KEEPING IT REAL- THE DOLOROUS DOLLAR
("DESPERATE HOUSEWIVES", EPISODE 6)

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"The mass of men lead lives of quiet desperation." Henry David Thoreau ("Economy", from "Walden")

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CONCLUSION

Stimulating American policies such as the trinity of money printing, sustained low nominal interest rates, and government "spend-and-borrow now/pay later somehow" only buy time. They delay reckoning rather than really solve underlying problems. The broad real trade weighted dollar ("TWD") rests near the major support of its all-time lows (1973-present). As marketplace players turn the floodlights more and more closely on America, the broad real trade weighted dollar will fall under its 84.00 floor by at least five percent to around 80.00.

All else equal, and in an environment of unappealing interest rates, the greater (and faster) the TWD's dive under all-time lows around 84.00, the less desirable American assets in general and debt in particular will appear to actual and potential owners (especially overseas players).

A dive of around five percent beneath that major TWD support would help to raise interest rates in general, including yields within the control of the Federal Reserve Board (rates probably would rise at least until equity prices began to plummet substantially). Would diminishing dollar values deliver long run deficit discipline in the US Congress? Not quickly, but one always can hope.

REAL FACTS

The poet Wallace Stevens says in "Adagia": "Money is a kind of poetry."

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There has been much trumpeting regarding currency wars. America is not alone in the global neighborhood, so depreciation efforts by other key nations may help to support the dollar. Many countries would like their currency to weaken, or at least remain weak enough to encourage domestic economic growth via net exports. Several nations in recent months have introduced tactics to slow excessive inflows of hot money.

Some oracles argue that the dollar's decline over a couple of long run time horizons has been substantial enough to justify a rally, or at least a sideways trend, especially given the proximity of major support. In October 2010, the TWD was 84.09 (the Federal Reserve reports the TWD as a monthly average; March 1973 equals 100.00). In November 2010, it was 84.01, with December at 84.52. Compare the major lows in October 1978 at 84.13 and July 1995 at 84.05, as well as the 84.00 bottom in April 2008. At around 84.00, the TWD has crashed 34.6pc from March 1985's 128.44 all-time peak (1973-present) and 25.4pc since February 2002's still-lofty 112.61.

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Despite currency dogfights and observations that the TWD has fallen a great distance, what intertwining considerations argue for additional dollar decay?

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In regard to its percentage share of world real GDP, the long run trend for the United States probably is a declining one.

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The US will not run a current account surplus anytime soon. The US current account deficit as a percent of GDP was 2.7pc in 2009 and 3.2pc in 2010, with 2001 forecast at 2.6pc (IMF, "World Economic Outlook", October 2010, Chapter 2, Table 2.2, p20).

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Foreign exchange cross rates of course are important for international and domestic economic and political policy. They are what make news headlines and stories and the majority of marketplace analysis. Think of the US dollar against the Euro FX, the US dollar against the Japanese Yen, or the Swiss Franc versus the Euro FX. Crosses obviously affect trading and commercial decisions in commodity, debt, and equity marketplaces. **Yet so-called real (or real effective) measures for exchange rates such as the broad real trade weighted dollar one are more important for assessing the "overall" level and trend (strength and weakness) of a given currency. Such a real currency measure thus probably is at least as relevant as key cross rates for the interest rate, equity, and commodity marketplace levels and trends of the given nation.**

Some of Europe is a danger zone in deficit spending terms, but not all of it is. Moreover, the US situation is probably worse. According to the International Monetary Fund, the "Euro Area" fiscal deficit as a percent of GDP for 2010 (and 2007-2009) was less than that of the US. The Euro deficit was 6.7 percent, that of America 11.1pc. For 20I1, the IMF projects the Euro fiscal deficit as 5.1pc of GDP, that of the US 9.7pc. (Fiscal Monitor"; "Fiscal Exit: From Strategy to Implementation"; November 2010, Table 1.1, p3). Also, the IMF issued its study before America at end 2010 widened its budget deficits by about $850 billion more over the next two years.

