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Commentary

Market Opinions and Topics of Interest

By Howard L. Simons (847) 304-1511

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Should We Fret About The Dollar?

"Three generations of imbeciles are enough."

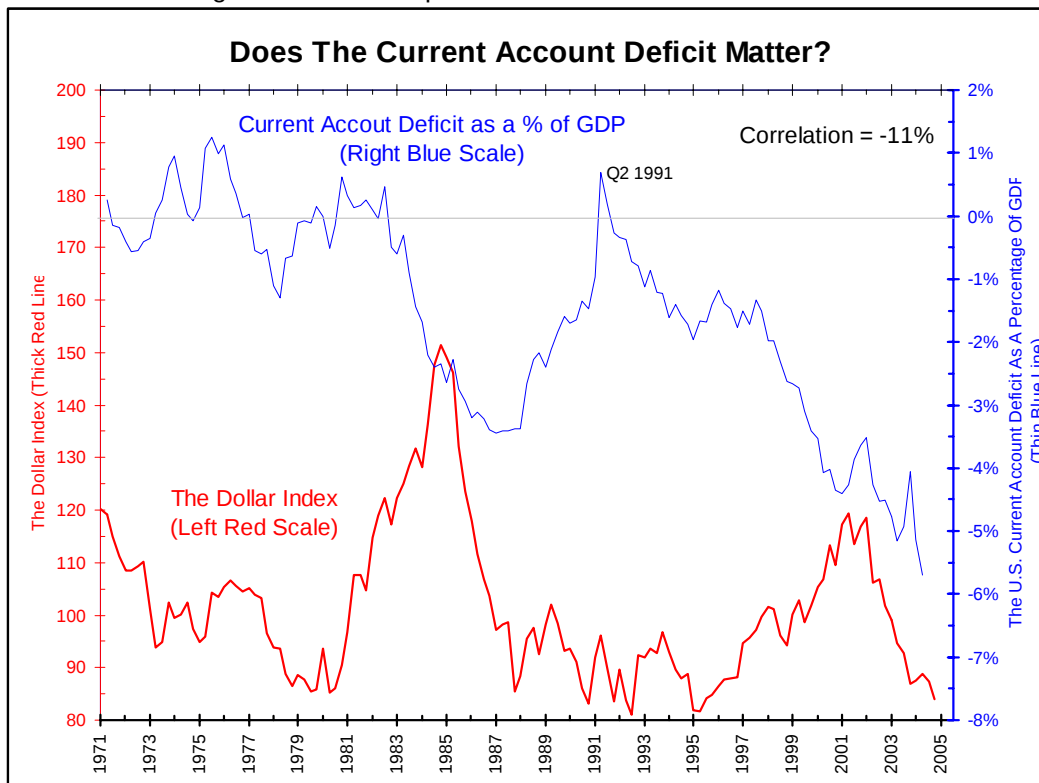
—Justice Oliver Wendell Holmes, *"Buck v. Bell,"* 1927

The grittiest chroniclers of urban life, men such as Raymond Chandler, Dashiell Hammett and Nelson Algren, always managed to create a mood of "the players change, but the game stays the same." So it is with the U.S. dollar. Regardless of the decade, the trend of interest rates, the level of economic growth or almost any other descriptor of the economy you choose to employ, the USD can find itself under assault.

Lost in these travails since the Bretton Woods system of fixed exchange rates collapsed

permanently and irrevocably between 1971 and 1973 are the ups and downs experienced by every other major currency, often by the issuing government's design.

Will the current dollar weakness lead to the various catastrophes predicted as a consequence thereof? **Our answer and the answer of all data since 1972 is a firm and unequivocal "no."** This emphatic answer holds for both macroeconomic concepts and for financial markets.



The Balancing Act

The chart above compares the relative paths of the U.S. current account deficit (thin blue line), a measure inclusive of service flows, as a percentage

of GDP and the trade-weighted dollar index (DXY, thick red line). The U.S. has been in external deficit for most of the past three decades. The present level of the deficit, both in absolute and percentage

terms, is the greatest it has been, which requires the U.S. to import capital in record quantities.

We have got them right where we want them.

