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The Value of a Dollar

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QB Partners

When most investors think of the US dollar, they usually think in terms of its value relative to other global currencies. Certainly its 30% decline over the last five years indicates US economic weakness versus other economies. [1] This is only indicative of a larger story, though.

We assert that the US dollar's decline in the foreign exchange market is not merely cyclical weakness, but a sign of the dollar's diminishing role in an emerging new world order. We argue the US dollar will ultimately lose its status as the world's reserve currency. In fact, we believe events currently unfolding may be foreshadowing the dollar's eventual demise and replacement.

Our rationale is premised on our strong conviction that substantial new supplies of dollars and credit are overwhelming organic commercial pricing functions on a global basis. A negative US savings rate and record public and private sector debt are forcing US policymakers to stabilize goods, service and asset prices in the US by increasing the money stock and by promoting credit expansion. This dramatic dollar dilution has begun to encourage foreigners to replace their US dollars and to seek revenues and assets elsewhere. Meanwhile, foreign central banks are creating increasing amounts of their currencies and credit, which is further increasing global liquidity and influencing global goods, service and asset pricing.

The changing supply and demand dynamic of money and credit is the primary analytical framework from which all investment values should derive over time.

We assert that consistently excessive money and credit growth has taken the US economy past the point of no return. We think policymakers have been grappling with an economic Sophie's Choice: should they constrict money and credit growth to save the US dollar or continue to promote the enlargement of public and private sector balance sheets in order to support US assets prices? We argue that what they have done consistently - and will continue to do - is to inflate the money supply and promote more credit, thereby sustaining asset prices at the expense of the purchasing power of the US dollar.

What emerges from this repeating, predictable pattern is this: the chief determinant of global asset values in the months and years ahead will be the pace of investors' recognition as to the importance of nominal versus real returns. As this becomes absorbed by the markets, ever larger nominal asset prices will not necessarily be mistaken for value. Based on this perspective, investment opportunities abound from both the long and short side.

Our conviction was developed through years of rigorous economic research coincident with our primary roles in global debt and credit markets.

History

Following World War II, the US and its allies used US dollars to help finance the re-construction of decimated economies. International economic participants - including commercial enterprises and global investors - sought profits from rebuilding the global industrial complex. They converted their currencies into dollars with which to invest. The US dollar became the lone and perceptibly stable currency used in the vast majority of global trade.[2] Ongoing commercial and monetary transactions (as well as profits from them) were kept in dollars. With the help of global capitalism and US dollars and credit, Japan and Western Europe re-built their economies into economic powerhouses and their currencies, by virtue of their eventual peg to the dollar, slowly regained respectability.

[1] DXY Index – March 2002 to March 2007; Bloomberg
[2] In 2002, it was estimated that US dollars comprised about 75% of global reserve currencies. Today, it is estimated that figure is about 62%.

This wasn't luck. It happened because post World War II US leaders applied a healthy dose of their recently earned moral suasion to expansionist monetary and fiscal policies. The US was able to distribute enough of its currency and credit to global banks, businesses and investors seeking profits from reconstruction. The credibility and creditworthiness of US dollars were the grease that made reconstruction possible. The US's role as the world's financiers was solidified because its currency was accepted by all global economic participants. Since then, the health of the US dollar has been at the center of world trade and geopolitics.

The US economy, which also had to be re-built following the war, was also able to absorb extraordinary money and credit expansion. Through legislation and tax policies, policymakers were able to direct where the new liquidity went (i.e. GI Bill, home mortgage interest deductions, energy tax credits, etc.). The supply of US money and credit grew so much in the 25 years following the war that it eventually outgrew the US's gold stock ostensibly backing it by a wide margin. Global holders of US dollars became so uncomfortable with this that they began to demand gold in exchange for their bloated US dollar holdings. In 1971, these pressures mounted to such an extent that the US dollar became a fiat currency – no longer backed by the US's gold reserves. [3]

The consequence of the US dollar becoming a fiat currency was profound. Policymakers had formalized their ability to print as many US dollars and promote as much credit as the market would bear. [4] And they did.

* * *

By the late eighties, American manufacturing competitiveness was already in decline, due in large part to years of less expensive imports from Japan. Global productivity had been improving consistently and there was (or was soon to be) excess global industrial capacity from the economic opening of China, India, Southeast Asian countries and the Soviet bloc. The new emerging economies posed an even bigger threat to the US manufacturing base. Left to its own devices, globalization per se would paradoxically leave no economic justification for balanced trade of goods and services between the US and its historic trading partners. US policymakers faced a daunting task to help maintain US manufacturing output and jobs.

They were lucky. Though the US's industrial competitiveness was being threatened with eventual obsolescence, America's *financial infrastructure* was undergoing a renaissance. Recent developments had given the US the ability to design, create, market and distribute money and credit in almost boundless quantities:

- The fiat status of the US dollar formally permitted the Fed to distribute limitless amounts of money and credit. [5] (First, during FDR's administration, officially in 1971 [6])

- US bank disintermediation following the S&L crisis promoted the dissemination of credit risk from bank balance sheets to capital markets. Banks evolved into credit marketing

[3] The word "fiat" is derived from Medieval Latin meaning "let it be done". In monetary circles, it is often used derisively as an arbitrary government order, proclaiming that its citizens use the uncollateralized paper or "fiat currency" without questioning its intrinsic or lasting value.

[4] Controlling the currency supply works as follows: The Treasury issues notes, which the Fed purchases and then credits to Treasury's account with freshly minted electronic dollars. Treasury then distributes these dollars into the economy through the political appropriations process. The Fed creates money in three ways: 1) It buys Treasuries directly and credits the Treasury's checking account, 2) It "lends" money through collateralized repurchase agreements and, 3) It buys Treasuries in the open market and credits the account of the seller with electronic dollars. The result is usually more dollars in the system.

[5] The Treasury issues debt, which the Fed buys in the open market and pays for with newly created dollars.

[6] Jordan Roy-Byrne; www.trendsman.com/v1/members/archive/pdf/269852696_AmericanInflation2.pdf; "The country was on a strict hard money standard until it was first significantly altered by FDR during the Great Depression. He outlawed ownership of gold and baited citizens into turning in their gold. The government's ownership of increased quantities of gold allowed it to devalue the dollar by 66% and thus, institute the New Deal programs. Following World War II, as per the Bretton Woods agreement, nations maintained a fixed price of their currency in terms of gold. This agreement fell apart when President Nixon took the US off the gold standard. He had little choice as foreigners were draining the country's supply of gold, in exchange for their paper dollars."