The European Central Bank's inflation fighting credentials are superior to those of the current Federal Reserve. Not only does the Fed mandate extend to try to boost employment, but also its current policy statements point out a desire to create some version of reasonable inflation . Thus the greater US deficit is thereby even more relatively troublesome.

For the near term at least, the melancholy Euro deficit problem appears to be contained rather than worsening. Note that China has promised to buy Spanish bonds (Financial Times, 1/4/11, p3). Attention may shift away from Europe as "the biggest problem right now".

Although numerous factors influence the foreign exchange battlefield and currency relationships, the dollar may start to appear vulnerable relative to the Euro FX as the world increasingly focuses on American problems. The Euro FX is below its highs versus the dollar of 7/15/08 (1.6038), 11/25/09 (1.5144), and 11/4/10 (1.4282), so many cross rate watchers will not see the Euro FX as "too high now".

Moreover, even though the dollar on a broad real trade weighted basis is near its historic lows, Europe is not asking for a stronger dollar these days. This differs from spring 2008, when the TWD also was around 84.00. What's different? Look at the Euro FX real effective exchange rate (ECB; 21 trading partner group of currencies versus Euro area 16 countries; 1Q99 equals 100). In

November 2010, that real rate was 102.97 (that of December 2010 probably was around 100.60, based upon applying Bank of England data to the ECB's November level). Thus the real Euro is over eleven percent beneath the April 2008 ceiling (113.26), as well as that of October 2009 (112.81); these peaks were around that of the last major high of 112.60 in November 1995. All else equal, this noteworthy depreciation of the real Euro rate since April 2008/October 2009 tops means that if the US dollar begins to weaken against the Euro FX, the Europeans are not likely to complain very much. According to the Federal Reserve, the Euro area in 2010 represents about 17.79 percent of the broad index of the dollar's foreign exchange value.

Japan has complained a bit about its cross rate versus the dollar as the dollar slumped in recent months (5/4/10 Y95.0, 11/1/10 about Y80.2). However, look at the Yen's real effective exchange rate (Bank of Japan data, 2005 equals 100). At a bit over 104.00 now, the real Yen has risen significantly from its lows as the world economic crisis began and accelerated (79.69 in July 2007, 82.41 in August 2008). However, around 104.00 is well underneath noteworthy real Yen heights of 151.11 (April 1995), 131.37 (December 1999), and 124.17 (November 1988). Thus even if the dollar weakens against the Yen and retreats under Y80 to Y75 (or even somewhat lower), Japan will grumble but not panic. As does Europe's real effective exchange rate, Japan's has some room to rise. Though Japan has enormous fiscal deficits, it can more easily finance them from home sources than America since its citizens have saved more.

China has been under pressure to revalue its currency. According to the Fed, China's trade weight for the TWD is 17.93pc, even higher than that for the Euro area. China's share has grown over time; note 2002's 10.51pc and 1995's 5.67pc. Compare Japan's declining role in the trade weight (8.27pc in 2010 versus 11.09pc in 2002 and 16.54pc in 1995). Suppose China revalues the renminbi versus the dollar by ten or more percent. That will represent a notable blow to the TWD.

Switzerland represents only about 1.54pc of the broad index of the dollar's foreign exchange value. Nevertheless, take a look at its effective exchange rate action (Bank of England statistics, 1990 equals 100). First, recall major highs of 116.35 (November 1995), 116.46 (March 2003), and 115.08 (November 2004). The real Swiss Franc drifted lower to around 107.2 in June 2007, around the dawning of the world economic crisis. By fourth quarter 2008, it had marched up to nearly 117.0, just above the earlier major peaks. Since then, it has steadily advanced, reaching about 137.09 in December 2009, a 17.5pc leap from November 2008's 116.6.

Any easing of the European financial crisis may induce some reversal of this real Swiss Franc rally. However, the soaring real SF has a couple of lessons for the TWD. If the major support floor in the TWD around 84.00 is broken, a five percent move is rather easy, and a ten percent one not unreasonable. Also, if Switzerland represents economic (financial) stability and discipline in the minds of much of the marketplace universe, what does America currently represent in comparison? Keep an eye on gold prices alongside of Swiss Franc trends.

