



The Week

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Watch the Dollar to Snare U.S. and International Investment Opportunities

The U.S. dollar, a key indicator for finding international investment value, has been steady since April, reflecting a global economic moderation. As the slowdown fades, the dollar should gain on the main developed-market currencies but lose ground against the emerging-market currencies. Portfolios should remain balanced, ahead of expected opportunities as the economic pace again quickens.

People who do not feel well often check their temperature with a thermometer. Likewise, investors can learn about investment opportunities by following the prices in certain markets – gold, oil, equity indices, and the U.S. dollar, for example. The “temperature” readings (high or low) on these prices reveal much about where in the world to look for investment value, or even whether conditions favor allocating new funds. The dollar is a particularly useful “thermometer”, as its exchange value can give important clues about where other markets – including gold and oil – may be heading. This week’s report considers the signals that the greenback may be sending investors for the coming quarters.

So far this year, the dollar’s exchange value has declined (i.e., depreciated) broadly against the currencies from developed and developing countries. The chart below shows the dollar’s decline against two composites or baskets of developed- and emerging-market currencies. But the greenback has steadied in the past 10 weeks. In fact, the dollar’s exchange rate has not been this steady for a 10-week period since the summer of 2009. Then, investors saw the “green shoots” of a nascent global economic recovery. Then, as now, there were questions about whether the recovery might be sustainable.

What is the dollar’s outlook?

Our base-case view sees the dollar strengthening against the developed- but weakening further against the emerging-market currencies. Various forces during the coming year should matter the most for the U.S. dollar’s value. The U.S. trade deficit remains a negative for the dollar. Also, low U.S. interest rates, relative to those in other developed countries, should continue to lead

demand for other currencies. We expect these disadvantages to push the dollar lower against most emerging-market currencies.

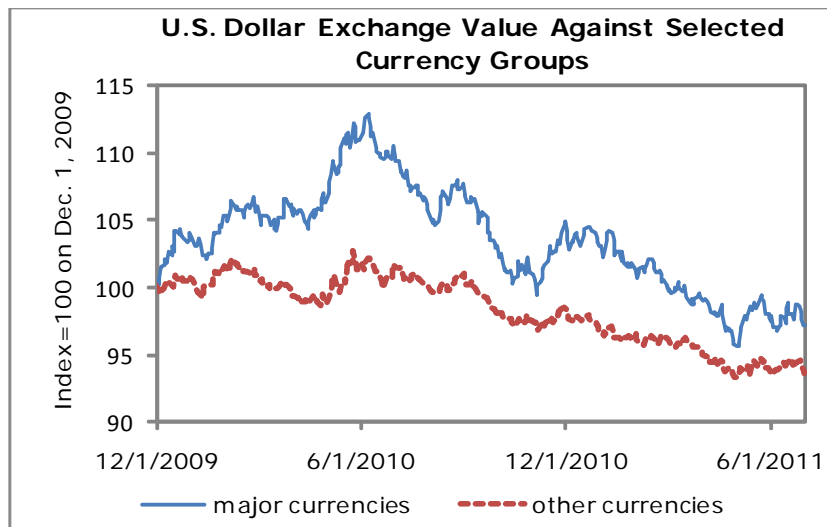
The dollar’s first-half slide against developed-market currencies exceeded our expectations. However, the dollar should find new strength against the euro, the pound, and the yen, whose economic growth rates should compare unfavorably to the U.S. pace. In this regard, European government austerity measures should come to weigh increasingly on economic activity across the continent. Monetary policy differences should also favor the dollar. In particular, slowing growth should limit the scope for rising European interest rates, while Japanese authorities may launch further quantitative easing measures to aid in earthquake reconstruction. If U.S. economic growth improves and U.S. bond yields rise, as we expect, the dollar should find new traction in the second half of 2011. Moreover, any deficit-cutting progress at the federal level could be a positive surprise for the dollar. Overall, sentiment on the dollar has been so negative that good news may matter more than bad news in the coming months.

The main risks to the base case are diverse and seem roughly balanced, which likely is the main reason for the small dollar exchange rate movements lately. For example, the dollar could strengthen significantly, if China’s economy unexpectedly slows sharply, or if worries about a Greek government default overflow to Lisbon and Dublin. On the other hand, the dollar could slide again, if China’s economy rebounds quickly and the debt issues resolve quickly and decisively. These alternative scenarios seem unlikely, but they are so different that market participants seem to be waiting for more information to develop an up-or-down consensus.

Investment recommendations under diverging dollar exchange rates

How the dollar and global markets break out of the current transition period may remain uncertain for a bit longer. Still, it is important to realize that global markets have been far more resilient in the face of this year's uncertainties than they were facing the same issues last year. Thus, we recommend a balanced approach during this transition period.¹ Investors should use take the present time to reassess their portfolio allocations across asset classes and match their U.S. and international holdings up (or down) to the percentage allocations indicated in our strategic recommendations. Investors should take particular care not to allow large positions in popular markets – gold, or equity positions in Brazil and China – to make international or commodity allocations larger than recommended. Concentrating in a few markets exposes the portfolio unnecessarily to volatility in those markets.

Looking ahead, diverging paths for the dollar are not necessarily negative for international markets. The emerging economies are still early in their expansions, and should quicken their pace again, as the transition period ends, to the potential benefit of their equity markets and commodities. Whether emerging-market financial assets ultimately look more attractive than those of developed markets may depend on two factors that remain unclear at present. A new round of European debt crisis contagion fears seems the main risk for developed markets, but an unexpectedly sharp slowdown in China's economy may be the principal risk to emerging markets and commodities. Investors whose portfolios are balanced should be well positioned to take advantage of any new opportunities that may arise as the transitional period fades.



Source: Bloomberg and Wells Fargo Advisors

Data Sample: Daily data, Dec. 1, 2009 - Jul. 1, 2011

major currencies index: A trade-weighted composite of U.S. dollar exchange rates against the currencies of major U.S. trading partners: the euro zone, the United Kingdom, Switzerland, Sweden, Australia, Canada, and Japan.

other currencies index: a trade-weighted composite of U.S. dollar exchange rates against other important U.S. trading partners: China, Mexico, Korea, Taiwan, Hong Kong, Malaysia, Singapore, Brazil, Thailand, India, Indonesia, the Philippines, Russia, Saudi Arabia, Chile, Argentina, Colombia, and Venezuela.

¹ For more detailed information, please ask your financial advisor for a copy of our 2011 midyear economic and market outlook, entitled *Finding Balance in Today's Economy*.

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