

IMPLICATIONS OF A FALLING U.S. DOLLAR

Investment Strategy Group

For many years, the strength of the U.S. dollar went without question as U.S. economic preeminence and the uncontested “safe haven” status of the dollar contributed to its support. The world, however, is changing and the dollar has been on a significant downward drift since the mid-1980s—losing its status as other currencies and faster-growing economies have gained more prominence in a shifting global economy.

Currently, the dollar faces a number of pressures, such as low interest rates. The Federal Reserve has kept interest rates aggressively low and has increased the money supply to help keep the economy afloat after the subprime and credit crisis. However, a consequence to low interest rates is that the U.S. becomes less attractive to foreign investors who can get larger returns in higher interest rate countries that are poised to grow at robust rates over the long term, such as China, India and Brazil. Lack of foreign lending and investment in the U.S. reduces demand for the dollar and results in currency depreciation. It is just too difficult for America’s highly developed, slower-growing economy to keep up with the growth rates of industrialized nations that are building wealth and have rising middle classes.

But is a declining dollar necessarily a bad thing? And what are the potential consequences of a weak dollar? Here are some broad observations about the impact of dollar valuation change—assuming the dollar’s value will decline—and what it means to investors.

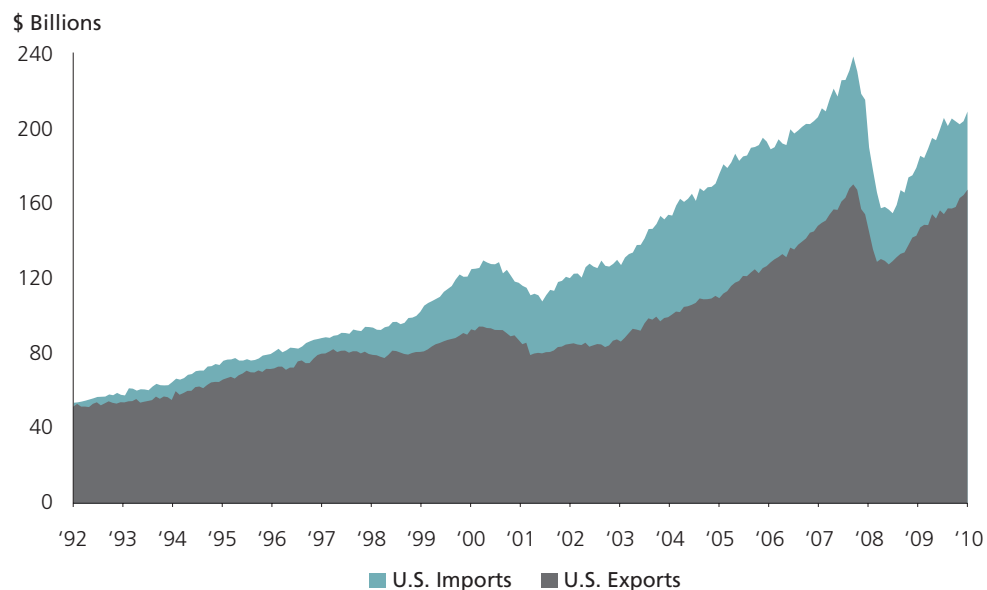
PROS AND CONS

There are both benefits and drawbacks to a low U.S. dollar. The positive impacts include:

- American exports become more competitive on a global level, with U.S. multinational companies benefitting from increased sales. With a weaker dollar, U.S. exports become cheaper and more competitive in foreign markets. This creates a high demand for our exported products and services, which may help reverse a long history of stubborn trade deficits.
- A weak dollar can also encourage foreign manufacturers to set up factories in the U.S., such as European automakers that want to increase their U.S. presence. Travel could also get a boost as it becomes less expensive for foreigners to vacation in the U.S. and purchase items in dollars.
- U.S.-based assets become increasingly attractive to foreign buyers (e.g., real estate), which further supports the economy.

U.S. TRADE BALANCE: EXPORTS AND IMPORTS

A lower dollar increases the price competitiveness of U.S. exports, leading to an increase in demand and a potential lowering of the trade deficit



Source: FactSet.

Alternatively, the negative effects of a falling dollar may include:

- The cost of imported goods becomes more expensive, such as rising prices for oil, commodity and retail products. Since the U.S. typically imports more than it exports, higher prices on foreign goods could translate into higher inflation, thereby reducing consumer and corporate purchasing power. Services outside the U.S. also become more costly.
- Just as foreign goods become more expensive, so too do investments priced in other currencies. For instance, suppose a dollar is worth exactly the same as one euro. In this scenario, a European company stock priced at €30 would be worth \$30. If the dollar were to fall and be worth half a euro, that same €30 stock would cost a U.S. investor \$60. This is a benefit if you already owned the company, but has a negative effect if you plan to invest abroad at some point in the future.
- The relative wealth of Americans, compared to that of nationals in other nations, also decreases as the dollar (the currency in which their assets are valued) falls. While this may have little effect on day-to-day spending or domestic investments, it may diminish Americans' sense of status in the world.

