Forex Focus: Dollar Bears Will Soon Have Had Their Day

By Nicholas Hastings
A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--Dollar bears should soon be hiding their faces.

A combination of soft U.S. economic data, over cautious Fed officials and sliding Treasury yields have all raised expectations of more quantitative easing.

As a result, the dollar has been sold heavily over the last few weeks as investors have turned elsewhere for higher returns.

See the euro's rise against the dollar:

http://www.dowjoneswebservices.com/chart/view/4367

However, the whole dollar-selling exercise has been overdone.

Chances that the Fed will actually ease policy further at its open market committee meeting on Tuesday are slim, to say the least.

Even if the Fed does surprise financial markets with a move, there is growing evidence that other central banks will have to follow suit.

This is hardly a reason for bears to continue selling the U.S. currency against other majors.

One of the unusual and telling developments in recent weeks has been the diverging performances of U.S. Treasurys and U.S. equities.

While Treasury yields have edged steadily lower to new record lows, with the two-year yield reaching a new nadir of 0.51% this week, equity markets have continued to rally.

Now, it looks more and more that the buoyant equities are right.

Sure, Fed officials are standing by, ready to react if the U.S. economy is about to fall back into recession. The fact that inflation expectations have subsided have only made them wary that further easing might be needed.

But falling inflation expectations aren't the be-all and end-all of Fed policy.

As Steve Barrow, senior currency strategist at Standard Bank in London, pointed out, Fed policy is also being guided by the inflation rate itself as well as unemployment.

"Right now, we'd say that there's only one of these three factors (out of inflation, inflation expectations and unemployment) that's flashing warning signs and that's not enough for a material change in Fed policy," Barrow said.

Fears of deflation certainly won't disappear right away, despite the strong ADP and non-manufacturing ISM that came out Wednesday.

Financial markets will no doubt remain nervous ahead of the latest U.S. payrolls on Friday and the dollar is hardly likely to stage any serious recovery before then.

By next week, however, as Fed officials start to gather for their latest deliberations, U.S. yields should start looking far too low by discounting a further easing in liquidity conditions that is hardly likely to come.

If anything, expectations of other major central banks having to contemplate looser policies of their own, could well prove the catalyst for turning the dollar around.

Take Japan. Its economic data has also weakened, suggesting that the economy remains reliant on exports. With the yen rising back to a 8-month high against the dollar, the Japanese authorities are under pressure to do something.

As market intervention isn't really a political option at the moment, the Bank of Japan will likely come under increasing pressure to open its liquidity taps even further.

On Thursday, as Japanese financial markets took this on board, 10-year Japanese government bond yields fell under 1% for the first time in seven years, ensuring that the yen's attractiveness, relative to the dollar, has diminished.

Similarly, in the euro zone, strong data at the end of the second quarter has started to give way to softer numbers at the start of the third quarter.

As a result, the risks are that German bond yields, which have been holding up fairly well, could start to buckle too.

Once again, the dollar, which has been driven steadily lower against the euro in recent weeks, should find a firmer footing.

Early Thursday in Europe, profit-taking was already stripping the dollar of some of the gains it made after the strong Wednesday data as investors start to square up ahead of payrolls.

The euro, meanwhile, is coming under pressure ahead of the latest European Central Bank policy meeting in case the bank's president, Jean-Claude Trichet, alludes to concerns over global growth in his press conference after the meeting.

By 0645 GMT, the dollar has fallen to Y86.14 from Y86.30 late on Wednesday in New York, according to EBS.

The euro was also down at $1.3140 from $1.3169 and at Y113.19 from Y113.65.

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