarter. "During the summer it is very possible the dollar bases out and begins its upward assault," he says. "This basing out action comes to fruition as the equity markets begin to turn around. This is not smoke and mirrors. Greenspan . . . is not going to go down in history as the person responsible for the economy's demise. With that thought in mind, I believe the Fed will be very generous with liquidity. Lower cost of funds will definitely spell higher equity prices and, ultimately, a higher dollar."

One factor that could have a bearing on consumer/investor outlook is the delay in reporting economic numbers. When the GDP figures for the first and second quarters are reported in the middle of the year, will the stock market be on the upswing or will there be blood in the street? Will the figures be used to confirm how bad it was — or how it wasn't so bad after all. Much will depend on the consumer attitude at the time the reports are released.

So how will the diverse out- ➠

## POSSIBLE 'SHOCKS'

- U.S. stock market does melt down or economic or unemployment data is so depressing that consumer confidence plunges and feeds on its own downward spiral.
- U.S. recession becomes "official."
- Intervention by one or more central banks, which usually try for a surprise.
- The Fed raises interest rates because of a brief bounce in inflation numbers.
- U.S. budget deficit comes back into vogue. Could a tax refund become a mistake?
- The U.S. "tech wreck" has much deeper systemic effects than realized.
- Oil prices collapse or, conversely, rise and hold above $30 a barrel.
- Mergers and acquisitions make Europe a more desirable place to invest.

## Tech Talk:

# Euro standing on its head? *By Greg Troccoli*

The euro established a major bottom on the weekly continuation chart during the week of Oct. 23, 2000, when it posted its cycle low of 0.8245. Subsequent to the selling pressure drying up, the market rebounded quite feverishly during the next 10 weeks. The result of this sharp reversal in price action was a major shift in the trend from bearish to neutral/positive. In addition, the slope of the 21-week moving average line shifted from negative to positive.

However, once the market reached the 0.9600 level, it abruptly came under selling pressure again. Although the erosion in price during January and February was somewhat minor and orderly (compared to the prior upside acceleration), the market lacked the buying confidence of traders, which is vital if the euro is to test the 1.0000 region eventually.

The possibility exists that the market may be forming the right shoulder of an inverted head-and-shoulders pattern. To confirm that scenario as reality, a weekly settlement above 0.9574 (neckline) is key. Near term, the market should avoid a settlement below 0.8930. That, in essence, would keep the pattern in good standing. Keep in mind that, should the market close above the neckline, thereby completing the inverted head-and-shoulders pattern, a measured objective of 1.0600 is not out of the question.

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looks for the U.S. economy play out in the major currency markets?

**Euro: Trailing the dollar** A bad day for the U.S. market has been a good day for the euro — up to a point. But after posting a low below 83¢ last fall and then rallying on U.S. weakness (see "Euro turnaround," right), the euro hasn't been able to gather enough strength to break above 96-97¢, much less its goal of 1.00 and parity with the dollar. According to analysts, that will continue to be a struggle for the euro.

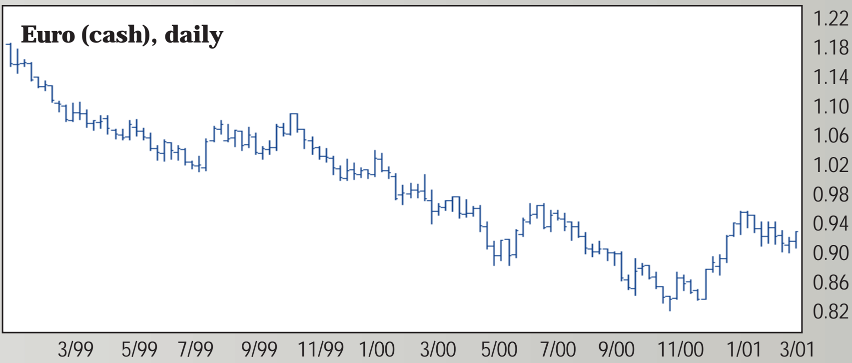
"Corporations are using rallies to sell the euro any time it gets into their target area above 95¢," observes Jamie Coleman, managing analyst at Thomson Global Markets in Boston. "Consequently, the euro keeps getting turned back when it gets that high." He expects the euro will hold in the 90-95 range but says that a break below 90 could bring out hedging by corporations that have their "finger on the trigger and are ready to move."

