



WILLIAM STERLING

STERLING'S WORLD REPORT



Dollar Dynamics – Why More U.S. Dollar Weakness is Likely

The major decline in the foreign exchange value of the U.S. dollar last year presented a huge challenge to investors in global markets. Even though equity markets posted strong returns in 2003, the dollar's decline meant that returns were far more pedestrian when measured in currencies that rose significantly against the greenback – currencies like the euro or the Canadian dollar.

This January brought a bit of a respite from that trend. The Bank of Canada reduced interest rates in an attempt to halt the currency's gains. European authorities expressed their displeasure with the dollar's slide. And U.S. Federal Reserve officials also surprised the markets by hinting that they would be raising interest rates later this year, after insisting for many months that interest rates would remain low for a "considerable period."

Does all of this suggest that the tide has turned for the greenback? We doubt it. A look at the history of dollar cycles (See Chart 1) suggests that major currency trends have been impressively persistent, with bear market dollar cycles lasting anywhere from five to 10 years. The current bear phase for the U.S. dollar is only two years old, so it would be the shortest cycle on record if the dollar is turning around now.

Is the Loonie Still Undervalued?

That said, every dollar cycle has its unique aspects, and this particular episode is likely to be no exception. In this cycle, for example, the Canadian dollar has had such a rapid ascent against the U.S. dollar that one might naturally ask whether it has dramatically overshot its "fair value" – whatever that is – and is headed for a major reversal. Our answer is no, because by some measures the Canadian dollar is still modestly undervalued.

Currency analysts at Deutsche Bank, for example, believe that the Canadian dollar is still nearly 5% undervalued on a "purchasing power parity" (PPP) basis. That type of analysis (See Chart 2) simply compares the price of a basket of goods in Canada with the price of similar goods in other countries. For a number of years, the Canadian dollar was one of the most undervalued currencies in the world by the PPP measure.

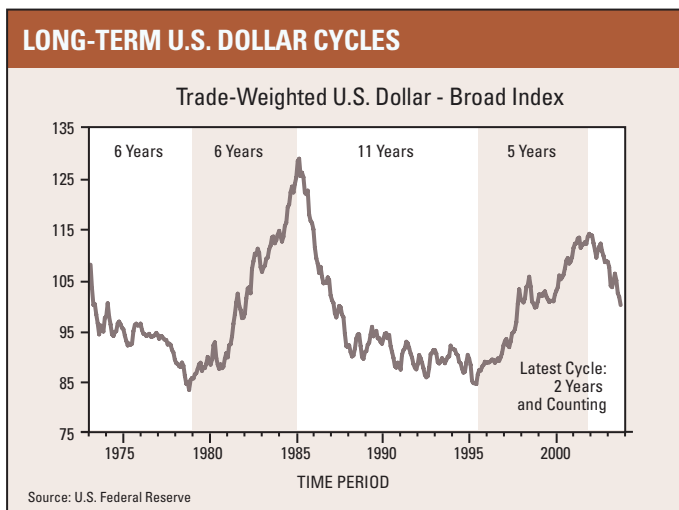


Chart 1: Bear market cycles for the U.S. dollar have been multi-year affairs. At just two years and counting, the current bear cycle could still be in its relatively early stage.



We did an analysis in mid-2002 that suggested, based on consumer price trends, a “fair value” for the Canadian dollar of about \$0.80 US – which is roughly in line with both the Deutsche Bank estimate and our own updated research. We have also done work comparing wholesale prices in both Canada and the U.S., which puts “fair value” near \$0.78 US – very close to its recent highs.

That said, like all other major currencies, the Canadian dollar has often spent long periods of time trading well above or well below its “fair value” range (See Chart 3). And given the substantial downward pressure on the U.S. dollar generated by America’s massive trade imbalance, it would be surprising if the Canadian dollar did not end up trading on the “overvalued” side of the charts for a few years. That was certainly the pattern in the late 1980s as the U.S. worked its way out of large trade and current account deficits.

