Debunking the Dollar

"Bureaucracy defends the status quo long past the time when the quo has lost its status."
– Laurence J. Peter

This May, after five consecutive months in decline, the US dollar staged an impressive reversal. We do not believe, however, that this indicates a broader dollar recovery. **Rather, we expect the dollar to sustain a protracted downward trend, punctuated by brief upside spikes prompted by a variety of factors including technical short-covering, expectations of fiscal tightening, or potential budgetary reform.** Ultimately, commodity-based emerging markets with positive real yields should outperform the US, substantially eroding the dollar's long-held dominance.

The US dollar has maintained its prominent status in the global economy thus far by playing an integral and multifaceted role as **(1) a destination for safe haven flows**, **(2) the base currency through which global trade is conducted**, and **(3) the reserve currency of record**.

Over time, however, these distinctions have become akin to honorary titles with which the USD's behavior seems incongruent. Although we recognize that the ingrained market psychology regarding the dollar cannot be unlearned overnight, we have identified **a number of factors poised to undermine the status quo as the global community begins to dissociate the USD from the key attributes enumerated above**.

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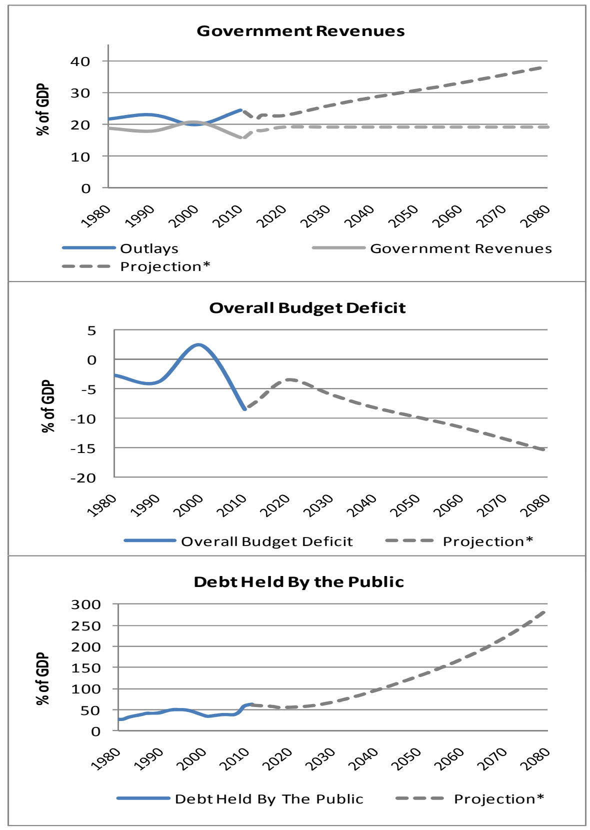
Redefining "safe" and "risk" assets

It has been a while since the USD has truly acted as the safe haven it is purported to be, and we do not view 2008's USD rally as a reflection of its value as such. Rather, we attribute the dollar's gain primarily to overleveraged global participation in USD-denominated subprime mortgages, credit default swaps, and other toxic instruments. When the US housing bubble at the epicenter of the crisis finally burst, what ensued was a mechanical trap that forced investors around the world to satisfy their margin calls by exchanging local currencies for dollars, which they then used to plug the toxic asset leak. This is hardly what one expects of a "safe" asset. In the last few years since the crisis, a meaningful lack of confidence in USD has materialized both internationally and domestically. Though we can envision future "risk-off" flows causing temporary flight to USD as investors cover dollar-denominated liabilities, these dollar rallies are unlikely to occur on the same scale seen in 2008.

