

## The U.S. Dollar – No Strong Feelings One Way or the Other

*But let's clarify a few things ...*

Against its major trading partners, the U.S. dollar fell about 9% in 2009 after rising about 9% in 2008. Before that, it had lost 10% in 2007, lost 6% in 2006, and gained 6% in 2005.<sup>1</sup> So over the last five years, the dollar has been a bit weak, but not too bad. Most investors – if asked – would probably guess that the dollar had fallen “easily 50%” over that time period. If you listen to the press, it sure seems as though we have a dollar crisis on our hands, doesn't it?



Source: *Financial Times*

But in an October 2009 market update, when pretty much *everyone* was bearish on the dollar, we said:

Despite what might appear to be “perfect storm” conditions, the dollar sell-off has been orderly. In reality, the dollar is about where it was in the winter of 2007, before the worst of the financial crisis hit.

At this point, we have no strong convictions on the dollar relative to the other majors, although if pressed, we'd say that we don't expect much movement over the next 6 months.

In fact, shortly after that we switched some of our equity exposure from global back to domestic because we anticipated that the dollar was being oversold and would bounce back.

Here are the reasons we did not expect the dollar to continue to fall (many still hold):

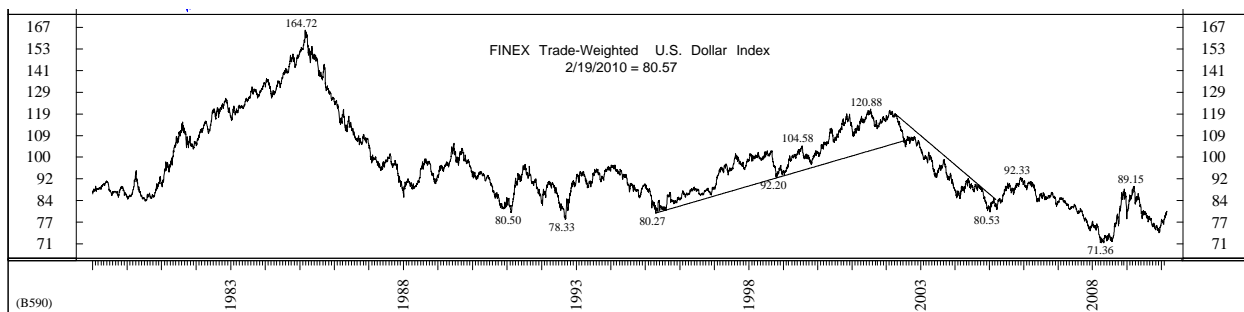
- On the basis of purchasing power parity, the dollar had become relatively cheap.
- “Anti-dollar” speculations on gold and some other commodities began to grow at an accelerating rate, symptomatic of a potential bubble in anti-dollar speculative plays.

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<sup>1</sup> Source: The Federal Reserve

- A spike in the number of news stories predicting a disorderly decline in the dollar as a result of the poor fiscal position of the United States (see the headlines from the *Financial Times* on the previous page).
- Long-term charts of the dollar index placed the dollar at the lower end of a range that usually produces a bounce (see below).
- A cheapened dollar was beginning to boost exports, paving the way for better relative economic performance.
- The euro, the only plausible alternative to the dollar for foreign currency reserves, is prone to significant imbalances owing to the differences among member economies. The yen is no longer a viable alternative because it represents, from a long-term perspective, a shrinking economy.

