CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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A Weakening Economy and Strengthening Dollar?

In April, stock and commodities markets were very strong. In the new month, oil and precious metals fell while the dollar rallied. Does this presage a weak economy and the beginning of an extended period of strength in the US dollar?

Strong employment growth augurs well for 'self-sustaining' economic expansion.

The Fed is determined to maintain very 'easy' monetary conditions, despite political opposition. This will support the economy indirectly and investment asset prices directly.

The dollar will likely continue its stately and long-term decline.

By

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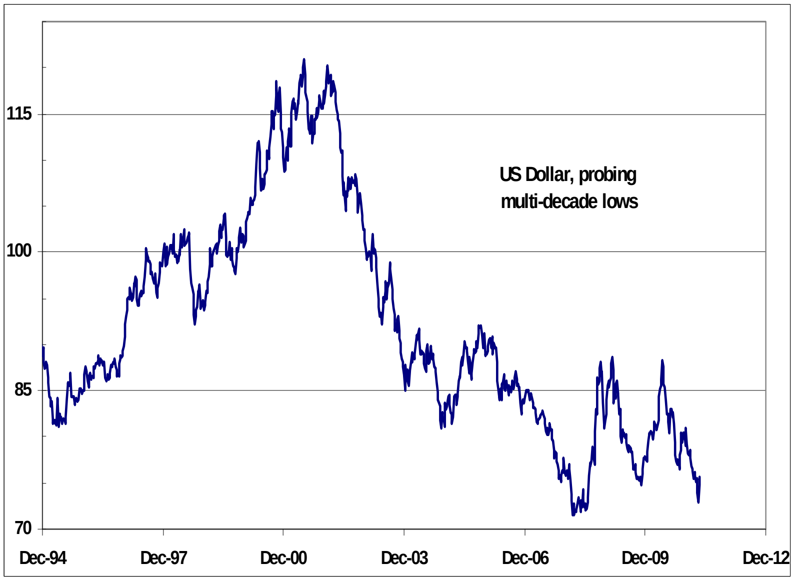
With the beginning of May came sharp changes across many markets: Commodities fell with a thud, the dollar has rallied, and stocks have declined modestly. The weakness in oil, other industrial commodities and precious metals follows speculative advances in many commodities, so the selling may represent nothing more than profit taking that invariably follows bouts of speculation. But selling in industrial commodities must raise the question whether global economic activity is slowing, and with it the demand for oil and other commodities. Quite separate are issues raised by the dollar's rise after many months of persistent declines. Commodities are priced in dollars, hence a decline in the dollar's value will, all other things being equal, cause an increase in the prices of commodities. Does the recent rally in the dollar mark the end of its long decline and the beginning of period of a stronger dollar? First, a look at the economy, then some comments on the dollar.

Self-Sustaining Growth. In the midst of days of intense selling in commodities came the monthly report about the US job market, a very strong one indeed, showing unexpectedly high levels of private job formation in April and upward revisions to already-strong estimates for February and March. The employment report lends support to the argument that economic growth is real and encourages the hope that growth in America is now 'self-sustaining'. As the term is used these days, 'self-sustaining' growth is sufficiently strong growth in the private sector as to be able to withstand the withdrawal of government support. Given the solid Republican rejection of federal government 'stimulus' spending and its determination to cut federal spending generally, it is quite likely that federal government fiscal policy will tend to slow economic activity. Will withdrawal of federal support turn economic growth into contraction? Not if economic growth is now 'self-sustaining'.

In addition to the likely diminution of fiscal support, what of the end of the Federal Reserve Board's policy of quantitative easing, by which, since November, it has been purchasing $600 billion of treasury bonds in its so-called QE2 program? Come June, this buying stops. Although the Fed is independent, it will be hard pressed to engage in a significant new round of monetary easing in light of Republican opposition. Fed Chairman Ben Bernanke has been forthright in his discussions of upcoming Fed actions. The Fed's Open Market Committee, its policy-making arm, confirmed at its last meeting that, apart from the scheduled end of the treasury buying program, the other aspects of the extremely accommodative monetary policy will remain in effect for 'an extended period'. By this we can be sure that, as it receives interest and principal payments from its huge portfolio (now exceeding $2 trillion), the Fed will reinvest these in more treasuries and that its very low short-term interest rates will continue.

The dollar. From an investment point of view, this has important implications. All the other major central banks in the world have 'tighter' monetary policies than does the Fed. The European Central Bank, for example, has begun to raise short-term rates and emphasizes inflation risks. The Fed's policies give a high probability to continuing depreciation in the value of the US dollar. Moreover, it is quite clear that the Fed--and the Treasury, as well--prefer a weak dollar, because it supports the export of US manufactured goods, making them cheaper for foreign buyers. As consumers spend less and save more, the direct and probably long-lasting result of the financial crisis, the US economy will depend more on manufacturing and less on consumer spending to maintain growth. Although Treasury Secretary Geithner and Bernanke utter the 'strong dollar' mantra, they really want the dollar slowly to weaken further.



The late 1990s extended rally in the dollar, shown in the graph above, came during the second term of Clinton's administration during the period of higher tax rates than now prevail, controls on Federal spending and a very vibrant economy. The Federal deficit fell sharply, then turned into a surplus during that period. Financial markets and job growth were very strong. Is it too much to hope that a similar period may begin soon?

Before the early May bounce in the dollar, its value against a basket of currencies of its main trading partners, shown in the adjacent chart, had been declining steadily since last summer. By the end of April, it was trading near its lows since the 1970s. The imminent end of the Fed's QE2 program, coupled with these very low levels, may be reason enough for the dollar to strengthen. In Core's view, the dollar's young rally does not presage the end of this long decline--about 40% since 2002. For most of this last decade, Core has held and continues to hold investments that benefit from the dollar's decline, either directly, in the case of foreign currencies, or indirectly, as with commodities. Our most recent is an exchange-traded fund that holds Asian short-term fixed-income investments (excluding the yen), denominated in local currencies. For a longer period, we have held positions in Australian and Canadian dollars and the Swiss franc. Additionally, our investments in agricultural commodities, gold and silver are fairly direct plays on US dollar weakness, since these commodities are priced in US dollars. (As the dollar weakens, one needs more dollars to buy an ounce of gold, for example.) Many of our equity investments benefit from a decline in the dollar in relation to other currencies, including those US companies involved in exporting manufactured goods, the oil companies, and the non-US companies in our portfolios, whose stock prices in US dollar terms rise as the dollar falls.

The dynamics that support the dollar's weakness will persist, especially if the jobs market remains weak. In this present political environment with its hostility to fiscal policies to encourage growth, the Fed must assume the burden on its own. The tools of monetary policy are not terribly well-designed to create jobs--the Fed cannot engage in road repair or the building of high-speed rail lines, for example--so its policies have an indirect way of helping the economy. The Fed's policies push investors into risky assets, among other things by cutting rates so low that holding money market funds is a losing proposition. The theory is that higher asset prices will lead to economic activity. Well, maybe so. But at all events, the investing business is about buying assets that increase in price, so Fed policies have a direct benefit for investors alert to the consequences of the Fed's work.

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