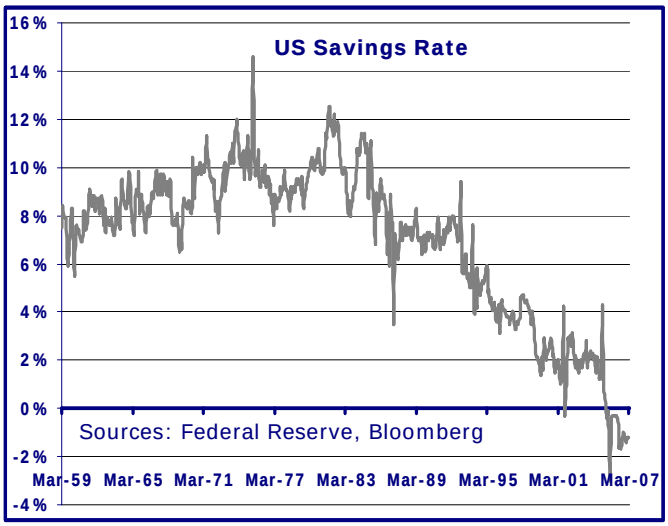
agents with healthier – and expandable - balance sheets.[7] Disparate institutional investors became collectively responsible for credit decisions. [8] (Early '80s)

- Digitalization had increased the capacity of financial transactions, bringing real-time quotations and settlement abilities to investors across markets and domains. (Mid '80s).

- The popularity of finance degrees from US business schools flourished, which engendered imagination, creation and acceptance of new financial products. (Mid '80s)

- The broad acceptance of asset securitization and off-balance sheet derivatives allowed Wall Street to disseminate financial risk and opportunity to global investors based on specific investment objectives (Mid to late '80s).

Though it would be easy for the US to exploit its new financial capability given the insatiable need for money and credit and the US Dollar's status as the world's reserve currency, the opening of formerly closed economies presented a strategic quandary for US policymakers. On one hand, the US could distribute enormous amounts of liquidity to emerging economies to help them grow while simultaneously giving US businesses and investors a competitive global edge (by funding them too so they could gain global market share). On the other hand, by providing emerging economies with US dollars and credit, policymakers would quicken the pace of US industrial obsolescence.



But beyond the obvious concerns about the US industrial complex, there were far greater, less obvious implications from providing easy money to global markets. If done to excess over a prolonged period, easy money would ultimately lessen the US's *financial* competitiveness too.

Here's how: The prolonged dilution of all outstanding dollars that naturally accompanies money and credit creation would cannibalize any existing US savings. Savers would have incentive to replace their saved dollars with investment assets experiencing price inflation. The more the savings rate declines, the greater the pressure on assets – commercial, financial and real estate - to produce positive real returns. Otherwise, maintaining speculative asset positions would have no economic justification. The accompanying graph shows the US savings rate over the past 48 years. Its decline coincides with US asset growth. The US savings rate is now negative.

We will not quarrel with the popular notion that today's "savings" are held in financial and real estate assets. Accepting this premise, though, demands that we accept the notion that assets are where *all* of today's liquidity is (since the savings rate is negative). Accepting this premise, in turn, demands that we accept the notion that *all* US liquidity is marked-to-market each day. Accepting this premise, in turn, demands that we accept the notion that policymakers can only provide liquidity to the system by protecting against a reversal in the upward trajectory of asset prices. So, despite all their protestations to the contrary (or whether they know it or not) policymakers are targeting asset prices ("The Fed Put"). [9]

[7] The Fed provides a borrowing facility (repurchase agreements) to member banks and brokers, which liquefies the capital markets. (The Fed also determines margin and bank reserve requirements.)
[8] The vast majority of these investors are judged by investors on the basis of relative, not absolute performance, meaning credit decisions are ultimately determined by relative performance metric.
[9] Digression: Whether government bodies should play a role in managing the economy and then do so by manipulating the value of private property is continually debated among investors, but rarely among policymakers.

* * *

By printing too much money for too long, which encouraged debt accumulation, asset growth and drove down the savings rate - policymakers now find themselves in the awkward position of having to sustain asset price growth. To sustain asset growth then, (economic liquidity), policymakers have to print even more dollars and promote even more credit. The antidote for falling prices of goods, services or assets – from organic competitive commercial forces - is to synthesize price stability by putting more money and credit in circulation.

There is nothing magical about the relationship tying money and credit to price levels. More dollars in circulation means all numbers shift higher. The greater the money stock, the greater nominal revenues, expenses, salaries, incomes and federal tax receipts. The greater the money stock, the greater the nominal prices of goods, services and assets. The greater the money stock, the less onerous the principal amounts of outstanding public and private debt.

Nominalization is institutionalized. Numbers simply get bigger – as they always have since the Fed began to inflate the money supply in 1913. [10] The US dollar has lost 95% of its purchasing power since then. We are not arguing a radical position.

So what's the problem? Can't policymakers simply keep inflating the money supply, thereby liquefying the asset markets and reducing the burden of current debt holders? [11]

We don't think so. Should the dollar-based numbers that define the US economy get too large relative to US savings and to global output, as defined in non-dollar terms, then the creditworthiness of the US government and of US commercial enterprises, consumers and investors would begin to deteriorate relative to those in non-dollar economies. US trade would slow, as would foreign funding of US debt. Gone would be the ability for policymakers to nominalize everything.

Since Americans have no savings and are invested almost 100% in US dollar-based assets (or assets valued based on receiving mostly dollar-based revenues), US revenues would slow and US asset values would lag non-dollar asset growth.[12] (This trend can be seen today in the US stock market, where companies that produce increasing percentages of their revenues in emerging markets are being rewarded.)

As the dollar goes, so goes the US economy. The US – with its base currency also the world's reserve currency – is not able to insulate its economy from the rest of the world. Sustaining the US economy now relies on maintaining the hegemony of the US dollar at the same time policymakers are devaluing it to the rest of the world (by diluting it through issuance). Is it reasonable to assume that the dollar can sustain its global hegemony as it is being quickly devalued? Will foreign central banks, businesses and investors stay loyal to the US dollar regardless of its relative value? Have US policymakers already gone too far?

*** * ***

The graph on the following page shows the growth in US M3 - the broadest measure of the money supply - over the last forty years.[13] The supply of US dollars and credit grew over 10% per year from 1995 to 2005.[14]

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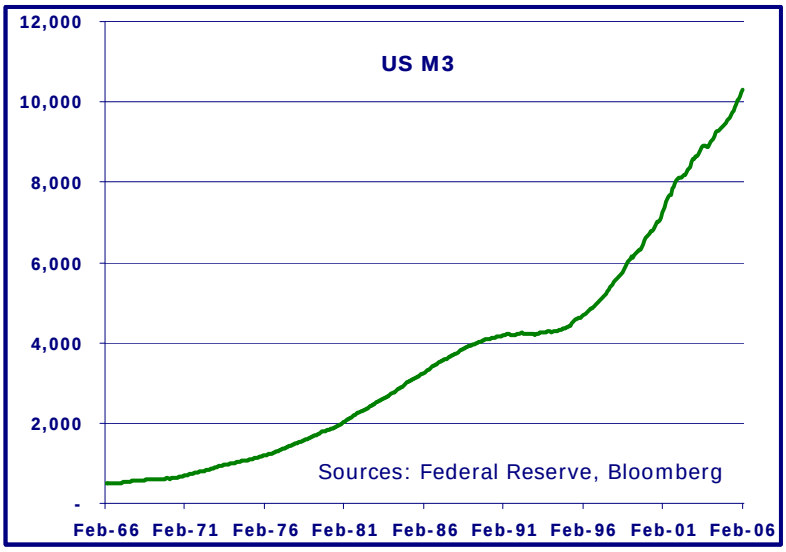
[10] The one time the Fed contracted the money supply was in 1929, when the money stock shrunk by one-third. Current Fed Chairman Ben Bernanke made his reputation by researching and analyzing the relationship linking money contraction in 1929 and the economic contraction that followed.