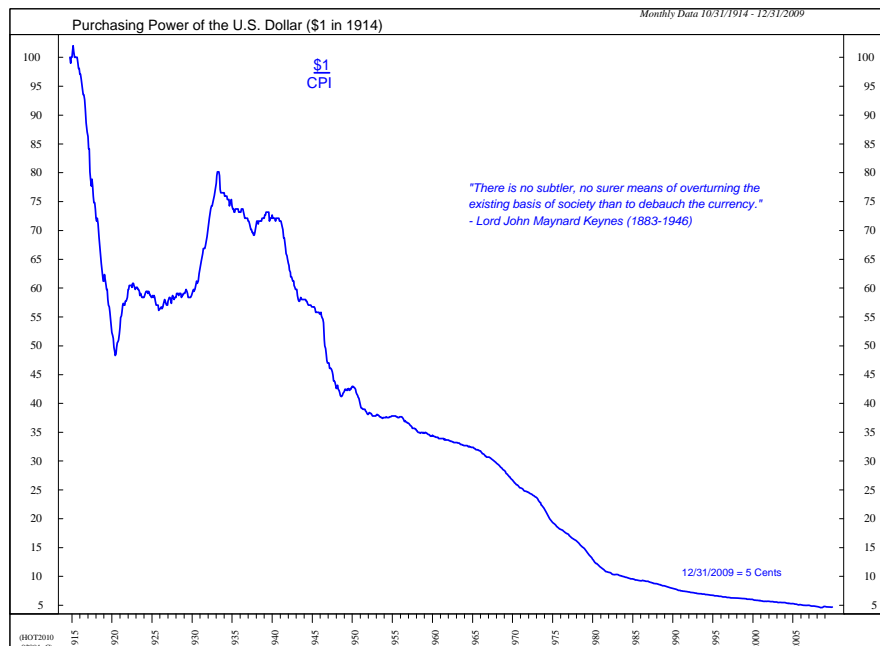
### 40 Years of Dollar Cycles



Source: Ned Davis Research

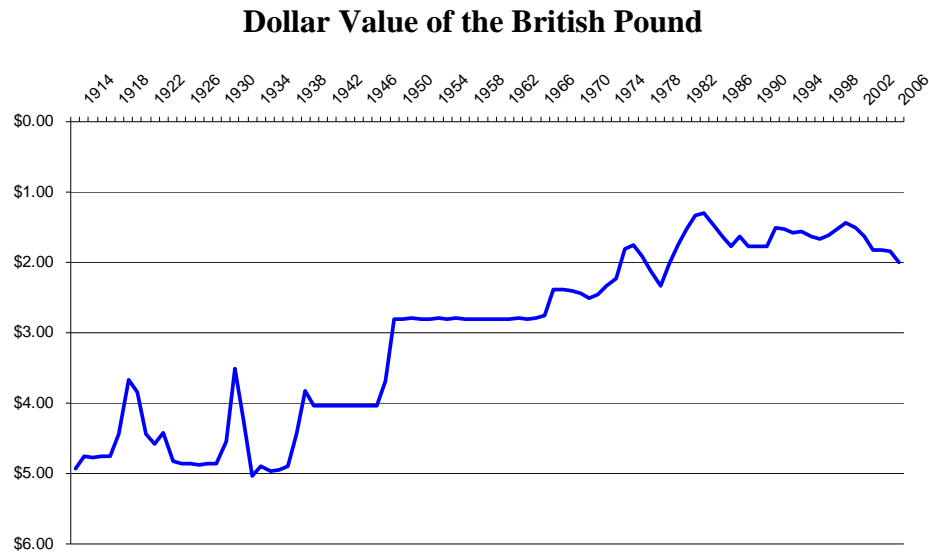
### The U.S. Has Debased the Purchasing Power of the Dollar, but So Has Everyone Else!

Since the Federal Reserve was chartered in 1914, what one dollar can buy has fallen by an astounding 95%. We can argue about whether the Consumer Price Index (CPI) is a good proxy for consumer prices, but with debasement like this, does it really matter?



Source: Ned Davis Research

The purchasing power of the pound sterling has been debased even further. The chart below illustrates how the dollar value of the pound has steadily decreased. In 1914, the pound was worth about \$5; now, it is worth less than \$2. Other major European currencies have suffered similar debasement.



Source: Bloomberg

People complain about how much the dollar has been devalued – and it certainly has against a basket of goods – but so have other currencies whose value is not backed by a commodity such as gold. What this means is that diversifying into foreign-currency-denominated assets to protect yourself against a weakening dollar may not give you the benefits you seek.

### **Long-Term Implications of Big Deficits**

At some point, the United States will certainly need to deal with its large federal budget deficit in order to avoid nasty repercussions such as the dollar losing its status as the world's reserve currency, a spike in borrowing costs to cover its debt, or a downgrade from the triple-A ratings its securities currently fetch. But for now the situation is still tenable.

Why? The U.S. has a large federal budget deficit, but that is not without precedent. For example, U.S. public debt as a percentage of GDP is currently about 85% (and rising). This is high by historical standards, but well below where it was shortly after World War II (125%) and below or near the levels of several large countries such as Japan (around 190%), Italy (about 125%), France (about 85%), Germany (about 80%), and the U.K. (around 75%).

Interest outlays aren't at particularly high levels either. Because rates are relatively low, the cost of servicing public debt is running about 8% of total spending. To put that into perspective, when Canada was in severe fiscal trouble during the low-oil-price years of the early 1990s, its debt servicing costs exceeded 20% of spending. Through belt tightening, Canada was able to make it to the next resource boom.

