The Oil Drum: Europe
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

A Dollar beyond the eighties

Posted by Luis de Sousa on October 1, 2007 - 7:00pm in The Oil Drum: Europe
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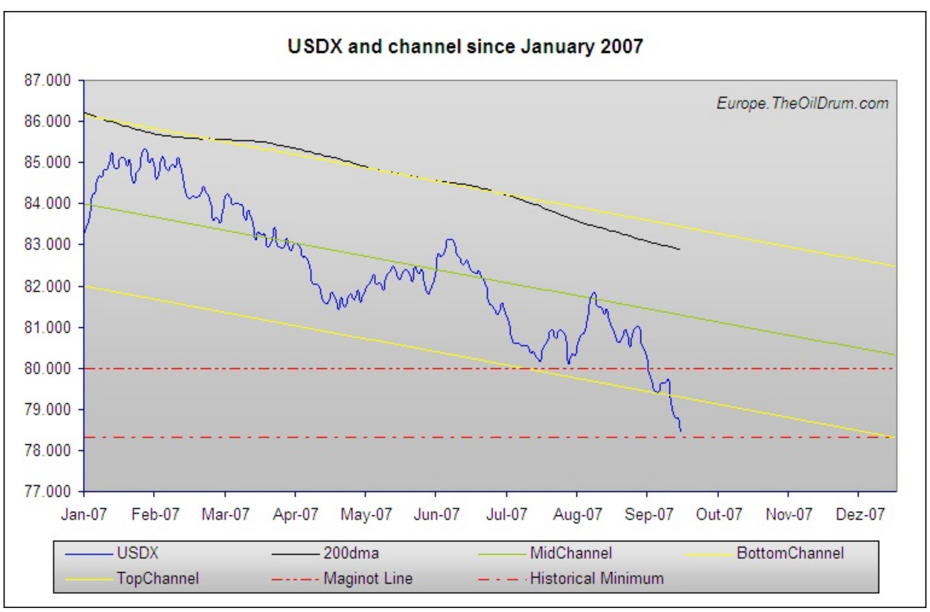
Tags: dollar, euro, oil prices, stagflation, usdx [list all tags]

The US Dollar Index (USDX) is a measurement of the strength of the Dollar against six other freely exchangeable currencies. Since 2002 the Dollar embarked in a secular downward trend that brought the greenback to historic lows today.



The USDX secular trend and rDollar channel since January of 2007. Click to enlarge.

This a crosspost from the European Tribune

Last August the first stages of a deflating housing bubble in the US brought a credit crunch that had visible impacts in much of the financial system of the Wealthy West. In a short space of time the Dow Jones lost almost 1000 points and most stock exchanges in Europe are yet to recover. Still during that time there was no visible move upwards on the USDX, which kept sinking piercing through the physiological barrier of 80 points.

On the 18th of September the Federal Reserve meet with an interest rate move on the menu as a way of giving some breathing space to those in trouble by the credit crunch.

The last time I wrote about this subject I wasn't that convinced of a strong move by the Federal Reserve. The Dollar was already below 80 points and in fact 5.25 wasn't a big number after all. Naturally I was wrong and the Fed cut the interest rate not by a quarter but by a full half point.

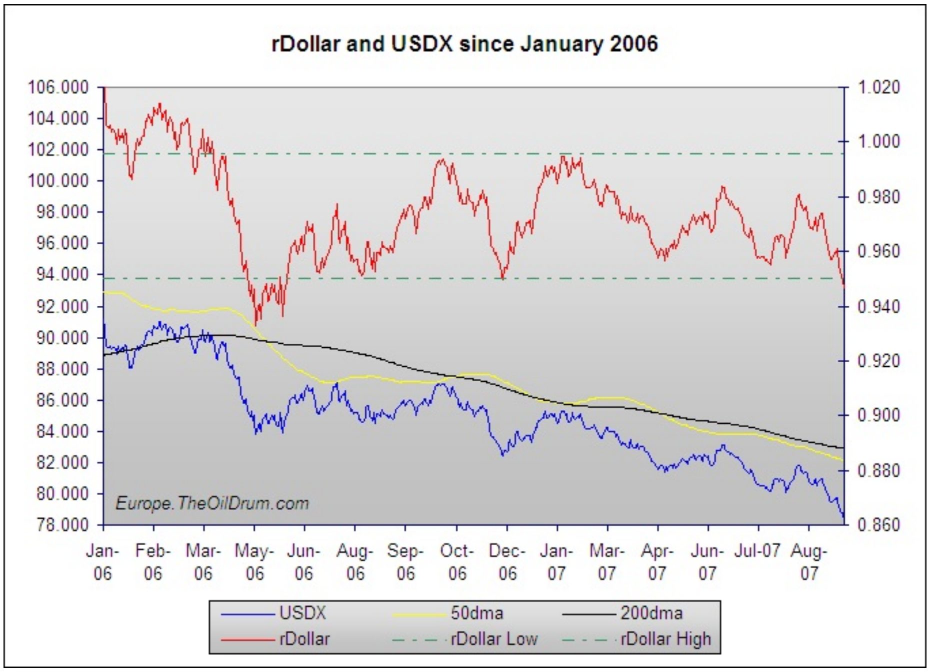
Panic, most people thought, and it was with panic that the markets absorbed the news. On the weekend of the 9th of September an analyst at Bloomberg was warning that we would see the Euro go through 1.40 and Oil go through 80 $/b before Christmas. Well, we got that in less than two weeks.