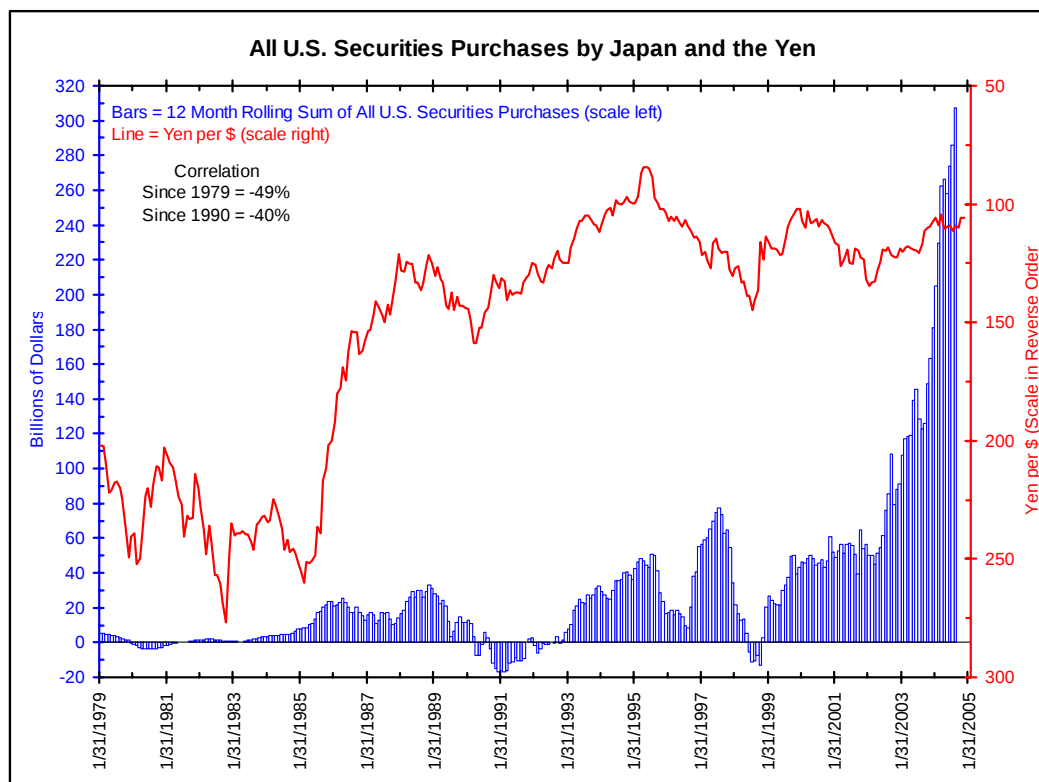
The mercantilist view of the world, wherein "surpluses" are viewed as intrinsically desirable and "deficits" are to be avoided has been a losing proposition ever since Jean-Baptiste Colbert, Louis XIV's minister of finance, articulated the concept in 1664.

If we view wealth as the capacity to consume, then we must view imports as an economic benefit and exports as a cost. After all, a good exported is one not consumed at home.

As a whole, nations such as Japan, Taiwan or South Korea, whose economies are dependent on exports,

are dependent as well not on their internal vigor, but rather on the health of their customers. While [current account] = [-1 * capital account] is a national income accounting identity under all circumstances, it takes on a special urgency for the export-dependent. They must reinvest their export revenues in currency of their customer back into financial claims issued by their customer.

For more than a quarter-century various commentators in all sectors of American life have warned that a weakening dollar would lead to the Japanese and other exporters either refusing to buy our bonds or selling those they already hold in their portfolios. Whether the door would be slammed in theatric anger was left unsaid. **A glance at the chart below confirms this view to be in error and exponentially so.**



Restated, the United States gets to consume the fruits of someone else's labor today. The exporters get to hold our bonds, which by definition are promises to pay in the future and are subject to both currency and inflation risks. The result to-date of this mechanism has been an American standard of living far in excess of those in trade surplus.

The End of Days

The objection this set of imbalances cannot endure forever must arise at this juncture. A similar

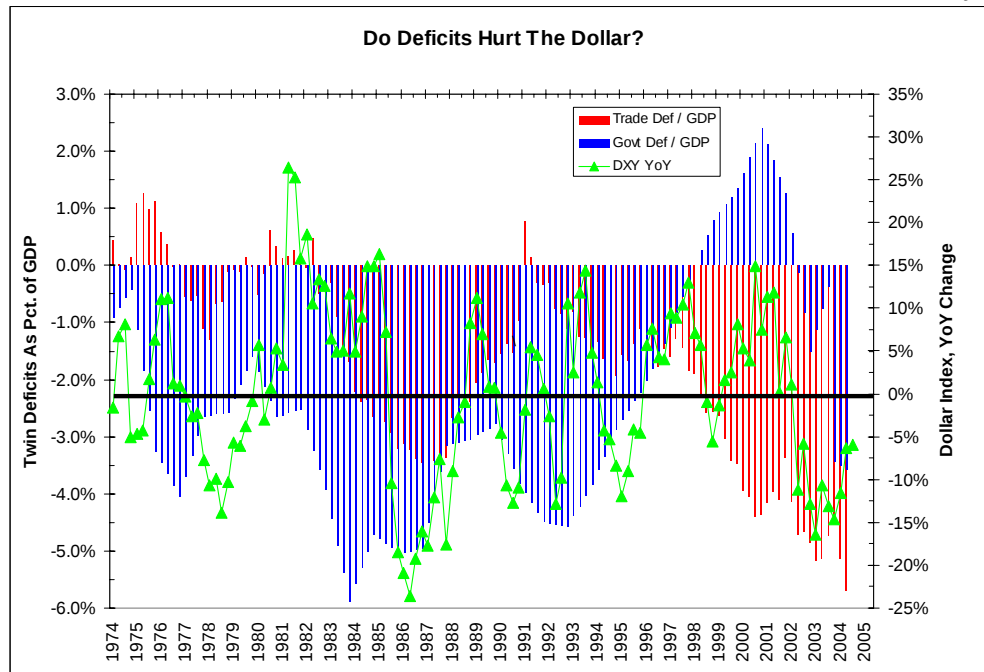
objection was raised in the 1930s regarding the national debt: Surely we cannot keep adding to the debt burden forever, can we? And, for that matter, the same objection has been raised about Third World debt both before the term existed and after they were upgraded to "emerging market" status.

