GOLDILOCKS, GREEN SHOOTS, AND THE US DOLLAR

 September 7, 2010

Scarlett O'Hara remarks in the film "Gone with the Wind" (1939): "After all, tomorrow is another day."

CONCLUSION

For major trends in the world economy and its equity, commodity, and interest rate playgrounds, observers should closely monitor the direction and level of the broad real United States trade-weighted dollar. Over the next several months, the world increasingly will worry about American economic sluggishness (or even decay). The globe will focus more and more on America's deficit problems rather than those elsewhere. In this process, the all-time dollar lows in the broad real trade-weighted dollar eventually will be challenged.

The dollar currently is relatively weak from the long run perspective. July 2010's 88.7 (the most recent monthly average) is only modestly above all-time lows around 84.0 (84.3 in April 2008, about 84.0 in July 1995 and 84.1 in October 1978).

CONSEQUENCES

Marketplace viewpoints are subjective, so the intertwining of marketplaces and the extent to which one marketplace leads or lags another are matters of opinion. However, significant stock and commodity trends of recent years apparently (even if often roughly) have moved together. As stock prices fell sharply, so did commodities "in general". Remember the mutual breakdown which preceded that recovery (S+P 500 final top on 5/19/08; broad GSCI peak 7/3/08 around 894). Noteworthy rallies in commodities have paralleled those in equities. Recall advances since the 2009 low (around 667 on 3/6/09) in the S+P 500.

Another very general guideline for the past few years relates to dollar movements in light of those in stocks and commodities. A strong US dollar has been tied to weak commodity and equity prices. A weaker dollar associates with a rally in stocks and commodities. The broad real trade-weighted dollar made a high at 97.1 in March 2009 as stocks hit bottom that month. As stocks gained traction and rallied, the TWD declined to 87.5 by April 2010.

Therefore note the S+P 500's recent top around 1220 occurred on 4/26/10- the time of the April 2010 TWD low, with the high in the broad GSCI not long afterward (556 on 5/3/10). Also take a look at early August 2010. Recall the coincidence of the minor high in the S+P 500 around 1129 on 8/9/10 with the broad GSCI's one of 547 on 8/6/10 (NYMEX nearest futures crude oil around $83 on 8/4) alongside a minor top in the Euro FX at 1.3334 on 8/6/10. Although the broad real TWD statistics for calendar August are not available yet, daily data reveals that the nominal TWD reached a minor low on 8/6/10.

For the near term, this existing pattern will continue. So emerging dollar weakness will initially encourage rallies in equities and commodities.

However, as the trade-weighted dollar substantially challenges its historic lows near 84.0, the so-called current rules of the game will change. That chapter in the dollar's dive will occur alongside weakness in stocks and commodities.

There are scenarios in which we could see a weakening US dollar "alongside" falling stocks and diving commodities. In the current environment, what if the US was unwilling to raise Federal Funds and related government interest rates as stock prices sank (watch around 1000 in the S+P 500), federal (and state) fiscal deficit levels and fears regarding them remained high, the US consumer balance sheet stayed weak, and foreigners diversified away from (or bought less of) US securities and other assets? What if central banks diversify from their dollar reserve holdings? What if there was another round of money printing by the Federal Reserve/Treasury, especially if accompanied by at least a bit of inflation in key statistics?

Relationships between the broad real TWD and stocks and commodities of course are not unchanging. We all recall the S+P 500's marvelous major peak on 10/11/07 at 1576. However, the TWD (which had been slipping since its February 2002 pinnacle around 113.0) fell alongside the achievement of that plateau in equities. It fell from September 2007's 90.5 until April 2008's 84.3. The era of 1986-87 is an instructive case where the dollar and equities (at least eventually) fell together. The TWD top of March 1985 around 128.4 preceded that of equities by over two years. However, the TWD kept declining as equities rose, falling clearly under 100.0 following July 1987, and then continuing downward. US stocks peaked in late August 1987.

As always, watch government and corporate interest rate levels and trends (including credit spreads) in the context of currencies, stocks, and commodities.

