
GREENWOOD REPORT

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WHAT A DIFFERENCE A YEAR MAKES

The end of the third quarter marked the first anniversary of the cataclysmic failure of Lehman Brothers and the collapse of the credit markets. There are a number of significant dates in everyone's life that warrant reflection, renewal, and often resolution. New Years, Anniversaries, Birthdays, and major historical events have typically been the most common. Investment professionals will add September 15th to the list. It is not our intention to use this commentary to provide a summation of what occurred. Much has already been written on this topic and we have spent hours understanding, debating, and learning from the crisis (for more reading see "Eight Days" by James B. Stewart in the 9-21-09 New Yorker). Now we *look ahead* at the changing global economy and its impact on future investment opportunities.

THE FUTURE OF THE U.S. DOLLAR

A successful investment strategy requires knowledge and understanding of three elements: economic analysis, security analysis, and portfolio management. Step one in this process, economic analysis, is essential to understanding factors that affect the investment environment. Technological innovation, demographics, and structural changes in the global economy are the primary long-term determinants in economic analysis. These factors are magnified in times of high volatility, uncertainty, and market dislocation. During crises, the condition of the global economy impacts *all* investments – a lesson re-taught over the last two years. However, economic change also presents opportunity, helping uncover new investment ideas.

Currently, the world economy is experiencing one of the most rapidly changing periods in modern history. This change is illustrated by a retiring baby boomer population in the United States, unprecedented growth in emerging markets, technology in the digital age, nuclear threats, terrorism, environmental concerns, and U.S. dollar weakness to name a few. The topic-du-jour is the U.S. dollar and its all-important place as the world's reserve currency, facilitating global economic activity.

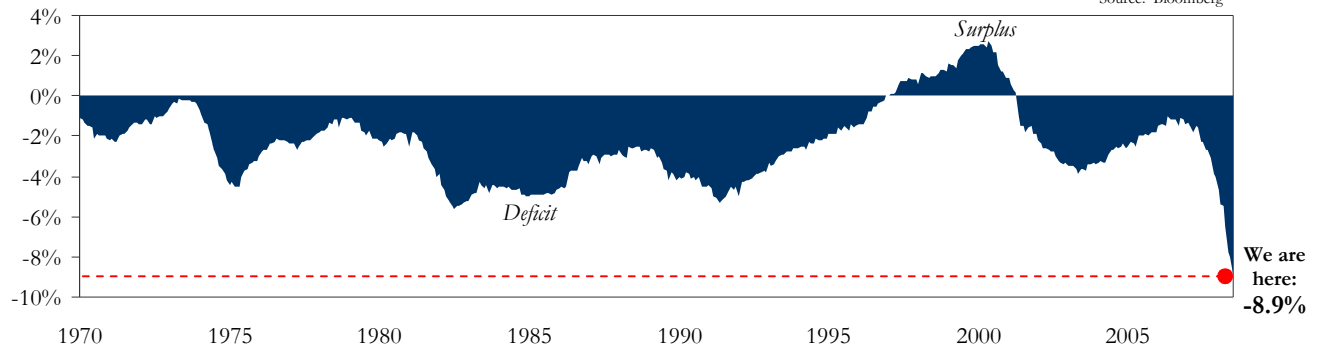
To fully understand what's at stake, it's important to review some definitions. A *currency* must satisfy the accounting, transaction, and investment functions for an issuing nation. A *reserve currency* is currency held in significant quantities by governments and institutions as part of their foreign exchange reserves. Importantly, it is the international pricing mechanism for products traded in the global marketplace, most especially oil. Holding large quantities of a reserve currency can lower the cost of doing business internationally as governments do not have to borrow and pay transactions costs each time they purchase a commodity denominated in a particular currency. The U.S. dollar has been the primary reserve currency since the end of World War II.

Recently, the dollar has come under scrutiny as the world's reserve currency due to the massive quantitative easing by the U.S. government to help stem the global financial crisis. The government's policy, while necessary, has flooded the market with dollars, thus potentially reducing each existing dollar's exchange value. China is perhaps the most vocal critic of this policy as they are the largest foreign holder of U.S. Treasuries (approximately \$800 billion), accumulated through years of exports to America. Their trade surplus has resulted in their dollar surplus. With an increasing budget deficit (currently 8.9% of GDP – see graph), the U.S. government's reputation for financial integrity is under the microscope.

US TREASURY FEDERAL BUDGET AS A % OF NOMINAL GDP

12-31-68 thru 6-30-09

Source: Bloomberg



The issues with the dollar go way beyond just an exchange rate and weakening currency versus other world economies. Because it is intertwined with the global financial system, the dollar's value impacts every country in the world, posing an inflationary risk if not managed prudently. Take the lessons of the 1970's. In 1971 the U.S. abandoned the gold standard and other industrialized nations soon followed suit. No longer pegged to gold, the U.S. increased the money supply to accommodate worldwide transaction demand to fund oil purchases. This expansion, without sufficient corresponding economic growth, effectively caused the dollar to depreciate versus other currencies. Simultaneously, the price of oil skyrocketed, tripling twice, which caused the demand for dollars to increase even further. In the 1970's the United States paid the price of inflation for the rest of the world, in part, by expanding its money supply to facilitate oil transactions.

With the Chinese generating attention on the issue, a new idea has been proposed: replace the dollar as the reserve currency with a basket of currencies managed by the International Monetary Fund. The basket might consist of, for example, the U.S. dollar combined with the Chinese yuan, the euro, the British pound, the Japanese yen, the Australian dollar, the Brazilian real, the Russian ruble, the Indian rupee, the Mexican peso, and the list goes on. But are these currencies prepared to take on worldwide transaction demand for oil and other goods the way the U.S. wasn't in the 1970's? Would this just push inflation onto the global economy? Would participating governments lose control of their use of monetary policy due to the exponential increase in their money supply? These questions only can be answered over time, but they are fundamental to the current debate.

The dollar *is* under pressure, no doubt about it. It shouldn't be surprising, however, that it will continue to weaken *relative* to other currencies. It does not take a weakening dollar for other global currencies and economies to strengthen. The dollar will remain the dominant currency in global finance because it satisfies, better than any rival, each of the criteria that bring confidence to global currency. It serves the accounting function, the transaction function, and the investment function for the world. Additionally, it is issued by the country with the combined most social stability, political stability, economic stability, and strongest military in the world. If none of the aforementioned currencies can fulfill all of these qualities individually, can they do so collectively in a "basket"?

This debate will intensify as the United States' debt continues to balloon with two wars, health care reform, and a (albeit slowing) financial crisis. The world's central banks are already beginning to diversify their reserves into alternative currencies with the goal of limiting their concentration risk to the U.S. dollar. As the world changes, a new dynamic may emerge. For example, central banks and private holders of large dollar balances could choose to purchase hard assets that hedge inflation, like gold, oil, and real estate. The Japanese chose real estate (i.e. Rockefeller Center) in the 1970's but, to their chagrin, it too was subject to depreciating value. Given these impending shifts, the United States may spend the next decade defending its position as the world's currency of choice. However, we believe the U.S. dollar will show its resiliency and relevance in the face of change.

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