Assertions unsubstantiated by data are the worthless rumblings of the terminally vapid. A series of charts below depicts the relationship between the so-called twin deficits, those of the federal government and the current account, and the variables of the dollar, inflation, GDP growth, bond yields and stock prices. In no case can we deduce

a level of either deficit, alone or in combination, that is either unsustainable or deleterious.

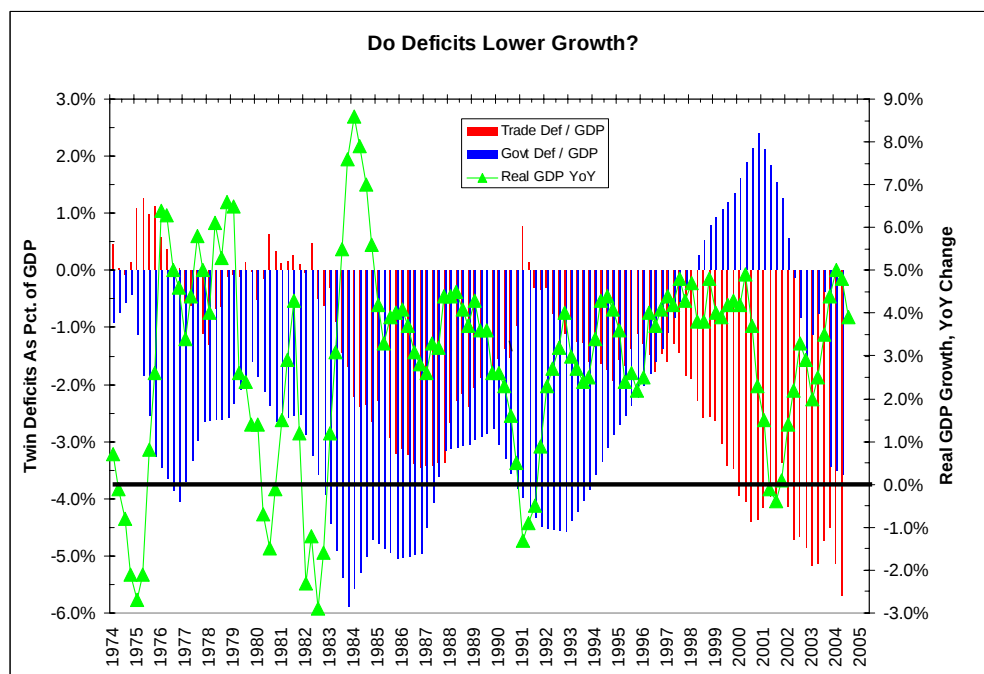
Do our deficits erode the dollar? Hardly: The greenback rallied strongly both during the first

Reagan administration, a time of growing federal deficits, and during the second Clinton administration, a time of budget surplus and growing current account deficit. The common environment in both cases was restrictive monetary policy.



Do deficits lower real GDP growth? Here the logic seems compelling by virtue of the net exports component of the GDP calculation. Alas, this, too, is unsupported by the record. Growth shot higher in the mid-1980s, a time when the term “twin deficits” entered the lexicon. It also was strong during the

Clinton years when the current account deficit expanded. The last time the trade balance was in surplus, 1991, the U.S. was in recession. A strong U.S. economy imports more, and that effect outweighs the negative impact of the current account deficit.