[11] As current Fed Chairman Ben Bernanke said in 2002; "But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

[12] Revenues generated abroad represent only 30% of total S&P 500 revenues.

[13] The Fed ceased publishing M3 in February 2006. M3 was the only monetary aggregate that included repurchase agreements, which is a key mechanism through which the Fed provides Wall Street banks and

Additionally, black market dollars - hoarded for decades - finally entered the global system following the demise of communism in China and the Soviet bloc. The rate of dollar inflation and the attendant diminution of the purchasing power of a saved US dollar far exceeded the published percentage rise in popular price baskets (CPI, PCE deflator).[15] (Please see graph on page 13.)



We presume the voracious demand for capital from emerging economies led US policymakers to "kick the can down the road" – to print excess dollars today in the hopes of developing thoughtful policies tomorrow that would enable the US to somehow transition its economy. Policymakers must have concluded that growth in the finance-based US economy – including jobs, output, consumption, etc. – would have to rely temporarily on shuffling dollars and credit to emerging economies and private enterprises seeking profits in them.

Aided by the US's financial capabilities and a free-spending government, the Fed liquefied the US equity and debt markets – including residential and commercial mortgage-backed and asset backed markets. [16] Credit became readily available to US investors, homeowners, consumers, commercial enterprises and real estate developers. Easy money created fuel for US consumers to buy goods imported from emerging economies. Increasing consumption drove asset growth higher, which in turn drove output growth and employment.

In effect, US policymakers helped make it easy for US consumers and investors to grow their balance sheets, which drove the global economy, in turn fueling even higher US asset prices. It appeared to be a virtuous cycle characterized by ever increasing dollars in circulation and the attendant increase in credit, debt and asset prices – promoted by policymakers, encouraged by financial intermediaries and enjoyed by US consumers and investors in financial assets.

* * *

brokers with credit. The financial intermediaries then pass on the credit to market investors, who in turn fund asset, consumer and homeowner borrowing.

[14] M3; US Federal Reserve

[15] Digression: The CPI is simply a basket of goods and service prices that change in composition and emphasis according to the best estimation of the Bureau of Labor Statistics. It may capture a relatively accurate loss of purchasing power for people living from paycheck to paycheck that spend all their wages on its mix of necessity and quasi-luxury items. However, we don't think it captures the loss in purchasing power of an *ambitious dollar* – one owned and earmarked to provide equal or greater spending power for other items at a later time. Like the CPI, the PCE deflator (price basket) may capture the loss of purchasing power when taken in the context of measuring price increases for items and services needed by paycheck to paycheck laborers. The PCE deflator is the Fed's *preferred measure of inflation*, which is a bit disingenuous given that it does not measure inflation (the increase in the money supply) at all. Despite the fact it does not capture the loss of future purchasing power on items bought in the future by receivers of fixed-rate bond coupons, the PCE deflator remains the *inflation* benchmark used by bond investors.

[16] Digression: Public debate on fiscal propriety usually centers on a political dimension – one party claiming they are fiscally conservative and the other arguing necessary benefits should take priority. From an economic perspective, both parties have deficit spent consistently, allowing politicians to use the budget process as leverage in contentious domestic and trade negotiations. This freed the Fed to control credit – ergo the economy - independently.

A Repeating Pattern

The pop of the NASDAQ bubble in early 2000 occurred when investors could no longer reconcile the implied future nominal growth rate of corporate earnings with the nominal growth rate of new dollars and credit needed to justify higher stock prices. (In effect, the market didn't believe the money supply would inflate fast enough - dilute *real* future corporate earnings fast enough - to justify the nominal appreciation of technology stocks.) This posed a problem for policymakers because equity bust threatened a key component in the virtuous cycle – increasing paper gains used as increasing collateral values for increasing credit and debt assumption.

There was an alternative, however, that could extend the US's economic life. Home prices in the fragmented (and lightly regulated) US residential real estate market had not formally declined with the stock market. Unlike corporate equity, home equity is not marked-to-market daily by its owners.

The Fed dropped overnight interest rates to 1%, citing the fear of "deflation".[17] Financial intermediaries were then able to pass on the lower mortgage and consumer rates to home developers, lenders, homebuyers and consumers. Home prices and home equity rose. The housing industry drove employment growth and equity cash-out refinancing drove incremental consumer spending. The US economy and stock market stabilized and then flourished on the back of the housing bull market. By promoting credit to homeowners, policymakers were again able to stimulate US consumption, which sustained the US economy.

Meanwhile, the can that policymakers had been kicking down the road was quite dented and there was still no valid economic basis for balanced commercial trade between the US and emerging economies. Low wage workers in China, India, South America, Russia and Eastern Europe continued to drive down global production costs and this continued to be passed on in the form of lower global prices for finished goods and generic services. Technology design – the US's most distinguishable export – was easily and quickly replicated by lower cost manufacturers in developing Asian economies. The US could still not provide basic goods and services on a competitive basis, nor could it export enough natural resources to make a difference in its economic growth.

As they continued to expand, emerging economies still used the world's reserve currency - US dollars and credit lines - to buy the natural resources they needed to build their infrastructures and buy goods and services. The relative value of the dollar – though beginning to weaken substantially – did not collapse versus other major currencies or other forms of money (i.e., precious metals).

Despite the dollar's fragile state, US policymakers pumped out even more of them and promoted even more credit, which US consumers re-distributed to foreign manufacturers and exporters in return for their goods. Foreign exporters then took the proceeds and deposited them in their local banks who, in turn, exchanged them for local currency. Foreign central banks – now flush with dollars from these exchanges – continued to buy US Treasury securities, which kept US market interest rates synthetically low. Low interest rates perpetuated consumption of foreign-made goods in the US, as much of it was bought on credit. The Treasury was able to issue increasing amounts of debt, further perpetuating the virtuous debt, credit, consumption, asset growth and employment cycle. It also continued to inflate the US credit bubble further.

