INDEPENDENT STRATEGY

Global

GLOBAL MARKETS

Doomsday for the US dollar?

INVESTMENT CONCLUSION

The US dollar is going to resume its secular decline (Figure 1). Its role as the world's dominant reserve currency will come under renewed threat over the next decade as export-surplus economies look to diversify their dollar reserves into other currencies.

This will not happen suddenly and there may be upward corrections for the dollar, particularly if markets are disappointed with the failure to achieve a V-shaped global economic recovery and there is a rush back to 'safe haven' assets.

But the US is undermining its 'safe haven' status and debasing its currency by trying to sustain a credit-fuelled economy through huge fiscal deficits and the monetisation of public debt. That will drive up government bond yields over time and reduce the willingness of China and other foreign dollar holders to hold US dollar assets.

We would be short the dollar versus the euro, but particularly against the Norwegian krone. We would hold gold as the main hedge against dollar weakness and the ultimate 'safe haven'. We are also long food commodities.

US$ nominal effective exchange rate (1988=100)

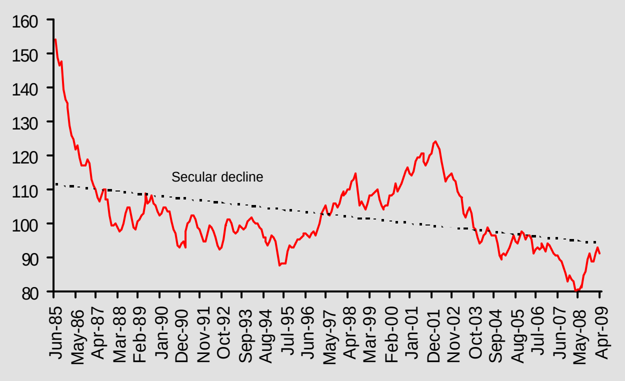


Figure 1. *Source: Datastream*

We removed most of our EM currency shorts after the recent announcements of IMF bailout funding at the G20 summit. Since then most EM currencies have strengthened along with global equities. We do not think this is warranted. So we are now adding the Turkish lira to our remaining short EM currency positions.

Our currency positions and performance are outlined at the back of this report (Inset 3).

27 May 2009

ANALYSIS

Losing reserve status

Back in March 2003, in a report entitled *End of empire*, we wrote that the US had developed a similar hubristic over-reach as Marlow's tragic kings and emperors and many a real empire at their zenith. We wrote that "the sun never sets on an empire, but it sets for its currency too".

We went on to develop the theory of New Monetarism (*New Monetarism*, 26 April 2004). The international aspects of the theory were that the dollar's role as global reserve currency and trading currency were a licence for the US to create liquidity or credit, boost asset values, over-consume, incur massive external current account deficits — and yet suffer no pain of currency-imposed adjustment (Figure 2).