Using our estimate of PPP based on wholesale price trends, which has tended to track the actual exchange rate better than the consumer-based measure, we would note that during periods of Canadian dollar overvaluation, like the late 1970s and late 1980s, the currency frequently traded about four to five cents above its PPP rate. So if that PPP rate is now \$0.78, it wouldn’t be surprising to see the Canadian dollar trade persistently around the \$0.82 to \$0.83 level in response to U.S. dollar weakness.

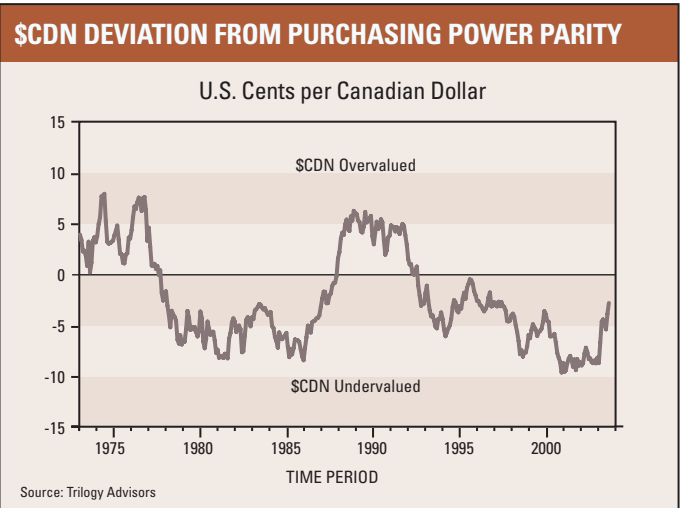


Chart 3: Based on history, it would not be surprising if the Canadian dollar were to trade five cents or higher above its current purchasing power parity value of \$0.78 to \$0.80 US.

What About the Fed?

Naturally, the Fed’s recent hint that it may be raising interest rates in the not-so-distant future complicates things somewhat. It does not change our view that the U.S. dollar is in a secular bear market. For example, looking at previous tightening cycles that began in 1976, 1982, 1986, 1994 and 1999, the trade-weighted dollar typically sold off during the first six months or so of the tightening cycle (See Chart 4). Also, as shown in the chart, the U.S. dollar sold off sharply after the tightening cycle that began in 1986, when the U.S. trade and current account deficit was, like now, a major issue.

The general tendency for the U.S. dollar to weaken in the aftermath of Fed tightening may reflect the fact that asset markets tend to get roiled during the initial phases of the tightening process, prompting global investors to keep their money at home. Since the U.S. has a voracious appetite for foreign funds, the dollar may tend to weaken during the early phases of Fed tightening simply because a lower value for the dollar is needed to bring foreign capital back into U.S. markets.

What about the Canadian dollar’s response to Fed tightening? Historically, the loonie has been somewhat more responsive to Fed tightening cycles than other major currencies. For example, the Canadian dollar tended to lose ground against the greenback in most of the five tightening cycles mentioned above.

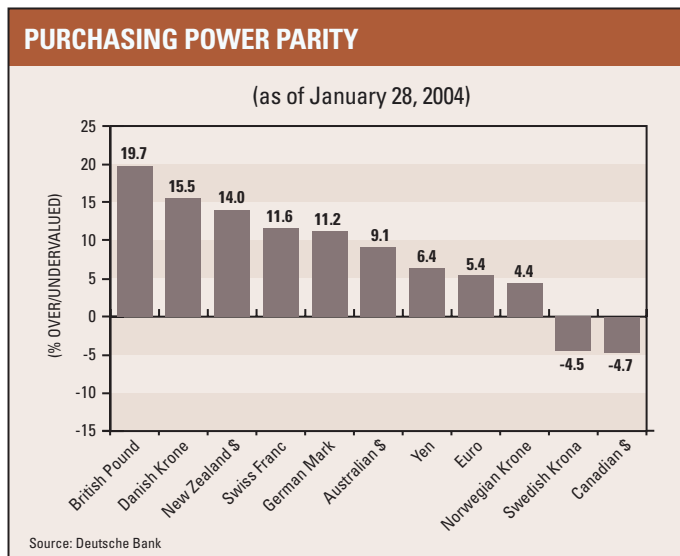


Chart 2: Despite last year’s surge in the value of the Canadian dollar, it remains modestly undervalued on a purchasing power parity basis, relative to a basket of foreign currencies.



