

Investment Update

November 2009

Too Much of a Good Thing

My first lesson in excess occurred in the late 1960s when I learned that you can have too much of a good thing. Much like any person under the age of ten, I could not fathom the concept of having too much ice cream — until I encountered the “pig’s trough” at Farrell’s Ice Cream Parlour. This dessert was the equivalent of two banana splits, consisting of two bananas, six or seven scoops of ice cream and all the other fixings. Those who finished received a ribbon, delivered to the table with great fanfare, declaring that you made a pig of yourself. Well I did get my ribbon, but would never look at ice cream the same way again. Fortunately, some things you only have to learn once.

The Dollar

Renewed Weakness Following Flight to Safety in 2008

Trade-Weighted Dollar



As of 10/21/09. Source: Bloomberg.

My story is in some ways reminiscent of the U.S. dollar. Since the mid-1990s, U.S. Treasury secretaries have followed a policy of what charitably might be referred to as benign neglect. While publicly stressing the importance of a strong dollar, they privately preferred that the decline continued, thus improving U.S. competitiveness. Aside from last year’s robust flight-to-quality rally, the dollar has fallen considerably, with only slight interruptions since its high in 2001.

Although the dollar’s decline has caused increased exports and, consequently, improved global competitiveness for U.S. firms, we may finally have reached the “too much of a good thing” point. Global investors fear that the U.S. will continue to allow the dollar to sink, depreciating the value of their existing U.S. investments.

Even among U.S. investors, concern has risen about a potential near term collapse in the dollar. At the same time, the weak dollar, very low short-term U.S. interest rates and an increased appetite for risk have combined to create a worldwide “carry trade” — a strategy in which an investor will borrow extremely cheaply in dollars to buy assets of almost every kind, including equities, commodities, gold, oil and especially foreign equities. Although U.S. equities have benefited from investors’ growing risk tolerance, they have underperformed global equities due to the weakening dollar.

The lower dollar has made new U.S. investments very attractive to foreign investors. U.S. equity markets are cheaper, on a dollar basis, for non-U.S. investors than they have been in years. The flood of foreigners into the U.S. markets is apparent in the AIG sell-off. More than 90 percent of the \$9 billion in assets that AIG has agreed to sell have gone to non-U.S. acquirers.

Over long periods, the correlation between the dollar and U.S. equities has not been that high. However, over the last year or two, most U.S. equities have been almost perfectly negatively correlated with the dollar. In other words, as the dollar has declined, these investments have risen. We have seen brief instances of this correlation working in the other direction too, with an appreciation in the dollar and a corresponding depreciation in equities. In fact, this occurred a few times last month.

Be Careful What You Wish For

We do not believe that the dollar will collapse but near term downward pressure likely will continue. U.S. interest rates are very low, economic growth is seeming to recover but likely will be more subdued than in past recoveries and, perhaps most important, confidence in the government is at its lowest point in more than a decade. Not surprisingly, almost everyone’s U.S. currency outlook is negative and many have positioned their portfolios based on expectations of further deterioration. When considering such a crowded trade — in this case, taking an extremely defensive stance against the dollar — investors must exercise caution. Those pounding the table for a stronger dollar in the near term should consider that a stronger dollar could result in a performance reversal in many assets.

Based on our belief that the Fed is not yet ready to begin hiking rates, we believe the dollar likely will remain weak and may continue to decline. With negative U.S. currency sentiment so prevalent, it may be helpful to consider events that could cause at least a near term interruption in the downtrend. Another financial crisis or resumption of the global recession, for example, could cause risk aversion or weaken commodity prices, likely propping up the dollar as happened so vigorously in 2008.

While focus has been primarily on the dollar's weakness, the impact it has on strengthening many other currencies is creating issues for other countries. We have only just begun to see the reverberations in this regard. Countries with strong local currencies create less competitive exports. If countries with strong currencies impose capital controls to stem appreciation, similar to Brazil's recent move, this could also help boost the dollar.

Finally, the almost universal view that the Fed will continue to signal low rates "for an extended period" also should be examined. At least some Fed members have become uncomfortable with this articulation. Risks in reversing accommodation too early do exist (à la the Japan experience). However, even a shift in the Fed's language that suggests removing the current accommodative monetary policy at a measured pace could be enough to shift views toward the dollar. The

Financial Times reported on October 23rd that "...senior officials are starting to mull changing the statement in a way that would soften this guidance. That would be a natural step in the slow glide path towards eventual policy normalization." An increasing number of voices, even within the Fed, have expressed that the federal funds rate should be raised soon to preempt possible future inflation and help defend the dollar. In a recent piece, Barron's also made the case for an increase. While we think that the Fed believes that it is too early for such a move, a shift in language is not beyond their consideration. When the Fed made such a language change five months prior to its first rate hike in 2004, the dollar and equity markets were significantly impacted.

What Investors Should Be Doing

We believe that the dollar will continue to decline in the intermediate term, therefore we are recommending an increased allocation to global equities, especially emerging markets, U.S. multinational companies and commodities. Some believe that an allocation to gold may provide a hedge against a weak dollar. We advise against extreme shifts as the dollar is, once again, close to a multi-year low and most of these defensive positions represent a crowded trade. Many investors' portfolios already are well positioned for a weaker dollar. A substantial dollar reversal could cause investors to rethink the degree to which they have positioned their portfolios towards dollar weakness and would likely result in reversals in the price of many of their investments.

Although we believe that a broad price increase for goods and services is unlikely, continued asset inflation — price level growth across many asset classes — could raise inflation expectations or put the market at risk for a new bubble. Either of these circumstances likely would result in a rate hike earlier than expected, causing the dollar to strengthen. Positioning portfolios too aggressively

against the dollar could prove to be costly in this scenario. Disappointing global economic growth also would challenge the current consensus of U.S. currency. Both situations could yield a higher dollar. We believe that investors should maintain a diversified portfolio to help protect against further U.S. currency depreciation. However, their portfolios should not be positioned for an absolute, extreme outcome.

A handwritten signature in black ink, appearing to read "Chris Sheldon". The signature is fluid and cursive, with a long horizontal stroke at the end.

Christopher Sheldon
Director of Investment Strategy