CONFIDENCE

"The best things in life are free
But you can keep 'em for the birds and bees
Now give me money (that's what I want)…
A lot of money (that's what I want)." "Money (That's What I Want)", by B.Gordy and J.Bradford

****

The worldwide economic crisis that emerged in 2007 and accelerated in autumn 2008 caused a mournful flight of the Goldilocks economy and its blissful rhetoric. Nevertheless, noble financial and political guardians in the United States and elsewhere performed dramatic deeds. Think of America's easy money via sustained low interest rates, a money printing parade, and a pageant of fiscal stimulus. Our saviors not only arrested economic decline and preserved the integrity of the financial system. They forced vicious economic bears to hide furtively in their forest. The substantial rallies in equity marketplaces since the spring of 2009, real GDP growth, and several other indicators are wonderful and encouraging green shoots displaying a recovery.

The International Monetary Fund's projections for world real GDP growth for the next few years indicate faith in economic recovery, and surely inspire hope among many marketplace watchers. Their "World Economic Outlook Update" (7/7/10; Table 1) states 2010 world GDP will rise 4.6pc (2009 fell .6pc), with 2011 up 4.3pc. In the April 2010 WEO, jumping out to 2015, clairvoyants predict growth of 4.6pc. The oracle indicates US growth of 3.3pc in 2010 (after 2009's decline of 2.4pc), with a further increase of 2.9pc in 2011 (up 2.4pc in 2015). The IMF's July Update forecasts Chinese growth at 10.5pc in 2010 and 9.6pc in 2011.

US corporate profits have spiked alongside the rally in equities. After tax corporate profits made their trough around $976 billion in first quarter 2009 (seasonally adjusted annual rate). By 1Q10, they had rebounded to $1.42 trillion, a 45.9pc increase. First quarter 2010's enthusiastic rate even exceeded 2007's lofty level (full year) of $1.32tr (2008 was $1.17tr). Though real GDP growth is wonderful, **there has been a vigorous quest to keep nominal GDP growing in the US and elsewhere**. Actual 2009 nominal GDP was $14.23 trillion (Congressional Budget Office), with 2010 forecast at about $14.67tr (and 2015 at $18.63tr). Nominal GDP increases of course tend to boost corporate profits.

The IMF predicts consumer prices in advanced economies up 1.4pc in 2010 and 1.3pc in 2011. The Fed likewise worries little about inflation. Does this mean that the good old days of modest (or even robust) economic growth without inflation are here to stay?

What other nations do with their policies and when- not just how America behaves- of course matters for the dollar. **And nowadays, many nations would like to depreciate their currencies- or at least keep them weak. This makes it difficult for the dollar to collapse.**

Nervous but no longer terrified, modestly clothed yet at least no longer wearing tatters, Goldilocks thus again manages to enjoy some porridge at the home and expense of the dreadful bears. However, several signs suggest that the bears are summoning their courage for another attack on the unwelcome intruder. The signals from the currency field intertwine with those from other landscapes.

CONCERNS

In "Uncle John's Band", the Grateful Dead sing: "when life looks like Easy Street, there is danger at your door."

****

Given that much of the worldwide and US economic growth for 2010 and 2011 derives from easy money policies and deficit spending, longer run real GDP results for the next several years (and even for 2011) may be not as glorious as the fairly sunny current forecasts. The longer run horizon for the worldwide economy and equities is becoming gloomier.

The generals of the world economy arguably have fired off most of their bullets. Low interest rates will continue to aid economic growth, but low nominal interest rates are old news on the current trading battlefield. The benefits of legislative stimulus programs are winding down. In addition, another round of quantitative easing by the Federal Reserve and its allies is less likely than before to bolster the economy and equities since that weapon already has been unleashed. Besides, another round of quantitative easing would warn of weakness (suggesting the terrors of very mediocre growth and even deflation) rather than confidence.

With the US 2010 election this autumn, it will be difficult to enact additional noteworthy financial stimulus soon. Will the current Congress or the new one extend some or all of the expiring tax cuts? The current gridlock probably will continue into the new Congress, especially given chances for Republican seat gains in the fall contest.