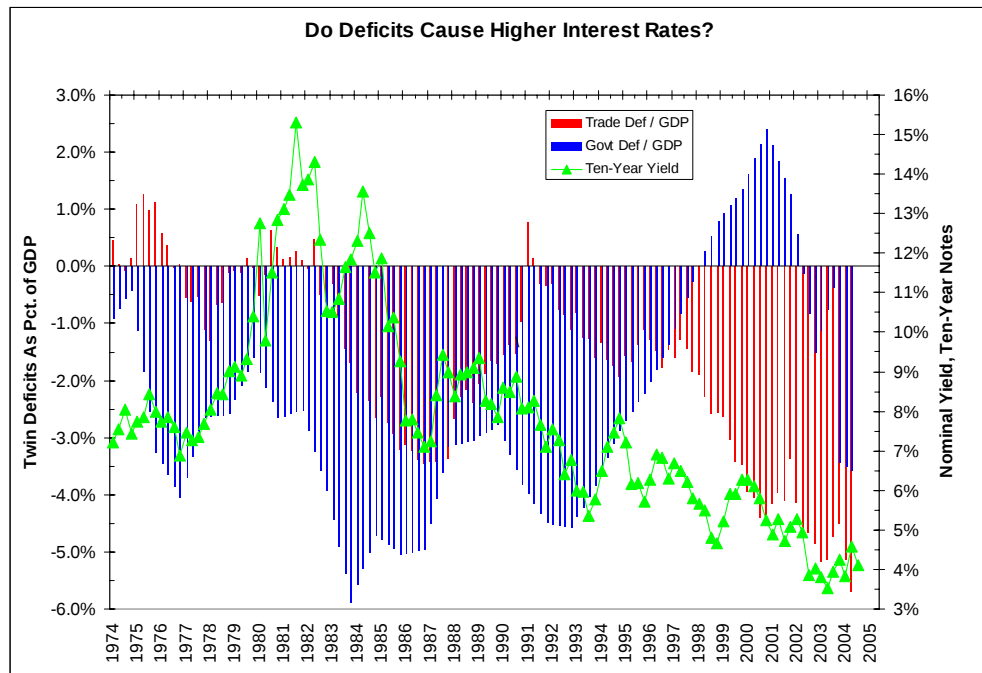


Well surely the twin deficits must force interest rates higher; all that debt must return the advantage to the

lender, right? No, nominal yields on ten-year notes have fallen as the deficits have risen. In fact, the

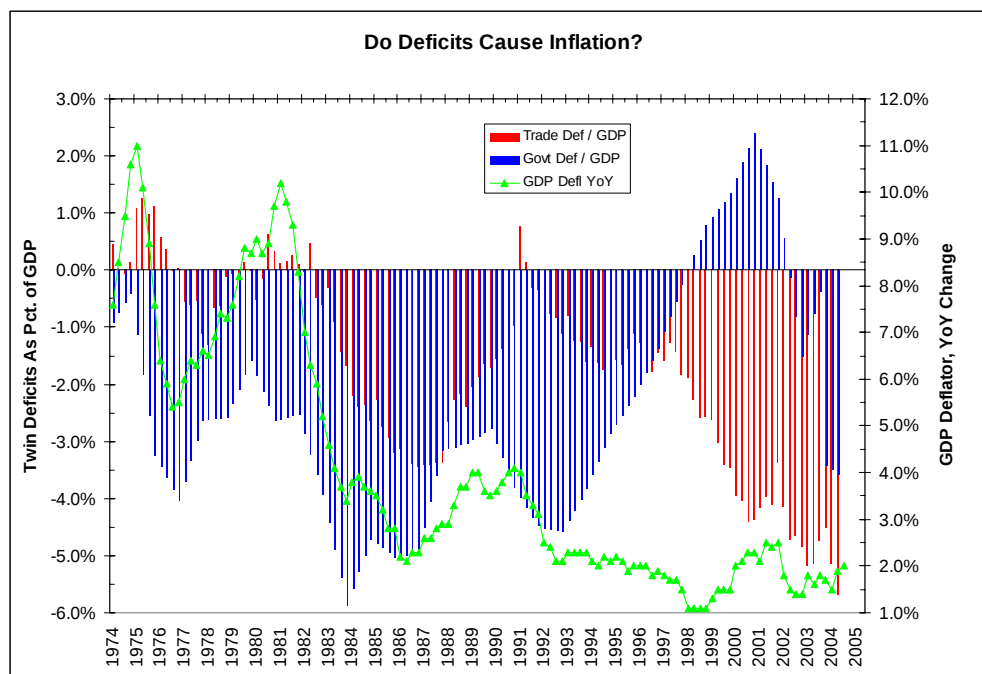
most discernible relationship in the chart following is how rising interest rates appear to lead – not lag – the federal deficit. It would be impolite to note how

nominal note yields have fallen as the current account deficit has risen, so the subject shall remain unbroached.



