

US Dollar Is Facing a Key Test For Stocks—and the Economy

MARKET, STOCK MARKET, INVESTMENT STRATEGY, CURRENCY, DOLLAR, YEN, EURO, BANK OF JAPAN, FEDERAL RESERVE, EURO ZONE
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CNBC.com | 04 Aug 2010 | 02:54 PM ET

The next few weeks could be critical for the US dollar, which has fallen lately after rallying earlier in the year.

A key patch of economic data awaits to see whether the greenback can reverse recent falls against the yen and the euro, which has gained as worries have eased over the sovereign debt crisis.

At stake could be not merely the currency trade but also the direction of stocks and whether the stumbling recovery can regain its footing.

"The only way you're going to see the risk factor return is if the dollar really strengthens again," says Peter Cardillo, chief economist at Avalon Partners in New York. "If the dollar strengthens and gets back to the highs we saw about four months ago, that could pose less risk for the equity markets."

The dollar's summer-long deterioration against the euro and yen is like a tale of two currency trades—one seemingly based on the end of panic and the other a technical bounce unlikely to last.

That's the opinion of currency experts who think that at least in the case of the **euro-dollar trade**, the weakening US currency is actually a return to normalcy after a stretch of uncertainty over European sovereign debt problems.

"What we're seeing is the euro strengthening against the dollar simply because of the fact that the fears were grossly overblown in terms of the debt crisis in Europe," Cardillo says. "The economy in euro-land is not likely to fall back into recession and will probably limp its way through the crisis."

The **dollar-yen trade** is a little more complicated, with many traders saying the Japanese currency's 15-year high against the dollar is hard to figure considering the respective countries' monetary policies.

Since the start of the financial crisis, the Federal Reserve has been actively devaluing the dollar in an effort to promote liquidity and make US exports cheaper.

But the Bank of Japan is even more aggressive in keeping its currency weak against the dollar, and there's widespread belief that if the trade keeps going in its current direction, the Asian bank will step in to devalue.

"The yen strengthening against the dollar makes no sense whatsoever. There is no rationale for a strong yen," says Dennis Gartman, author of The Gartman Letter investor guide. "Nonetheless, it has been getting stronger. Everybody I know has been trying to pick the top of the yen and the bottom for the dollar, and they've all gotten taken to the woodshed."

Indeed, investors face tough choices these days **in the currency trade**.

A succession of **weak US economic data** has bets on a strong dollar a tougher sell. The greenback rallied about 13 percent against the euro during the spring months after concerns were raised over debt defaults in Greece and across the euro zone.

But as countries began passing austerity measures and bond sales went off fairly well, the euro turned around after hitting a low June 7 and has rallied back to where it was before the debt crisis hit.

The question is whether the strength holds. Gartman is a euro doubter.

"Has the move from \$1.18 to \$1.30 been surprising? Yeah, it's been surprising. But the major trend is still a strong dollar against the euro," says Gartman, who believes the two currencies will hit parity at some point.

Whether Gartman's prediction comes true likely will depend on how well the US economy fares against the euro-zone countries.

That question could be resolved when the US government reports employment trends later this week, and when the Federal Reserve Open Market Committee **meets next week to decide interest rates** and issue its forecast on economic conditions.

"What's really going on in the market is risk-on and risk-off scenarios," says Dean Malone, currency director and forex strategist at CompassFX in Richardson, Texas. "The next couple of weeks it's going to be imperative to watch what the market does with unemployment and the FOMC meeting going forward. If there's movement toward quantitative easing and an extended low (interest) rate, then there's no reason for investors to stay with the dollar from an appreciation standpoint."

Conversely, the dollar trade can turn higher on such events as Wednesday's reading of the **Institute for Supply Management's service sector activity**, which showed higher-than-expected expansion. The dollar rallied against both the euro and the yen during the day's trading.

"The last couple of months have been more dollar-strong because it was just less bad—it was winning an ugly contest," says Michelle Gibley, senior international analyst for Charles Schwab in San Francisco. "The euro situation was so bad. We just reversed that."

Since then, though, the euro zone has shown signs of stabilization, particularly in the banking sector, Gibley added.

"We had the stress tests in Europe. The criteria they used were probably not stringent enough, but they gave enough transparency for investors to do their own analysis on the strengths of the balance sheets," she says. "For the most part banks were capitalized better than most people thought."

Investors, then are likely best off simply to follow the bouncing economic ball to figure out whether the dollar can regain its strength, or whether it continues to fall under the weight of low interest rates and massive government spending.

"Obviously, the currency markets continue to be pretty volatile," says Michael Church, president of Addison Capital, in Yardley, Pa. "I don't know that a lot of the moves made a ton of sense to begin with. The sharp move we saw starting at the end of April into early June has reversed itself completely now. We're back to where we were before."