The steady climb since early 2009 of commodity prices in general has encouraged rallies in many "commodity currencies" (think of Australia, Brazil, and Canada). Continued high commodity prices from this perspective tend to undermine the TWD.

Review the IMF's COFER statistics, which go back to 1995 (Currency Composition of Official Foreign Exchange Reserves; 12/30/10). The data (claims in US dollars as a percentage of allocated reserves- those with identified currency composition) hint at a move away from the dollar. In part, this may reflect diversification. Also, as COFER statistics are reported in dollars, the dollar's decline (take the real TWD peak of first quarter 2002) may affect the percentages of

total reserves held in dollars. Nevertheless, the statistical trend warns that further dollar erosion for the dollar looms ahead.

As for the real TWD, the peak for the holdings of all countries (advanced economies plus emerging and developing countries) was in 1Q02, at 71.6pc. By 3Q10, they were 61.3pc. Holdings of advanced economies were 70.6pc in 1Q02, but 63.8pc in 3Q10. Note the dramatic decline in the dollar share in the emerging/developing group. In 1Q02 it was 74.2pc, with that of 3Q10 58.2pc (1Q10 was 58.1pc; 1997 represents the high of 75.5pc).

Note the growing share in recent years of total foreign exchange holdings (allocated and nonallocated reserves) of the emerging and developing nation category. At end 2002, they were 40.1pc, end 2005 51.9pc. At end 2009 they were 66.0pc, with 3Q10 only slightly lower at 65.5pc. As the United States slips in its share of world GDP, and as other currencies (and their financial instruments) increasingly appear as satisfactory alternatives to the dollar, what does this trend portend for the broad real TWD?

Regarding the desirability of US assets and thus to some extent the dollar from an overseas vantage point, don't forget to watch net foreign buying (selling) statistics of United States securities via Treasury TIC data. Watch direct foreign investment patterns for the US, too. These numbers do not yet suggest "insufficient net purchasing" by overseas participants.

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Even though the TWD has been around all-time lows in recent months, US policy makers in general are not bellowing about the need for a strong dollar now. Such sounds of silence argue for further depreciation.

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An especially grave and probably worsening factor for the broad real trade weighted dollar is the US deficit disaster. Suppose the world turns some of its attention from Europe's deficit problems (such as Greece, Ireland, Portugal, and Spain). Then America's probably will capture more of the limelight. **Current Federal Reserve policy is another variable damaging the TWD.** Now let's focus more closely on the US deficit circus and the Federal Reserve's policy acrobatics.

<u>BUDGET BURLESQUE: US STAGECRAFT</u>

In "Big Spender", from the Broadway musical "Sweet Charity", dance hostesses sing:

"The minute you walked in the joint,
I could see you were a man of distinction,
A real big spender,
Good looking, so refined.
Say, wouldn't you like to know
What's going on in my mind?" They warble: "Hey, big spender, spend…A little time with me."
Decades ago, TV commercials for Muriel Cigars varied that line: "Hey, big spender, spend a little dime with me."

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The embrace of deficit spending by politicians in America and overseas is no new phenomenon. Yet the US budget deficit scene is no nickel-and-dime affair. Experts say

America's long run fiscal deficits must be remedied since they are unsustainable. Moreover, the increasing abdication of fiscal responsibility and the reduced prospects regarding serious action in regard to financing current and long run structural deficits makes the US fiscal situation look more and more worrisome. Let's cast attentive eyes on some recent episodes in America's federal government spectacle.

A headline heralds: "G.O.P. Sets Up A Huge Target for Budget Ax". (NYTimes, 1/14/11, p1). House Republicans aim to shave $100 billion from domestic spending this year. This number looms large for some specific programs. Such proposals may not be enacted due to Administration and Senate opposition. Yet the $100 billion total is a skinny sum, not only in light of the overall deficit, but also in comparison with the recently enacted deficit boost. Recall the additional $850 billion deficit spending extravaganza (spread over the next couple of years) enacted at end 2010.