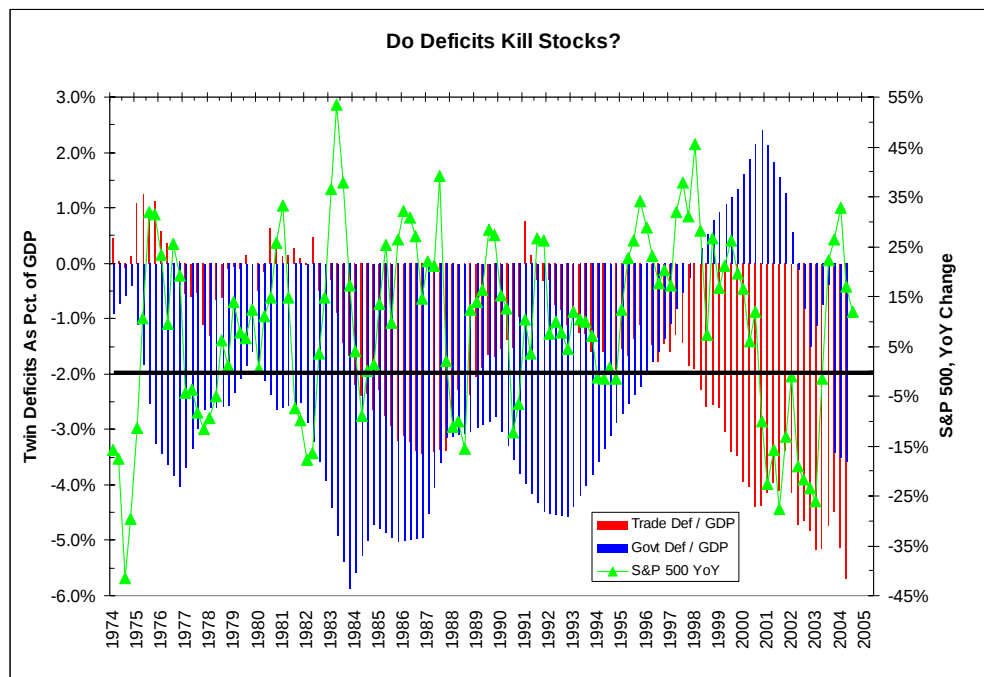
But deficits are inflationary, right? We all know how perfidious politicians over the eons, starting no doubt with the mythical King Hedon the Adjustor, have

conspired to repay their debts by inflating the currency. A compelling argument, to be sure, even though we cannot find it confirmed by recent history.



Finally, let's take a look at the effect of deficits on the stock market. This market is supposed to look ahead and discount the corrosive effects of deficits on the ability of American business to operate profitably. A corollary worry to those we have seen

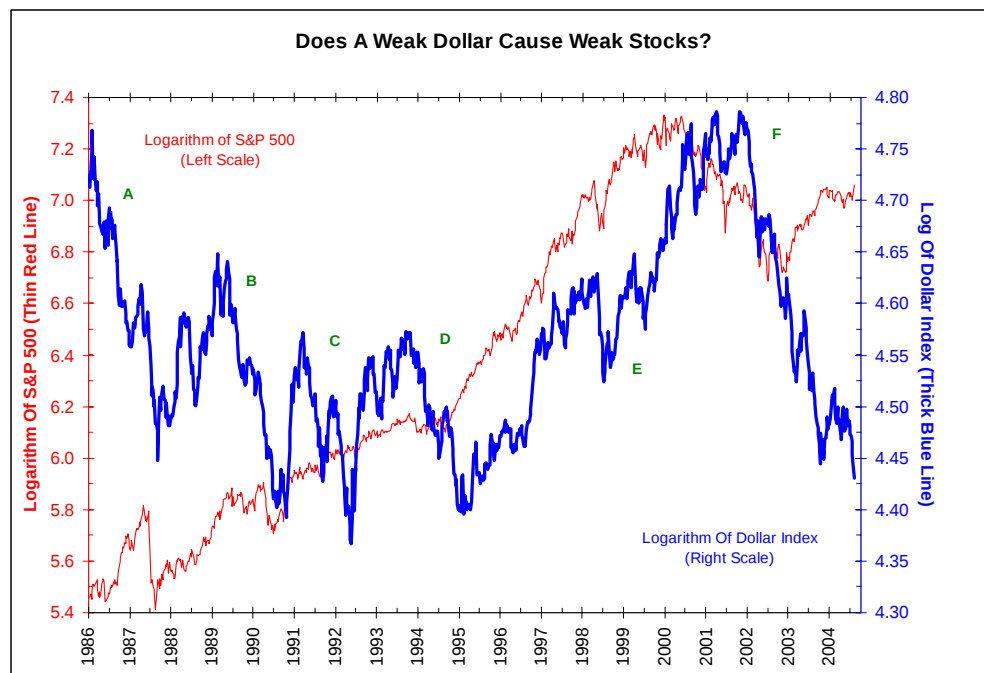
above is that the American consumer is "tapped out" or otherwise bereft of funds. How, then, do stocks react to deficits? The answer appears to be, "they don't."



Impact of The Dollar On Markets

Is all of the talk about deficits a smokescreen hiding the real issue, and that is the damage that a weaker dollar will do to financial markets? Let's start to answer this by examining the relationship between the dollar and the U.S. stock market since the mid-

1980s. The DXY (thick blue line) and the S&P 500 (thin red line) are presented on logarithmic scales to emphasize their relative growth paths. Six DXY downturns are highlighted by the letters A-F.



The six episodes are:

A. The 1985-1987 deliberate policy of dollar weakness produced by rapid interest rate reductions. This monetary largesse fueled the mid-1980s rally and culminated in the 1987 crash. The market at that point feared an

interest rate reversal as part of a dollar defense policy.

B. The 1989-1991 weakness produced by a combination of rising European interest rates, the Japanese bubble, and the weak dollar preferences of the first Bush administration. Stocks experienced a period of slow growth.