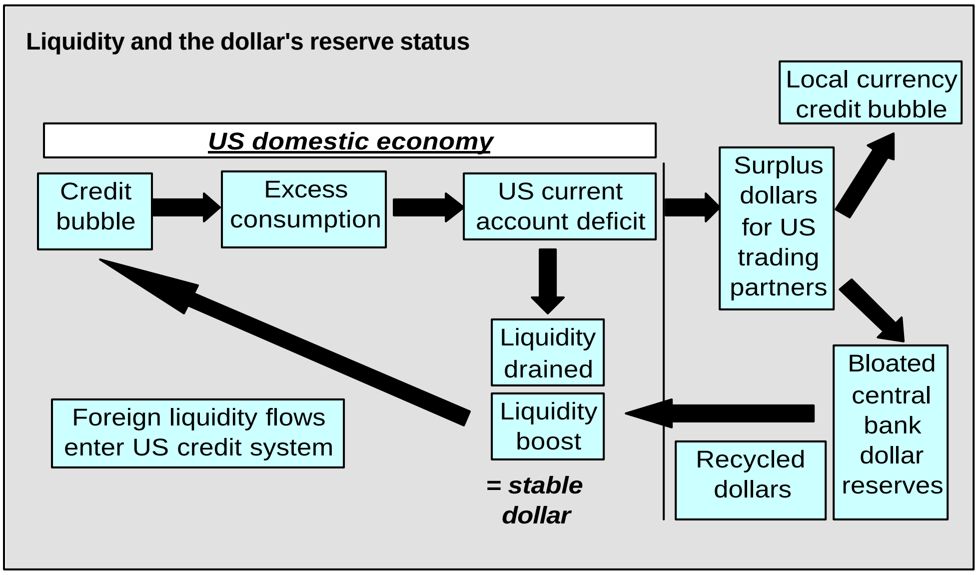


Figure 2. *Source: Independent Strategy*

The dollar's global reserve role attracted all the current account deficit dollars that the US hemorrhaged back into the US credit system and much foreign savings to boot. And the global trading system funnelled all money into dollars like a torrent emptying into a finite sea (Figure 3).

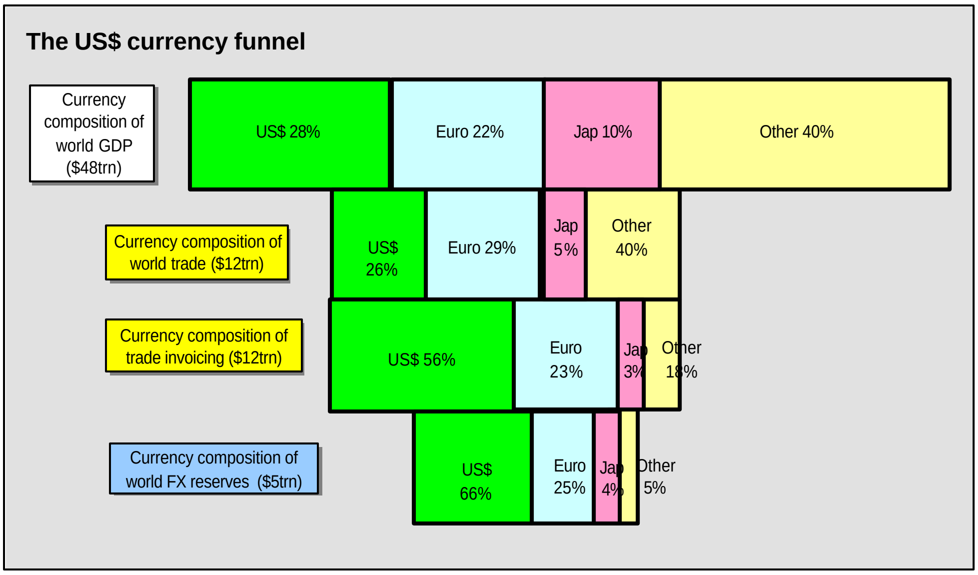


Figure 3. *Source: Independent Strategy*

The holding of dollars by exporters, savers and foreign central bankers was a voluntary one. It was based upon the belief that the US economy was stable, despite its obvious disequilibria of excess consumption, lack of savings, credit bubble and external deficits. This is the 'stable state of economic disequilibria' that the current Fed chairman characterised as 'sustainable, but sub-optimal' and that we called 'a momentary accident of history' (see our report, *Bubble psycho and the global savings glut*, 13 April 2005).

The havoc of the credit crisis has now undermined all such optimistic beliefs in the stability of the US economic paradigm. In doing so, it changes the role of the dollar forever (see our report, *New monetarism and the currency accelerator*, 1 November 2006).

It is clear that the free ride for the dollar is over, given China's current rush to buy gold and real commodities (beyond any production needs); to shorten the duration of its holdings of US Treasuries; to get out of US GSE debt and to propose the substitution of the IMF's Special Drawing Rights (SDRs) for the dollar as global reserve currency.

