Green'back': The Dollar is on a Comeback Trail

Following a decade of underperformance, the US currency appears to be regaining ground against currencies of nations with large current account deficits and high rates of inflation

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Portuguese-speaking concierges have of late been much in demand in New York hotels. A record number of Brazilians are floating around the city on shopping expeditions and could do with all the local help possible.

The people of a country with one of the most expensive currencies in the world are flocking to a nation where the currency is about as cheap as it has ever been. Adjusting for relative inflation differentials, the US dollar by mid-2011 was at the lowest level against currencies of its trading partners in its floating rate history, which dates back to the end of the Bretton Woods system in the early 1970s.

While the Brazilian real is an extreme case, lying at one end of the valuation spectrum, the multilingual cacophony on Fifth Avenue suggests tourists from other parts of the world too are finding the US a bargain. Tourism on its own hardly dictates a currency's trend but other data — from US exports to foreign direct investment, or FDI, inflows — reaffirm the greenback's highly competitive position.

After steadily declining for many decades, the US share of global exports is beginning to tick higher from a low of 8% in 2008. FDI inflows have picked up meaningfully over the past decade and are currently running at 1.5% of US GDP compared to the mere 0.5% share in 2002. These flows are all working to narrow the US current account deficit from a peak of nearly 7% of GDP at the height of the US consumption boom in 2007 to 3% now.

The long-talked-about trade imbalance should narrow even more in the years ahead as the US import bill for energy falls further and some manufacturing moves back home. These trends are already in progress but are yet to be recognised by the conventional wisdom. From a low of 68% in 2005, the US is now 78% self-sufficient in terms of its overall energy needs. The ramp up in production of shale gas with new technological breakthroughs has played a meaningful role in cutting down the US import bill for energy. Perhaps more surprisingly, US imports of oil too have declined over the past five years, not just due to weak demand but also on account of an onshore production boom in places such as North Dakota, higher efficiency as well as greater use of biofuels and unconventional liquids such as shale oil.

Meanwhile, a recent report by the Boston Consulting Group, or BCG, suggests that the US manufacturing sector is set for a major revival. China used to be the clear choice to build a manufacturing plant for global suppliers because of its low-cost labour, cheap currency and significant government incentives to attract foreign investment. But over the past five years, the renminbi has appreciated 20% against the dollar and China's annual inflation rate has averaged 1% more than that of the US inflation. Pay and benefits between 2005 and 2010 rose 19% annually for the average factory worker in China while the cost of employing US labour increased by only 4%. BCG estimates that by 2015, manufacturing in the US will be just as economical as in China for many goods made for North American consumers.

With multinationals likely to bring some production work for the North American market back to the US, the country's trade deficit could further narrow. The situation was very different a decade ago when China was just joining the WTO and the US dollar was in the midst of a powerful bull market. Between 1991 and 2001, the greenback appreciated by more than 30% on a trade-weighted and inflation-adjusted basis. That undermined the competitiveness of the manufacturing sector and contributed to the record widening of the US current account deficit. The dollar bear market of the past decade more than reversed the earlier gains with currencies of many emerging markets rising the most instead.

The Brazilian real appreciated by more than 200% against the dollar over the past decade, followed by other commodity-exporting currencies such as the Russian rouble and the Chilean peso that more than doubled in value during that period. Booming exports, surging capital inflows and stable to falling inflation rates, all abetted the trend of emerging market currency strength.

However, as is the nature of markets, the pendulum swung too far and is probably now retracing its path. Many emerging market currencies have depreciated significantly against the dollar over the past few months. The popular explanation is that the currency weakness is a function of heightened risk aversion arising from troubles in euroland. That can explain some of the volatility, but the bigger story may well be that the dollar is on a comeback trail as many of factors that led to its decline and the rise of emerging market exchange rates have exhausted themselves.

Some of the world's weakest currencies in 2011 belonged to those countries running a large current account deficit and with inflation rates much higher than the US. The South African rand, the Turkish lira and the Indian rupee fell by 15-20% against the greenback. The current account deficits of these economies ran at anywhere between 3% and 9% of GDP while inflation was close to double digits in India and Turkey. Similarly, the Brazilian real, the Chilean peso and Polish zloty declined by around 10% largely due to their current account deficit positions of 2.5-5% of GDP though all of these countries had less of an inflation problem.

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To be sure, if capital flows return with the sort of fervour seen in many years of the past decade, then the large current account deficits will get funded easily and not be a drag on the currencies. However, risk appetite is unlikely to get anywhere near as high as in the heydays of the 2000s. The psychological scars suffered during the serial financial crises take a long time to heal, and so will keep risk-seeking behaviour in check. Further, the domestic fundamentals of many emerging markets are deteriorating now after the vast improvements from the low expectations base of a decade ago.

Traditional metrics such as inflation rate differentials and current account positions that long dictated exchange rate movements but were forgotten in the last decade's mad rush to chase growth in emerging markets are back on the ascendant and that situation is likely to persist for the foreseeable future. Valuation has never been a good timing tool on the currency marketplace and deviations from fair value can persist for years at a run. Usually, some catalyst is needed to correct the misalignment, and once the process begins, it can happen in very quick time.

In this regard, the sharp weakness of many emerging market currencies over the past few months and, conversely, the sudden strength of the dollar is not strange behaviour. Interestingly, while the rupee's recent fall appears dramatic, on a three-year basis, the Indian currency is, in fact, unchanged on an inflation-adjusted and trade-weighted basis.

While the rupee now appears to have more than made for its past overvaluation, currencies such as the Brazilian real still have a very expensive feel about them. Relatively high commodity prices are preventing a bigger decline of the real. When commodity prices come unhinged due to a likely fall-off in commodity demand from China, the real will correct rather abruptly.

The real story here is that the dollar appears to have turned the corner after a decade of underperformance. Its fundamentals are improving as evident in the narrowing current account gap and the underlying US economy is more competitive than it has been in a long time.

On the other side of the equation, many economies from those in Europe to the big emerging markets are grappling with all sorts of local problems and their exchange rates are no longer that competitive. Markets always price in any change at the margin and the dollar could be in a bull market for the next few years as its fundamentals improve relative to the rest of the world. Fifth Avenue may yet again become a primarily English-speaking zone.

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