Also note the change by the GOP in House rules (NYTimes, 1/6/11, pp A1, 17). Buried in the article: "To reverse what they say is a Congressional process tilted toward spending increases, the new Republican majority in the House – over strong Democratic objections – approved rules that would require spending increases to be directly offset with cuts elsewhere." So far, so good, perhaps. Yet there's more: "But the rules would allow future tax cuts to be enacted without offsetting spending reductions". Even if no further tax cuts are enacted soon, does this foretell future fiscal discipline? What if the Republicans gain further power in the 2012 elections? And the rules "would permit repeal of the health care legislation, which was estimated to save the government more than $140 billion over 10 years, without any requirement that those revenue losses be made up elsewhere." (See House Resolution 5.EH; 1/5/11).

Note too the headline versus the fine print in another NYTimes article (1/7/11, pA1, 3). The US Defense Secretary "seeks cuts in armed forces, citing economy". These slashes, however, merely represent the slowing of a growth rate. "The Pentagon's proposed operating budget for 2012 is expected to be about $553 billion, which would still reflect real growth, even though it is $13 billion less than expected. The Pentagon budget will then begin a decline in its rate of growth for two years, and stay flat - growing only to match inflation – for the 2015 and 2016 fiscal years."

Congressional squabbling does not bode well for deficit cutting progress. The Democratic President and Senate face a Republican-controlled House. According to the Congressional Budget Office, the Republican plan to repeal the recent health care legislation would add $230 billion to federal budget deficits over the next decade.
http://cboblog.cbo.gov/?p=1750
The new House speaker rejects the CBO report's arguments (NYTimes, 1/7/11, pA15). Incidentally, watch litigation on that health care bill. Suppose the Supreme Court declares it unconstitutional.

So the United States confronts enormous deficits now and in the future. There is troublesome and often misleading rhetoric from and loud quarrels within Congress. Admittedly many American politicians have been braying, grunting, and squawking about fiscal discipline, yet when will there be major tangible actions? If the US federal government were a household, would you say it was well-managed right now? Nowadays, would you want to lend it a big bucket filled with your cash?

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Recall a famous quotation from the comic strip "Pogo": "We have met the enemy and he is us."

The tangled United States tax code (policies) itself does not suggest widespread enthusiasm by Americans to resolve their serious deficit problem. The Internal Revenue Service's ombudsman calls for a major overhaul of tax rules ("Taxpayer Advocate Service"; 12/31/10). Its long report notes: "While narrow tax breaks [for special interests] certainly do exist, the reality is that the biggest 'special interests' are us – the vast majority of U.S. taxpayers. Virtually all of us benefit from certain exclusions from income, deductions from income or tax credits." Such "tax expenditures" total about $1.1 trillion per year. (Executive Summary, pp2-3; see also the NYTimes, 1/6/11, pB3).
http://www.irs.gov/pub/irs-utl/execsummary_2010arc.pdf
"There is a widespread belief that the influence of 'special interests' is the biggest roadblock to comprehensive tax reform. There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers…But the dirty little secret is that the largest special interests are us – the vast majority of U.S. taxpayers." ("Introduction: The Most Serious Problems Encountered by Taxpayers", p9).
http://www.irs.gov/pub/irs-utl/2010arcmsp1_taxreform.pdf

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And let's not overlook America's state and local government situation. Here's a Census Bureau note. http://www.census.gov/newsroom/releases/archives/governments/cb11-03.html

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To see fiscal balances around the globe, review the International Monetary Fund's long "Fiscal Monitor" report ("Fiscal Exit: From Strategy to Implementation"; November 2010). For the world as a whole, the overall fiscal deficit was .4pc of GDP in 2007, 2.0pc in 2008, and 6.8pc. The study projected the 2010 overall deficit at 6.0pc, with 2011's at 4.9pc (Table 1.1, p3).
http://www.imf.org/external/pubs/ft/fm/2010/fm1002.pdf

REALITY CHECK

In "Credit in the Straight World", the rock band Hole advises:

"Go for credit in the straight world
Look a dealer in the eye
Go for credit in the real world, won't you try?
I got some credit in the straight world
I lost a leg, I lost an eye
Go for credit in the real world you will die…
Lots of credit in the straight world gets you high."