Behind this seemingly virtuous cycle though, there was a problem brewing. Eventually, investors and policymakers from emerging economies would begin to balk at subsidizing US consumption on uneconomic terms (given their enormous and growing dollar reserves and the strong negotiating positions that that engendered). As their affluence and influence grew they would negotiate directly with US competitors, attempt to use their own currencies to pay for global resources, goods and services, and begin to enforce their own trade policies.

[17] "Deflation" is thought by most to be a decline in general price levels of goods and services. It is not. It is the decline in the money supply, which is directly manipulated and influenced by the Fed. The Fed was never in fear of deflation per se, because it can manipulate the money supply simply. However, the Fed may have been fearful of declining prices as reflected in popular price baskets (which would have elicited further drops in equity values).

We think emerging economies began exerting their influence on US monetary policy in 2004. We suspect businesses and central banks in exporting nations grew tired of funding US consumers in return for 1% to 3% interest rates. In June 2004, the Fed (citing a fear of "inflation") began raising overnight rates from 1%.[18] This gave foreign exporters renewed incentive to reinvest their commercial proceeds back into US Treasuries at higher rates.

Higher US interest rates motivated foreign actors to increase their financial leverage too. The Bank of Japan could issue as many JGBs as it wished, take the proceeds, buy US Treasuries and collect the yield spread. The widening yield spread separating JGBs and Treasuries also encouraged private investors to seek returns via the renowned "Yen Carry Trade". China, which pegged its Yuan at what many observers cited as an artificially cheap exchange rate to the dollar, could print as many Yuan as it wished, exchange them for US dollars and buy Treasuries for very little cost or risk.

These activities greatly liquefied the central banks of these two exporting nations (and benefited global investors in the Yen Carry Trade) and gave the US outlets for new dollars. From 2002 to 2005, the IMF reported that reserve holdings rose from about $2 trillion to over $5 trillion. Global dollar inflation was off and running with the tacit but material support of major Asian central banks.[19]

Meanwhile, US consumer and homeowner debt was climbing to record levels and home equity was declining (through cash-out refinancing). US consumer balance sheets and the broader economy were becoming very vulnerable to the inevitability of a weakening housing market. So, coincident with raising overnight US rates to satisfy foreign dollar holders, the Fed once again accelerated its dollar and credit creating effort, which, again, kept the US consumer ostensibly liquid. By doing so, US policymakers continued to create demand for the supply of goods from emerging economies. The inflationary credit-driven virtuous cycle was picking up velocity.

Though overnight US interest rates were rising (eventually to 5.25%), the Fed, with the clear support of the Bank of Japan (BOJ) and the People's Bank of China (PBoC), was being aggressively stimulative in promoting money and credit creation. To counteract the impact of increasing US fixed mortgage rates, home lenders created clever new mortgage products (including hybrid ARMs, Interest-Only and negative amortization mortgages). Though alternative mortgage products allowed homeowners to purchase and refinance homes even as rates rose, they also increased homeowners' vulnerability to a reversal of the upward trajectory of home prices (as they simply back-ended the borrower's liability stream – recall the NASDAQ).

It appeared (in the short run at least) that home values were inelastic to the level of intermediate and longer term interest rates. Clearly, this would prove unsustainable. At the end of 2005, 40% of new mortgages issued (and 22% in total) had adjustable rates - due to reset in one or two years at significantly higher rates. (By remaining mute, policymakers - who also happened to be regulators – implicitly condoned the issuance of these products.)

Not surprisingly (in hind sight at least), policymakers began cultivating yet another outlet for new money and credit - hedge funds and private equity funds. Private equity funds had great success leveraging formerly stagnant institutional pension fund capital and hedge funds had begun to gain acceptance and raise capital by outperforming the stock market when the NASDAQ bubble popped in 2000.[20] Importantly to policymakers, these private entities had

[18] "Inflation" is thought by most to be an increase in general price levels of goods and services. It is not. It is the increase in the money stock, which is directly manipulated and influenced by the Fed. The Fed was never in fear of inflation because it can reverse it simply by draining money and credit from the system. However, the Fed may have been fearful of rising prices as reflected in popular price baskets (which would have driven market interest rates higher, placing an untimely burden on the indebted US public and private sectors and their debt holders).

[19] Digression: The disparity in comparative yield curves is, in itself, an effective provider of economic liquidity and hence, a form of monetary stimulation. This contrasts greatly with the traditionally held view that a "low" US fed funds rate is, in and of itself, an indicator of "easy" or liquid market conditions. The "globalization" of central banking allowed the US economy to remain liquid while Fed rhetoric created the illusion of "monetary restraint" as a responsible cause of action in response to heightening "inflation risks".

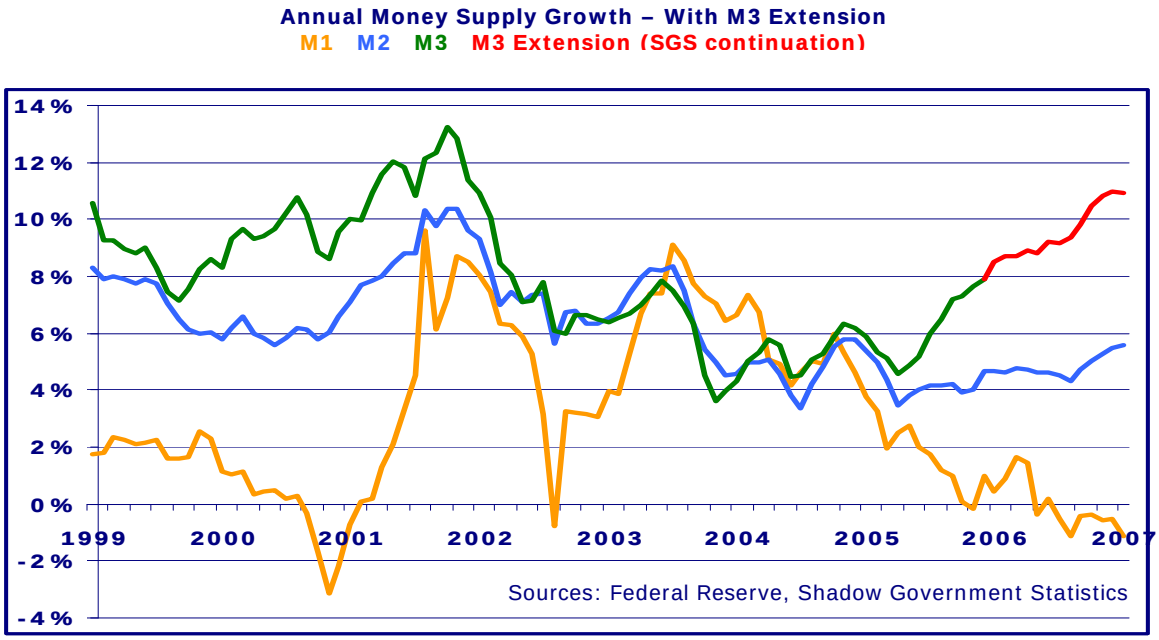
[20] Digression: Only later did significant asset scaling begin to change the investment programs of many hedge funds that morphed from traditional "hedged" investment vehicles into either "levered long asset" conduits or institutional hedge fund indexers.

substantial room to grow their balance sheets and then to leverage them on top of that. Additionally, they interacted directly with the Fed's money and credit distribution agents – the financial intermediaries (Wall Street and the money center banks).