China's dollars

This dethroning of the dollar as international reserve and transaction currency may take time. At the end of 2008, China had $2.92trn invested overseas, with about 70% of that invested in US dollar assets (Figure 4). That compares with annual GDP of $4.3trn. Two thirds of this wealth sits in the central bank, which has one of the largest balance sheets relative to GDP in the world.

So a 1% loss on the value of China's dollar assets would wipe out Chinese wealth worth 0.67% of GDP and create a hole in the central bank's balance sheet (if its forex assets were marked to market) equivalent to about 0.5% of GDP. If China stopped buying US assets, the dollar would, of course, fall precipitously. But the first victim would be China. The second would be the US Treasury and then the US economy.

So the Chinese are hoisted with their own petard. They have been sold a pup (a whole economic model based on making and exporting widgets to sate excessive US consumption). They are now stuck with it. This is as much their fault for being duped as it is America's fault for failing to diagnose and address its credit and consumption excesses.

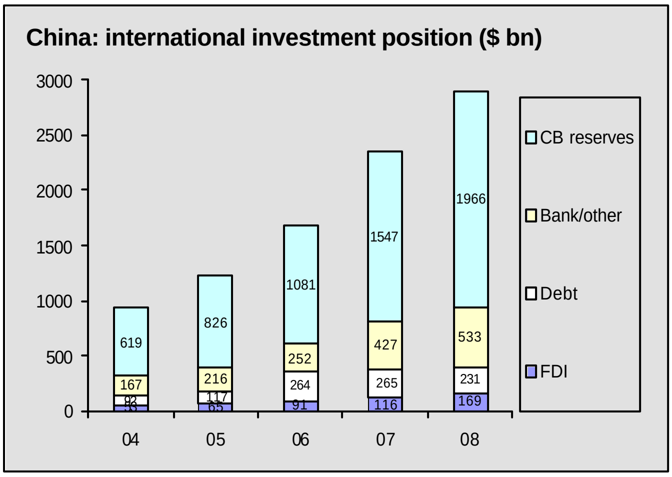


Figure 4. *Source: Datastream*

But have no doubt in your mind, the Chinese may be stuck with the pup, but they don't like the dog! They will not repeat the mistake of giving their unreserved backing to the dollar, because to do so would allow the US to repeat the same mistake — financing growth with leverage, as it is now attempting to do.

In the Chinese view, ending the monopolistic reserve currency role of the dollar means that the autistic recycling of dollars to the US by foreign export-surplus and excess-saving nations will cease. Consequently, the dollar will increasingly be priced on foreign exchange markets to reflect the 'acceptability' of US economic policy and external balances. Markets (foreign exchange and, in consequence, fixed income) would then blow the whistle on any attempt to renew a US credit-financed consumption boom.

As this is what the US administration hopes for, even the rethinking of the dollar's role makes it far more likely that it will be foreign investors, rather than domestic US markets, that will pull the plug on US fiscal and monetary profligacy.

The Chinese are already creating the process for this to happen by moving to transform the renminbi into China's trading currency wherever possible and to promote the yuan as a reserve currency (through swaps) on a regional basis. These are small beginnings but big signposts!

The smartest thing that the Chinese could do would be to 'sell' as big a chunk of their dollar reserves as possible to the IMF in return for SDRs. This would diversify the reserves that they hold by up to two-thirds out of dollars without ever touching a forex market. This is because the SDR is composed of only 34% weighting in the dollar and 66% in other currencies (yen, euro and sterling). The IMF could invest any dollars it did not need to bail out any emerging economy in difficulty, by investing in US treasuries and parking them at the Fed. Then everybody would be smiling, including, for a time, the markets.

A prolonged whimper

We reckon that the doomsday for the dollar will play out inexorably and gradually, more as a prolonged whimper than a crash. This makes the dollar a long-term short against any decently managed global currency, gold and not a few commodities (we prefer food — see our Update, *Food commodities* 2 April 2009).