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Everyone adores real economic growth. Perhaps the US and world economy will keep recovering gradually and sustain a decent pace for the next few quarters and beyond. But why should nominal measures- even if kept in place for extended periods- by central bankers and politicians act as a permanent (genuine) fix? Supposedly real growth may turn out to be of short duration.

Anyway, some nominal economic expansion is better than none. America's Federal Reserve cooks remain determined to inflate nominal GDP and repair consumer net worth. By printing money via its beloved quantitative easing program and sustaining low policy interest rates, it battles to boost nominal equity and housing prices. These Fed recipes probably will not change in

the near term. For recent indications of its policy stance, see Chairman Bernanke's testimony before the Senate Committee on the Budget (1/7/11) and the Fed's FOMC 12/14/10 Minutes.

Thus the noisy Congress is not the only American crew responsible for dangers facing the dollar. Federal Reserve policies are a source of dollar weakness. The vigorous Fed is at least as determined as other key central banks to generate inflation (and boost employment). **In addition, in this process, the Fed has hinted that it is willing to risk further dollar wilting.**

Given the Fed's resolve to sustain low rates and print money, and given the deteriorating fiscal husbandry in Washington (and many state and local yards), growing inflation will make many people (especially foreigners) increasingly reluctant to hold US interest rate obligations. Regardless of twisted Fed rhetoric, increased inflation nevertheless tends to produce higher debt yields. Selling (reduced net buying) of interest rate securities will contest with the Fed's desire to keep short and long rates low.

Moreover, reduced net buying (and of course net selling) by foreigners of dollar denominated debt and the shift of at least some of the funds into non-dollar assets tends to weaken the dollar. The longer the time and the greater the extent to which US interest rate yields appear unattractive (especially to foreigners), the greater the risk of noteworthy dollar depreciation. Perhaps foreigners less fond of US debt instruments may more warmly embrace US equities or other dollar assets, but this might not happen if both rates and the dollar weaken together. And won't higher interest rates (however long delayed by Fed gatekeepers) alongside a sagging dollar make even domestic US stock owners fearful about holding equities?

And if foreigners don't finance much of the US government deficit, who will? Maybe the Federal Reserve and its friendly Treasury neighbors will just print more money! Maybe Fed watchdogs will keep barking that they are not worried about inflation (and that they will snuff out excessive inflation), are always vigilant, and that they possess a fancy exit strategy and numerous tools in their trusty toolbox.

The Fed and its allies indeed preach the importance of having faith in them. Perhaps the Fed will exit from its assorted recovery strategies in a timely fashion, thus mitigating inflation "problems". But perhaps not. The Fed is likely to act on a delayed basis, in relatively slow fashion. Recall the sleepy central banking guardians, both before the worldwide economic crisis dawned and in the early afternoon of the disaster.

In the intertwined global economy, forces for rising interest rates also may come from outside the US. China's official measure of annual consumer price inflation jumped 5.1pc in November 2010, with the food price measure 11.7pc higher year-on-year. As for Europe, its December 2010 inflation reached 2.2pc (Eurostat, 1/4/11).

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Could the dollar slump even more, say around 10 percent, relative to its all-time broad real trade weighted low (84.00*.9 is 75.60)? It's a reasonable long run scenario. One enticing path for debtors to pay their existing debt (denominated in their currency) and enhance their exports is the depreciation of their currency. In any event, a breach of around ten percent would induce significant international pressure on the US to defend the dollar.

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The TWD rallied as the stock marketplace collapsed from the spring of 2008 to March 2009, and equities have flown upward since early 2009 as the dollar has deteriorated (TWD low April 2008

at 84.00, high at 96.69 in March 2009). Many high priests are devoted to the "weak dollar equals rising stocks, strong dollar equals declining stocks" hymn. However, "flight to quality" arguments are less compelling now than two years ago in regard to both the dollar and US government securities. Note that the Fed now wants inflation. It also has printed a lot of money relative to two years ago- and will keep doing so for at least a few more months. And the US deficit problem is arguably less and less of a temporary phenomenon. Raising interest rates is one strategy for rescuing an imperiled greenback.

