

US Dollar Bounce Explained

On July 15th the US Dollar Index closed at 71.87, the lowest close since reaching its record low in April. This index was in the process of breaking down, and in fact it had actually fallen out of its uptrend channel on the following chart.



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However, rather than continue lower and fall off the edge of the cliff, the Dollar Index suddenly and mysteriously reversed course. It has now risen on 12 of the 17 trading days since reaching that low, and closed today at 74.55, a 5-month high. What caused this index to suddenly pull back from the brink and then reverse course to shoot higher over the past three weeks?

The Federal Reserve did not suddenly contract the amount of dollars in circulation. Its latest H.6 report shows that both M1 and M2 expanded in recent weeks, so there was no shortage of supply.

The Federal Reserve did not raise interest rates during this period. Consequently, inflation adjusted interest rates remain negative. In other words, the annual inflation rate is higher than the amount of interest one can earn on a 1-year dollar deposit, which is highly inflationary and a major disincentive to holding dollars.

There has not been any news exceptionally favorable to the dollar. In fact, the banking problems in the United States continue to mount, while the federal government's deficit continues to soar out of control. On July 28th Reuters reported that *"The Bush administration on Monday plans to project the U.S. budget deficit will soar to a new record...because of the slowing economy and an economic stimulus plan approved this year."*

So what happened to cause the dollar to rally over the past three weeks? In a word, *intervention*. Central banks have propped up the dollar, and here's the proof.

When central banks intervene in the currency markets, they exchange their currency for dollars. Central banks then use the dollars they acquire to buy US government debt instruments so that they can earn interest on their money. The debt instruments central banks acquire are held in custody for them at the Federal Reserve, which reports this amount weekly.

On July 16, 2008 (the closest date of the weekly reports to the July 15th low in the Dollar Index), the Federal Reserve reported holding \$2,349 billion of US government paper in custody for central banks. In its report released today, this amount had grown over the past three weeks to \$2,401 billion, *a 38.4% annual rate of growth*. To put this phenomenally high growth rate into perspective, for the twelve months ending this past July 16th, assets in the Federal Reserve's custody account grew by 17.3%, which is less than one-half the growth rate experienced over the past three weeks.

So central banks were accumulating dollars over the past three weeks at a rate far above what one would expect as a result of the US trade deficit. The logical conclusion is that they were intervening in currency markets. They were buying dollars for the purpose of propping it up, to keep the dollar from falling off the edge of the cliff and doing so ignited a short covering rally, which is not too difficult to do given the leverage employed in the markets these days by hedge funds and others. So central banks pushed in one direction and funds and traders then stepped on board. In other words, central banks ignited the fuse of a bear market rally.

With this intervention, central banks have bought some time. But alas, they have not fixed the problem. Central bank intervention does not make the dollar "as good as gold", the description that once accurately described the dollar.

In the final analysis, it is fundamental factors that determine the course of markets and the process of price discovery that results from them. Central bank intervention - like fiat currency itself - is ephemeral. In contrast, gold lasts throughout the ages. So what would you rather own? A sick dollar that it requires central bank intervention to prop it up? Or gold?

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