Of course, there will be many reversals on the way down for the dollar. The dollar could gain for a while when the current risk rally reverses and there is a 'flight to safety' again, although the number of investors who believe that the US policy of currency debasement is compatible with safety must be waning.

Not being in the business of being financial martyrs, we have to adjust our convictions to deviate from our articles of faith. When we sensed the current risk rally taking hold and the IMF losing its grip on financial orthodoxy, we cut our emerging market currency shorts (see our Update, *The IMF exclusion zone*, 3 April 2009).

Between August and December 2008, we were long the dollar as we rode the wave of dollar deleveraging by emerging market corporations (see our report, *The big'un for the dollar too*, 11 August 2008). This demand, which we estimate was up to $570bn or 6% of EM GDP, is now waning. Central banks in quite a few emerging economies (among them, Brazil and Korea) are taking back the swap lines extended to bail out corporations from their dollar-shorting follies.

That leaves the greenback's fate dependent on trade and capital flows. The US trade and current account deficits will both narrow as the US consumer deleverages and spends less. (They won't narrow if the much-fantasised V-shaped recovery happens!)

But the US need for credit will not diminish as much as personal consumption does, because US government leverage (dissaving) will replace it. We reckon that household savings rates will double from here to 7.5% of GDP, but that fiscal deficits will be 10-12% of GDP. Despite a fall in investment that helps the net national savings deficit, it still looks like the US will need more, not less, foreign financing to fund the fiscal deficit (Inset 1).

The US cannot really afford to behave like post-bubble Japan in the 1990s, because it has no dumb domestic stock of household savings to fund government profligacy and control its long-term borrowing costs. But that won't stop this US administration trying.

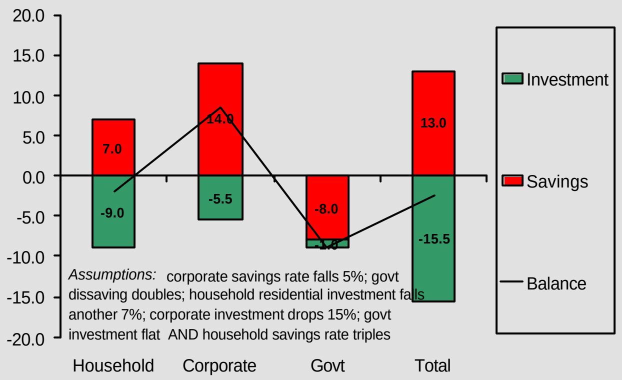
US savings-investment balance

The lack of thrift created the US current account deficit, which reached a high of 6% of GDP in 2007. To enable the US to finance its external obligations comfortably, the deficit must be reduced, say to 2.5% of US GDP (Chart A).

In other words, domestic savings must be brought more in line with domestic investment. As domestic investment will be falling in the short term, that will provide some 'automatic' improvement in the domestic savings-investment balance. But that won't be enough to do the trick, especially longer term, if reasonable economic growth is to be sustained.

The US public sector dissaving rate is set to reach 8% of GDP this year (a doubling over 2008) and will stay there for many years thereafter. So the heavy lifting of the national savings rate must be done by households turning thrifty. This implies a rise in the household savings rate to at least 10% of disposable income from today's 4% level. That translates into 7.5% of GDP, or a tripling as % of GDP from the current level. That's a huge task. If it is not achieved, then dollar assets will suffer.

