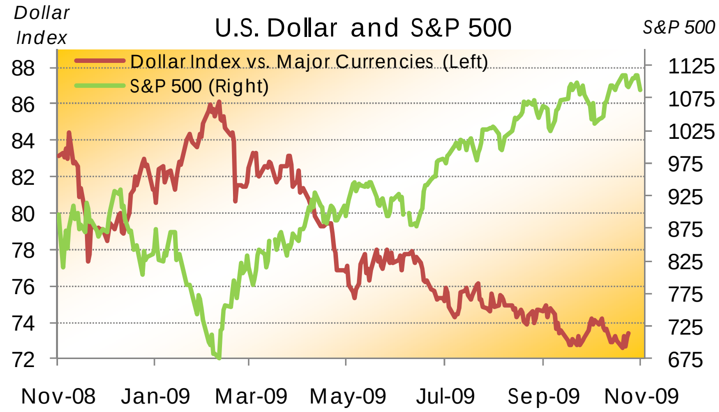
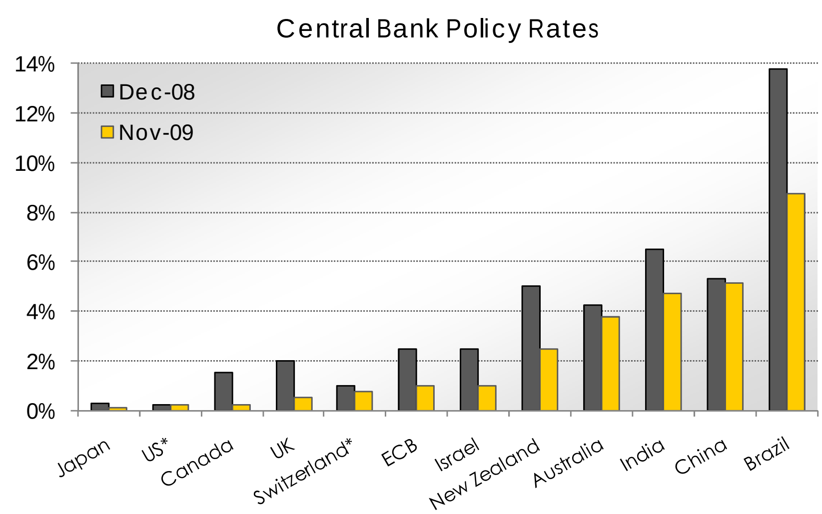
Bet Your Bottom Dollar

In the last twelve months the U.S. dollar has experienced being both the favored child and the outcast. When some of the darkest days of the financial crisis hit in the autumn of 2008, investors flocked to the currency to buy U.S. Treasuries as a safe haven in the storm. It seemed a vote of confidence in the status of the dollar that it was a refuge, despite the fact that the U.S. was the eye of the credit and real estate storm. Then, as suddenly as the currency appreciated, it turned and fell precipitously as equity markets (and risk taking) recovered. Many investors follow the dollar's wild ride, but we hear a lot of confusion about what is driving its ups and downs. Here we discuss the current weakness in the dollar, the "carry trade" phenomenon, and the dollar's relationship with other asset classes and currencies.



Source: St. Louis Federal Reserve Bank, Yahoo!Finance
Major Currencies index includes the Euro Area, Canada, Japan, UK, Switzerland, Australia, and Sweden.

In the musical "Annie," the little Depression-era orphan sings that you can bet your bottom dollar there will be better days ahead. While the equity market may feel that same way today, the dollar itself is on shakier ground. Historically-low interest rates in the U.S. – both on an absolute and relative basis – have sparked a so-called "carry trade." A *carry trade* occurs when investors **borrow** money in a currency with very low interest rates (like the U.S. now, or Japan over the last decade), and then **sell** it to invest in higher-yielding, riskier assets. The relentless selling of dollars to fund the carry trade has pushed the greenback to depressed levels. This easy money play has led investors to increasingly bet on the likelihood that interest rates will remain low in the U.S., as promised by Bernanke & Co., thus encouraging them to funnel liquidity out of the country. The chart at left shows the federal funds rate (the Fed's target policy rate) compared to other major global players. The current target is 0%-0.25%.