The equity rally from March 2009 depths partly reflects a jump in corporate profits and a dramatic reduction of "end of the financial world" fears. Admittedly factors such as easy money, deficit spending, and a fairly weak dollar tend to boost nominal US corporate profits and thus stock marketplace benchmarks such as the S+P 500 in nominal terms.

In military terms, there's a difference between a wounded dollar and a killed one. Thus a sustained and notably weaker dollar alongside rising interest rates (and high commodity prices) is a recipe for weaker US equity prices, even if it takes some time after the dollar, debt, and commodity dances for stocks to commence their descent. How real will corporate earnings turn out to be if interest rates soar and consumers flee into their foxholes to preserve their net worth?

COMMODITIES AND THE DOLLAR

If consumers are the key to the door of recovery, not all Fed policies make it easy to open the lock. All else equal, low interest rates and a weak dollar help to rally commodity prices in dollar terms. How happy are American consumers, though getting their balance sheets patched by rising equities, about having their incomes torn into via higher food and energy prices?

Worldwide food and energy and other commodity prices have risen not only because of dollar weakness. Many commodities have a bullish supply/demand story due to actual or potential low inventory coverage. In addition to easy money and deficit spending policies, rising stock marketplaces and commodity buying strategies of speculators and buy-and-hold (alternative) investors bolster commodity prices.

In any event, substantial increases in food, energy, and metals probably undercut overall world economic growth. The United Nations Food and Agricultural Organization's food price index recently achieved a nominal record in December 2009 of 214.7, surpassing June 2008's 213.5. A FAO economist heralds this recent price spike shows world faces a food price shock. If the alarming high prices are prolonged for several months, they could lead to a food crisis (Financial Times, 1/6/11, p1).
http://www.fao.org/worldfoodsituation/FoodPricesIndex/en/

Recently OPEC (notably Saudi Arabia) talked about how 70 to 90 dollars represents an acceptable current range for crude oil. Dollar weakness may be raising even this historically high nominal band. Kuwaiti comments hint the high end is now around 100, and that OPEC is unlikely to increase supplies in first half 2011. The Iranians agree with Kuwait that there's no need to supply more oil now. (Financial Times, 1/6/11, p20).

DOLLAR TIME

When will renewed deterioration or the actual break under all-time lows (or both) occur in the broad real trade weighted dollar? A sustained break under all-time lows may occur at any time,

but probably will occur no later than early March through late spring 2011. Even if the dollar manages to rise in the very near term, arguably it will begin to decline again sometime in early March through late spring 2011. The US deficit situation, allied to other bearish factors, should be closely watched in this timing context.

The US Treasury Secretary warns the government will reach its legal borrowing limit as early as end March and no later than mid-May (NYTimes, 1/7/11, pB7).
http://www.treasury.gov/connect/blog/Documents/Letter.pdf
This past week, the House of Representatives approved new rules pushed by Republicans. Debt limit increases no longer occur automatically with the passage of a budget resolution. Debt limit expansion will require a separate vote. The Federal Reserve, after its 1/25-26/11 rendezvous, meets 3/15/11 and 4/26-27/11. A major high in the broad real trade weighted dollar was in February 2002 at 112.61, the important low of 2008 at 84.00 in calendar April. The all-time TWD pinnacle was 128.44 in March 1985. In March 2011, it will be two years since the 3/6/09 bottom in the S+P 500. Recall that the final low in the S+P 500 for the prior major bear move was in March 2003 (3/12/03 at 789).

If a major break in the TWD under 84.00 occurs sooner (as in calendar January or February) rather than later, March through late spring 2011 would represent a period to look for at least interim support. However, regardless of when the TWD deterioration develops, price support may need to await the passage of even more time. Although marketplace history is not destiny, keep in mind July (July 1995 low) and October (1978 low).