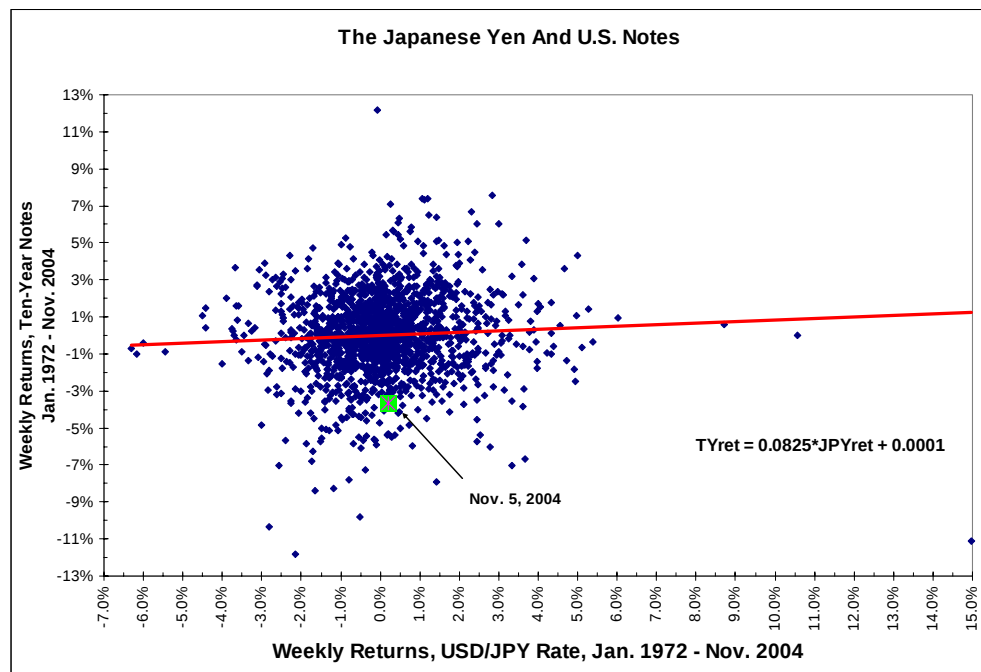
- C. The 1991-1992 weakness produced by the U.S. recession and a series of interest rate cuts in the U.S. combined with a tight monetary policy by the Bundesbank in the aftermath of German reunification. Stocks experienced a period of slow growth.
- D. The 1993-1995 period of weakness produced by foreign investors' lack of confidence in the Clinton administration prior to the fiscal discipline imposed by the new Republican Congress. Stocks were flat in 1994 and then began the late 1990s bull market.
- E. The short-lived 1998 drop associated with the Russian default and Long Term Capital Management debacle. Stocks fell sharply for a short period and then surged higher into early 2000.
- F. The present downturn created in large part by the series of interest rate cuts beginning in 2001. Those cuts are in the process of being rescinded, but the interest rate and expected inflation differentials still work against the dollar. Another factor, one that cannot be ignored as we move into the second Bush administration, is the obvious acceptance of a weaker dollar by Washington. The bear market in stocks ended by the spring of 2003, but the bear market in the dollar continues.

The record, obviously, is mixed. Every market environment is different. **The one combination of stocks and the dollar missing conspicuously is the one feared at present, and that is a weak stock market produced by a weak dollar.**

The Dollar and Rates

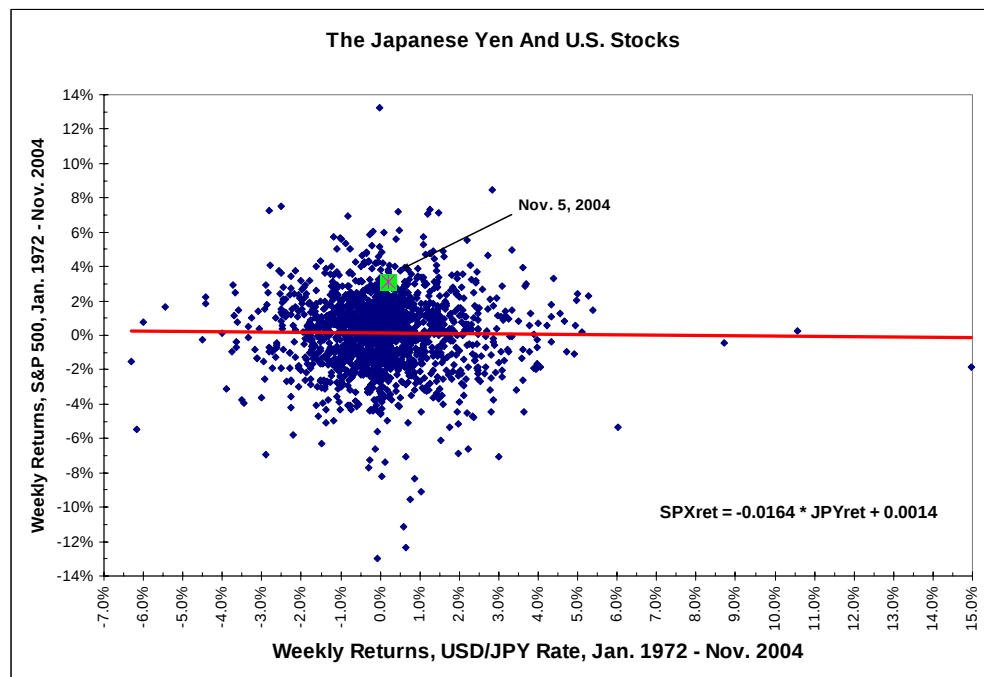
For a financial relationship to hold, it must hold for a long time and across different market environments. Otherwise it is a collection of anecdotes in search of a theory. Let's take a series of very long data relationships, going back to January 1972 and encompassing more than 1,700 weeks, to discern the effect of various individual currencies on American financial markets.

