Forex Focus: Turning Dollar's Losing Streak Into A Winner

By Nicholas Hastings

A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--The dollar's recent "lose-lose" situation could well turn into a "win-win" one.

At the moment, financial markets are heading into the Federal Open Market Committee later Tuesday expecting the Federal Reserve to confirm the worst.

The decline in U.S. two-year Treasury yields to a new record low suggest markets are braced for the Fed to confirm that deflationary risks have returned to the U.S. economy and that quantitative easing needs to be increased, not just preserved at current levels.

As a result, dollar support has continued to ebb away, especially against the yen, in a market that has been driven largely by yield differentials.

See the dollar's steady decline against the yen:

http://www.dowjoneswebservices.com/chart/view/4393

Despite concerns about Japan's recovery and constant warnings about what the yen's rise will do to Japanese exports, the market had remained fixated by evidence that the U.S. recovery is faltering and that a double-dip recession is in store.

However, this is the point at which market fears could turn into reality and investor appetite for yields finally disappear.

Chances are that if the Fed does confirm that the U.S. outlook is as bad as the market has been speculating, yields could fall even further but investors just won't care.

In fact, global market sentiment could take another dive as investor concerns about the U.S. recovery leads to a retreat from risky assets--back into safe havens such as the dollar.

Let's face it, if the U.S. is in such dire straits, where are the other major fiscally-constrained economies headed?

One comment from UBS currency strategists sums it up: "We remain constructive on the dollar's prospects given that growth differentials between the U.S., the euro zone, Japan and the U.K. are likely to widen to the dollar's advantage into year-end."

Of course, that is the worst case scenario, where the U.S. is seen hurtling towards deflation, taking other major economies behind it.

The other option is that financial markets have got it wrong. They have got carried away, read too much into recent dovish comments from Fed officials and pushed Treasury yields much lower than is warranted.

So if the Fed comes out later today, either just preserving liquidity levels for a little longer, or postponing any monetary moves until its next meeting on September 21, global risk appetite may not come under pressure after all.

But, Treasury yields will more than likely bounce, ensuring that at least some of the support that the dollar has lost in recent weeks returns.

For speculators, who cut their dollar positions by the largest amount in a single week since July 2008, this could be bad news, as a dollar rally would force a scramble to cover dollar shorts.

Early Tuesday, the dollar was finding a little respite from last-minute book-squat ring ahead of the FOMC as well as from news that China's trade surplus had grown more than expected with its exports rising by a hefty 38.1% in the year to July. This signalled that while domestic demand might be flagging, global demand is strong.

The dollar remained steady at Y85.86, compared with Y85.84 late on Monday in New York, according to EBS, as the Bank of Japan confirmed that it was leaving rates and liquidity levels unchanged. Some market players had been looking for signs that the central bank would ease more.

The euro fell to $1.3165 from $1.3225 as well as to Y113.02 from Y113.57.

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