The one notable exception was the tightening cycle that began in 1986, which was the last time the U.S. faced a trade and current account deficit of comparable magnitude to the current imbalance. In that episode, the Canadian dollar gained 3% to 5% against the U.S. during the first six months of Fed tightening. That burst of Canadian dollar strength occurred at the same time that the U.S. dollar lost nearly 10% on an overall basis, which meant that the Canadian dollar was losing ground against other major foreign currencies at that time.

The China Connection

And that brings us to one final important aspect of the current challenge facing the U.S. dollar, namely China. With nearly \$100 billion of America's overall trade deficit now accounted for by China, it is certainly noteworthy that the U.S. dollar has so far not declined against the Chinese yuan. That's because the Chinese have pegged their currency to the U.S. dollar in order to promote their export competitiveness.

At some point, the Chinese will most likely have to relent and permit their currency to move up against the U.S. dollar. In the meantime, the Chinese central bank has been buying massive amounts of U.S. dollars and U.S. Treasury bills, delaying the inevitable adjustment. If and when China's

central bank finally relents, it may be related to policies to slow down the Chinese economy to prevent overheating.

In the absence of Chinese currency adjustment, freely floating currencies like the Canadian dollar and the euro have done all of the adjusting to U.S. trade imbalances. But when the Chinese finally move – which may not be for another year – it should take some of the pressure off the Canadian dollar and the euro.

If China's move to revalue coincides with an "austerity program" to cool down the overall economy, it could also affect the Canadian dollar by taking some of the steam out of global commodity markets. Commodity prices have benefited tremendously from China's rapid growth. In that sense, last year's remarkable strength in the Canadian dollar can be viewed as a surprising byproduct of the China boom.

For that reason, watching what is happening in China will be an important part of our currency research. With some analysts warning that China is preparing to step on the monetary brakes, the China connection is a reason for believing that further upward pressure on the Canadian dollar is likely to be fairly modest.

Continuing to Hedge

For now, we continue to hedge against U.S. dollar exposure in our global equity and fixed-income portfolios. Despite the recent bounce in the greenback, for the reasons outlined above we think the bounce will be short lived. That said, we reserve the right to change our mind, especially if Fed tightening turns out to be more aggressive than currently expected, or if the Chinese initiate a major austerity program and/or currency revaluation.

In thinking about currencies, we try to respect the wisdom of John Maynard Keynes, economist and currency speculator extraordinaire. As Keynes once noted: "When somebody persuades me that I am wrong, I change my mind. What do you do?"

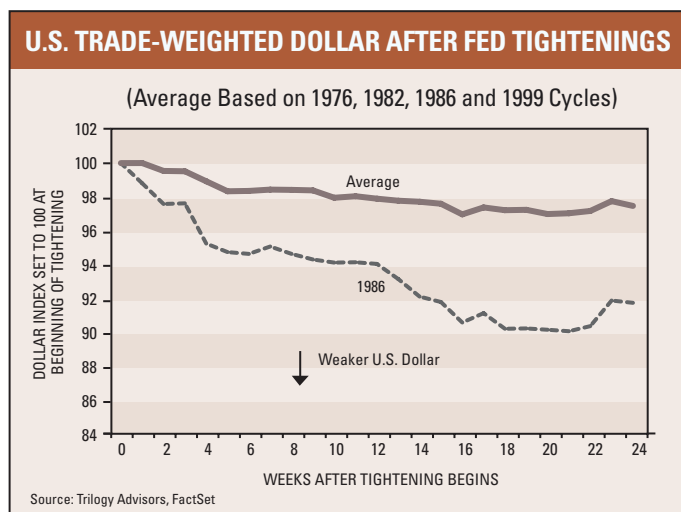


Chart 4: The greenback typically weakened in the first six months after Fed tightening began. This was especially true in 1986 when the trade imbalance was a big issue – as it is now.

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