The Dollar entered a secular decline in the first half of 2002 that kept pushing the currency down until it got close to 80 points by December of 2004. During 2005 it paused in the wake of steady interest rate hikes by the US Federal Reserve, just to resume by the early days of 2006 when it started to become clear the rate hikes wouldn't last forever.

Secular trends are usually visible on the 200 day moving average (200dma) of a certain traded title or index. When the trend is up the 200dma marks the price floor, when upwards marks its top. In the case of the Dollar index (USDX) this is quite visible in the periods between early 2002 and late 2004 and between early 2006 and now.

Another useful measurement is the relative value of the title or index against its 200mda. When on a secular trend the value is usually kept inside an interval of the percentage of its 200dma. For instance between 2002 and 2004 the Dollar kept between 90% and 101% of its 200dma. This relative value is usually represented with an "r" prefix, in the case of the Dollar we get the rDollar.

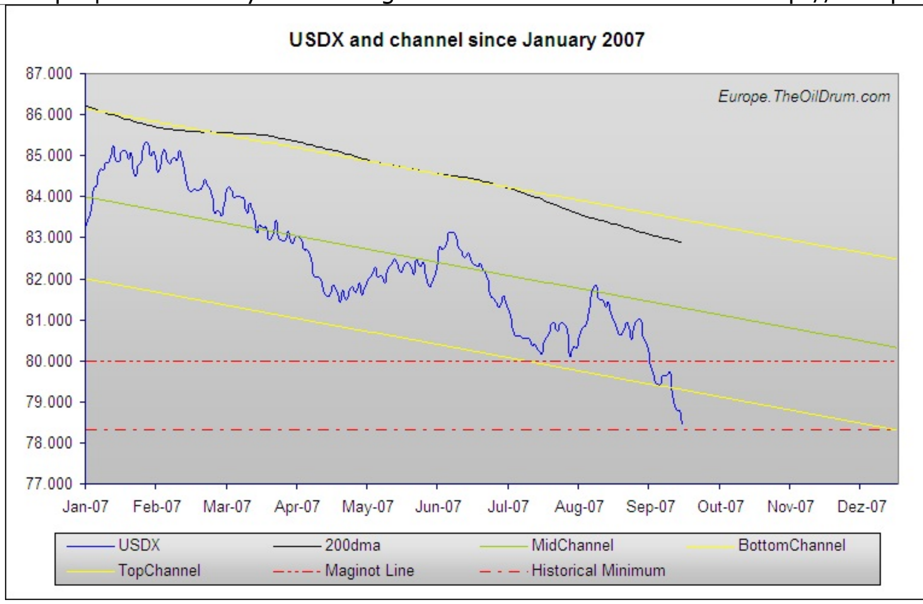
The next graph shows the evolution of the USDX and its 200dma and in parallel of the rDollar since the beginning of 2006.



The USDX secular trend and rDollar since January of 2006. Click to enlarge.

The secular downward trend resumed its slow roll by May of 2006 when the 200dma started pointing down again. Since then the rDollar has kept steadily in the interval 95 - 99.5 %. Every time the rDollar reached close to the lower bound of this interval a bear rally set in that brought its value up, just to gain more steam for the next decline. That is, until last week.

On the next graph this interval is represented in a different way. A line was fit to the 200dma and then replicated at the previous lower bound of the rDollar thus creating a channel and then replicated again at the middle of this channel.



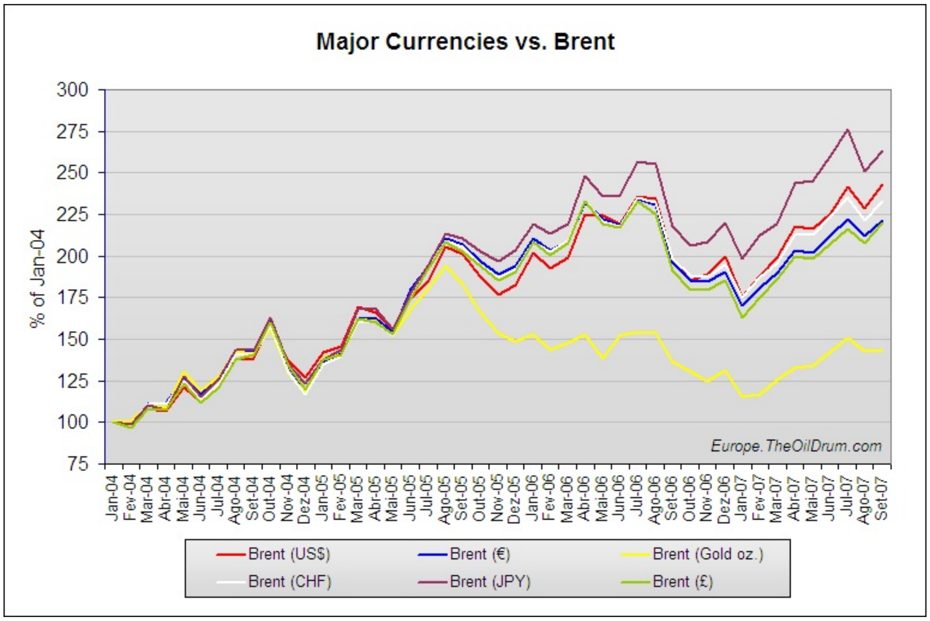
The USDX secular trend and rDollar channel since January of 2007. Click to enlarge.