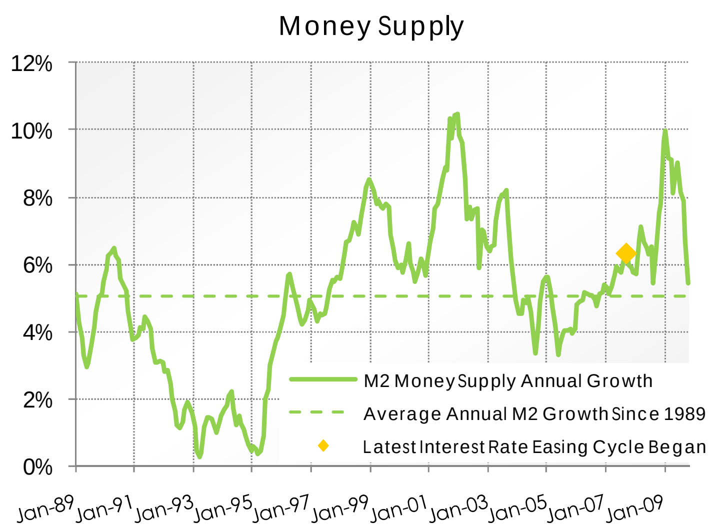
** Policy rates for these countries are ranges; high end of range is shown*
Source: Individual central bank websites, fxstreet.com

It's the Hard Knock Life for the Fed

There is a worldwide debate as to when the Federal Reserve should begin raising interest rates from their near-zero level. Some U.S. policymakers deny the existence of a carry trade at all, claiming that the dollar slide we have seen this year is just a necessary reversal of the risk aversion of 2008. Countries with currencies and asset prices rising on the opposite side of the carry trade – including Europe, China, and Brazil – are calling for an end to this arbitrage "bubble." An aide to French President Nicolas Sarkozy called the euro above $1.50 "a disaster" for European industry. Brazil has levied a new tax on investments in the country to counter its rapidly appreciating currency. Meanwhile, Chinese regulators are blaming the U.S. for speculation in world markets and for putting the nascent recovery at risk, particularly in emerging markets.

Accusations that the U.S. is trying to inflate away its ballooning debt are being countered by U.S. officials' assertions that inflation is not a pressing issue and that rates will stay low until the employment situation has firmed. It has been our opinion that the U.S. Fed is willing to err on the side of inflation to avoid risking a "double dip" recession. Though inflation is a monetary phenomenon, and monetary policy is traditionally a domestic issue, in today's economy the world is in play. Even if weak employment and falling housing prices in the U.S. warrant low interest rates domestically, policy makers cannot ignore the risk of exporting inflation on the back of the dollar – only to be re-imported down the road. A weak dollar could increase the cost of goods we import from Asia as inflating real estate, commodity, and financial asset prices drive up the general price levels in those countries. Alternatively, a strong-currency country could decide to intervene and print money in order to deflate its currency's value – as Europe has threatened – which would also pour fuel on the inflationary fire.

What was different in this easing cycle? The problem in the financial system was not one of restricted money supply as in previous cycles; it primarily was a crisis of confidence. When the Federal Reserve began lowering benchmark interest rates in September 2007, growth in the supply of money (as measured by M2[1]) already was above its 20-year average. Minutes from that policy meeting cite tightening credit conditions and *"adverse effects on the broader economy that might*



Source: St. Louis Federal Reserve Bank

[1] M2 equals M1 + savings deposits, time deposits less than $100,000 and money market deposit accounts for individuals. M1 consists of currency outside Federal Reserve Banks and the vaults of depository institutions, traveler's checks of nonbank issuers, demand deposits, and other checkable deposits.

