

Current Thoughts on the Dollar

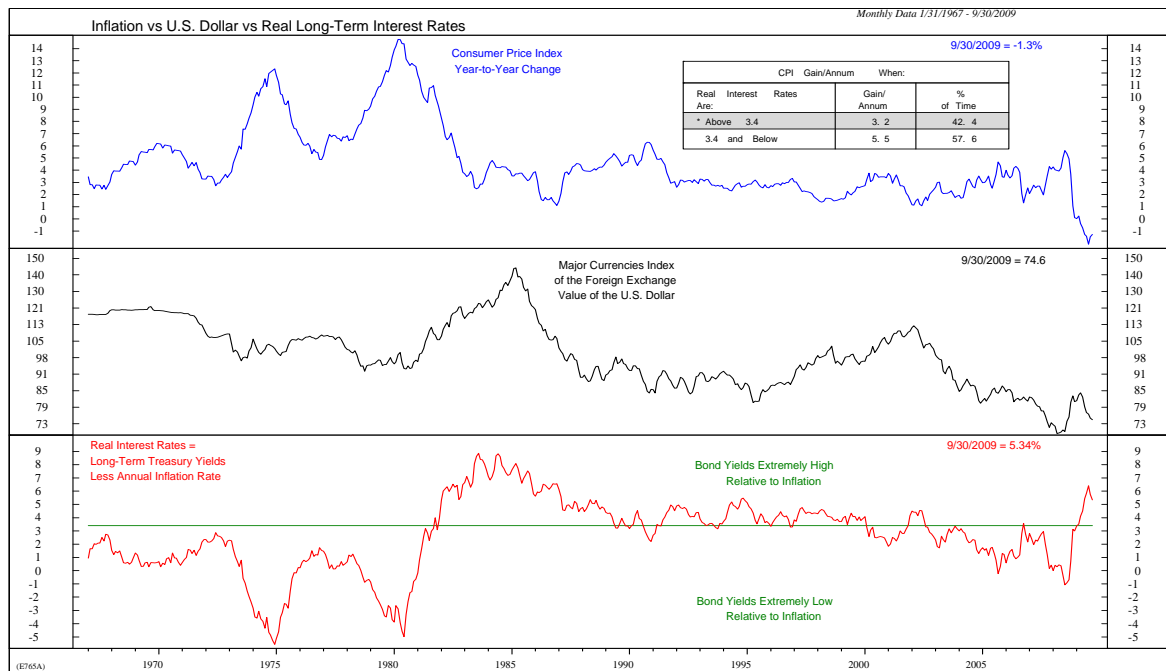
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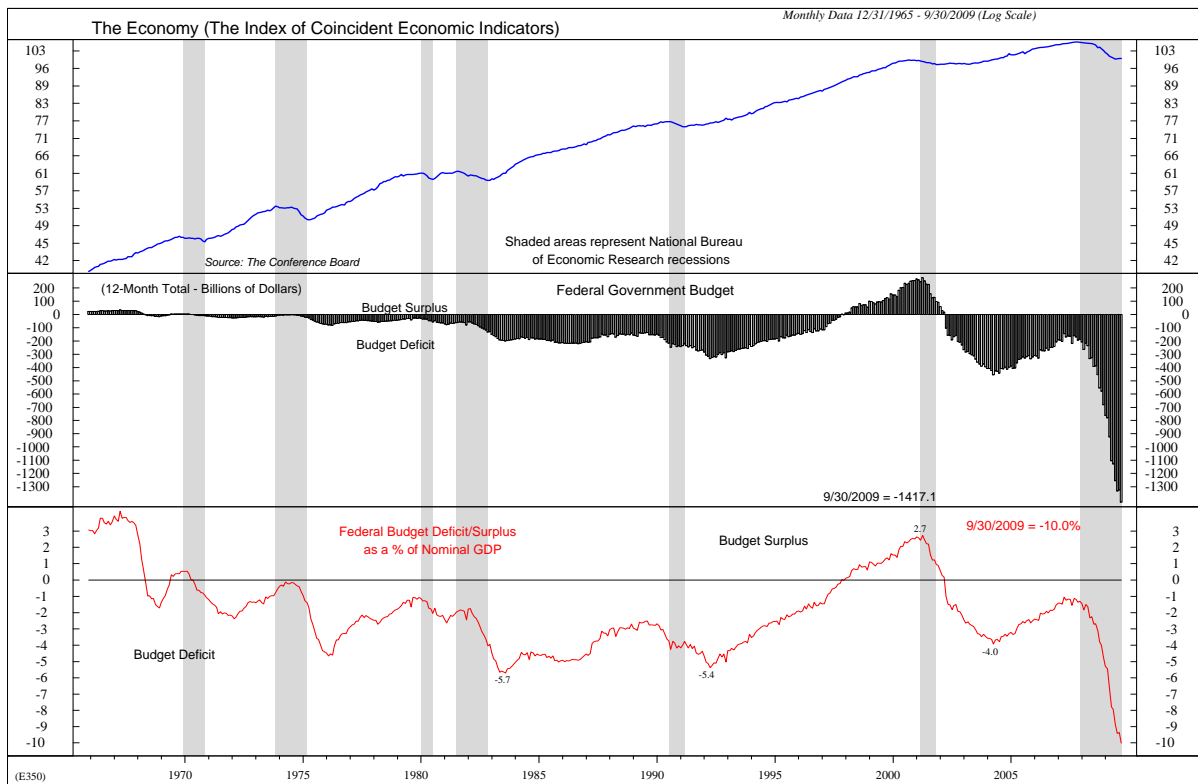
At the present time, there seems to be widespread concern over the value of the U.S. Dollar. Foreign investors are worried about the value of their investments and domestic investors worry about the potential impact on inflation that a weaker dollar would have. About a year ago, concerns about market events translated into significant market disruptions, the likes of which have not been seen for some time. The pain caused by these events might make investors more likely to overestimate the likelihood of current market concerns translating into significant market disruptions in general, and overestimate the potential behavior of the dollar specifically.

