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STERLING'S WORLD REPORT

Has the U.S. Dollar Peaked?

Predicting short-term currency movements is a mug's game, as anyone who has ever tried it can readily attest. Consider the U.S. dollar. If you had correctly believed a few years ago that the U.S.

would enter into recession in 2001, that the Nasdaq Index would fall more than 65%, or that widespread doubts about U.S. accounting integrity would roil the markets, you might be excused for having expected the dollar to decline markedly.

Instead, the U.S. dollar has become a virtual Energizer Bunny of global financial markets, having reached a 16-year trade-weighted high earlier this year. The dominance of the dollar is also reflected in its prominent role as the currency of choice among finance ministers of other nations. Currently, almost 70% of all global currency reserves are held in U.S. dollars, compared to roughly 50% just 10 years ago.

Surprisingly, dollar strength has occurred against a backdrop of truly massive trade and current

account deficits. According to projections by the Organization of Economic Co-operation and Development (OECD), the U.S. current account deficit is expected to rise from a level of 4.1% of gross domestic product last year to nearly 5% in 2003 (see Chart 1). That represents roughly \$500 billion, give or take a few billion, or nearly 10% of global savings.

An Unsustainable Current Account Deficit?

Is this sustainable? We doubt it. A recent study by the Federal Reserve of large current-account deficits in industrial economies found that deficits that exceed 5% of GDP tend to be unsustainable and are subsequently reversed. And such reversals were typically accompanied by an average fall in the exchange rate of 40%, together with slower GDP growth needed to curb the growth of imports.

Perhaps, just perhaps, the U.S. will be able to avoid the experience of the typical nation running a large external deficit. Thanks to its unique geopolitical position and its dynamic, open economy, the U.S. has been able to attract ample capital from both private investors and public sources overseas for a number of years.

A very benign interpretation of the U.S. current account deficit is that it is simply a reflection of the fact that foreigners have – until recently at least – found the U.S. to be an attractive place to invest. By adding some of their savings to the savings of Americans, the nation has been able to invest more than its local citizens save. That process is what has kept the dollar strong and made foreign goods very cheap for American

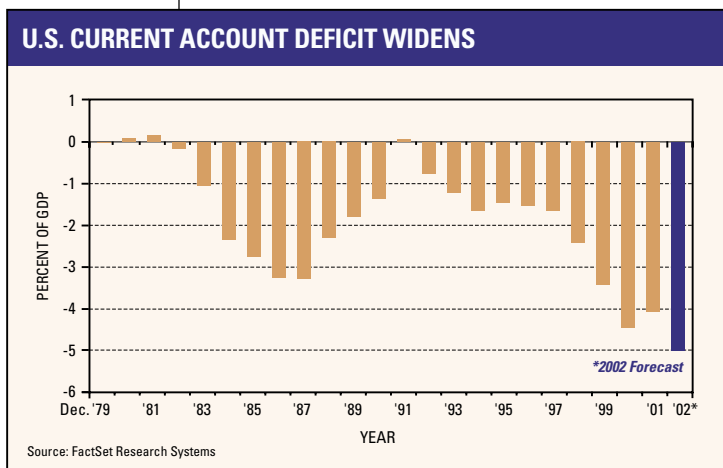


Chart 1. The U.S. current account deficit is expected to reach nearly 5% of GDP in 2003. A significant depreciation of the U.S. dollar may be necessary to reverse this trend.



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consumers. If the result has been a large trade and current account deficit, what's wrong with that?

That is precisely the interpretation that U.S. Treasury officials offer in any public discussion of the U.S. external deficit. The officials are well aware that to offer any kind of negative assessment would risk a major change in sentiment toward the dollar that could be far from orderly.

The less benign interpretation is of the type recently offered by the Financial Times of London: "That the dollar has defied gravity for so long does not invalidate the view that it is overvalued. It simply means that we cannot predict when it will fall. But fall it almost certainly will, for the U.S. has spent more than it has earned for the past six years."

As a matter of arithmetic, both views are correct. The U.S. is investing more than it saves and foreigners are making up the gap. And the U.S. is consuming more than it produces, with foreigners making up the gap. Add to that the Fed's finding that few countries are able to do this for long beyond a certain point – whether the explanation is benign or not – and there is ample reason to think that the dollar is ultimately headed down.

What Makes the Dollar Unique

The trickiest part of the analysis has to do with the dollar's unique role as the key currency in the global financial system. The experience of other industrial countries that have run large trade deficits may not be exactly applicable to the U.S. In view of America's role as the sole global superpower, other countries have been willing to finance U.S. deficits for a variety of reasons that would not apply to, for example, Sweden.