otherwise arise from the disruptions in financial markets[2]" as reasons for lowering the target rate. The subsequent series of interest rate decreases has done little to stimulate domestic bank lending as questions about the health of the sector remain: the true value of "toxic assets" on banks' balance sheets are still unknown; commercial real estate remains a threat; and an uncertain amount of new regulation and oversight lies ahead. In light of these issues, credit conditions at banks remain tight, and the liquidity generated by quantitative easing is flowing outside of our borders. The Fed seems willing and even eager to feed the beast with near-zero interest rates as officials continue to reiterate their commitment to keeping rates low. Meanwhile, they give what seems like lip service to a "strong dollar" policy.

Yesterday, Today…and *Tomorrow*?

Every day we hear about how the equity, fixed income and commodity markets are intertwined with the movements of the dollar, but the relationships between the currency and these other assets have changed recently. Today, the commonality in these relationships is ***risk***. On days when risk aversion grips the markets, the dollar strengthens as does demand for U.S. Treasuries. Meanwhile, equities and other risk-bearing assets decline in value. When risk is in favor the opposite holds true – demand for the dollar and Treasuries falls while risky assets rally. Risk has largely been in favor since mid-March as the U.S. government continues to reassure that they will do everything in their power to keep the recovery alive. In reality the implied-government guarantee is propping up both sides of this trade – stimulus on the risk-taking side, and government backed bonds on the risk-aversion side.

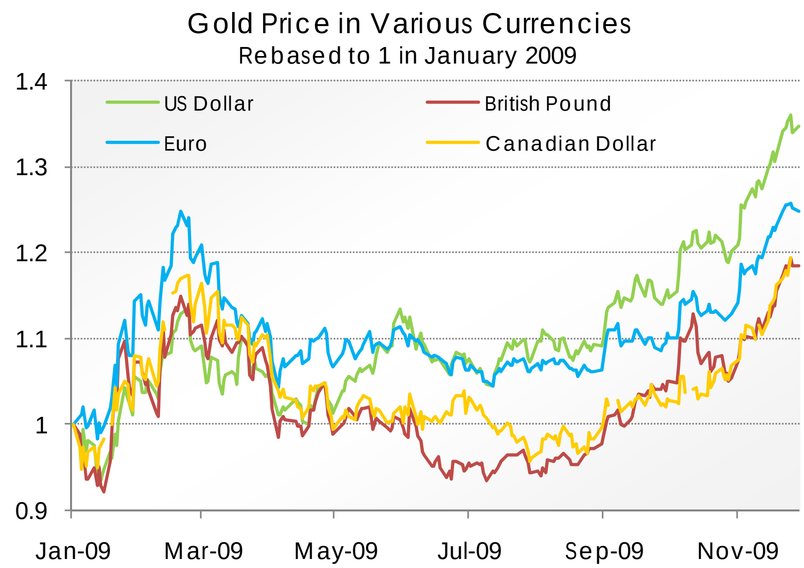
Correlations with U.S. Dollar		
	2000-Present	2009 YTD
Dollar	1.00	1.00
S&P 500	-0.18	-0.96
10-Yr Treasury Yld	0.53	-0.73
Gold	-0.84	-0.70

The recent tightening in the relationships between asset classes has been remarkable. During the nearly-10 years since early 2000, there was a weak negative correlation of -0.18 between the dollar and the S&P 500. During 2009, this relationship strengthened dramatically, and the two asset classes now have an almost perfectly-inverse correlation of -0.96. Treasuries also benefit from the risk aversion trade, as investors buy dollars to invest in the safe-haven bonds, driving the prices down and the yields up. This can be seen in the correlation between the dollar and the yield on the 10-year Treasury, which is now -0.73. Commodities like gold and oil, which are priced in dollars, have necessarily maintained their negative correlation over time. As the U.S. currency weakens, it becomes more expensive to buy gold and oil in dollar terms, other factors equal. The market's attitude toward risk is driving equities, Treasuries, the dollar, and commodities as well. These relationships promote a strong case for asset allocation over stock/security selection in this environment. Risk is not just the tail wagging the dog; it is the tail wagging the entire pack at once.

