

Haven status adds to dollar attraction

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No matter how dire the news out of the US, the dollar strengthens.

In recent days, it has carried on rising in spite of new bail-outs for two leading financial institutions - Citigroup and AIG - a catastrophic fall in US gross domestic product and more dreadful news about the US housing market.

Such is the state of fear in world financial markets that the US currency is being viewed as a haven in spite of the negatives surrounding it. Its haven status was particularly apparent yesterday when equity markets saw a new wave of selling and government bonds and gold failed to rally as much as they have done during previous bouts of market turmoil.

Indeed the dollar index, which tracks the US currency's progress against a basket of six leading currencies, rose to a three-year high of 88.969.

"Given the dollar's credentials as safe haven, its unchallenged role as global reserve currency, plus the fact that the market continues to give US fiscal and monetary policy action the benefit of the doubt, buying the dollar on dips remains the strategy of choice," says Ulrich Leuchtmann at Commerzbank.

The dollar's strength partly reflects the weakness of other currencies.

Faith in the yen as a haven has been eroded by a flurry of dismal Japanese economic data while concerns over European banks and their exposure to problems in central and eastern Europe have seen the euro and, to some extent, the Swiss franc fall from favour. For some analysts, the dollar's haven support is at odds with the sharp sell-off in the US Treasury market over the past eight weeks.

"If the search for a safe haven were the reason why investors piled into the dollar, US government bonds, the foremost safe haven asset, should have been the biggest beneficiary," says David Woo at Barclays Capital.

Mr Woo believes it was the sell-off in the US Treasury market and the corresponding rise in US yields, rather than increased risk aversion, that propelled the dollar's recent rally.

Since a speech from Ben Bernanke, chairman of the Federal Reserve, on December 1, in which he mentioned the possibility of the Fed's buying "longer-term Treasury securities on the open market in substantial quantities", currency and bond markets have been trading on whether and when this will be implemented, says Mr Woo.

After an initial sell-off, the dollar rallied, however, as the minutes of December's Federal open markets committee meeting revealed that such action lacked broad support among its members, sparking a sell-off in US Treasuries prices and a rise in yields.

"This triggered a sell-off in US Treasuries that contributed to a widening of interest rate differentials in favour of the dollar," says Mr Woo, who adds that the general sensitivity of the dollar to interest rate differentials currently stands at its highest level in six months.

The key question, accordingly, is whether, the Treasury sell-off has run its course.

The ability of central banks in Brazil, Russia, India, China and Saudi Arabia, which over the past few years have accounted for at least 30 per cent of net Treasury buying, to finance the ballooning US budget deficit is limited by the fact that their currency reserves are either falling - as in Brazil and Russia - or no longer rising, as in China.

The dollar has risen 10 per cent against the euro so far this year, and by 7.4 per cent against the yen. The dollar last week had its best performance against the yen for 13 years, rising 4 per cent.

Aside from the actions of global reserve managers, analysts point to activity from US mutual funds, which have shown an unwillingness to increase their allocations to foreign markets.

Analysts say this matters because US fund managers hold \$30,000bn of domestic and foreign securities, compared with the estimated \$7,000bn of foreign currency reserves managed by the world's central banks.

Having increased their share of overseas assets from about 12.5 per cent at the start of the decade to a high of 26 per cent last summer, risk averse US funds reduced that share to 23 per cent, where it has remained so far this

year.

Mansoor Mohi-uddin at UBS says further reductions in the proportion of their portfolios held in overseas markets and the subsequent repatriation of capital will help the US to continue to fund its current account deficit and thus support the dollar this year.

Furthermore, he says, long-term portfolio allocation data for all US investors shows global shocks historically have caused US investors to steer away from overseas markets for several years.

"This time risk-averse American fund managers are unlikely to behave any differently in their response to the global economic slump," says Mr Mohi-uddin.

But while the dollar is finding support in the short-term, analysts are wary over its longer-term prospects, given the aggressive loosening of fiscal and monetary policies undertaken by the US authorities in response to the crisis.

Analysts say that because it has been in the interest of other countries to have a strong dollar to export to US consumers, the US has got away with policies that would have been detrimental to the US currency had it not enjoyed haven status.

But Axel Merk, president of Merk Investments, says the actions of the Federal Reserve could stoke US inflation and ultimately undermine the dollar.

He believes that the Fed thinks a rise in inflation is a lesser evil than further falls in house prices.

"Reserve currency status has to be earned: at some point the abuse may come back to haunt the US. We are concerned about the dollar," Mr Merk warns.

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