Dollar to Drop on Concern About U.S. Fiscal Situation, HSBC Says

By Benjamin Purvis - Aug 24, 2012

Concern the U.S. fiscal situation will deteriorate may push the dollar down versus the euro and the yen, according to HSBC Holdings Plc, Europe's biggest bank.

"U.S. fiscal dynamics are actually much worse than what they are for the euro zone as a whole," said Paul Mackel, HSBC's head of Asia currency research in Hong Kong. "We think the clock is ticking and the market will eventually catch up to this. When they do, then the dollar will start to go down."

The U.S. budget shortfall will reach $1.1 trillion this year, according to the nonpartisan Congressional Budget Office, the fourth consecutive year with a trillion-dollar deficit. The office predicts U.S. debt will total 73 percent of the nation's gross domestic product this year. The country, which heads to the polls in November, will also confront a so-called fiscal cliff at the end of this year when spending cuts and tax increases will kick in automatically unless Congress acts.

"The dollar is facing very, very strong headwinds," Mackel said at a briefing today in Sydney. "The market will start to push the dollar lower against a broad range of currencies."

The greenback will weaken to $1.35 per euro and 74 yen by the end of 2012, HSBC predicted. The euro traded at $1.2558 as of 6:31 a.m. in London, while the U.S. currency fetched 78.60 yen.

**ECB Action**

Action by the European Central Bank will probably buoy the euro against its U.S. counterpart, according to HSBC. Speculation is mounting that the ECB will implement new policies to counter the euro-area debt crisis when its governing council meets on Sept. 6, and this could have an impact that is "quite powerful and long lasting," Mackel said.

The European debt crisis has cast a shadow over global financial markets for more than two years, driven up borrowing costs for the most indebted members of the euro zone and led to bailouts involving five of the bloc’s 17 states.

A failure by the ECB to come up with a plan that satisfies investors would lead to a flight from riskier assets, "which would mean the likes of the U.S. dollar would get even stronger, even if the Fed is seen trying to do more QE around the corner," he said, referring to the U.S. central bank's asset purchase program, known as quantitative easing. Such measures tend to debase the greenback.

**Fed Stimulus**

The Federal Reserve probably will engage in further stimulus measures, Mackel said, although "the exact timing of that is still difficult to define." Minutes released this week of the Fed's latest meeting indicated that many policy makers saw the need for additional loosening if the economy doesn’t show signs of a durable pickup. The next meeting of the rate-setting committee is on Sept. 12-13.

With Europe's debt crisis as yet unresolved, the Chinese economy slowing and a U.S. presidential election later this year, there is a "significant amount of event risk" to foreign-exchange markets, according to Mackel, who said he was puzzled by the relative lack of volatility in currencies.

The implied volatility of three-month options on Group of Seven currencies is near the lowest level since November 2007, based on a JPMorgan Chase & Co. measure. The gauge was at 8.35 today, having touched a 4 1/2 year low of 8.32 on July 20.

"The market seems very, very relaxed about things that could be quite big," he said.