The Japanese yen may have been the most critical of the major currencies over this period of time given our near-permanent trade imbalance with Japan. **Some may be surprised to learn that ten-year notes and the Japanese yen have a positive correlation of returns.** However, this relationship should not be surprising: The expected return on dollar assets falls along with interest rates, which makes the USD a less-attractive currency while note prices are rising. This is consistent with the initial observation that foreign investors do not sell dollar instruments when the dollar is weak.



The relationship between the yen and U.S. stocks is far weaker, and is negative, but it certainly cannot be

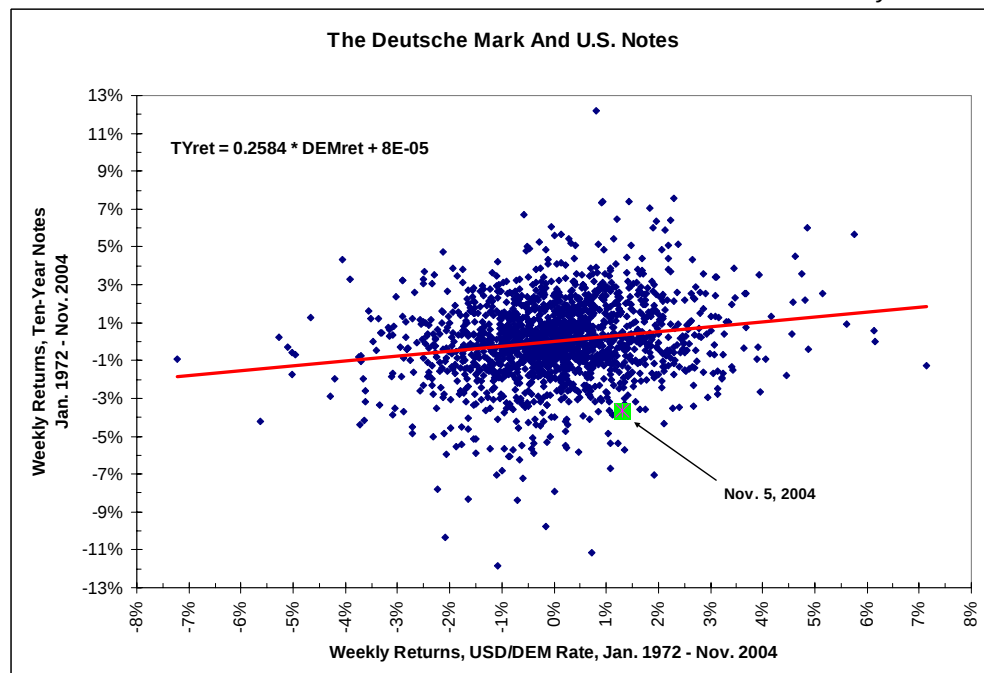
construed as Japanese investors fleeing American markets when the dollar weakens.

