



Making Sense of the Dollar: The U.S. Will Lead the World Again

By Susan B. Weiner, CFA
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The U.S. economy is in better shape than you think. It may even start coming back in the second half of 2009, and the dollar will end 2009 higher versus the euro and yen.

At least, that's the optimistic outlook Marc Chandler, Brown Brothers Harriman's global head of currency, set forth in his keynote address at NICSA (National Investment Service Company Service Association) East Coast Regional Meeting on January 15, "Making Sense of the Dollar."

"The U.S. will emerge from this crisis the way we emerged from World War Two" and other crises since, Chandler told his audience - "Stronger than before."

The U.S.'s Path to Recovery

The U.S. economic crisis isn't over yet. Chandler predicted that the economy may have experienced its worst losses in fourth quarter 2008, with an annualized 5% to 6% decline in gross domestic product (GDP). But things will improve from there. In his opinion, the economy will contract again in the first quarter of 2009, but less severely.

A first quarter contraction at an annualized rate of 3%-4% would "lay the groundwork for the economy losing its downside momentum," he said. After that, he predicts that GDP will be flat during the second quarter. "A flat economy would be good news," said Chandler, because things will improve from there.

Chandler feels optimistic that the U.S. economy will begin to grow again during the second half of 2009. Three factors will be critical:

1. Stimulative fiscal spending, with the \$750 billion package proposed by President-elect Obama expected to increase in the hands of Congress
2. Very aggressive monetary stimulus
3. Low oil prices — "We had a huge oil shock last year," said Chandler. He said that hurt the economy, but what pushed us into recession can help us out. Lower oil prices now provide a welcome boost.



The U.S. Will Lead the World

Look for the U.S. to recover more quickly than the rest of the world. "Other countries are doing poorly and are behind us on the curve," Chandler said. Despite talk of the U.S. being in a long-term decline, Chandler sees our adversaries and competitors falling behind us.

Consider how times have changed for our oil-rich adversaries. On the eve of the Summer Olympics, Russia invaded Georgia and Venezuela and Iran talked about charging for oil in currencies other than the U.S. dollar. In fact, Iran was already charging Japan in yen for oil. But that was then. Now all three countries are weaker. Russia has lost one-third of its currency reserves since August. "Now Russia cannot project its power like it could at \$140 or \$150 a barrel," said Chandler.

As for Europe, "Some say the euro zone will eat our lunch," Chandler said. But he disagrees. He thinks it's more likely that the euro zone will break up. He pointed to the fact that countries like Spain, Portugal, and Greece must currently pay higher interest rates than Germany. This reflects a lack of confidence in the credibility of the euro-zone and the idea that one monetary policy fits everybody, said Chandler.

Then there's China, which has built its success on factory wages that are only 3% of those in the U.S., according to Chandler. But "China might get old before it gets rich.... [and] China might get sick before it gets old," he said. In other words, China faces a demographic crisis as its population ages, and it has a huge health care problem. He thinks the U.S. should push China to create unemployment compensation and national health care. Meanwhile, Chinese currency doesn't pose a threat to the U.S. dollar because it is not convertible outside China, said Chandler.



he Future of the U.S. Dollar

What does this international situation mean for the future of the U.S. dollar as a reserve currency? "It doesn't look like the euro can replace the dollar," said Chandler. While some experts worry about central banks diversifying their reserves away from the dollar, "There is no evidence they're selling dollars," Chandler said. "They hold more dollars than ever before." While central banks are also holding more euros than ever before, he said, the euro only accounted for 26% of the world's reserves as of third quarter 2008. That isn't much changed from the 23% accounted for by the French franc, German mark, and ecu (a predecessor of the euro) prior to the European monetary union's start, he noted.

Two things would have to happen to shake Chandler's confidence in the dollar. First, a stronger alternative currency would have to emerge. Clearly, he doesn't believe that has happened yet. Second, the U.S. would need to abdicate its role in the world — to "build a fence around the U.S. and let nobody in and nobody out," as he put it. He doesn't see that happening under an Obama administration. America's history of taking in roughly one million immigrants a year from 1980 to 2000, he added, makes him optimistic about its medium-term and long-term outlook. Those immigrants "have been a great source of dynamism for the U.S. economy," he said.

Chandler believes the dollar will strengthen versus the euro and the yen over the coming year. The dollar began bottoming out versus the G-7 currencies in late 2007. "I think the euro is going back to its birth rate," said Chandler, meaning it will fall from about 1.32 euro to the dollar to around 1.17 euro to the dollar. He's less certain about the yen because Japanese are repatriating their yen (i.e., converting foreign currencies into yen), which will shore up the currency in the near-term. But he figures the yen will fall by year-end because the Japanese aren't tackling their economic problems as aggressively as the U.S.

Four Indicators that the U.S. is Bouncing Back — and One Way to Profit

Chandler believes there are four signs that will indicate that a U.S. recovery is under way. First, a further drop in margin usage for U.S. equities at the New York Stock Exchange will mean deleveraging is over. Second is a sustained uptrend in the price of copper — a leading indicator. Once both of those occur, he said, the economy will have bottomed out. The third and fourth leading indicators of a rebound are a sales pick-up in consumer durables, especially autos, and an upturn in the stock market, which often anticipates the economy by six to nine months.



Meanwhile, Chandler has distinct views on how to profit in the current environment. Two classic methods — the carry trade and taking advantage of mean reversion — won't work, he said. The carry trade has been derailed by the collapse of interest rates and mean reversion by the fact that reversion has already occurred. That leaves momentum investing, said Chandler. "Over the next several months and quarters," he said, "I don't want to be the first one at the party, but I don't want to be the last one either."

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