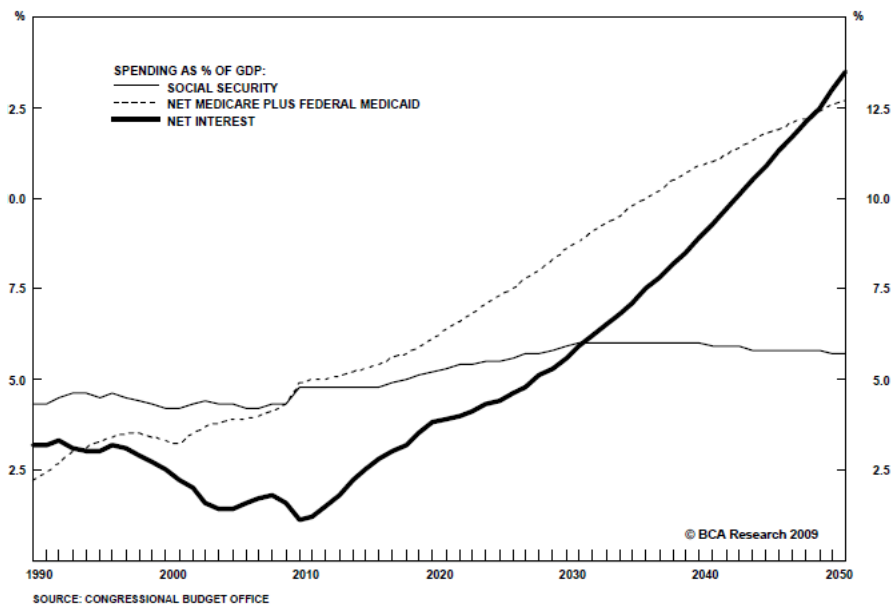
### Debt as a Percentage of GDP

	Gross Debt*	Government Budget Deficit*
Portugal	83.8	-9.3
Italy	123.6	-5.5
Ireland	65.8	-12.2
Greece	114.9	-12.7
Spain	59.3	-9.6
Euro Area	81.8	-6.1
U.S.	83.9	-11.2
U.K.	71	-12.6
Japan	189.3	-7.4

\* SHOWN AS A PERCENTAGE OF GDP; SOURCE: OECD.

But the U.S. must be careful. Without either a major boost to receipts (can we sell the Grand Canyon?) or significant fiscal restraint, the picture is expected to get worse, mainly because of growing interest expenses and increasing outlays for entitlements associated with an aging population, such as Medicare, Medicaid, and Social Security. For example, spending on Social Security (including Medicare and Medicaid) and interest on our debt are currently running about 9% of GDP but are expected to rise to more than 20% by 2030.

### Past and Projected Spending on Key Federal Budget Line Items

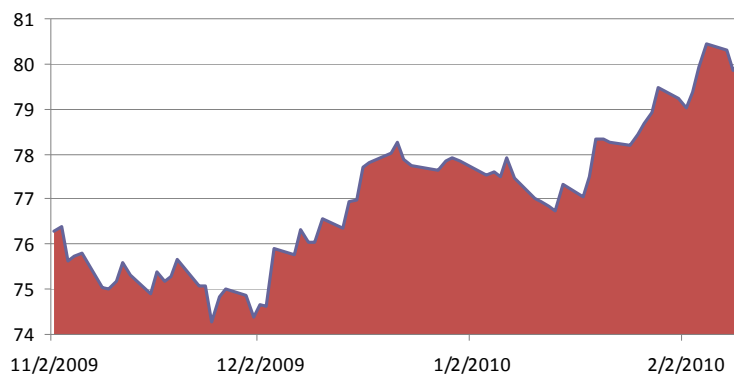


## The Recent Bounce in the Value of the Dollar

Since the end of November 2009, the dollar has rallied about 10% and is now more fairly valued on the basis of purchasing power parity. Exporters are reaping fewer benefits from a *really* cheap dollar, and anti-dollar plays such as gold and silver have temporarily stopped rising. Therefore, we see fewer stories in the press about the doomed dollar. So where do we stand now?

Over the next six months to a year, we at Contango do not have strong convictions about the movement of the dollar and have decided to stay with an asset allocation that is global but perhaps slightly more “domestic” than would normally be the case. We see no compelling reasons to overweight foreign assets now. However, if the dollar continues to rally, we may decide that foreign assets represent a better value.

### Recent Performance of the Dollar (Index)



Source: Bloomberg

We continue to hold a decent-sized position in emerging markets equities and emerging markets local currency bonds for most clients. We have been more bearish on the dollar versus the currencies of the emerging world than the dollar versus the currencies of the developed world based on the likely growth of most of these emerging economies and their relatively strong fiscal positions. But we expect relatively high volatility in this position because emerging markets currencies are prone to wide swings in value. However, emerging market bonds do have higher yields.

### Should U.S. Investors Hold Non-Dollar Assets?

Because our clients primarily spend in dollars and because we are not particularly bearish on the dollar or particularly bullish on a class of non-dollar assets, we think hard assets or foreign currencies should be included in a portfolio only to the extent that they provide diversification benefits. We believe that diversification benefits are real and significant in most market environments but can break down during high-volatility periods, as we have seen.

However, when we think that foreign assets offer decent relative value (as we have with emerging markets for some time), we will shift more assets into foreign equities and bonds. When commodities have presented a compelling valuation opportunity, we have shifted up to 20% of client assets into this asset class as both a diversifier and a value play.

## Conclusions

For most clients, we hold some non-dollar assets such as European equities and emerging market bonds and equities as both portfolio diversifiers and as allocations to pockets of world growth with different, and sometimes more compelling, economic drivers. We think that a disorderly dollar decline is unlikely in the near term.

*About the author: Perry Piazza is director of investment strategy, responsible for asset allocation and portfolio development. Previously, he held a number of trading-related roles in New York and London with Citigroup and Morgan Stanley. He earned an MBA from Yale and a BS from the University of Delaware.*

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