One source of the recent concern is the accelerated drop in the dollar over the last 9 months. Most of the accelerated drop is explained by a reversal of the ‘flight to quality’ investment into the dollar last year. This reversal has happened to coincide with much larger budget deficits and concerns over governments view towards future spending.

The chart below shows the value of the dollar vs. a Major Currencies Index by Ned Davis. You can see in the center box the steady decline over the 2002 to 2008 time frame, and the spike in value starting in 2008. The reversal that we have seen over the last 9 months has brought the value of the dollar roughly to where it was at the beginning of the crisis.

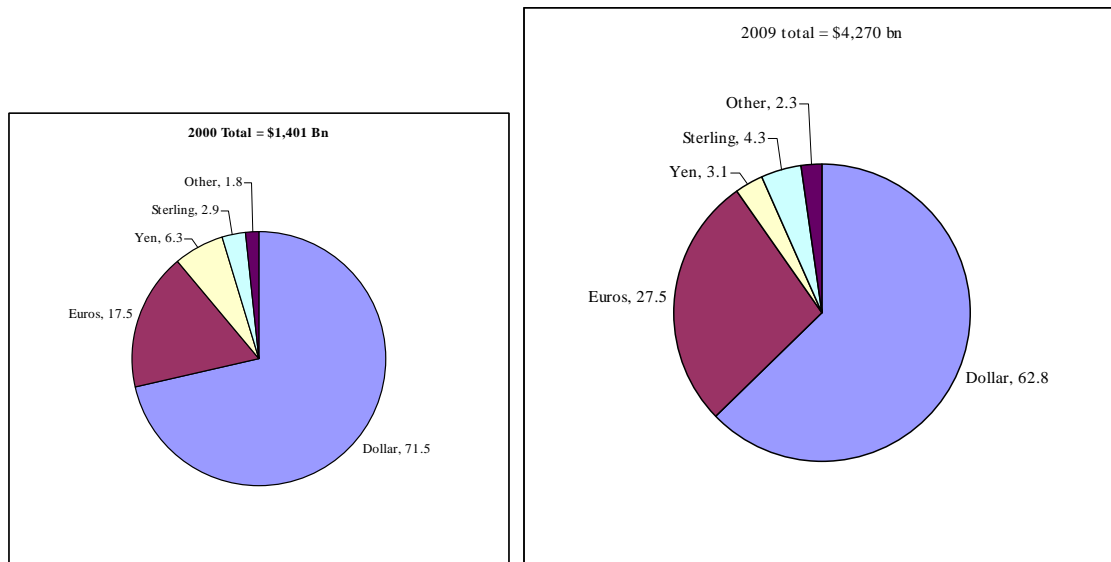


We believe that the longer steadier decline has reflected the budget and trade deficits over this broader time period. The center box in the following chart shows how the budget deficit has grown and the current heightened level.



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The size of the recent deficit and forecasts for continued near term deficits have coincided with the recent dollar decline stoking fears of a near term dollar collapse. We tend to believe that continued trade and fiscal deficits will support continued, reasonably paced weakness in the dollar. We do not believe that a dollar collapse is imminent. There is an orderly shift occurring in the global economy in currency reserves.



Sources: Thomson Reuters Datastream; Barclays Capital; IMF; Financial Times

Dollar reserves as a percentage of total reserves have for a long time been higher than you would expect if you just looked at the U.S. economic output as a percentage of global output. This is what is meant by a reserve currency. There are investors and economic agents around the world that insist on transacting in dollars or keeping reserves in dollars because of its liquidity and safety. The dollar's status as a reserve currency creates more demand for dollars than would otherwise exist. To the extent that the liquidity and safety attributes of other currencies increase, it would be normal that the demand for those currencies would increase, and that their share of global reserves would increase. This is what is happening, and I agree with those who expect this to continue.

In any short term period, however, events could occur globally that would result in another period of 'flight to quality' into the dollar. These short term moves can be abrupt, unpredictable and can cause losses in portfolios that are positioned against the dollar.

The long term challenges for the dollar are clear. Current trends of deficit spending are not sustainable. Investors should be cautious about aggressive bets against the dollar, however, because of the losses possible in such strategies. The magnitude of potential losses stemming from these potential events should be in line with the risk tolerance of the investor. At one level exposure to non-dollar assets is prudent. At another level it can become speculative.

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