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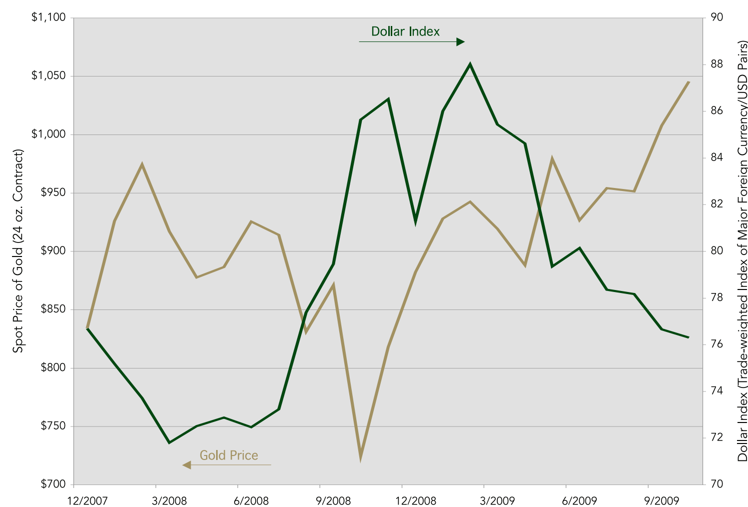
Economic Theme:
Demystifying the Dollar

One of the "holy grails" of economic forecasting is to create a statistically-valid model for forecasting the trend in the dollar's exchange rate versus other currencies. Among the several difficulties of this challenge is the fact that variables impacting the dollar trend tend to shift in importance over time. For instance, interest rate differentials might hold sway at one point, only to be supplanted by relative growth rates, or inflation rates, or current account deficits. Compounding the situation is the exchange rate activity of traders whose vested interest may be more short-term and less fundamental. From an asset allocation perspective, the dollar trend is important in that it affects the performance of dollar versus non-dollar assets, risky assets, such as emerging market equities, and commodities, such as gold and oil.

To our surprise and delight, we have recently found the "holy grail" of variables that explains three-quarters (76% R-squared) of the dollar trend since the start of the decade. This is a very gratifying statistical result given that the model is based on quarterly data which tend to be more volatile than annual statistics. The three variables that explain three-quarters of the dollar's (Spot Dollar Index) performance versus six foreign currencies since the first quarter of 2000 are described below:

1. **Treasury Note Supply/GDP** – rising Treasury debt means lower dollar and vice-versa
2. **Three-Month T-Bill Rate** – low short rates mean lower dollar and vice-versa
3. **Current Account/GDP** – increasing current account deficit means lower dollar and vice-versa



These variables are intuitively plausible from the standpoint that huge debt issuance and current account deficits tend to debase a currency, and easy money policy (low interest rates) signifies non-competitive investor returns and future inflation consequences. Regarding low interest rates, witness the current dollar carry trade wherein the low-yielding dollar is sold to fund purchases of higher-yielding currencies, commodities, emerging market equities, and other risky assets.

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So what does this imply for the dollar near-term? Even though the dollar index has experienced a not inconsequential fall of 10% from 1Q09 to 3Q09, we believe the immediate trend remains down. The Treasury will be forced to issue record amounts of debt to pay for fiscal stimulus programs and cover likely revenue shortfalls stemming from an anemic economic recovery. Economic conditions will require the Fed to maintain its zero interest policy for much of 2010. The current account deficit could show modest improvement as US consumption falters, and exports benefit from dollar weakness. However, this positive influence will not offset the aforementioned negatives. In the short run, we expect the dollar index to decline about 9% to 68 from 75 currently. The longer-term fate of the dollar will depend importantly on the extent to which the US can successfully complete the deleveraging process (higher savings, less debt) and get its fiscal house in order (lower budget and current account deficits).

It is clear that the financial crisis has contributed to the slide in the dollar in recent years. The crisis has also benefited gold in a major way, in our opinion. Gold has come to be viewed as a diversification alternative to depreciating paper assets such as the US dollar. Proof of this can be observed in gold's very strong inverse correlation to the dollar index between 1Q07 and 3Q09. During this period, the R-squared of this relationship has been 83%. The high inverse correlation contrasts with an R-squared of only 29% since the beginning of the decade. In the near-term, we expect the anticipated slide in the dollar will continue to accrue to the benefit of gold prices. On this basis, we believe spot gold can reach about $1,200 near-term for a gain of 9% from a current price of $1,103. Longer-term, gold might find support from ongoing diversification efforts of central banks, institutional investors and individuals; supply constraints reflecting the cost and riskiness of new ventures; and its resilience in both hyperinflation and

deflation scenarios. Risks to gold's performance include reversal of the dollar carry trade and jewelry demand. We have recently added gold as an alternative asset ETF and will be establishing a position.

Return Expectations

Three- and six-month returns for asset classes as of October 30 showed little change regarding the conventional wisdom as it relates to economic scenarios/regimes. Fixed-income returns were indicative of subdued inflation and increasing uncertainty, while equity returns were supportive of the V-shaped recovery, liquidity trade. International asset classes continued to outperform domestic asset classes. For the month of October, our overweight fixed-income position was beneficial in that this category outperformed equities by about 2.5% on a holding period basis.

We have adapted a more conservative outlook for prospective fixed-income returns based on supply considerations. While our view of the amount of supply has not changed, the Treasury will be issuing more debt in the 10- and 30-year maturity range to take advantage of low prevailing rates. Coincidentally, the Fed's massive ($1.3 trillion) bond purchase program will be winding down in early 2010. As a result, we believe the benchmark 10-year Treasury note will have difficulty breaking 3% on the downside and could trade in a range of 3.15% to 4.50% during the ensuing 12 months. We still favor the return outlook for fixed-income versus equities and international versus domestic.

ASSET ALLOCATION RECOMMENDATION

Our recommendation remains overweight fixed-income and underweight equities. We also have an international tilt versus domestic. Regarding new asset classes, we are planning to add a corporate credit component to fixed-income. Investor demand for yield should result in ongoing spread compression, and corporate bond issuance could be about 30% lower next year. As indicated earlier, we have also added gold to the alternative category. We recently eliminated the VIX position due to extreme volatility.

MARKET CLOSES		
S&P 500 Index – 1087.24	**Dow Jones Industrial Average** – 10,197.47	**10-Year Treasury Yield** – 3.44%

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