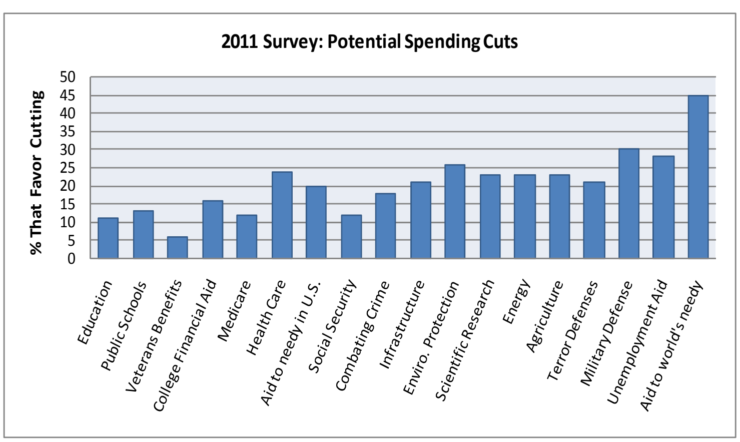
Having just breached the $14.3 trillion debt ceiling, it is unclear as to how the US will manage to return to a state of fiscal health (Figure 1). For those interested in looking beyond the "official" $14 trillion debt figure, you may find www.usdebtclock.org interesting, if a bit frightening. The US debt estimates tick ominously upward as you watch, showing total US debt of over $55 trillion[1] plus unfunded liabilities of over $114 trillion[2] (and counting). In our investment analysis, we do not focus solely on country-specific debt-to-GDP ratios, but also on individual nations' debt as a percentage of global GDP (which the World Bank states was $58 trillion in 2009). From this perspective, a comprehensive US debt figure of $170 trillion represents 293% of global GDP, eclipsing other debtor nations and casting a totally different light on the accepted definitions of "risk" and "safety".

Figure 1



Source: Congressional Budget Office

Figure 2



Source: Pew Research Center

Over the past year, USD concerns have been amply vocalized. In January 2011, the IMF cautioned the US to rein in its deficits; in April, S&P downgraded their outlook on US debt; and on June 2nd, Moody's warned that progress must be made on the debt ceiling compromise or else they intend to cut the US's credit rating. Intellectually, there seems to be a fairly non-controversial consensus on how to bring down US debt – cut government spending and raise taxes. But the political will is not there yet, and neither is public sentiment (Figure 2). Meanwhile, this year's 100% depreciation allowance has pulled 2012 demand forward into 2011, so further damage could be done next year if a major slowdown in demand is coupled with anemic 2011 tax receipts.

As we mentioned in our February 2011 letter, Bernanke's characterization of recent inflation as "transitory" seems to indicate the Fed's overconfidence in the idea that agricultural inflation does not pass through to core. Additionally, the US has seen less headline inflation than other developed markets, so while the ECB and BOE have started to raise rates, the Fed is likely to wait until mid-2012 to move. This is one more factor that should weigh on the dollar: as JPMorgan recently noted, low-yielding currencies of debtor countries such as the US should fall during periods of global expansion when other central banks are raising rates. We do not believe that this fact is lost on the Fed: to some degree, a declining USD is expedient as a means to boost GDP without losing control of core inflation.

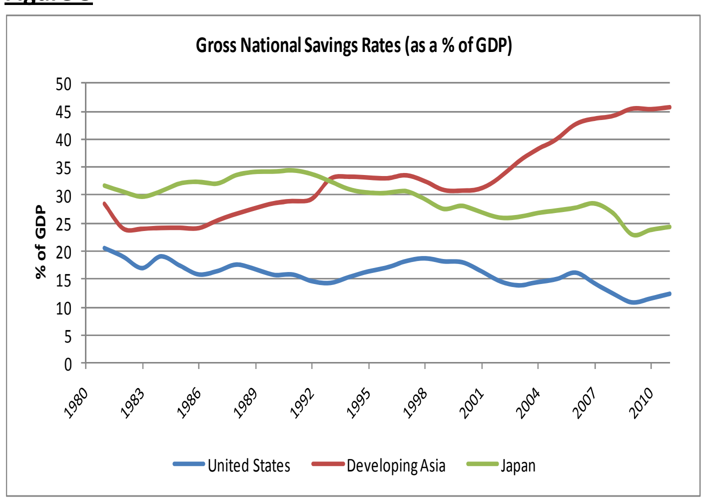
Meanwhile, EM currencies traditionally regarded as "risky" are looking better and better relative to USD. Capital controls in emerging markets have been growing less restrictive, encouraging investment and trade. In our December 2010 letter we commented on significant developments in Mexico as Pemex prepared to accept bids on several onshore fields in 2011 – the first time in more than 70 years – and planned to auction deepwater contracts in 2012. A major campaign proposal of President Calderon, the reform of Mexico's ailing oil and gas production had been aggressively challenged since approved by the country's legislature in 2008. The court, however, ruled that the reforms do not threaten the state's monopoly on operations.

