

*Economic Update*

THOUGHTS FROM OUR ECONOMICS TEAM

OCTOBER 7, 2014

**THE DEATH OF THE DOLLAR HAS BEEN GREATLY EXAGGERATED**

The United States dollar put in its strongest quarterly performance since Q3 2008, rising nearly 8% since the end of June (see chart below). How do we explain such a strong performance for the greenback? Differences in economic growth and diverging central bank policies may provide clues. Plus, many of the dollar doomsday stories have failed to materialize.

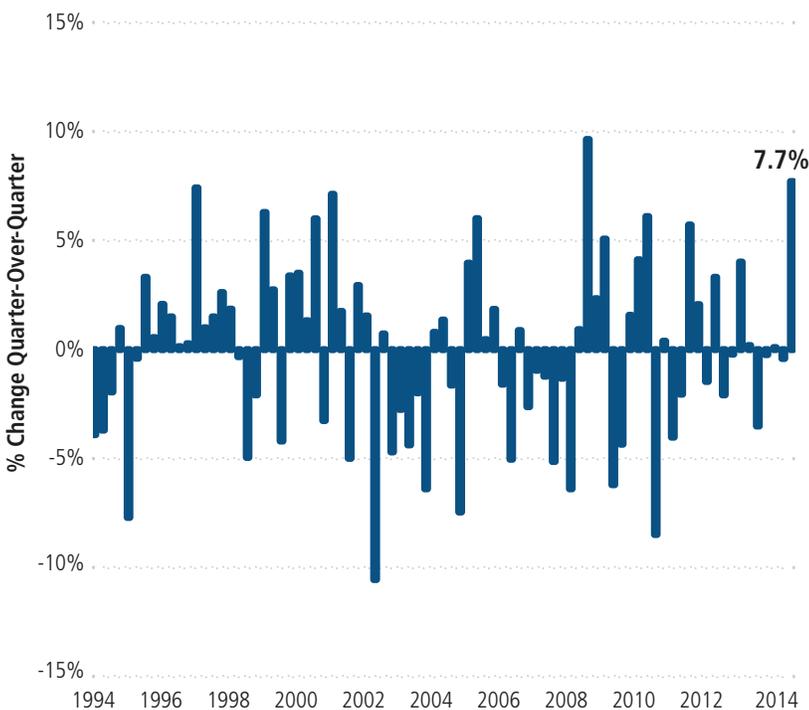
On the first point, economic growth has varied widely by country. Since the end of 2011, GDP growth in the US has bested most developed countries, adding 5.4% to GDP (see chart at top of next page). Output has scarcely increased at all in Japan (up +1.7%) and the euro area fared even worse (+0.9%) over the same period. Also, slowing in emerging economies pushed the US dollar higher. In the International Monetary Fund's most recent growth outlook, four of the five BRICS countries had their growth forecasts lowered, with India the only country left unchanged. Better economic growth for the US relative to global peers generally leads to a stronger buck.

Second, the different monetary policy paths pursued by global central banks have consequences for currencies. Indeed, investors now seem more certain that the Fed will raise interest rates in 2015 at the same time as the Fed's large scale asset purchases end (scheduled end: October 2014). If the US central bank does shift toward tighter monetary policy, the fears of currency debasement that have haunted the US dollar in recent years may fade from memory.

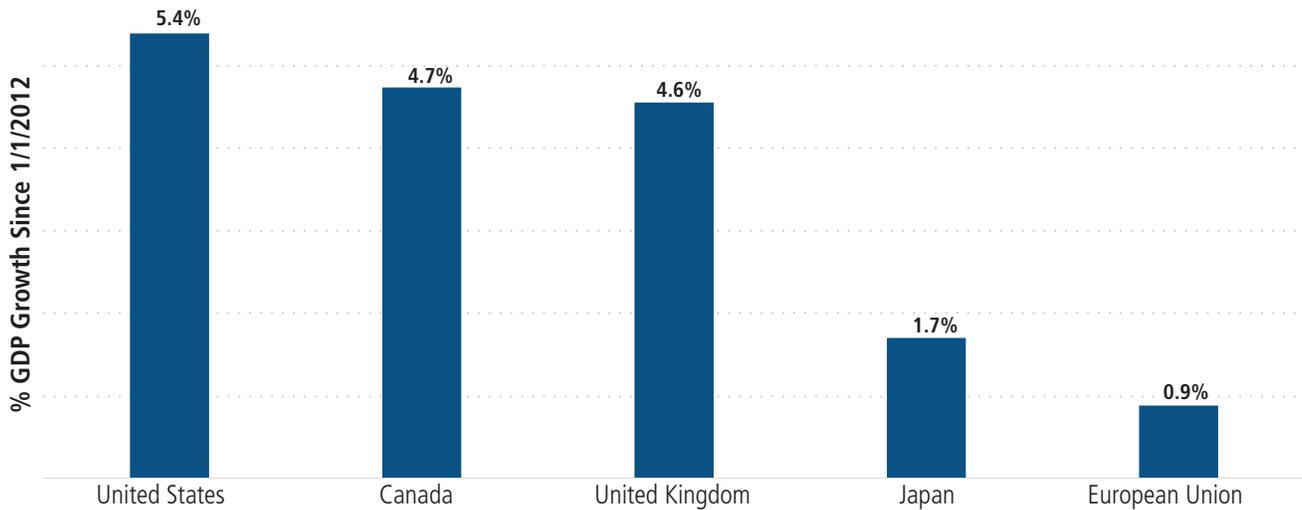
And, as the US central bank shows restraint, the European Central Bank recently announced plans to become even more aggressive in the opposite direction. The ECB's balance sheet will balloon by EUR 1 trillion through asset purchases and conditional lending to banks. The Bank of Japan, for its part, is in the middle of a campaign to drive inflation to 2% by doubling the monetary base and buying large quantities of assets.