"Even if the United States has a harder landing than we now expect, Europe will also have a slowdown," points out Barbara Rockefeller, president of Rockefeller Treasury Services in Stamford, Conn. "Current denials by Europeans are nonsense. The United States will recover faster than Europe because of superior adaptability. The euro, therefore, will get stronger only later in the year. The euro also is subject to weakness because of European Monetary Union enlargement issues."

"Contrary to prevailing expectations, foreign investment will continue to finance the U.S. current account deficit," says Ashraf Laidi, director of news and analytics at MG Financial Group in New York. "More specifically, we may note a slowdown in the rate of U.S.-bound mergers and acquisitions from the Eurozone, but the rate will remain instrumental in keeping the dollar boosted into the next four quarters. During 2000 and the first month of 2001, the United States remained the highest recipient of foreign flows while the Eurozone continues to leak the highest rate of outflows in the G7. These forces will serve as an important offset to narrowing growth/yield differentials between the Eurozone and the United States"

**EURO TURNAROUND**

The euro possibly has reversed its extended downtrend vs. the dollar in late 2000. If U.S. growth (and interest rates) continues to decline, the new trend could extend even higher.




Source: CSI

However, Laidi does think the euro could turn up towards the end of the year "in anticipation of the elimination of national notes and coins as well as the enactment of more pro-growth tax reforms."

Bercuson expects growth in Europe to slow to only 1%-1½% while the U.S. economy remains much stronger than most expect in the second half of the year. He doesn't know when the market will begin to focus on this fact, but when it does, he thinks the euro will take out last year's lows, probably in the July-August time frame.

"The brief flurry in the euro is over," Dohmen agrees. "It was based on the perception that the U.S. economy was weak and Europe was stronger. Europe will now get infected with the recession bug."

David Abramson of BCA Research in Montreal expects the European Central Bank "will take its time before stimulating, but the return on capital in Europe stays low so the euro stays cheap."

The sterling will find it difficult to rally when the euro looks weak, but, on a relative basis, it has several positive factors going for it. First, Bercuson expects UK growth to be around 3% or about twice the rate as in Europe. Second, the Bank of England is more likely to take pre-emptive action to reduce interest rates, sometimes perhaps even prematurely if it anticipates that the risk of a U.S. slowdown could affect the U.K. economy adversely.

However, analysts say movement of the British pound will probably be confined to its recent range in the 1.40s and 1.50s.

**Yen: Perpetually weak** Although views vary on most currencies, the most persistent opinion is the lack of optimism about the Japanese economy and the yen.

With the end of the Japanese fiscal year on March 31, the key near-term feature for the yen is what happens to the "window-dressing" funds that Japanese institutions and companies brought home to shore up their year-end balance sheets. The Japanese banking system is totally bankrupt and saddled with bad debts, Bercuson says, so the banks again had to repatriate funds in the last two months just to show that they had money

**BEST TRADES**

Short the euro at the top of its range and be aggressively short. Be prepared for a quick drop. (Bercuson)

Long dollar, short yen. (Dohmen)

We expect to make a lot of money by shorting the yen against a wide range of currencies (example: long euro/yen at 100). We also hope to range-trade the euro within the bounds of the past 12 months. (Abramson)

Buy dollar/yen in the 109-110 range for a possible 20%-25% return. (O'Sullivan)

Buy dollar/yen, capitalizing on the end of post fiscal-year repatriation flows. (Laidi)

Long sterling/short euro. (Bercuson)

The yen for 20-yen swings. (Rockefeller)



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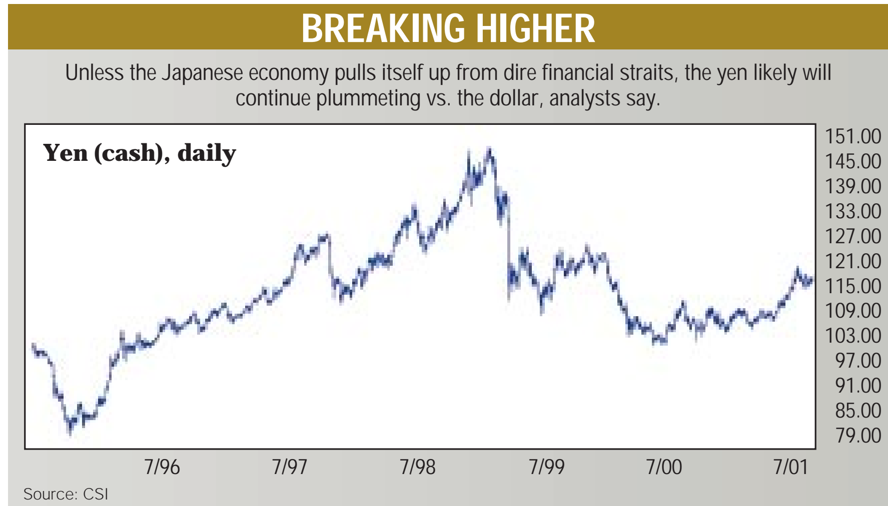
on hand and to pay bills as the economy seems to be imploding.

