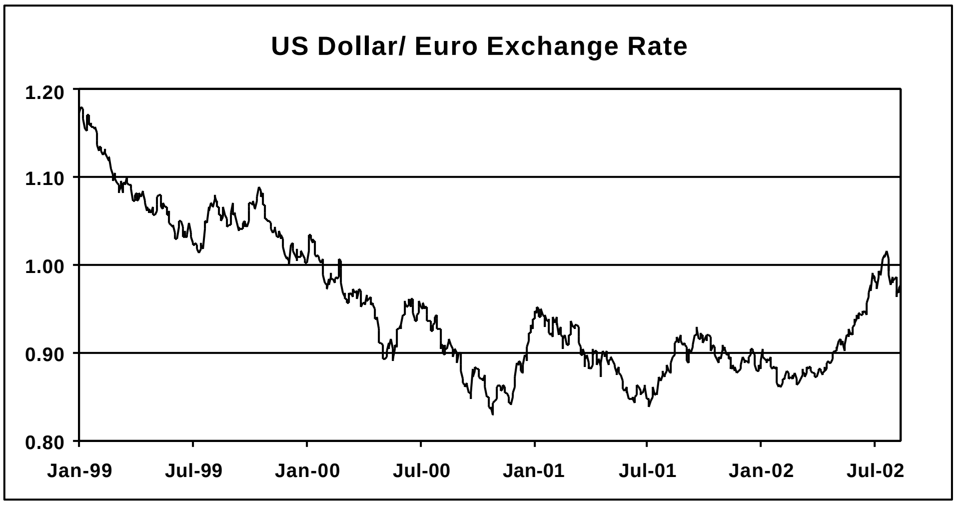
Dollar on Emotional Roller Coaster

The failure of the Fed to provide a boost to the US economy by cutting interest rates has seen some of the bearish sentiment towards the dollar return. Speculation that the Fed could cut rates had helped to turnaround a wave of negative sentiment against the US currency. This had seen it lose some 15.5% of its value against the euro, and about 11.5% on a trade weighted basis, between late January and mid July this year. Also helping to arrest the dollar's decline was a repatriation of overseas funds by US investors, to cover massive equity losses at home and as they realised that the more perilous US economic outlook has negative implications for other world economies.

However, these factors (which see the dollar trading some 3% above its July lows) may not provide long term support to the dollar and renewed negative sentiment towards the US currency could continue to build. Furthermore, interest rate differentials, concerns about the impact of a weak equity market on the US economy and a rising current account deficit, combined with falling capital inflows, all have potential to keep the dollar under pressure until at least the New Year.



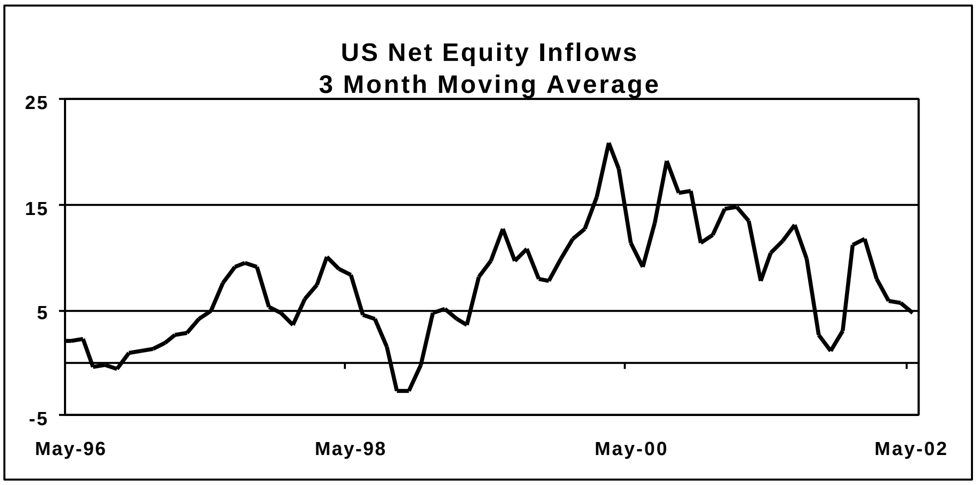
Recent data have shown a rising savings rate, falling consumer spending and little sign of real improvement in the labour market. If these trends continue, the threat of a double dip recession in the US will become more real. In these circumstances sentiment will remain largely weighted against the dollar compared to other major currencies, which are not as heavily influenced by stock market trends.

Meanwhile, monetary policy in the US is extraordinarily loose. Real interest rates (nominal Fed funds less core CPI) are, at -0.75%, the lowest interest rate of western industrial countries. With the timing of US interest rate hikes consistently being pushed outward, this situation is unlikely to change until well into next year.

Nominal interest rate spreads should remain supportive of the euro versus the dollar going forward. The risk is that the 3-month spread could widen out in the months ahead, if the Fed decides that it does need to cut interest rates. Meanwhile, long-term interest rates in the US have moved well below those in the eurozone, with the ten year US-German yield spread at 0.35%.

An analysis of US capital flows also indicates worrying trends for the dollar. Net capital inflows in the five months to May are 15.8% below where they were in the same period in 2001. There has been an improvement on a month to month basis over the period but this mostly reflects an increased demand for corporate debt.

From the dollar's perspective, the most disturbing aspect of the capital account data is the decline in foreign demand for US equities. During the month of May there was a $0.3 bln net selling of US equities by non-residents. The last time net selling on the equity account occurred was in September 2001. Before that, it was in September 1998 in reaction to the Russian debt default crisis. A sustained period of net selling of US equities by non-residents has not been experienced since 1994. The US capital account remains exposed to the prospect of further selling of US equities. Declining capital inflows mean that the current account deficit will continue to pose a significant threat to the dollar.



A further negative for the dollar comes from the recent downward revisions to US growth and productivity levels relating to the 1999-2001 period. These suggest that the dollar's gains over this period were not entirely fundamentally driven and therefore that further correction is needed. With sentiment and the stock market performance playing such a large part in day to day direction, we expect plenty of volatility in forex markets over the coming weeks and months. On balance, though, over the short to medium term, given the weight of factors against it, a period of renewed dollar weakness is quite possible. This could result in the euro moving to a $1.00 - $1.05 range or beyond before the year end.

Longer-term, fundamentals, including growth prospects and interest rate differentials, should begin to support the US currency. Despite downgraded expectations of US economic activity, the GDP growth rate in the US should still exceed that in the eurozone both this year and next. Thus, we expect a gradual and modest improvement in the dollar in 2003 with a return to a $0.95 - $1.00 range against the euro by H2 2003.

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