A stronger dollar brings important domestic consequences as well. Orthodoxy says that exports dive as a country's currency

**THIRD QUARTER GAINS IN THE DOLLAR INDEX WERE THE SECOND LARGEST IN THE LAST 20 YEARS**



IN TERMS OF RECENT GDP GROWTH, THE US HAS OUTPACED MUCH OF THE DEVELOPED WORLD



Source: Bureau of Economic Analysis, Office of National Statistics, Statistics Canada, Eurostat, Japanese Cabinet Office

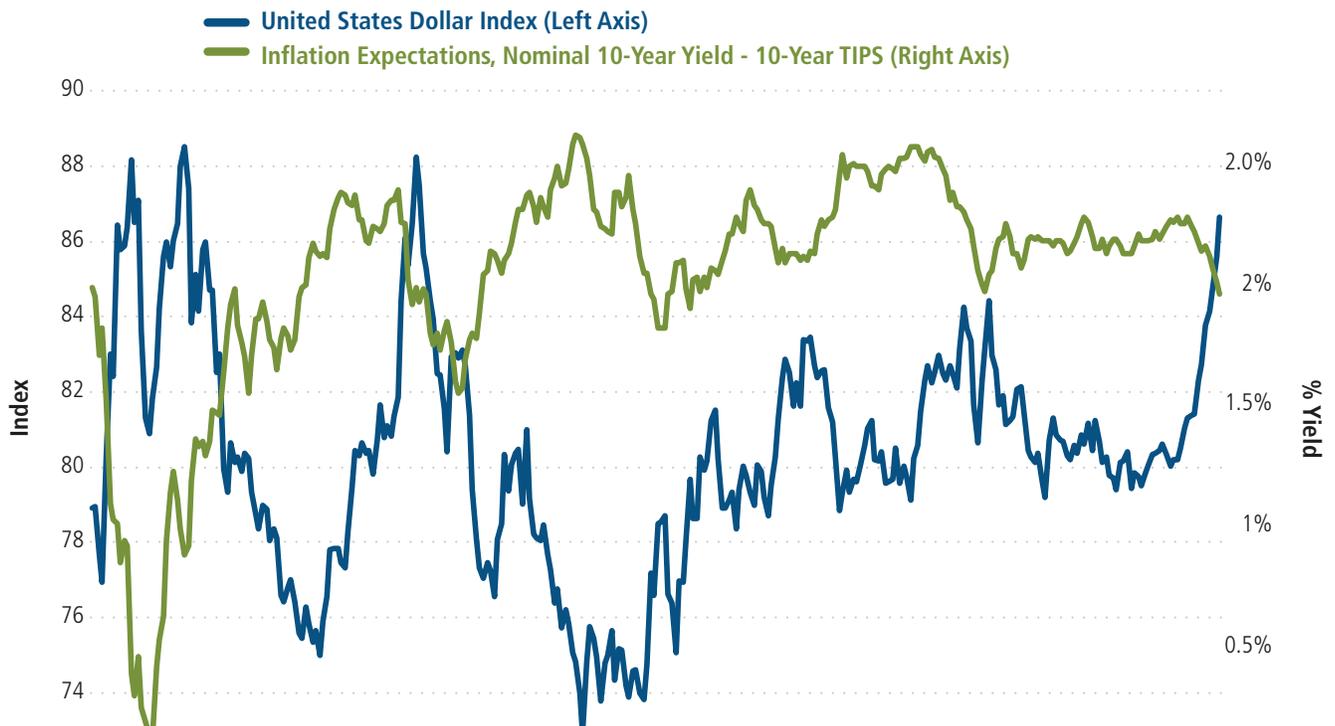
strengthens—we are less convinced. Instead, we think the real impact of recent dollar strength comes in the form of declining inflation expectations (see chart below). When the dollar gains, inflation expectations fall. And, at a moment when the Federal Reserve is contemplating an exit from low interest rate policy, falling inflation expectations are the last thing any central banker wants to see. If the bond market prices in less future inflation, the FOMC may exercise its option to wait a bit longer before hiking interest rates.

Where will the dollar go next? One thing to keep in mind is that despite the Q3 boost, the dollar remains well below its 20-year average. Room

exists for the world's reserve currency to appreciate further in the years ahead. However, a subtle shift in Fed rhetoric could arrest the recent trend in the short-term. A few words about dollar strength and disinflation from a central banker may discourage the market fervor over an imminent rate hike. If the rate hike is delayed, dollar strength may be deferred.

The dollar move was perhaps the most interesting market event of the third quarter. In light of that, we paraphrase Mark Twain and say, the death of the dollar has been greatly exaggerated.

WHEN THE DOLLAR STRENGTHENS, INFLATION EXPECTATIONS FALL... WILL WE CONTINUE TO SEE DECLINES IN INFLATION EXPECTATIONS ON THE BACK OF A STRONGER DOLLAR?



Source: Bloomberg

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