Rating services such as Standard & Poor's added a little embarrassment by downgrading Japan's bonds in February. "The debt-to-GDP ratio (the highest, relative to GDP, among advanced economies) is expected to hit 150%, the worst for any G10 nation since the 1920 depression," Laidi reports. "Japan cannot protest such downgrades on the basis of its trade surpluses. Its trade balance has just become a deficit for the first time in four years."

Repatriation flows of non-yen assets tend to give the yen a seasonal boost from late January through March or at least provide support to keep the yen from sinking, according to Laidi.

"In 2000, the yen shot up 9% between Feb. 23 and April 3 before losing all of the gain over the rest of the year," Laidi points out. "We could expect the same process this year. Thus, the dollar could fall to 115.20 or even 114 before making it back to the 118-119 level. Spring has always proven to be a cruel season for the yen."




Now that the window-dressing period is past, the seasonal outflow could add another element of weakness on top of the fragile economic and political conditions that continue to put pressure on the yen. Laidi ticks off a few examples: Consumer and capital spending are dismal, retail sales have been down for about 45 consecutive months, industrial production is falling, etc. The poor economy hurts the Nikkei Index, which, in turn, could exacerbate the banks' precarious asset posture if it slips below 12,000.

Abramson expects the Bank of Japan will create "a lot of money at a time when return on capital in

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Japan is lousy" and the U.S. return is much more attractive. He sees long-term capital leaving Japan and shifting into the United States and, to a lesser extent, Europe.

The United States doesn't particularly want dollar/yen to be significantly higher because of the impact on the already huge U.S. trade deficit — at least, nothing like 130 or the 147 yen to the dollar (0.68¢) low in 1998 (see "Breaking higher," left). In Japan the tug of war for the yen is between the politicians, who want a weaker yen, and the Bank of Japan, the bastion of yen support. To boost economic recovery, the Bank of Japan dropped the discount rate from 0.50% to 0.35%, a historical low, in early February and then to 0.25% on Feb. 28, leaving little more room to go on the downside. Despite repeated calls for change, the major financial reform that many analysts think are necessary remain in limbo, keeping the yen a perpetual guessing game.

There is a positive twist for the yen: "Everyone knows" how bad the situation is; how much worse can it get? Therefore, the yen that almost everyone continues to target as the best short could instead benefit from the other currencies' weakness at some point during the year.

Rockefeller thinks Japan could be in for another banking crisis but, "once that is perceived as under control, stocks zoom up, pulling the yen with it (as in 1999). The yen always moves the most, if you can spot the turning points. It will be weak, strong and then weak again in less than a year, moving a minimum of 20 yen each time." Her forecast: 125 yen to the dollar on July 1, 100 on Oct. 1 and 120 again by year-end.

**The 'other' dollars** Because the value of the dollars in Australia and Canada are associated more closely with commodity prices, analysts are not optimistic about their prospects in the months ahead. With the prices of many commodities already at lows, they won't add much more weight to the downside; on the other hand, the potential on the upside also seems limited for both commodity prices and the dollars.

A long Canadian dollar/short Australian dollar might be a possible trade for those who prefer spreads rather than outright positions in currencies, Bercuson suggests. Low commodity prices will pressure both dollars alike, he notes, but the Australian dollar suffers from the added disadvantage of being a victim of weak Asian economies whereas the Canadian dollar will benefit from the stronger growth and export demand provided by the U.S. economy. Even so, the Canadian dollar may go no higher than about 66¢ and could sink toward 60¢, the analysts forecast.

"The Australian dollar is the most undervalued currency of all time but seems to be in thrall to the euro, for some reason I do not understand," Rockefeller adds. FM

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