As it can be seen the USDX broke the Maginot Line by early September and two weeks later broke the previous rDollar lower bound neighing rapidly on its all time low. The term Maginot Line was coined by [Roland Watson in 2004](#) and is indeed an interesting concept. And has long announced by various analysts the USDX was shocked up after crossing it.

Presently the 200dma seems to be moving to a steeper shape and at the same time there's a new rDollar bound to observe. Looking back to the previous three bear rallies they were progressively weaker and short-lived, announcing the acceleration of the secular downward trend.

Again, I personally don't expect this kind of movements to develop as fast as last week, my best guest is that a new bear rally is forming, but the acceleration of the 200dma is indeed worrying.

At the same time Oil visited its own records. The Brent blend pierced again the 80 $/b barrier and the WTI went as far as 84 $/b on what looked like panic trading. To understand what happened there's a graph worth updating:



Major currencies against Brent. Click to enlarge.

Basically to take home from this graph is that Oil is at an all time high only against the Dollar. Against other currencies Oil was more expensive in the summer of 2006 or in last July. Against Gold the all time is still in the summer of 2005, but it is interesting to see that since the beginning of this year Gold has kept weakening against Oil.

We haven't seen record high Oil prices this month, just a very weak Dollar.

Looking ahead

Where will the Dollar end? Who knows, some say 70, others 60, others even hint at 40 with the full reversing of the "head-and-shoulders" previously formed. Unless there's a serious steering from the current policy by the Federal Reserve the secular downward trend is here to stay. At least until the Trade Deficit is brought to the ground, or in a worse scenario until when most of the Dollar currency kept as foreign reserve currency is dumped in the market the USDX will keep going down.

The crossing of the Maginot Line was left unattended by most of the media, possibly because it is more a psychological barrier than a real minimum. But, even if it gets back to the previous trend, the Dollar will one day close below its all time low (78.33) possibly during the next months. And then we'll see how weak it really is.

***[Update 01-10-07] :** This text was written originally Wednesday and it took only two days for the USDX to close at a record low – 77.72. The Dollar has now completed 13 consecutive trading days below 80 points, the same amount of time it had been below 80 since the establishment of the index in the 1970s.*

All of this talk concludes that the US is accepting the current resource scarcity with Inflation. After the burst of the sub-prime credit bubble the US is facing a typical stagflationary environment, whatever the monetary policy, disadvantageous results will come out.

Some people think that the inflationary crisis into which the US is stepping in won't affect visibly other economies. In my perspective that will hardly be the case. First of all the root of the problem affects every country on the planet that's a net importer of commodities (be it energy, metals, food, etc) and secondly because the US economy is not closed.

The US imports raw materials from South America and Africa, manufactured goods from Asia and Services from Europe. In its turn all will eventually suffer. In 1980 the economy wasn't as globalized and dependent on Oil as it is today but the crisis eventually affected all or most industrialized and developing nations. The US might be first to seriously face the crisis but eventually it won't face it alone.

On the particular case of Europe the crisis has a different flavour from that of the US; here the problem is a currency on a secular upward trend against the Dollar. For now other major currencies are moving along the Euro, but if some of them stop moving that way we are in trouble (the sterling is unfortunately doing that).

Prices are becoming increasingly higher than in most of the world and that can't simply go on. Last week in Dublin I paid 11€ for two pints of lager, that's 15.5$ for a liter of beer. Eventually a deflationary crisis will hit Europe.

There have been serious calls on the press for a move on the interest rates set by the ECB, in order to stem the Euro's strength. Although not doing that exactly, Trichet took the chance given him by the sub-prime burst to loose the money supply lending hundreds of billions (US bn) €, but to no real effect. The problem is that at 4% the rate is already at an historically low value. A move downwards might be inevitable, but Trichet has to realize he has only four rounds in his barrel so he'd better use them sensibly.

And so we leave the Age of Cheap Oil and move into the future with Stagflation.

Previous log entries on the subject:

[That double 80]

[Macroeconomic notes on resource scarcity]