Chart A: **US domestic investment-savings balance required (% of GDP) for current account deficit at 2.5% of GDP by 2010**



Inset 1. *Source: Independent Strategy*

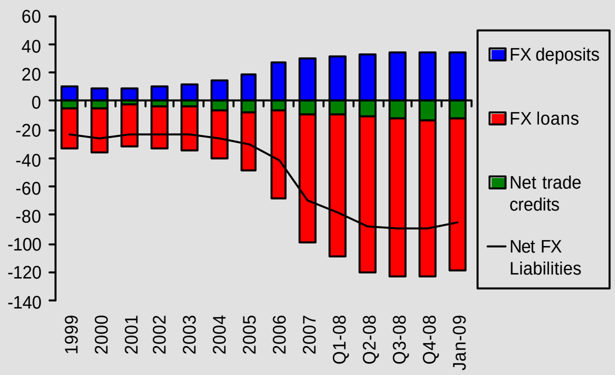
Turkey looking vulnerable

The Turkish economy remains vulnerable to shocks. Public finances remain under threat as the economy heads deeper into recession. Sure, this has cut back the current account deficit, but the corporate sector still has a large open FX position that is difficult to finance (Chart A). The rollover rate on refinancing continues to decline.

This makes an IMF bailout deal of paramount importance. But the government has been very reluctant to commit to such a deal because of the social and political consequences for its popularity, already diminished. By delaying such a deal, it is taking a big risk in the hope that a V-shaped global recovery may save the day.

The longer the government procrastinates, the more likely it is that Turkey can only adjust its external and public debt financing through a weaker lira.

***Chart A:* Turkish corporate sector net open FX position ($ bn)**



Inset 2. *Source: CBRT, Independent Strategy*

The US must ask foreigners to do the funding. But we doubt they will want to at current Treasury yields. Alternatively, the Fed can continue printing money and buying treasuries and funding the budget deficit directly and indirectly with liquidity injections into the banks. This will paper over the cracks of capital mispricing and fiscal insolvency for a time. Such money printing is direct monetisation of government debt and is a measure of the debasement of the currency, not its health. The ultimate result will be a much weaker dollar and higher US treasury yields.

It seems unlikely that US policies will succeed in maintaining household and banking over-leverage by the addition of a new layer of leverage incurred by government. So it won't succeed in fuelling a consumer with more credit just when consumption has collapsed under the weight of too much borrowing. Yet these policies have to work if the V-shaped economic recovery that financial markets hope for happens.

Emerging market currencies

Therefore, with much trepidation, we are starting to add to our short EM currency positions. We have kept a small number of EM currency shorts: those with economies that are seriously pressed to meet IMF conditionalities on bailouts (Hungary, Romania and Ukraine); or are trying to sustain overvalued currencies (the currency peg Baltic states and Bulgaria). Now we are adding the Turkish lira (Inset 2).

IS currency positions

Position		Start	Finish	*% Gain/loss*
US$/€ long	11 Aug'08 to 11-Dec'08	1.499	1.323	*19.5*
US$/€ short	11 Dec'08 to now	1.323	1.401	*11.6*
US$/¥ short	17 Sep'08 to 20 Feb'09	104.73	94.16	*11.2*
US$/¥ long	20 Feb'09 to now	94.16	95.05	*0.9*
US$/£ long	11 Aug'08 to now	1.917	1.590	*20.6*
€/¥ short	17 Sep'08 to 20 Feb'09	148.6	118.8	*20.8*
€/¥ long	20 Feb'09 to now	118.8	133.1	*12.0*
US$/EM curr long (Mex peso)	11 Aug'08 to 3 Apr'09	10.12	13.76	*26.5*
NKr/Thai baht long	8 Dec'08 to 3 Apr'09	19.97	18.5	*7.4*
NKr/US$ long	3 Apr'09 to now	6.55	6.32	*4.6*
NZ$/US$ long	24 Mar'09 to now	56.08	61.63	*9.9*
Gold/US$ long	11 Aug'08 to now	853	957	*12.2*
Food (soya)/US$ long	2 Apr'09 to now	966	1170	*22.3*

Inset 3. *Source: Independent Strategy*

We are also ending our long dollar/short sterling position. Sterling has made a comeback from lows in the last month or so and the greenback is unlikely to make much headway against sterling from here (except when in 'safe-haven' mode), even though the UK's fiscal position is as dire as that of the US, with the sovereign credit rating under threat. From here, we would be just long euro/short sterling.

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STRATEGY

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