Policymakers clearly wanted to ensure this money valve remained open, despite populist and political calls for investment program limits and more stringent regulations. In response to these pressures, Alan Greenspan argued at the time that "[I]t would be very difficult to design a set of capital requirements for hedge funds that is appropriately sensitive to the diversity and flexibility of investment strategies that different funds employ and to the lack of diversification in the portfolios of individual funds."[21] And later, according to Ben Bernanke, "The primary mechanism for regulating excessive leverage and other aspects of risk-taking in a market economy is the discipline provided by creditors, counterparties, and investors."[22] And according to Anthony Ryan, Assistant Secretary of the Treasury for Financial Markets, "The combination of market discipline and existing regulatory authorities are well-positioned to protect investors."[23] These retorts all carried great weight in the debate regarding these investment vehicles at the time. The ultimate verdict is clear as can be today.

With the clear and robust endorsement of money and credit creators at Treasury and the Fed, leveraged private investment funds stayed free to raise as much capital as they could from previously unlevered individual and institutional investors. Mechanically, Wall Street prime brokers and leveraged loan departments - funded through Fed repurchase agreements absent from M1 and M2 and no longer observable in the now defunct M3 measurement – financed these private investment funds.[24] The buy-side private investment conduits then levered their equity bases anywhere from 2 to 10 times.

Today



[21] http://www.federalreserve.gov/boarddocs/speeches/2005/20050505/default.htm; Remarks by Chairman Alan Greenspan; Risk Transfer and Financial Stability To the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure, Chicago, Illinois (via satellite); May 5, 2005

[22] Bloomberg; May 17 2006; Bernanke Adopts Greenspan's Stance Toward Hedge Funds; Craig Torres and Scott Lanman

[23] http://www.treas.gov/press/releases/hp296.htm; Remarks of Assistant Secretary for Financial Markets Anthony Ryan On Hedge Funds World Hedge Fund Forum; March 6, 2007

[24] Digression: The Fed ceased publishing M3 in February 2006. M3 was the only monetary aggregate that included repurchase agreements, which is a key mechanism through which the Fed provides Wall Street banks and brokers with credit. The financial intermediaries then pass on the credit to market investors, who in turn fund asset, consumer, investor and homeowner borrowing.

And so it goes…Shadow Government Statistics (SGS), a private research and consulting organization, calculates that total US money growth including repurchase agreements is accelerating and stands at an annualized run rate of about 11%.[25] (This may be observed in the graph on the preceding page.)

By issuing debt and printing, distributing and promoting substantial amounts of money and credit, policymakers (in this instance, the Fed and US Treasury) are smoothing over US economic contractions so that Americans can stay employed, the dollar remains relevant and the US stays globally competitive. This is reasonable policy taken at face value.

As a consequence, though, US consumers and homeowners have assumed record quantities of debt. For example, median household debt grew by almost 34% between 2001 and 2004 while household net worth rose only 1.5% during that period, according to the latest Survey of Consumer Finances (a report issued every 3 years). Currently, the average household is carrying an average of over $90,000 in debt and policymakers are encouraging more debt assumption by doing what they can to keep the credit markets liquid.

We presume they know they have gone too far - that the US can't afford to have a deep or prolonged recession given incredibly stretched public and private sector balance sheets and the likely decline in private business and public tax revenues that a recession would engender. Overlaying this risk against the backdrop of emerging economies not in need of goods and services produced by the US, and it is conceivable that policymakers see the strong possibility that a US recession could turn into something much worse.

We think policymakers will continue to inflate the money supply in the hope, we presume, of somehow coming out whole on the other side. The US consumer base will continue to be lent to manufacturers from emerging economies. The markets will continue to add leverage while reducing absolute and real returns on assets. The market volatility skew will continue to get more negative. Risk premia will continue to narrow. The average US household savings rate will continue to become more negative. The future purchasing power of most US savers, investors and consumers will continue to fall and go negative as their debts compound and continue to grow. Nominal US bond yields will continue to not keep pace with US inflation. Nominal US equity market returns – though becoming more and more generated by leverage – may join bonds in producing negative real returns.

In fact, US equities have already generated poor returns for global investors. Though the S&P 500 is up about 38% since April 2002 in US dollar terms, (about 7.5% per year not including dividends), it has not faired so well for investors who fund their purchases in other forms:

Japanese Yen	+28%
Swiss Franc	+ 3%
British Pound	+ 0%
Canadian Dollar	- 1%
Euro	- 8%
Australian Dollar	- 11%
Gold	- 42%

Aside from the Dow's performance vis-à-vis other money forms, its performance against natural resources has been poor. This is especially important to US consumers and to investors in resource-rich emerging economies, such as those in the Middle East, South America and Eastern Europe, who don't want to see their new wealth squandered by investing in US assets. Consider the Dow's performance versus:

Oil	- 33%
Industrial Metals	- 73%

Though global central banks are creating a lot of liquidity, enough of it isn't flowing into US assets to be worthwhile for global investors. So then, where does the prudent US or global investor turn if traditional vehicles can no longer be expected to provide positive real (net of inflation) returns?

[25] http://www.shadowstats.com

Market Manifestations

We believe that the economics that, at the margin, give *most* private investment funds the ability to pursue their strategies derives from the "interest rate subsidy" that foreign central banks currently provide US investors. US interest rates are high enough (for now at least) to keep attracting foreign capital (central banks and Yen/Swiss Franc carry traders), yet low enough to allow private levered US funds to pursue leveraged buyouts and other levered expressions (e.g. US credit hedge funds). US rates are priced (by central banks and private investors) to sustain a financial arbitrage that yields an acceptable nominal rate of return for highly-levered capital that, simultaneously, is becoming increasingly unacceptable to un-levered or moderately levered capital.

This, we believe, is the crux of the current privatization trend. Private equity funds are taking public companies private despite lower likely IRRs and they are assuming more transaction risk to do so. Private investment funds are borrowing up to ten times their equity bases at Libor to Libor +1.5% and investing in assets that may return Libor +2% (in today's interest rate environment), if all goes according to a perfect plan (multiples of cash flow paid are at historically high extremes). If rates were to rise, their returns could be Libor *less* 2%, 4%, 6% etc. And, as hedge fund capital has increased towards $2 trillion, most funds have become more institutionalized and are thus seeking nominal returns more correlated with underlying indexes. We imagine many investors in private funds will increasingly grow disillusioned with the decreasing risk/return tradeoff of private funds in conjunction with the relatively high fees associated with them.

