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Whither the US dollar?

by Ronald Solberg | November 03, 2008

US dollar Appreciation

The US dollar as measured against six major world currencies has appreciated approximately 19% during the last three months through end-October. In particular, the US Dollar index stands at 85, up from a recent low of 71.3. This trend reversal takes the US dollar's valuation back to levels not seen since October, 2006 and represents nearly a 38.2% retracement from its index peak of 120 in January, 2002; by any measure a significant move and one largely unexpected by the financial markets both in terms of its timing, speed and magnitude.

What has caused this abrupt appreciation of the US dollar during the past quarter and what can we expect over the next 12-24 months? There are both fundamental and technical reasons that have been US dollar supportive in the past several months.

Fundamental Factors

First, the seven-year decline in the US dollar's value through July 2008 improved US competitiveness and, once the J-curve effect dissipated, has led to an acceleration of export revenue. Slower GDP growth is also allowing imports to decline. These two effects have begun to stabilize the US trade deficit in nominal terms and allowed net exports in real terms to contribute 1.1% to Q3 2008 GDP growth. The shrinking trade deficit has also contributed to the narrowing of the current account deficit. By pumping fewer US dollars to our foreign suppliers, this narrowing is shrinking global liquidity and creating further support for the dollar.

A second fundamental reason for US dollar strength has been an improvement in US terms-of-trade: the ratio of export prices over import prices. Since the United States is a net energy importer and this cost represents a significant portion of total import expenditures, the recent decline in crude oil prices has been a boon to our terms-of-trade. The improvement in US terms-of-trade has also supported the US dollar.

Thirdly, it is suggested from viewing the highly unusual negative break-even yields for inflation-linked bonds (TIPs) that investors believe the US will suffer deflation, not inflation, for the foreseeable future. This expectation for a declining price level, as a corollary, also creates the expectation for US dollar appreciation. This is because, once the currency depreciates in real terms, there is a tendency for the currency to appreciate in nominal terms to compensate for the price-driven depreciation, especially given that the notional rise will not undermine international competitiveness.

Technical Factors

Perhaps the most important driver of the US dollar's recent appreciation is not a fundamental but a technical factor. The meltdown of prices in the commodity complex, particularly energy, has generated a very strong impulse for US dollar strength. Whilst many commodity end-users were outright cash buyers, other buyers that were investing or speculating in commodities as a newfound asset class over the past five years would typically fund their position with US dollar-denominated credit, in effect, creating a US dollar short position. Now that these commodity carry trades are being unwound, it exacerbates commodity weakness and contributes to US dollar strength. In addition, US investments in foreign markets, particularly equities, were primarily un-hedged and large amounts of those monies are now being repatriated which holds similar bullish US dollar effects.

Dollar Strength Sustainability

How sustainable are these four fundamental and technical factors in underpinning US dollar strength?

The trade and current account deficits should continue to narrow for several more months or perhaps quarters. As the US economy falls deeper into recession, imports should begin to decline more precipitously due to declining volume. This collapse along with rising export receipts will narrow the trade deficit and continue to lend support to the US dollar.

Despite the US dollar supportive narrowing of the trade and current account deficit, the pace of improvement may begin to slow for several reasons. First, once the prices of energy and other commodities stabilize, trends in import prices will no longer help lower overall import expenditures. Furthermore, stabilized import prices will also stop contributing to improved terms-of-trade. Second, it seems that a synchronized global recession is on the horizon. If so, then exports will once again decelerate despite US dollar competitiveness. As the growth of economies representing our important export markets slows or even falls into recession, weaker export growth will result. The combined effect of these counter-veiling trends is that the incipient narrowing of the US trade deficit may be short lived.