For example, China and Japan have in recent years built up a huge stock of foreign exchange reserves based on the dollars that their export giants have earned in the U.S. Had those governments not decided to fill their coffers with dollars, their currencies would have appreciated in value and their export competitiveness around the world would have suffered. Since their exports are denominated in U.S. dollars – the key currency in many markets – their governments have had a major incentive to acquire dollars as part of their overall economic and exchange rate policy.

In effect, these countries have provided the United States with "vendor financing," as seen by companies who sometimes lend money to their customers in order to keep their order books full. Unlike a company that is limited in the amount of risk it can take on to make such loans, a country can choose to do so for an indefinite period. In other words, the Bank of Japan, which can create yen at the stroke of a pen, can then turn around and use that yen to buy dollars. In the process, it can help keep the dollar-yen exchange rate at a level that is favourable to Japan's export industries.

Since the Japanese and Chinese may wish to keep their currencies weak for an extended period of time – especially given the huge challenges they face with various internal economic issues – the dollar could stay stronger for longer than would be the case for a normal industrial nation with a large trade deficit.

The limit to this type of "vendor financing" will tend to be political rather than purely economic. And that is why currency traders are so sensitive

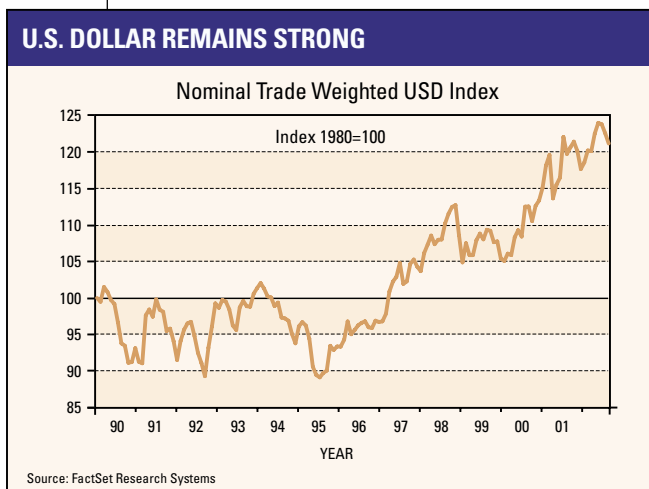


Chart 2. Despite a modest weakening this year, the trade-weighted U.S. dollar remains extraordinarily strong. That has contributed to surging imports and weak exports.



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to statements by finance ministers and central bankers about whether current policies will be allowed to persist. The day that the U.S. administration begins to even hint that it is no longer happy with the "strong dollar" policy that it inherited from the Clinton administration, is the day that the dollar is likely to begin a long slide.

So far, the Bush administration has been steadfast on the strong dollar policy, despite complaints by some of the administration's friends in industry that it is hurting U.S. competitiveness. However, the administration's recent decision to penalize foreign steel imports has been viewed by many as a sign that the large U.S. trade deficits are becoming politically unsustainable, and this has contributed to a recent weakening of the dollar.

Other Dollar Negatives

Even if U.S. policy on the dollar does not change drastically, there have been a number of other issues that are chipping away at the dollar's underpinnings. These include the recent outperformance of foreign equity markets versus the U.S. market, the crisis in U.S. corporate governance exemplified by the Enron fiasco, and doubts about the probable strength and composition of the U.S. recovery.

As shown in Chart 3, the U.S. market has begun to significantly lag the MSCI World Index in recent months after outperforming it for years. While this may be just a temporary trend, it would have major negative implications for the dollar if it persists much longer. The reason is simple: the U.S. will need to attract nearly \$500 billion in foreign money over the next year to fund its current account deficit. If foreigners begin to scale back on their purchases of U.S. assets, the dollar will come under pressure.

This relates closely to the second issue, namely the loss of confidence in U.S. corporate governance that has followed the collapse of Enron. This erosion of confidence has extended to concerns about lax standards by Wall Street firms, major accounting firms and even bond-rating agencies as key participants in the capital-raising activities of corporate America. Again, since the U.S. needs large amounts of new foreign capital to finance its current account deficit, diminished confidence on the part of foreign investors can only be a negative for the dollar.

Finally, the probable strength and composition of the U.S. recovery is an important issue for the dollar. While the reported GDP growth rate of 5.8% for the first quarter was impressive, about half of the growth was attributable simply to a reduction in the rate at which firms were liquidating their inventories. Final demand grew at a less impressive rate of 2.6% – and that is probably a better read on the underlying pace of growth than the 5.8% headline number. There is nothing wrong with that, but it does suggest that the Fed will be in no hurry to raise interest rates (as we argued last month).

