RICHES FLORES RESEARCH
GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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GLOBAL MACRO

How Far Will the Dollar Fall Now?

Over the past few years, we have been resolutely bearish on the dollar, in contrast to the consensus view. The reasons behind our contrarian outlook are three-fold:

- We foresee lastingly low GDP growth now that the 2008 crisis has brought an end to the support previously provided by private sector debt—creating a shortfall we estimate at 1.8 percent a year, and pushing U.S. potential output down from its pre-crisis 3.0–3.2 percent range to somewhere between 1.5 and 2 percent today.

- We expect the Federal Reserve to stick to its unconventional monetary policy for now and the greenback to continue losing ground as a result. To make matters worse, the euro area has opted for a structurally deflationary policy mix to sustain the euro, even if that means undermining European industry.

- We anticipate an eventual inflationary exit from the 2008 financial crisis—one that will almost certainly affect the United States much sooner than the euro area.

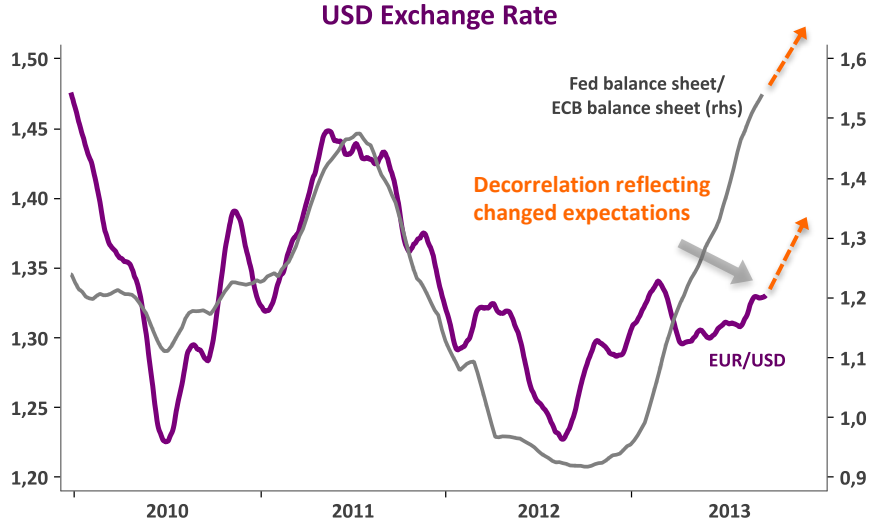
These factors also prompted us to cut our projections for the dollar in June, when we simultaneously lowered our 2014 forecast for the U.S. economy—and thus for long-term Treasury yields as well. Although challenged by developments since the early summer, our bearish dollar outlook seems once again pertinent in the wake of this week's FOMC meeting. So just how low might the dollar fall?

With the adoption of unconventional policies, fluctuations in the euro-dollar exchange rate over the past three years have to a large extent reflected changes in the relative size of the Fed's and the ECB's balance sheets (see graph below). It wasn't until 2013, when the markets started betting on a rate hike by the Fed, that interest rate differentials re-emerged as the primary determinant of the euro-dollar exchange rate. With its decision on September 18, however, the FOMC has upset the forecasting applecart. **And this new game-changer may well**

make the exchange rate between the two currencies once again heavily dependent on the relative size of the Fed's and the ECB's balance sheets. In other words, things don't look so good for the dollar.

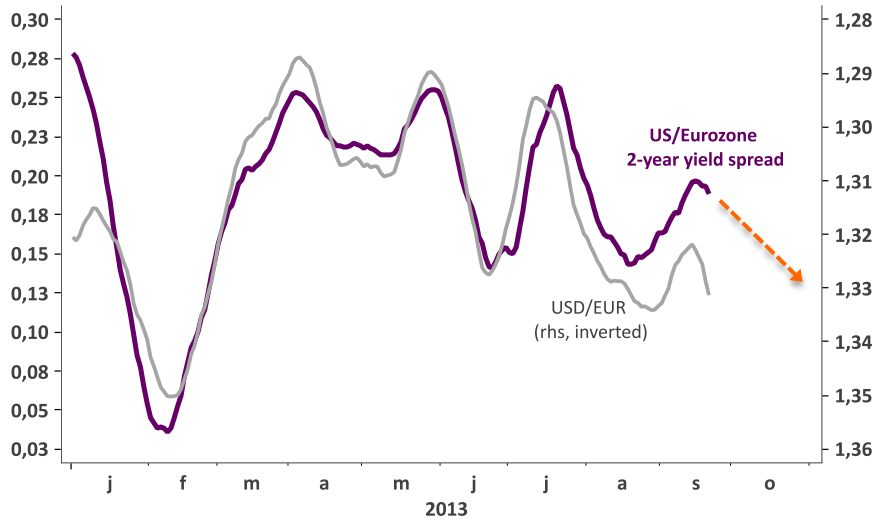
As the FOMC announcement makes clear, the Fed will continue to expand its balance sheet to the tune of $85 billion a month for some time to come—at least until spring 2014 in our view. In contrast, the ECB's balance sheet should shrink even further due to repayments on its two LTROs (from late 2011 and early 2012). The dollar will be hard-hit by the increasing gap in balance sheet size between the two central banks, while the spread on 2-year yields should narrow once again following the FOMC announcement. **So in the next few months, the dollar may well be in for a real plunge, perhaps even to beyond 1.40 against the euro.**

Change in the Relative Size of Fed and ECB Balance Sheets and the EUR/USD Exchange Rate



Sources: RichesFlores Research, Macrobond

US/Eurozone 2-Year Yield Spread and USD/EUR Exchange Rate



Sources: RichesFlores Research, Macrobond

After briefly perking up, the greenback is in a bad way once again. This renewed "dollar risk" is likely to have at least three major consequences:

- First, it will encourage the ECB to maintain an accommodative monetary policy. Mario Draghi, whose recent comments sound downright dovish, should have few doubts about being on the right track. As a result, the ECB may feel it can afford an additional rate cut even though the EU growth outlook has improved—and however much the Fed's latest move may annoy certain ECB [Governing Council] members.

- Second, an anemic dollar combined with highly inflationary policies in the U.S. will ensure a steady flow of funds into a number of safe haven assets. Commodities and precious metals should be the leading beneficiaries.

- Third and last, thanks to a weaker dollar, emerging market currencies can probably look forward to a less-bumpy ride than up until now. At least for a while.

With economic recovery under way in Europe, European stocks are unquestionably well-poised to cash in on this changed landscape.

Véronique Riches-Flores
contact@richesflores.com

Véronique Riches-Flores,*contact@richesflores.com*