[2] http://www.federalreserve.gov/newsevents/press/monetary/20070918a.htm

Daddy Warbucks or Orphan Annie? Depends on the Currency…

From the dollar-centric viewpoint of the U.S., it appears that many assets have had large run-ups from their lows. Since commodities such as gold and oil are priced in dollars, a weaker dollar means that their prices will increase for dollar-based investors, all other things equal. For those investing in other (stronger) currencies, however, a weaker dollar will likely mean cheaper commodities.



Source: St. Louis Federal Reserve Bank, lbma.org.uk

Much has been made of the worldwide demand for gold in light of its recent strength. Gold is regularly setting new (non-inflation-adjusted) highs as it climbs toward US$1200 an ounce. This price, however, does not tell the global story. The graph at right shows the movements of gold throughout 2009 in U.S. dollars, euros, British pounds, and Canadian dollars (rebased to 1 in January 2009 for all currencies). The metal has posted impressive gains in all four of these currencies, but none to the extent of the U.S. dollar. Gold has gained nearly 35% year-to-date for dollar-based investors, but has reached only about half that gain in pounds or Canadian dollars. The euro-based rise stands at roughly 25%. The differentials may help explain why worldwide demand for the metal remains strong, particularly in emerging markets, despite its price in dollars. Even priced in U.S. dollars, though, gold is still much lower than its inflation-adjusted peak of almost $2300 hit in 1980.

S&P 500 Returns	
	2009 YTD
U.S. Dollars	24.1%
Euros	14.9%
British Pounds	8.7%
Japanese Yen	17.9%
Canadian Dollars	6.0%

A similar comparison may be made for the U.S. equity rally in 2009. While the S&P 500 has risen more than 24% year-to-date for dollar-based investors, it has boasted far less impressive gains in other major currencies. Canadian and British investors have experienced only a fraction of the run-up of American investors, while Europeans have made just more than half. These returns put a new perspective on the overvaluation arguments made by many analysts.

Never Fully Dressed Without a Smile

Negative dollar sentiment is a crowded trade at the moment, and contrarian investors have been looking for a catalyst for dollar strength. Weak economic data from the U.S. and abroad prop up the dollar for only a short time – until a Fed official is quoted on his or her commitment to support the economic recovery, and equities rally again. Many thought the trigger for an extended period of dollar strength could be the announcement from state-owned investment company Dubai World that it was trying to restructure its debt. By the time U.S. markets opened on the Friday after Thanksgiving, however, the reaction was muted. Speculation that the cash-and-oil flush United Arab Emirate capital, Abu Dhabi, would step in and back the debt was being circulated, providing a different twist on the guaranteed-backer phenomenon.

Going forward we see two possible scenarios for a turnaround in the dollar. One, the current, strongly-inverse correlation with risk/equities remains intact, and some shock brings risk aversion back into favor, supporting the dollar and driving equities down. Two, the correlation with equities turns positive once again, and a long-term economic recovery boosts both risk-bearing assets and the currency at the same time. Both of these scenarios mesh with the "dollar smile" theory formulated by former Morgan Stanley currency strategist Stephen Jen. The theory asserts that the dollar rallies when the U.S. economy is in either boom or bust mode – the left- and right-side curves of a "smile" – and weakens in favor of higher-yielding assets when growth is moderate. Our belief is that the dollar is now in the trough of that "smile" as the recovery proceeds at a moderate pace. When we have a clearer picture of how the recovery will evolve from here – either gaining strength on the back of inventory restocking and emerging-country growth, or weakening into a double dip – then we could see the dollar realign with either the boom or bust scenario and regain strength against other major world currencies.

November 30, 2009

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