The recent (8/10/10) Federal Reserve FOMC meeting indicates increasing fears about the US economy. The FOMC stated: "Information received since the Federal Open Market Committee met in June indicates that the pace of recovery in output and employment has slowed in recent months….the pace of economic recovery is likely to be more modest in the near term than had been anticipated." The Fed continues to believe that "economic conditions…are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

Moreover, even the Fed admits the “Longer run” central tendency real GDP range is 2.5 to 2.8pc. Also, the Congressional Budget Office (August 2010; assumes no legislative changes) has US Real GDP for 2010 at 3.0pc and that for 2011 at 2.1pc, down from the IMF’s forecast. The next Fed meeting is 9/21/10.

Despite its somewhat optimistic growth forecast, the IMF fearfully cries: “Most advanced economies do not need to tighten before 2011, because tightening sooner could undermine the fledgling recovery, but they should not add further stimulus….Given subdued inflation pressures, monetary conditions can remain highly accommodative for the foreseeable future in most advanced economies.” (July 2010 Update).

If economic fields are full of robust plants with deep roots, or likely to be full of such vegetation soon, why worry about raising interest rates a bit or otherwise engaging in significant so-called exit strategies? Are policy makers more worried about economic tragedies than they confess?

In the US, Europe, and elsewhere, deficit troubles worry central bankers and finance ministers and a few politicians. Yet there’s a dilemma. Suppose governments rein in their deficit spending. Won’t that slow down economic growth for the near term? To what extent will that undermine stock marketplaces?

The CBO indicates the 2009 US federal deficit as a percentage of nominal GDP of 9.9pc is the highest in the past 65 years. As for 2010, it is little healthier at 9.1pc, with 2011 at 7.0pc. However, the CBO proclaims the shortfall will diminish to 4.2pc in 2012, 3.1pc in 2013, and 2.5pc in 2014. But what if the tax reductions enacted earlier in this decade, scheduled to expire at the end of 2010, are extended? Deficits will deteriorate relative to the existing forecast. Also, the CBO projects annual real GDP growth of 4.1pc for 2012-14. This seems rather optimistic given historic growth trends and the current economic situation.

Despite the rally in US equities since the spring of 2009, US consumer balance sheets (net worth) remain weak. US consumer net worth wilted about $16 trillion from its 2006/2007 tops to the 1Q09 low. This dismal decline exceeded one year’s US nominal GDP. By the end of 1Q10 (the most recent Federal Reserve Z.1 data), net worth had risen only $6.3 trillion from the 1Q09 depths.

Sustained high unemployment is no mere scarecrow. The US August 2010’s headline number was 9.6pc, the broader level 16.7pc. **In the US and elsewhere, weak residential and commercial real estate prices clearly worry financial sheriffs.** The July 2010 inventory of existing US homes spiked to 12.5 months, way up from June’s 8.9 months. **Relatively elevated commodity prices** obviously do not plant seeds of economic growth in the US and most of the rest of the world.

Money supply statistics are a challenging variable. However, given the substantial increase in the US monetary base since August 2008, modest recent M2 growth hints that the economy is not growing too strongly. US M2 has grown only two pc from July 2010 versus July 2009. Recall the worsening of the economic crisis around mid to late summer 2008. The US monetary base peaked in February 2010 at about $2.1 trillion, 2.5 times the $843bb of August 2008. The current monetary base level remains high, at around two trillion dollars.

Does this modest M2 growth, in light of other factors, make some regulators somewhat fearful of deflation? Yet the huge increase in the monetary base arguably remains an inflationary factor.

US government bond yields have fallen from around four pc in spring 2010 to about 2.5pc now, not much above the yield lows of end 2008 of about two pc. Does this signal that the economy will grow slower than desired (or that recessionary blight will return), or that deflation looms? In the interest rate garden, **widening credit yield spreads between governments and lower grade corporates** can warn of or confirm equity marketplace price weakness. US 10 year yields made a low against a 10 year US BB industrial corporate bond index on 4/27/10 around 395 basis points- about the day of the recent equity high.

CURRENCY CONSIDERATIONS

In the views of some policy makers a weaker dollar could be a very useful instrument (at least up to a point) in the financial toolkit.