Perhaps the key factor will be the length of the time it takes for global de-leveraging to run its course. No

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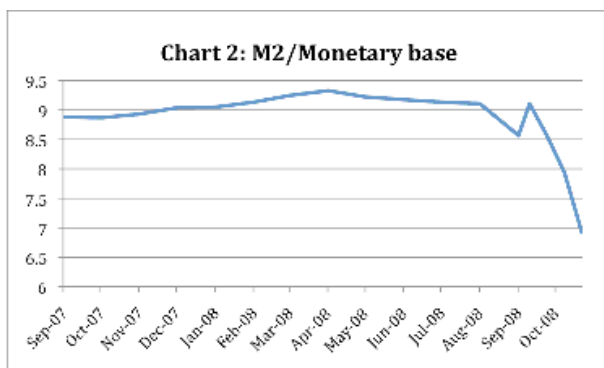
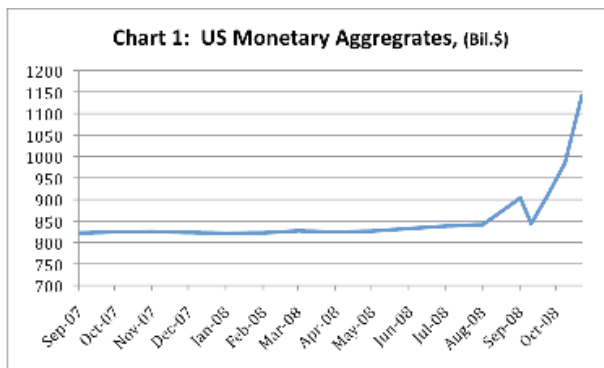
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one knows precisely how long it will take for investors and speculators to unwind US dollar-denominated commodity and other carry trades. It could be one month or half a year. However, once complete, the strongest driver for recent US dollar strength – de-leveraging -- will dissipate. At that juncture, FX traders and investors will once again re-focus their attention on the supply of US dollars being pumped into the US economy and on the global system and investors' willingness to hold additional Greenbacks in their portfolio.

The weight of US dollar supply

It is beyond the scope of this paper to itemize the growing cumulative costs of the various aspects of the bailout. Suffice to say that the supply of US dollars is dramatically growing and measured in the trillions. To best measure this aggregate growth, let's look at the growth of the Fed's balance sheet and the monetary base.

After remaining relatively stable for more than a year through August 2008 at around \$825 billion, the monetary base has exponentially exploded. BCA has recently highlighted that in the past eight weeks, the monetary base has grown 38% to \$1.142 trillion, and shows no signs of slowing down.¹ Yet these reserves injected onto the balance sheets of the banks have not been disseminated into the broader economy. This is apparent by the ratio of M2 to base money, which over the same time period since end August, has plummeted from 9.1 to 7.8 (see Charts 1 & 2). This is not surprising since most of the capital injected into banks has been used to repair and shrink the balance sheet (i.e., write-off bad assets) rather than expand it. So fractional banking's normal stimulatory impact through the money multiplier has by-in-large not been activated.



Source: US Federal Reserve Oct 30, 2008, BCA Research

In addition to the Fed pumping money into the banking sector, the US Treasury will have gargantuan funding needs. According to Goldman Sachs estimates, the US Treasury faces an unprecedented financing need in fiscal year 2009.² Excluding funding requirements under the Supplemental Financing Program (SFP), they estimate 2009 FY issuance at \$2 trillion compared to last year's \$1.12 trillion, which itself was already outsized. This prospective amount is driven by an estimated budget deficit reaching \$850 billion, funding TARP purchases of up to \$500 billion and the rollover of maturing debt equal to \$561 billion. On top of these needs, it would not be unreasonable to expect additional SFP funding requirements of \$500 billion, the amount already issued to date in FY 2008 used to recapitalize the Fed's balance sheet.

The magnitude of such funding requirements will test the operational efficacy of the Treasury, requiring increased auction size, frequency and expanding maturity buckets on debt issuance, and will likely extend through FY 2009 and into FY 2010, prior to these pressures abating. Perhaps even more ominously, issue size will severely test market demand for such an avalanche of debt. If there is significant resistance by investors to accommodating these needs, failed auctions would require the Fed to hold new US Treasury issuance (i.e., monetization) which of course would be inflationary and foment US dollar weakness.

