



The Dollar Debate

A year ago, market sentiment toward the U.S. dollar was extremely negative following nearly three years of erosion of the greenback's foreign exchange value. At that time, a number of prominent academic economists were publishing papers focusing on the unsustainable nature of the U.S. trade deficit and making the case for

a further decline in the value of the dollar of anywhere from 30% to 50% over the next few years.

What happened in 2005? Despite the fact that the U.S. external deficit remains a major concern, the U.S. dollar frustrated the bears by rising an impressive 14% against the euro and 15% against the yen. During a year when the U.S. Federal Reserve hiked interest rates steadily over the course of the year, only a few other major currencies – like the petro-charged Canadian dollar – managed to post gains against the U.S. unit.

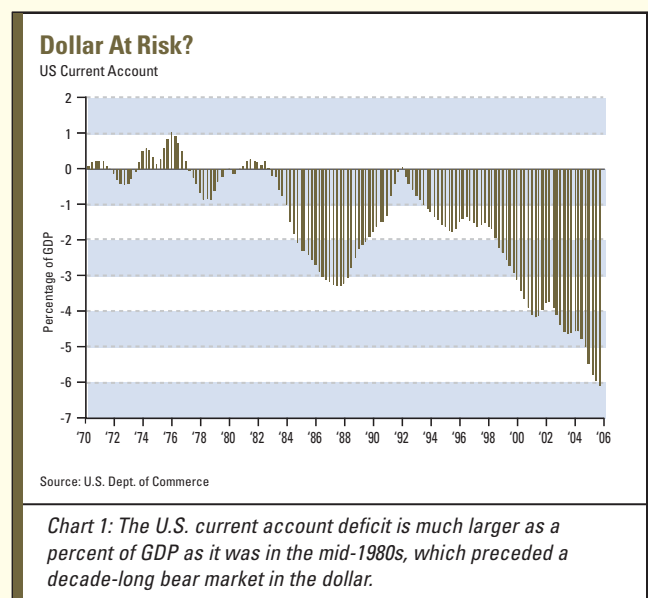
This by no means suggests that the fundamental bear case for the U.S. dollar has no basis. As we show in Chart 1, the broadest measure of the U.S. external imbalance, the current account, is running a deficit of more than 6% of GDP or a whopping \$780 billion per annum. Historically, many nations' currencies have tended to come under pressure when their external deficits exceed 4% of GDP. So there is still ample reason to believe that the U.S. dollar will sooner or later revert to a downward trajectory against most of the world's major currencies.

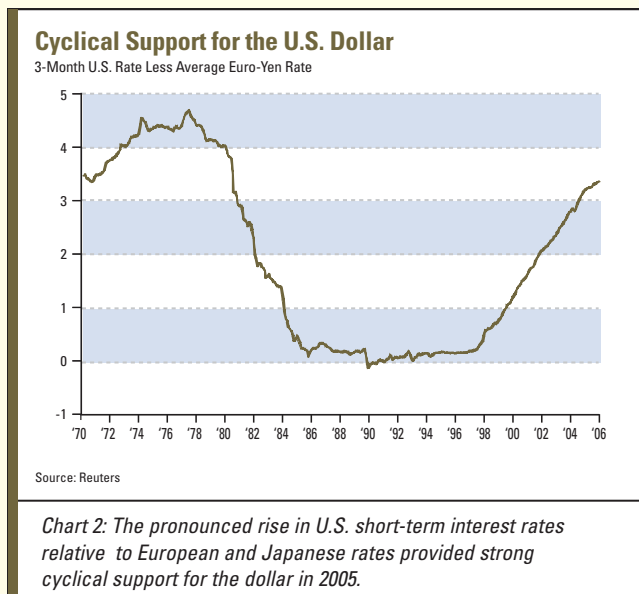
Rates Support the Greenback

That said, even though the dollar may have a structural problem rooted in the trade imbalance, it has enjoyed considerable cyclical support. That reflects both the recent

strength of the U.S. economy and the move toward tighter monetary policy on the part of the Fed. The cyclical support can be seen in Chart 2, which shows the difference between U.S. three-month interest rates and the average of comparable rates now prevailing in Europe and Japan.

As is clear from Chart 2, U.S. rates have moved up decisively relative to European and Japanese rates over the last year. The wider interest rate spread has made it increasingly expensive for international investors to bet against the U.S. dollar, since they then have to forgo the higher yields available in U.S. money markets.