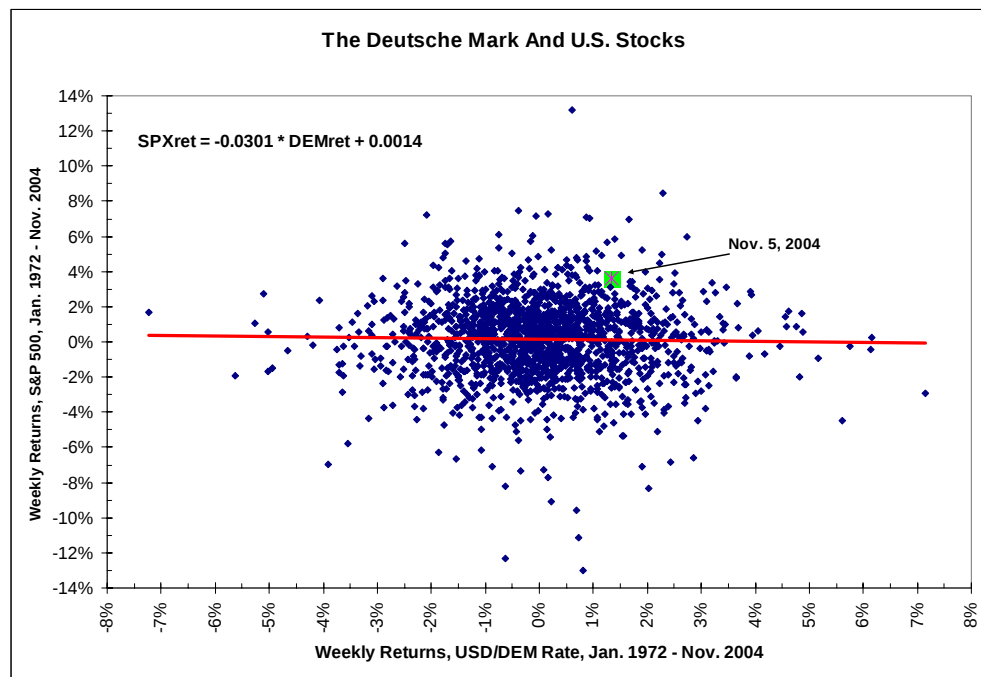


German Confirmation

Can we confirm this observation with the Deutsche mark, both in its pre- and post-euro incarnations? Yes: For both ten-year notes and for stocks, the USD/DEM rate has the same directional impact as

does the USD/JPY rate. The correlation of returns between U.S. notes and the DEM exchange rate is even more positive; this, too, should be unsurprising given the greater propensity of European currencies to trade as interest rate instruments as opposed to the more – how shall we say this? – directed JPY.





Conclusion

The United States began its life by holding certain truths to be self-evident. Despite the beliefs held fervently by what often feels to be a majority of financial market commentators that deficits are wicked and cause a weaker dollar, which is even more wicked in turn, these truths should not be held to be self-evident. Three decades of constant refutation by the data should count for something.

The decline of the dollar often is construed as the result of a capital outflow, of foreign investors cashing in their chips to head home in disgust. While this may have happened on occasion, it flies in the face of the requisite capital inflow mandated by the U.S. current account deficit.

The dollar's value is determined for the most part by interest rate arbitrage, a process that can occur in the complete absence of any underlying trade flows. You simply borrow/lend in one currency, sell/buy another currency, and then lend/borrow in that second currency. The process is reversed at a later date. As there are three unknowns in this equation, the two interest rates and the spot exchange rate, the system is mathematically "unidentified;" solution requires fixing either two of the three variables or one of the variables and the relationship between the other two.

The mechanics of this procedure de-link the exchange rate from underlying flows; those who mistakenly cling to the belief that there is some critical level of the dollar capable of closing the current account deficit need to embrace this reality. Quite simply, in the short run, any level of the dollar can clear the market for all transactions. Moreover,

there is no reason to believe that the optimal or equilibrium state of the current account balance is zero. As seen above, deficits can and do persist with indeterminate consequences.

The only conclusion we can reach about the dollar and its impact on financial markets is that markets do not care so much as to whether the greenback is "high" or "low," which ultimately are value judgments, but rather that it was not manipulated to that level. If the market senses that the U.S. will "defend" the dollar, which has a chivalrous ring to it, it will conclude that higher short-term rates are on the way. The experience of October 1987, where currency manipulation precipitated a stock market crash, should be instructive in this regard.

Conversely, if foreign investors sense the dollar is being driven lower by a deliberately inflationary policy, they will be loath to extend new investment.

At present, capital inflows are strong. This could be interpreted as foreign central bank intervention on behalf of the dollar in an attempt to finance the U.S. as a customer. If this is the case, and the evidence suggests it is possible, then the U.S. can continue to have its cake and eat it, too.

Yes, these are imbalances, and our instincts want imbalances to be redressed. But imbalances that have yet to present a danger unless misguided 1980s-style interventions were involved are not cause for alarm in U.S. financial markets. Like higher oil prices, they just "are" and need to be accommodated.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511 Fax (847) 304-1749
e-mail: research@biancoresearch.com
<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 304-1511
James A. Bianco jbianco@biancoresearch.com

Strategists/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
John J. Kosar jkosar@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Neil Bouhan nbouhan@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 876-1825
Fritz Handler fritz.handler@arborresearch.com
Patrick Lovett pat.lovett@arborresearch.com
Peter Forbes peter.forbes@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595
e-mail inforequest@arborresearch.com
<http://www.arborresearch.com>

For more information about Arbor Research & Trading and its services:

Director of Fixed-Income Sales (800) 876-1825
Daniel Lustig dan.lustig@arborresearch.com
Director of International Sales (847) 304-1560
James L. Perry james.perry@arborresearch.com

Arbor Research & Trading (UK) LTD

75 Cannon Street London England EC4N 5BN
Phone 44-207-556-7309 Fax 44-207-896-1887

For more information:

Director of Arbor (UK) 44-207-556-7309
Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com