Despite diminishing returns-on-investment and rising credit and investment risks, US policymakers will likely continue to pump money and credit into the financial system for as long as the markets are willing counterparties, thereby encouraging economic participants (including private funds) to take on more leverage. The effect of this policy on the public markets should be to promote higher nominal valuations than otherwise would prevail (for as long as policymakers are successful at passing through credit to the markets).

The flip side of this equation is that levered funding gives the public markets an embedded tendency to fall faster and harder than they otherwise would, should liquidity conditions contract organically. Leverage enters markets slowly. As we've seen repeatedly, though, credit and leverage can leave specific sectors quickly and violently. Therefore, the impact of increasing market volatility is skewed heavily against the markets. (The Fed's preferred and historic antidote for declining markets – more liquidity – would tend to help them recover faster also.)

The one occurrence that can't be overcome by creating more liquidity is when *demand* for it declines. The Fed generally distributes substantial money and credit to the system when more organic economic conditions begin to slide. Should this occur when foreign demand for credit is down and already high indebtedness limits new credit assumption, the Fed would then fail in its attempt to perpetuate its easy money policy. Stock, bond and housing markets would deflate, financial intermediaries would call in loans, private investment funds would be forced to de-lever, returns-on-assets would turn negative, and the virtuous debt to credit to asset to consumer cycle would morph into a vicious deflationary spiral. Nominal debt balances would remain constant as asset values collateralizing them would drop.

Not surprisingly, the US corporate equity market is highly vulnerable to such an event. Prolonged easy money policies have altered its internals. Basic metals companies – US-based or US-listed exporters that produce products that emerging economies import - comprise just 3% of the S&P 500. Financials comprise 22% of the index. According to Gerard Minack of Morgan Stanley, the financial sector's earnings have risen 14-fold since 1990 while the rest of corporate earnings have risen only four-fold.

Based on our negative view of the US dollar and its preeminence in determining asset values this market structure may present eventual opportunities. Jonathan T. Lin, of Louise Yamada Technical Research Advisors, recently published an interesting analysis that shows the correlations of various US equity market sectors to the US dollar:

"As can be seen in the table on the following page, the Energy (3.83%) and the Materials (0.22%) sectors have the lowest correlation coefficients to the Dollar Index. As such, overweighting in those sectors would theoretically make a portfolio more immune to a falling dollar.

Correlation to U.S. Dollar Index (DXY) 1990 - Present	
Information Technology Sector	52.29%
Telecommunication Services Sector	51.31%
Health Care Sector	48.09%
Utilities Sector	41.09%
Consumer Discretionary Sector	37.29%
Industrials Sector	36.54%
Consumer Staples Sector	33.06%
Financials Sector	32.77%
Energy Sector	3.83%
Materials Sector	-0.22%

The findings seem intuitively correct as well. Should the U.S. dollar further weaken against other currencies, commodity prices would most likely increase in dollar terms, all else being equal. Energy and Materials companies should benefit from a rise in their products' prices, offsetting whatever negative impact a falling dollar may have on the equity market in general.

We then applied the same calculations to the S&P 500 sub-industries. Not surprisingly, many sub-industries within the Energy and the Materials sectors show *low to negative correlations to the DXY*. The most negatively DXY-correlated sub-industries within the Energy sector are: Oil & Gas Exploration & Production (-37.08%), Oil & Gas Storage & Transportation (-55.73%) and Oil & Gas Refining & Marketing (-57.40%). The most notable sub-industries in the Materials sector are: Steel (-44.02%), Diversified Metals & Mining (-49.54%), Metal & Glass Containers (-49.94%), Construction Materials (-54.62%) and Gold (-70.26%).

These sub-industries will likely benefit the most (or falter the least) from a deteriorating U.S. dollar, given their historically negative correlations to the DXY."[26]

Lin/Yamada's technical findings within the equity market comport with our fundamental views across markets. Substantial long and short opportunities currently exist in global equity, debt, Forex and commodity markets by tracking the growing degree of recognition of the demise of the US dollar.

We think policymakers will continue to try to balance keeping the US dollar credible among global economic participants while they devalue dollars for US domestic consumption and investment. They will also try to continue to try to keep as many global exporters and importers sanguine about holding US dollars in reserve and using them for trade settlements. If pressed to choose, they will continue to try to support US financial assets should they falter. (After all, their stated mission includes price stability, which has been extended to financial asset prices.)

[26] Welling@Weeden; *Louise Yamada Technical Research Advisors, LLC,* April 18, 2007.

The Fed must inflate and trust that their contemporaries at other global central banks will follow suit. We see no other credible resolution at this point. Clearly, a globally-synchronized inflation in which the dollar does not collapse explicitly in the FX markets is about as close to a "soft landing" as can be imagined. Global bondholders will suffer, no doubt.

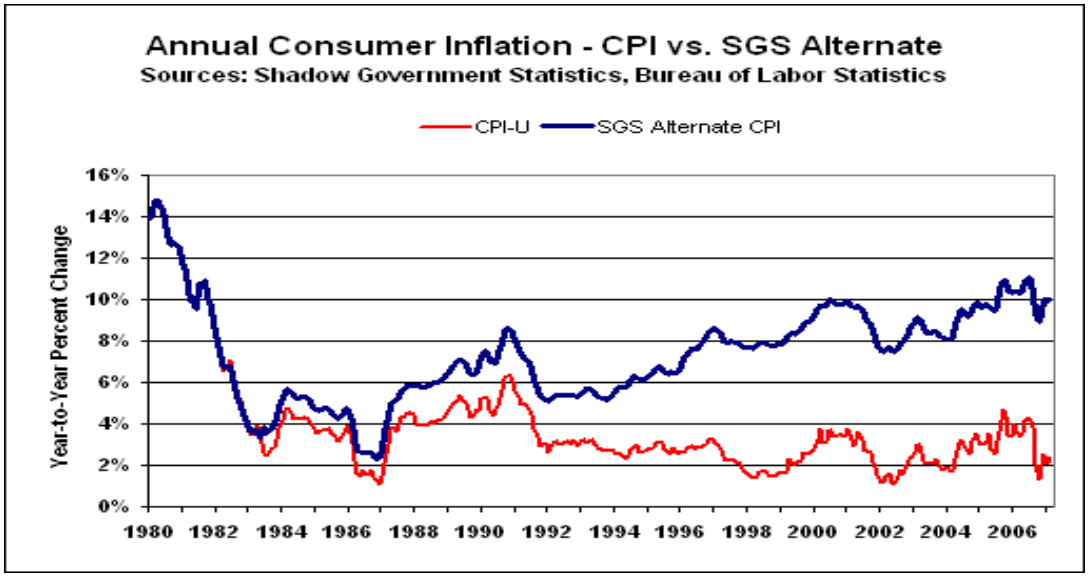
Signs & Rumblings

Though we're confident policymakers will continue to try to inflate the US dollar in order to maintain stable US economic conditions, it appears that their time may be running out. The efficacy of the monetary and fiscal policies that have sustained the virtuous cycle is waning.

