



Worry of the Dollar's Collapse Is Overblown

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Since the global equity markets rebounded earlier this year, the U.S. dollar has resumed its decade-long decline. The pace of its decline has accelerated recently, causing worry that the dollar is headed for an imminent collapse.

The fundamentals for the dollar could not be worse. The U.S. economy has continued to struggle, the federal deficit has skyrocketed, and the government has adopted super-easing monetary policies and aggressive fiscal spending. But anxiety over a potential dollar collapse is overblown. A gradual decline appears more likely.

Let's examine why:

- ***The U.S. economy is currently undergoing an unprecedented, multi-year deleveraging transformation that should put a lid on rampant inflation despite the above-mentioned government policies.***

This deleveraging process will force consumers to spend less and save more, lessening pressure on price levels. Housing is the largest component of the consumer price index, and the housing market is unlikely to recover for years to come thanks to high unemployment and limited credit. As a result, a sharp rise of the consumer price index is quite unlikely. On the money supply side, the money-creation function of the U.S. banking system will be limited – it will take years for most banks to repair and enhance their damaged capital base, and thus they will be very cautious when making new loans.

- ***Externally, because of its world currency status, the dollar will face less pressure than it otherwise might.***

It can be argued that any other country that dared to adopt such accommodating monetary and fiscal policies would have already seen its currency collapse, but the U.S. is unique. The U.S. dollar is the only universally accepted currency in the world, backed by a single sovereign government that oversees the world's most influential economy and military. In many countries, the dollar is either the



second-most accepted currency (next to that country's own) or simply the de-facto currency. What's more, the majority of world's wealth is in dollar-denominated assets. As a result, the collapse of the dollar would hurt not only the U.S. economy but also the world's economy.

- ***A gradual decline of the dollar (as opposed to an abrupt decline) is in almost everyone's interest.***

The U.S. is the obvious beneficiary of a gradually declining dollar. Not only would U.S. exports become more competitive, but the government's future debt repayment burden would also ease (\$100 in debt issued today will be worth less than \$100 when it matures). Most U.S. consumers do not consume a lot of foreign goods, so as long as inflation is under control, the impact will be minimal. As for foreign governments, by far the biggest holders of U.S. debt, it is not all that bad either. Though they may seem to be big losers in this scenario, it is in their interest to keep the dollar from collapsing, and they may benefit from other aspects of the weaker dollar.

To understand why, look no further than China, the biggest creditor of and exporter to the U.S. While China would not be thrilled at the diminishing returns of its investment in U.S. debt that a weaker dollar would lead to, its exports to other countries will become more competitive because its currency, the RMB, is pegged to the U.S. dollar. A weaker dollar means a weaker RMB.

What should investors do?

I expect this to be a gradual, multi-year trend that may exhibit occasional sudden and violent counter-trend movements. For example, the dollar snapped back an eye-popping 28% against the Euro between July and November of 2008, severely punishing those who overly bet against it. Those counter-trends can last a long time, too. The appreciation of the dollar against the Euro, for example, lasted almost an entire year between December 2004 and November 2005 before it resumed its decline.

Investors should take a patient, long-term approach that may include overweighting their portfolio allocations to international stocks and large-cap stocks, as these companies tend to generate more revenue and profits in foreign currencies.

It is highly unlikely that the U.S. economy will run into rampant inflation or that the dollar will collapse. This worry is largely caused by the painful experiences of many developing countries that neither had credible currencies like the dollar nor very sophisticated monetary authorities like the Federal Reserve Bank. The Fed has succeeded in taking the potential for a depression off the table and revitalizing the capital markets; it should also be capable of managing inflation down the road.



This material represents the opinion of Frank Wei, CFA, as of October 29, 2009 and is not meant as a recommendation or endorsement of any specific investment product or strategy. Past performance is not a guarantee of future results. Market data source is Bloomberg.

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