With the U.S. economy set to slow in coming quarters as the lagged effect of Fed rate hikes take effect, cyclical support for the dollar could begin to erode as the year progresses. In addition, with Europe having just started a cycle of monetary tightening and Japan expected to back away from zero interest rates in coming quarters, interest rate differentials may no longer provide as much support for the U.S. currency as was the case in 2005.

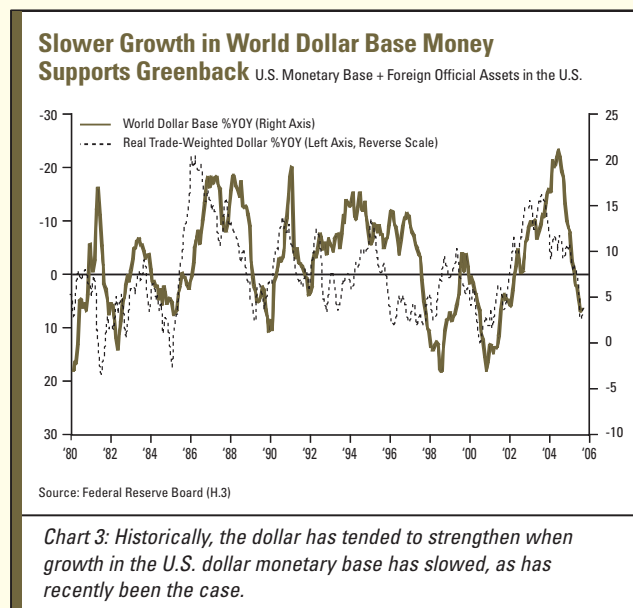
Based on recent economic trends, it seems improbable that European and Japanese authorities will raise rates aggressively any time soon. And even if the Fed completes its monetary tightening at the end of this quarter, as seems increasingly likely, it has historically taken about six months from the time of the last tightening before the Fed reverses course and begins to cut interest rates. So interest rate differentials should continue to lend support to the dollar this year, even if they begin to narrow somewhat from 2005 levels.

Most successful currency traders focus on two types of models for establishing positions in foreign currencies: technical trend models that basically bet on recent trends

continuing, and “carry” models, which basically bet on currencies with the highest interest rates continuing to attract capital. Last year, both trend and carry models turned in favour of the dollar. This year, some trend models have reversed course in the early part of the year, but models based on interest rate differentials continue to support dollar strength.

Fewer Dollars mean Stronger Dollar

Another fundamental approach toward thinking about the dollar is simply to focus on growth in the supply of dollars. As we show in Chart 3, the broad U.S. dollar index has been closely correlated with growth in the U.S. dollar monetary base (also known as “high-powered money”), which is the sum of the U.S. monetary base and foreign central bank holdings of U.S. assets. When the Fed is trying to reflate the world economy, as was the case in the early part of this decade, the monetary base soars and the U.S. dollar has tended to weaken. When the Fed curbs growth of the monetary base, dollars become scarcer, and value of the dollar tends to rise on foreign exchange markets.



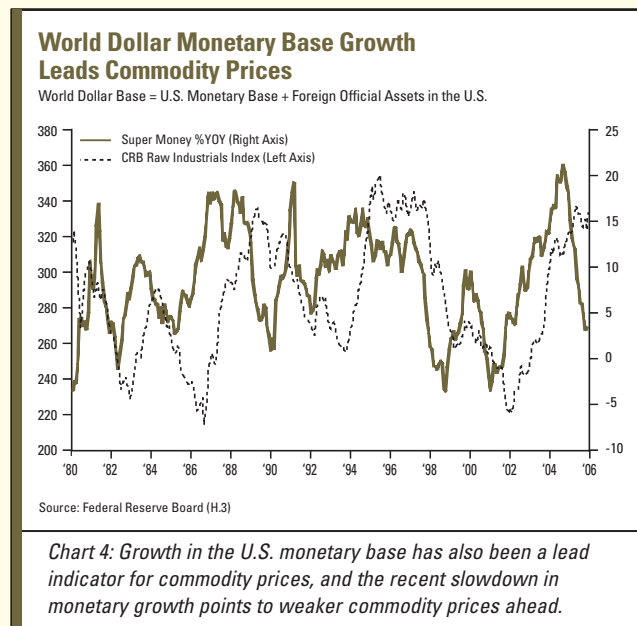


Although some market participants believe that the incoming Fed Chairman, Ben Bernanke, may be “soft on inflation” compared with Alan Greenspan, we highly doubt that will be the case. Accordingly, we tend to think that it will take hard evidence of a very significant U.S. slowdown before the Fed will wish to promote an acceleration of high-powered money growth that could usher in a period of pronounced U.S. dollar weakness. That type of economic scenario could develop later this year as U.S. real estate markets and consumer spending continue to cool off. That said, we are still probably at least two quarters away from any significant Fed easing that would result in a major acceleration in the supply of high-powered money. If we are correct, that means that dollars will continue to be relatively scarce and maintain their value on foreign exchange markets for the next few quarters.