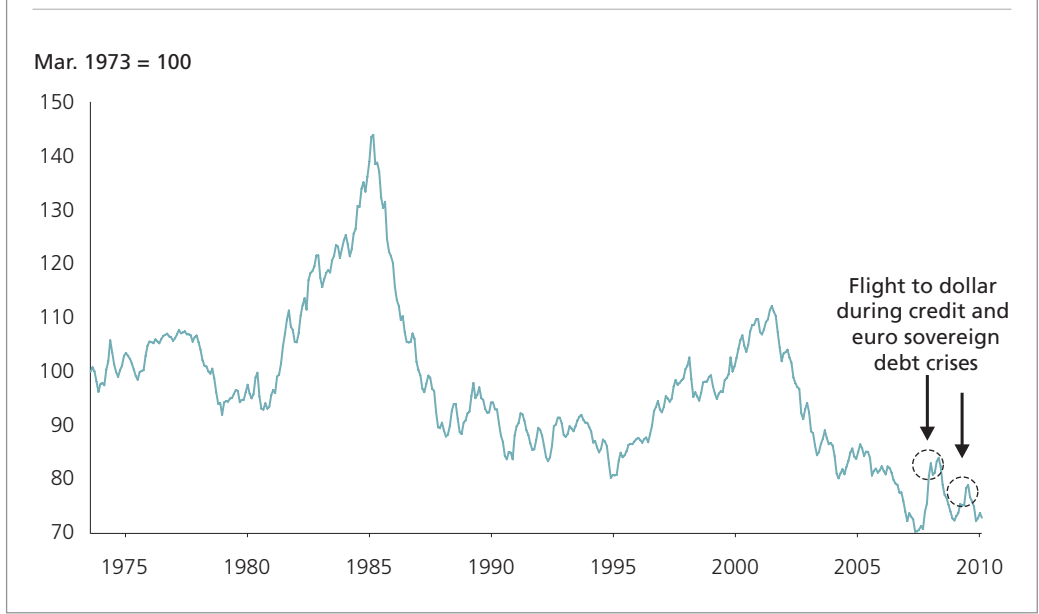
STILL THE BENCHMARK WORLD CURRENCY

Though the U.S. economy and the dollar will encounter a number of headwinds going forward, investors still seek the safe harbor of the venerable greenback in times of turmoil. Ultimately, many investors seek the greatest level of certainty possible, and this is as true for central banks as it is for individual investors. For example, China and Russia alone hold nearly \$2 trillion in U.S.-denominated assets. And while the dollar

has softened against a broad basket of global currencies, this is not an indication of an unfolding dollar crisis. For one, the Eurozone fiscal crisis may have put to rest the notion that the euro could replace the dollar as the primary reserve currency, and has likewise renewed interest in the greenback as the most stable currency.

U.S. DOLLAR VS. BASKET OF GLOBAL CURRENCIES

The role of the dollar as the world’s safe haven currency does not seem to be challenged as seen by periodic rallies in the last few years



Source: Board of Governors of the Federal Reserve System. TWEXMMMTH is a weighted average of the foreign exchange value of the U.S. dollar against a subset of the broad index currencies that circulate widely outside the country of issue. Major currency index includes the Euro Area, Canada, Japan, the United Kingdom, Switzerland, Australia, and Sweden. The exchange value was indexed to 100 in 1973.

OUTLOOK

Despite the macroeconomic bumps we have seen through this recovery and expansion cycle, we foresee continued improvement in the U.S. economy in 2011. However, an improving economy does not necessarily translate into a stronger currency. A key point to remember about currency is that it reflects relative value more than anything—so while the U.S. economy may continue to display stronger fundamentals, our relative growth compared to those of other countries is equally important.

In the short term, we believe the dollar will be relatively range-bound with respect to the other major currency blocks—namely the euro and the yen. In this environment, investors may not need to take action within their portfolios. Longer term, we expect the dollar to remain weak versus a broad basket of global currencies. As such, allocations to commodities and emerging markets equities may become attractive—both of which have historically benefitted in times of dollar depreciation. Though a declining dollar can be a worrying thought for investors who own a significant amount of dollar-denominated investments, international diversification, exposure to multinational companies, and allocations to noncorrelated asset classes can help investors protect and grow assets through periods of dollar weakness.



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