So what might be the repercussions of this role reversal between "risk assets" and "safe havens"? For one, we anticipate the effects to be extremely bullish for commodity-based emerging economies with higher real yields, as they far outshine the low-to-negative real interest rates in the US and other developed markets. Per our April 2011 letter, we expect to see EM curves bull flatten as prudent policy measures should help curb longer-term inflation, while any further flattening in DM should come from pressure on the short end. In the US, if short rates do rise in response to inflationary pressures, we wouldn't rule out further steepening due to both lack of fiscal discipline and USD weakness.

Restructuring global trade

A strong dollar has typically been advantageous in the eyes of exporters eager to encourage further US demand for their goods. Today, this policy makes less strategic sense in light of the overextended US consumer that is reducing expenditures and deleveraging via increased savings, while emerging markets achieve notable growth through robust domestic demand. In a credit-constrained world, discretionary spending power will continue to reside with those who have established a higher level of savings as a percentage of GDP – a big reason that the BRICS are now recognized by most as the drivers of global growth (Figure 3).

Figure 3



Source: International Monetary Fund

The EM consumer simply has the wherewithal to increase consumption relative to his or her US peers. According to March 2011 figures from the National Bureau of Statistics, the per capita disposable income of urban households in China has grown 11.5% per annum over the last three years. By contrast, disposable income levels in the US have stayed relatively flat even as the economy stabilizes. This divergence between EM and DM saving habits has resulted in a conspicuous bifurcation of spending patterns. For instance, the last four years' compound annual growth rate for domestic passenger car sales breaks down as follows: +30.4% in Brazil, +32.8% in India, +45.9% in China, and -7% in the US. Unfortunately for US growth prospects, the ability to increase debt-fueled consumption has just recently started to rebound. The prolonged credit contraction at

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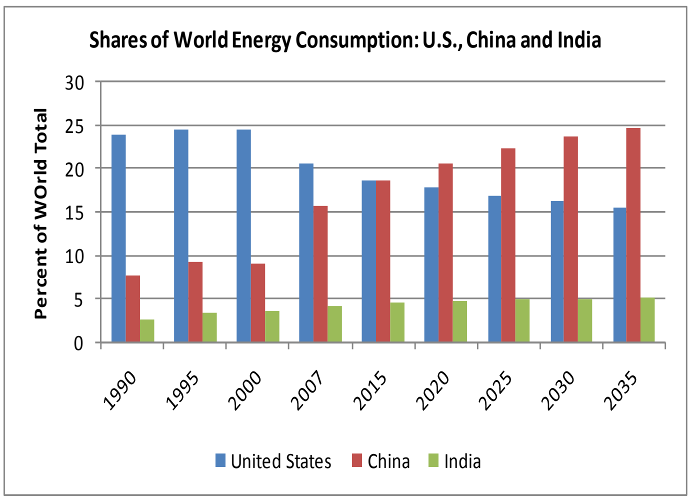
the consumer level began in 3Q 2008 and only started to rise sequentially in 2Q 2010. Total outstanding consumer credit (ex-housing) is still 6% below pre-recession levels and has yet to post a positive year-over-year comparison since 1Q 2009, illustrating how constrained spending capacity has become here.

The remarkable shift of unleveraged consumer power in favor of developing economies is a major driver behind many EM nations' plans to decelerate export-driven policies in favor of those that foster internal consumption. China's 12th Five Year Plan, adopted this March, reflects this commitment. In addition to public welfare measures that put more disposable income in the hands of consumers, the plan places heavy emphasis on the transition from an over-reliance on exports to a balance between import- and export-led growth. Through the implementation of similar policies across the BRICS, we expect the longer-term consumption trends between emerging and developing markets to continue along their inverse trajectories (Figure 4). Unless credit or income growth in the US unexpectedly recovers to pre-recession levels, any further increase in the gross national savings rate would have to come at the expense of discretionary spending.

Figure 4



Sources: U.S. Energy Information Administration, World Energy Projection Plus
(please note that post-2007 data is projected, not actual)

As emerging economies advance, they have remained cognizant of the risks they face due to imported inflation. More recently, China has signaled its awareness that the long-held policy of targeting both a cheap yuan and low inflation is not sustainable. Because their mandate to control inflation generally trumps everything else, it is feasible that they will have to allow CNY appreciation sooner rather than later. The rising yuan is likely to trigger a commensurate rise in value of other Asian currencies, followed by a global trend whereby non-USD crosses become more significant. As noted in our February 2011 newsletter, currency appreciation can in fact help contain imported inflation, an idea that we believe inflation-sensitive countries including China, India, and Brazil have come to accept. For this reason, developing economies may seek to contain inflation by allowing their currencies to appreciate against the USD (as long as cross-rates do not oscillate too severely).