We see this in numerous ways:

- The dollar's declining purchasing power – resulting from its increasing float (inflation) - is being recognized and responded to by non-dollar-based economic participants. The dollar's 30% decline in the foreign exchange markets since 2002 indicates true US monetary inflation is running substantially higher than compensation for it currently available in US fixed-income products.

- Prices paid in the US for goods, services, financial assets, real estate assets and natural resources have risen in recent years significantly more than population growth and organic demand. Shadow Government Statistics, an independent research organization, calculates US prices have been increasing at annual rates ranging from 8% to 11% since 1996.[27] This contrasts with the Bureau of Labor Statistics' core CPI, which has risen in the 1.5% to 4.5% area or with the core PCE deflator – the preferred indicator of the Fed, which has risen even less in that time. The graph below illustrates this difference.[28] We presume most Americans intuit their rate of inflation more in line with the higher "unofficial" rate than the ones reflected in the more traditional figures.

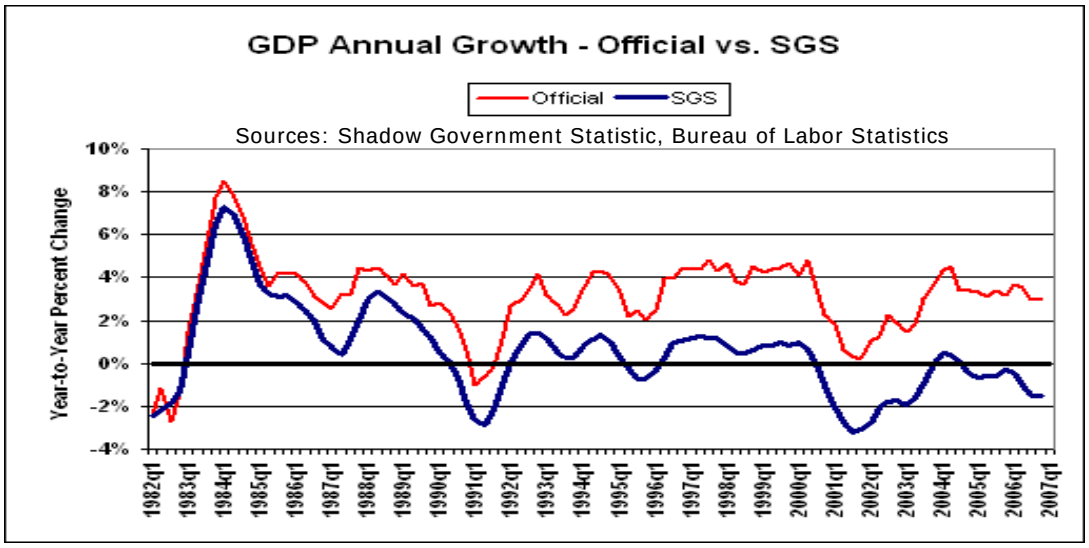


- The debt that is funding asset growth is becoming more mismatched every day as baby boomers are beginning to monetize their assets. Overnight liquidity - from the Fed to banks and brokers to levered investors - is funding the daily pricing of assets that investors believe are monetize-able long-term holdings and consumers believe are stable collateral for their debt. To sustain asset prices as baby boomers begin to retire,

[27] http://www.shadowstats.com

[28] According to Shadow Government Statistics: The Alternate CPI numbers tend to show significantly higher inflation over time, generally reflecting the reversal of hedonic adjustments, geometric weighting and the use of a more traditional approach to measuring housing costs, measures all consistent with the reporting methodology in place as of 1980.

the Fed would need to ease credit conditions enough (print enough new dollars and promote enough new credit) to stabilize the *nominal* prices of assets. It is unclear whether such pump priming could be absorbed following already substantial dollar and credit creation and significant recent increases in the prices of goods, services, financial assets, real estate and natural resources.



The only way asset sellers could successfully monetize their paper gains at or near current valuations would be for US output to grow significantly, justifying asset growth. As the GDP graph above shows, the last time US output grew even remotely that strong was in the early eighties.[29] That annual growth coincided with an era of precipitously declining global resource prices and US interest rates.

We think it is highly unlikely that natural resource prices (especially in dollar terms) will decline in the same manner given the organic demand from emerging economies. We also think it is virtually impossible that declining interest rates will drive US output in the foreseeable future to the degree they did in the eighties (please see the following point). So with each day that passes the inevitable credit/dollar unwinding gets closer.

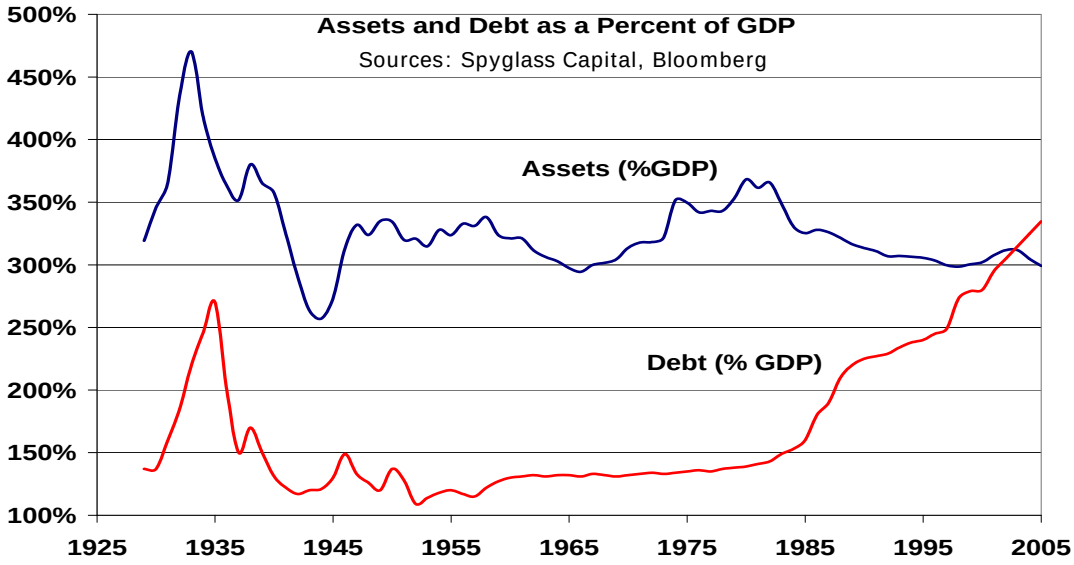
- Presuming policymakers continue to print dollars and promote credit in an effort to neutralize inevitable asset devaluation, they would have to raise interest rates meaningfully at some point should the dollar begin to tumble on global FX markets (in an attempt to keep foreign central banks and investors interested). The process of doing this would clearly pressure asset valuations, likely defeating its original purpose. Anticipation of this predicament is beginning to build among people like us – and you.