Incidentally, that view also suggests some caution on the outlook for commodity prices as well. As we show in Chart 4, the growth of the U.S. dollar monetary base has tended to be a good lead indicator of the CRB raw industrials commodity price index. That is, when growth in the money base slows, commodity prices have tended to weaken six to 12 months later, and vice versa. Given the sharp slowdown in the growth rate of the U.S. dollar monetary base in recent quarters, we continue to believe that commodity prices are in the process of peaking.

Is the Current Account Deficit Unsustainable?

To return to where we started this discussion, the sheer size of the U.S. current account deficit still suggests to most economists that the long-term trend in the U.S. dollar must inevitably be further weakness. As we mentioned in these pages last year, a “one-stop shop” for the bear case on the dollar can be found on the website of New York University professor Nouriel Roubini (www.rgemonitor.com/blog/roubini). His site has established links to virtually every major study



of the U.S. current account dilemma and includes Prof. Roubini's own colourful commentary.

The logic of those papers is fairly straightforward: Since U.S. imports are now a significant multiple of U.S. exports, the U.S. trade imbalance is almost certain to become much worse in coming years unless a sharp change in the terms of trade curtails imports and boosts exports. Otherwise, the U.S. will become increasingly indebted to the rest of the world, and so forth. The arithmetic is hard to argue against, especially since the U.S. has permitted its manufacturing base to decline to only about 10% of GDP, compared with close to 30% several decades earlier. That means that a huge change in relative prices may be necessary to divert U.S. spending away from imports and to get foreigners to buy American-made products.

The most thoughtful response we have seen to the more Armageddon-like analyses of the U.S. current account was written by Harvard University professor Richard Cooper last September (www.sedinc.com/PDFs/Cooper.pdf). His analysis puts the size of the \$700 billion U.S. current

account deficit into perspective by noting that the world outside of the U.S. generates about \$6 trillion to \$7 trillion of gross savings every year, or nearly 20% of those nations' collective GDP.

After reviewing the fact that U.S. capital markets are among the deepest, most liquid and most efficient in the world and that the return on capital invested in the U.S. has also been superior for many years, Prof. Cooper raises an interesting point:


“Given these realities, is it in fact inconceivable, much less improbable, that savers around the world will want to put 10-15% of their gross savings into the U.S. on an ongoing basis – a share that will fall over time in the scenario of constant deficits? It certainly is not. Indeed, 10-15% seems if anything to be low of the mark.”

From this type of reasoning, he concludes that large U.S. deficits may be sustainable and even desirable for a much longer period of time than many of the strident current account pessimists are willing to concede. That does not, by the way, imply that Prof. Cooper is bullish on the dollar, since he has conceded that further dollar weakness may be appropriate to keep the deficit from widening beyond current levels.

His key point, however, is that the U.S. imbalance reflects not only U.S. savings and consumption behaviour, but also the preferences of overseas policy makers and consumers that may remain in place for years to come. He also stresses that Americans should not be overly concerned about borrowing abroad per se, but rather about borrowing abroad to finance large and possibly unproductive government budget deficits as opposed to financing productive investment.

When reviewing the dollar debate, we are reminded a bit of the active debate about U.S. budget deficits that arose in the mid-1980s in response to widespread academic horror about Reaganomics. Predictions of fiscal disaster abounded at that time and proved to be wide of the mark. And while there is certainly ample room for concern about the long-term trajectory of the U.S. dollar, we suspect that predictions of current account Armageddon may turn out to be greatly overdone as well.

Our bottom line: Based on the likelihood of continued support from positive interest rate differentials and the Fed's anti-inflation posture, we maintain a relatively neutral view of the dollar's prospects for the New Year. We continue to view the long-term trend as down, but still believe prospects of a current account crisis are quite low.



William Sterling
William Sterling
Chief Investment Officer
Trilogy Advisors, LLC