Lastly, our expectation is that the current account deficit, while narrowing, will not disappear. Indeed, it will ultimately expand again once the trade deficit reverses course, which will once again increase the supply of US dollars to the rest of the world. Whilst emerging market economies have revealed their lack

of immunity to the US and European slowdown, they may be the first to recover for several reasons, partly because their banks have avoided most of the toxic assets currently plaguing US and European banks. Their elevated population growth rates and migration of self-sufficient farmers into the industrialized cities looking for jobs is a secular trend that will only be deterred by the financial crisis for a short time. Within 18 months, these economies will be growing strongly and once again driving energy and commodity prices higher. This, in turn, will once again widen the US current account deficit and increase America's reliance upon foreign savings.

Inflationary Seeds being Sown

This dramatic growth in the monetary base has not yet been inflationary since the velocity of money may have recently fallen due to the rise of deflationary expectations. Some will argue that liquidity being injected into the bank system will be drained subsequently by the Fed via open market operations. In principle, this could abate the ultimate inflationary impact of the bailout operations. However, currently this liquidity cannot be removed without collapsing the banks and worsening the recession. Since bringing bank balance sheets back to health is probably a multi-year process, this argument does not seem to stand.

We currently stand on Occam's razor, staring into a deflationary abyss on one side and incipient inflation on the other. The Fed and US Treasury have shown their policy hand, revealing a strong preference to avert deflation. No doubt this reflects a broad political consensus that prospects of inflation are to be preferred to deflation, if those are the two choices. Claims that these massive debt levels can be financed and ultimately retired by future economic growth, taxation and lower government spending ring hollow.

Whilst the velocity of money has been quite stable in the past several years and perhaps even fallen most recently, this will not always be the case. As spring surely follows winter, it can be relied upon that velocity will accelerate in the future. Once it does, it will combine with this huge increase in the monetary base to boost liquidity and elevate price inflation.

There also remains an open question whether foreign investors will continue to be willing to accumulate additional US dollar assets. A strong argument could be made that foreign investors are already sated with US dollar debt. Foreign holdings of US Treasury and Agency debt stands around \$4.1 trillion, representing approximately 36% of publicly held issuance. The concept of Bretton Woods II -- wherein foreign investors were the lender of last resort extending vendor financing for their exports sold to the US (consumer) -- was predicated on the stability of sustained household consumption. With the US household suffering from declining home prices, falling real wages, job loss and collapsing confidence, the American consumer will take years to recover their former spendthrift ways. With this missing critical link in the global relationship, it is suspect whether foreign governments will be willing to significantly increase their holdings of US dollar debt, if there is not the quid pro quo of increased export receipts from further US consumer spending.

Any meaningful pushback from foreign investors on buying additional US Treasury debt or US dollar denominated assets will imply either a steeper yield curve or monetization of new Treasury debt issuance. Neither outcome is desirable. A steeper yield curve implies declining Treasury bond prices and, by raising interest rates, also creates a headwind for US equities. In this scenario, it is hard to imagine a strong US dollar in the face of weakness in both US stocks and bonds.

In the second scenario, if investor demand is inadequate to absorb new issuance, then the Federal Reserve will have to hold a portion of new debt issuance by the US Treasury on their balance sheet. This is sheer monetization of the debt and highly inflationary since it is equivalent to simply printing money. Such a scenario would quickly lead to higher inflation and a weaker US dollar.

Conclusions

The tsunami of oncoming US Treasury debt issuance holds the real potential to crowd-out private sector issuance both here and abroad, steepen the US Treasury yield curve, put downward pressure on the real economy, undermine the US' AAA rating, weaken the US dollar, and if the Treasury is required to resort to monetizing new debt issuance by "selling" it to the Fed due to pushback from foreign investors, it could even threaten the Bretton Woods' US dollar reserve status and the Greenback's role of denomination currency for commodities: a very high price to pay for a decade-long party on Wall Street.

So it seems that, despite the violent rally in the US dollar over the past three months, it may not be long lived. Much will depend on the capacity of foreign investors to offer safe harbour for new Treasury issuance and/or the likelihood of a policy mix set in Washington, DC that runs tight money and a fiscal surplus. When was the last time that occurred?

1. BCA Daily Insights, "The Fed: Moving Closer to Monetization" October 29, 2008
2. GS US Daily Financial Market Comment, "The Treasury's Financing Need: Pressing All the Buttons", October 29, 2008

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