It is also worth noting that the economy's surprising strength since last September has been almost entirely due to the consumer sector. Investment spending continued to decline in the first quarter as businesses respond to a drastic drop in profits over the last two years. However, do foreign investors want to put money in the United States to fund a surge in consumer spending that will worsen the trade deficit down the road? If the economy were being driven by buoyant

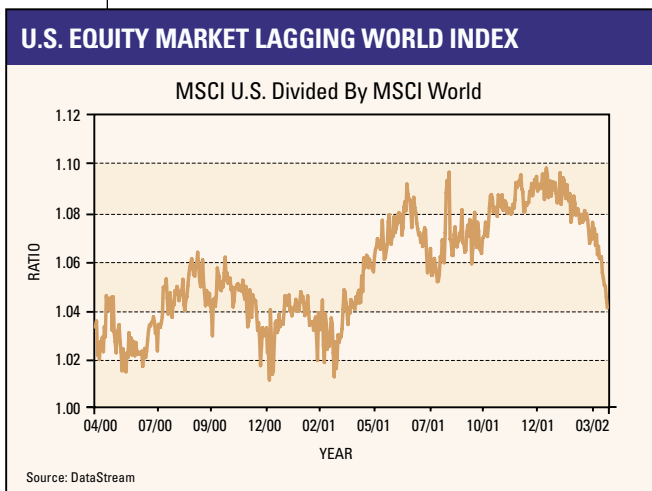


Chart 3. Most foreign equity markets have outperformed the U.S. market this year. If this trend persists, the dollar could come under further pressure as foreign money flows shrink.



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investment spending, it would support a strong dollar story. But if U.S. firms are continuing to curb investment spending, why should foreign money be pouring in?

Burgeronomics

Our bottom line is that we would not be surprised to see the U.S. dollar drop by 10% or so over the next year against the currencies of its major trading partners, with a larger drop possible if the U.S. recovery remains tepid. The yen is the possible exception because of the Bank of Japan's need to fight deflation by maintaining a weak currency.

We are fans of what The Economist magazine calls "burgeronomics," which compares the value of international currencies in terms of how much a standardized product – a McDonald's Big Mac hamburger – costs around the world. According to the latest survey, a Big Mac sells for an average of \$3.33 Cdn in Canada versus \$2.49 US in the United States. According to that, the "purchasing power parity" exchange rate should be 1.34 Canadian dollars per U.S. dollar (3.33 divided by 2.49). This measure implies that the Canadian dollar is 15% undervalued at a recent exchange rate of 1.57 Canadian dollars per U.S. dollar.

As shown in Table A, most other major currencies are also undervalued against the dollar, some by much wider margins. This is especially true of many emerging market nations. As we mentioned above, if foreign nations support such undervaluation as ongoing policy, it may persist for some time to come. But as the U.S. current account deficit widens, the probability of an across-the-board dollar decline will increase.

In our funds, we are currently tilted away from U.S. dollar exposure and toward exposure to the Canadian dollar, the euro and selected emerging markets currencies. If we are right about the U.S. dollar, the next year or so should see international mutual funds generally outpace U.S. funds, and international bond funds do well relative to domestic U.S. bond funds.

Is the potential for a weak dollar likely to be a huge negative for U.S. stocks? We doubt it, because unlike many other nations a weak currency does not necessarily imply a sharp rise in interest rates. That is, because of the dollar's unique stature, the U.S. can set its own domestic interest rates without having to target a given level for its currency. The U.S. experienced a major dollar weakening in 1986 and the stock market did well – even if other markets posted even larger gains in dollar terms.

The last point is key: If the dollar is set to weaken over the next year or so, foreign markets may offer more potential than the U.S. market. And we intend to take advantage of that trend.

*William Sterling, Global Strategist
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BURGERNOMICS: CURRENCY VALUES IN BIG MAC TERMS

	Big Mac Prices		Implied PPP of USD	Actual dollar exchange rate 4/23/02	Under/Over valuation against USD (%)
	In Local Currency	In USD			
United States	\$2.49	2.49	–	–	–
Australia	A\$ 3.00	1.62	1.20	1.86	-35
Brazil	Real 3.60	1.55	1.45	2.34	-38
Canada	C\$ 3.33	2.12	1.34	1.57	-15
Euro Area	Euro 2.67	2.37	0.93	0.89	-5
Hong Kong	HK\$ 11.2	1.4	4.50	7.80	-42
Malaysia	M\$ 5.04	1.33	2.02	3.80	-47
Poland	Zloty 5.90	1.46	2.37	4.04	-41
Switzerland	SFr 6.30	3.81	2.53	1.66	+53
UK	GBP 1.99	2.88	1.25	1.45	+16

Source: McDonald's, The Economist

Table A. A comparison of a standardized product – McDonald's Big Mac – across nations suggests that the dollar is generally overvalued against other major currencies.