It's no secret the US nation has big debts. Part of the creation of the joyous Goldilocks economy derived from a determined desire and easy ability to borrow, particularly by Americans. Anyway, debtors like it when it costs them less to pay off their obligations to creditors. **All else equal, if you owe a foreign creditor money denominated in your home (national) currency, depreciation of the value of your currency makes it less costly to satisfy those existing obligations.** Admittedly, some creditors may want to receive a higher interest rate to keep loaning the debtor money.

Everyone knows that a depreciating currency often can encourage a country's economic growth via a substantial increase in exports relative to imports. For the US, despite the recovery, not only does its fiscal deficit problem loom large, the current account deficit nevertheless remains notable. Though much narrower than 3Q06 peak at about $214.5bb, it has not evaporated. In 2Q09, it was $84.4bb, the lowest since 3Q99; 1Q10's was just under $110bb. Though the increased deficit for 1Q10 perhaps is a sign of economic recovery, its level is still worrisome for a nation with substantial indebtedness.

The US government and its regulators may prefer to take currency and inflation risks rather than suffer a renewed economic downturn (or disaster) and social unrest. Recall the 1970s and equity trends. The TWD fell from January 1973's 107.6 to October 1978's 84.1.

The IMF's Currency Composition of Official Foreign Exchange Reserves data (COFER; available for years from 1995 to the present) **manifests danger signs for dollar bulls. From this perspective, dollar holdings have become increasingly less desirable in recent years.** Claims in US dollars as a percentage of allocated reserves is a noteworthy statistic. For the world as a whole in 1995, a year in which the US dollar made a major low in broad real trade-weighted terms, that pc (at year end) was 59.0pc. At end 2001, it had risen to 71.5pc; remember the major high noted above in the TWD for February 2002 and the long run decline since then. Despite the periodic squawking about how the US wants a "strong dollar", this percentage of dollar reserve holdings has generally fallen since end 2001. At end 2004 it was 65.6pc, at end 2007 and end 2008 64.1pc, with end 2009 62.2pc and 1Q10 61.6pc. At end 1Q10, advanced economies held 64.6pc of their official reserves in dollars, whereas the emerging and developing category had only 58.0pc in the greenback.

Assume the US keeps adding substantial sums to its debts. Unless American institutions and individuals purchase an increased quantity of Treasury (and agency) securities, foreigners will have to keep buying them at a notable pace**. Suppose foreigners become increasingly unwilling**

to buy US debt obligations (or that they even become net sellers of those they own); that will tend to weaken the dollar. Some Treasury statistics (TIC data), though they lag the current date by several months, give additional insight into currency issues. Mainland China's holdings of US Treasury securities (including T-Bills) fell to about $844bb in June 2010 (the most recent month) from April's $900bb. Overall foreign official holdings of Treasuries were $2.72tr in 4/10, dipping to about $2.70tr in 6/10. Also note that foreigners were slightly net sellers of US equities in May and June 2010, an ominous sign for equities if this continues.

Will the US economic role in the world decline relative to recent levels? The US share of world GDP for the past several years has tended to be a bit over twenty percent. Will this level erode if nations such as China, India, Brazil, and many other nations continue to expand much more substantially than America?

Think not only of China's growing role in the world economy. **Take a look at currency weights for China in the TWD. The US should be careful what it asks for in regard to a significant revaluation in the Chinese currency versus the dollar, for the TWD already is not far from historical lows.** For 2010, China's trade weight is 17.9pc, up sharply from 10.5pc in 2002 (and 5.7pc in 1995). China currently slightly exceeds the Euro area's 17.8pc (which was 18.5pc in 2002).

Keep an eye on foreign direct investment in the US. In calendar 2008, it totaled about $328bb. It fell to around $134bb in 2009, with only about six billion dollars in 1Q09 as the equity marketplace made its lows. The US needs a fairly strong economy- and a dollar that is not collapsing- to encourage this investment. The 1Q10 direct investment annualized equals about $189bb.

Gold's current lofty heights reflect numerous factors, including concerns about currency depreciation in general, not just that of the dollar. However, given the dollar's role in currency marketplaces, sustained strong gold prices are a bad omen for the dollar.

****