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Tea Leaves and Dollars: Read 'em and Weep

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The dollar jumped in value against the euro yesterday, reflecting both a possibly misinterpreted signal of higher interest rates and the strong desire of many investors, right now, to own dollars.

The confusion also helped push Treasury prices lower even though an important inflation measure, the Producer Price Index for finished goods, fell an unexpected 0.7 percent in December.

Expectations that the Federal Reserve might move more aggressively on interest rates were heightened after William Poole, the president of the Federal Reserve Bank of St. Louis, told Reuters on Thursday night that "at some point" Fed policy makers would drop a sentence included in their recent policy statements that said future interest rate increases would come at a measured pace.

The dollar began to rally after the Reuters report because the remark, some traders said, was taken as a signal that the Fed might be raising its benchmark, short-term interest rate faster than had been expected. A faster rise in interest rates here could help the dollar because higher interest rates than those in Europe would make owning dollars more attractive.

Later Thursday night, Mr. Poole repeated many of his comments to reporters after a speech in St. Louis. In those comments, however, Mr. Poole made clear, according to Bloomberg News, that he "didn't predict" that the measured pace language would be dropped "at the next meeting" of Fed officials, which is on Feb. 1 and 2.

Mr. Poole's comments may have been paid more attention than they were due because of the Fed's new policy of releasing the minutes of Fed policy-making meetings just three weeks after the session. In the past, the minutes were not released until after the succeeding meeting, meaning they provided much less insight into current Fed thinking.

Because the minutes of the Dec. 14 meeting of the Federal Open Market Committee, which were released Jan. 4, said that a "few members" suggested removing the measured pace language, traders are now attuned to figuring if and when such a change will occur and deciding if it will mean a faster pace of rate increases. They are also left to decide whether the "few" is a potent minority or not.

The measured pace comments, along with "a number" of policy makers worrying about inflationary pressures, sent the dollar and interest rates higher on Jan. 4.

Fed officials at the Dec. 14 policy session, which approved the first early release of meeting minutes, "debated the possibility that the markets would misinterpret the minutes," according to the minutes.

Misinterpretations seem possible when the minutes say "a few members" want to drop the measured pace language but that "more of the members believed that this language was useful." On inflation, the worries were
from a "number of participants." But the minutes went on to say that "despite these concerns, participants generally expected that inflation would remain low in the foreseeable future."

Louis Crandall, chief economist at Wrightson Associates, said that it was going to take time for both the markets and the Fed to learn how to handle the new process without undue market disturbances.

"There will be a period of confusion," he said, "while the market learns how to read the minutes and while the Fed learns how to write the minutes when they are going to be read this way."

Most of the dollar's rise yesterday - it climbed 0.7 percent against the euro - was over by the morning trading in New York.

Steven Englander, chief foreign exchange strategist for the Americas at Barclays Capital, said that Mr. Poole's comment was not really new because of the Dec. 14 minutes. And he argued that much of the dollar rally was just a desire by many investors to buy dollars and sell euros now to take advantage of a dollar rally that many analysts expected after the American currency dropped sharply at the end of last year.

An indication of this desire can be seen, he said, in the swift rebound of the dollar since Wednesday, when it fell 1.1 percent against the euro after the government reported that the trade deficit surged to a monthly record of $60.3 billion in November. In late trading yesterday, the euro was valued at $1.3106, almost the same value as on Tuesday, the day before the trade deficit report.

Another indication that the dollar's move was more related to owning dollars instead of euros, is that the dollar fell against the Japanese yen yesterday to a new five-year low while the dollar rose against the euro. In late trading, the dollar was at 101.91 yen, down 0.5 percent from 102.45 Thursday.

When the Dec. 14 Fed minutes were released Jan. 4, the dollar jumped against both the yen and the euro.

Mr. Englander also said that supportive comments from President Bush in an interview with USA Today helped the dollar.

In the bond market, the yield on the Treasury's 10-year note rose to 4.22 percent, from 4.16 percent Thursday, while the price, which moves in the opposite direction, fell 16/32, to 1006/32.

William Prophet, interest rate strategist at UBS, said that the 0.8 percent jump in industrial production in December, which was larger than expected, played a role in the sell-off. While producer prices fell in December, for the year they rose 4.1 percent, the biggest annual gain in 14 years. And even if the Consumer Price Index is unchanged for December, which is the current consensus of economists surveyed by Bloomberg, it will still have climbed 3.6 percent last year, also the biggest increase in 14 years.

But Mr. Prophet said that Mr. Poole still had his impact. "The fact that Poole made these comments and what the Fed said in the minutes about inflation exaggerated the reaction to the data," Mr. Prophet said.