With the USD fading from the international stage in terms of trade, it stands to reason that the de facto pricing of goods in dollars will fall by the wayside as a consequence. This has already begun to materialize, with non-USD-denominated transactions becoming more frequent. Russia and China, for instance, agreed in November 2010 to use their own currencies in bilateral trade. More recently, Rio Tinto (the world's third largest miner) has openly contemplated switching from USD to CNY for iron ore pricing, as roughly 30% of the company's revenue comes from China. With intra-BRIC trade growing at 30% per year since 1999, we expect this trend to accelerate, potentially resulting in a broader and more permanent de-pegging of commodities from USD.

Reweighting Sovereign Reserves

Much has been made of China's massive USD holdings, and with good reason: approximately two-thirds of its $2.5 trillion currency reserves are rumored to be held in dollars. As the US fiscal crisis becomes more pronounced and the zero-yielding dollar has begun to weaken, China has articulated a growing distaste for overexposure to a depreciating asset. While they are not likely to shoot themselves in the foot by abruptly dumping the dollar, their motivation to diversify into other stores of value has intensified. Last July, a top official from the Chinese Central Bank suggested that "using a basket of currencies from the nation's top trading partners (in lieu of the dollar) would allow the Chinese yuan to better reflect trading fundamentals." If, as hypothesized above, less trade is conducted in USD-denominated assets going forward, this should temper the need for central banks to hold USD as a hedge, exacerbating the trend of dollar attrition. Furthermore (per our December 2010 commentary), we expect that over time there will be some sort of dual convertibility between HKD and RMB in Hong Kong; prior to this, however, we believe that the HKD is likely to strengthen versus the USD as markets move more freely and as Hong Kong is prompted to stop importing loose monetary policy from the US. This could very well represent a test balloon being floated by China to gauge the merits of increased flexibility in capital controls. If China is reassured that looser capital controls would help their importers as well as decrease the future need to own dollars, then we foresee a more flexible policy in the long-term pipeline.

Sovereign diversification away from USD is more than hypothetical. The sheer volume of dollar-denominated trade conducted by the BRICS has caused these economies to accumulate a surfeit of USD: together, these countries account for roughly 40% of global currency reserves, the majority of which is in dollars. In April 2011, the BRICS summit provided a forum for more serious discussions on how to diversify foreign reserve exposure away from the USD. Such proposals covered a range of possibilities, including the creation of a common BRICS currency as well as a dramatic expansion of the IMF's SDR basket.

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Though "USD doomsday" predictions have come up short in the past, we view current conditions as especially conducive to a resignation of the dollar's position from the international limelight. The dollar can no longer claim to represent a "haven" from riskier assets, and in actuality is beset by a plethora of structural risks. The US continues to decline as a major importer, with little hope for a near-term rebound to pre-crisis consumption levels. Finally, and perhaps most significantly, the USD cannot rely on a lack of competition to perpetuate its status – at least, not for long.

Despite the strong psychological hold that the USD has maintained over the global monetary system, even American investors are now joining the rest of the market in seeking ways to mitigate the risks associated with USD exposure, to which they in particular are highly vulnerable. We believe that the most expedient means of diversification away from USD – whether on behalf of a central bank, an institution, or an individual – is through investment in fundamentally-supported commodities. If our hypotheses do not materialize and the USD happens to pull off a meaningful recovery, those commodities supported by bullish factors should continue to perform well and provide alpha. If, however, the dollar continues its fall, investors holding real assets should benefit due to the merits of the commodities themselves, as well as the inherent USD short they would ultimately own.

Renee Haugerud, CIO

June 2011

[1]According to www.usdebtclock.org, "US Total Debt" includes Household, Business, State and Local Governments, Financial Institutions, and The Federal Government. *Source: Federal Reserve.*

[2]According to www.usdebtclock.org, "US Unfunded Liabilities" includes Social Security, Prescription Drugs (Medicare Part D) and Medicare. *Source: Federal Reserve.*

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