- Debt is no longer providing the boost for asset prices that it used to. According to Dick Bove of Punk, Ziegel, in the 1960s, an incremental dollar of US real total debt contributed to $0.64 in additional real GDP. In the current decade, a dollar of real additional debt now contributes only $0.15 in additional real GDP. The US was an under-leveraged economy in the '60s. It made good sense to borrow because it served the greater good – debt created more output, more employment and a higher standard of living. The economics of lending makes little sense in today's economy when compared to the risks of asset devaluation.[30]

[29] http://www.shadowstats.com

[30] Digression: Why has the private sector accommodated such leverage on uneconomic terms? Over the last twenty years credit decisions have moved from discrete banking organizations to disparate participants in the financial markets. The vast majority of these disparate credit market investors are judged based on relative – not absolute - performance. So, unlike banks, a bond fund or pension fund that holds hundreds of billions of dollars worth of dubious debt doesn't care about losses from foreclosures or bankruptcies. They only care about having less of them in their portfolios than their competition.

Clearly, the marginal economic utility of debt has dissipated, which implies its only real function now must be to promote liquidity growth which in turn will support positive nominal investment returns. This should become more apparent in the coming months as investor returns are compromised by inflation.



- Un-economic (poor risk-adjusted) loans have been made in the US simply because there has been too much global liquidity in circulation. In a finance-based global economy, whether a dollar in US debt produces a dollar in US GDP becomes only a minor consideration. A borrowed dollar produced a financial return regardless of whether it produced a dollar of US output growth.

  The recent sub-prime loan episode is an example of an event that, while it very well may be contained on its own, will force buyers of debt to be more discerning. More importantly, it should constrain the markets' ability to securitize dubious debt, which has been a major outlet for new money and credit.

- Output in the US, which for the most part does not export vital natural resources, goods, and services to emerging economies, would have already contracted meaningfully if not for the global reserve status of the US dollar. This negotiating leverage is fading fast.

  Though it's been threatened often over the past 10 years, (Iraq, Iran, Venezuela, Russia…), exporters of natural resources have recently begun to sell their goods in return for other currencies. Reuters reported last month;

  > "China's state-run Zhuhai Zhenrong Corp. – the biggest buyer of Iranian crude worldwide, began paying for its oil in euros late last year as Tehran moves to diversify its foreign reserves away from U.S. dollars. The Chinese firm, which buys more than a tenth of exports from the world's fourth-largest crude producer, has changed the payment currency for the bulk of its roughly 240,000 barrels per day (bpd) contract, Beijing-based sources said." Japanese refiners who buy about 500,000 bpd of Iranian crude, nearly a quarter of Iran's 2.2 million-bpd shipments, continue to pay in dollars but are willing to shift to yen if asked, industry sources and officials said separately. Iranian officials have said for months that more than half the OPEC member's customers switched their payment currency away from the dollar as Tehran seeks to diversify its reserves, but news of the Zhenrong change is the first outside confirmation." [31]

  It is difficult to say whether confirming the sales were ploys by the Iranians, Chinese and Japanese - posturing for more concessions from the US (nuclear weapons for the

[31] http://www.reuters.com/article/companyNewsAndPR/idUSSP6884420070327; "China shifts to euros for Iran oil, Japan holds off" by Chen Aizhu; ; March 27, 2007.

Iranians and higher interest rates for Chinese and Japanese on US dollar reserves?). Nevertheless, the transaction indicates the gravity and immediacy of the threat to US dollar hegemony.

- There may already be contingency plans to replace the US dollar with a currency shared by the US, Canada and Mexico (the "Amero"). At the conclusion of a March 2005 meeting in Waco, Texas, Presidents Bush and Fox and Prime Minister Martin announced the formation of a trilateral partnership called "The Security and Prosperity Partnership of North America" (SPP). Aside from security and immigration issues, the SPP seeks to "expand economic opportunity for all our people by making our businesses more competitive in the global marketplace…"[32]

  In May 2005, the Council on Foreign Relations (CFR) published a task force report titled "Building a North American Community." It is thought by many observers, though denied on SPP's website, that the Bush administration is pushing for the establishment of a North American Union (NAU). A leader in this movement is Robert Pastor, the Director of the Center for North American Studies at American University. Pastor was a vice chairman of the Senate Foreign Relations Committee's task force that produced the report "Building a North American Union." He has called for the creation of a new currency, which he has coined the "Amero," to replace the U.S. dollar, the Canadian dollar, and the Mexican peso. Though there is no current legislation or an official plan to replace the US dollar, thought is clearly being given about potential alternatives should conditions begin to deteriorate.

- When spot gold prices spiked to $730 per ounce in May 2006, the ECB sold substantial amounts, initiating or exaggerating the sudden, precipitous retreat to $550 per ounce. (Gold is the arch enemy of the dollar and other fiat currencies because its transactional supply is relatively finite and its history as a store of wealth during inflationary times, a.k.a. *currency devaluations*, is well documented.) In March and April 2007, the ECB again sold significant amounts of gold, yet its price increased.

  The obvious inference is that the demand for gold now is much stronger than it was last year. We also suspect – from our experience as market makers – that the intense selling would have taken the spot price of gold down significantly, if it had not been absorbed by one or two large buyers. We suspect other central banks not wedded to sustaining the reserve status of the dollar (Middle East? Russia? China?) are stepping in to buy gold in large chunks when their Western European counterparts disgorge theirs. Gold's strong price action is sending a clear signal that the relative (FX) and absolute (purchasing power) values of US dollars are under continued pressure.

- After leveraged private equity funds and hedge funds, we've yet to identify the next large credit consumer. Clearly, filling an eventual void here is essential to keeping the game going.

For all these reasons, we think the avenues available to policymakers seeking to perpetuate US dollar and financial asset strength are fading fast.

Expectations

We contend the Fed is targeting asset values through credit creation that is raising public and private US debt burdens to levels that cannot be settled.[33] In doing so, they are cannibalizing future US wealth and output.

We argue that the pre-eminent investment consideration today is the grandest of all financial paradoxes - the battle by US policymakers to sustain US dollar hegemony while they

[32] http://www.spp.gov/

[33] By "settled" we mean that all US public and private sector debt could not be paid off by liquidating the assets collateralizing it.

consistently increase monetary excess that intrinsically devalues the currency. They are destroying the dollar long-term as they try to retard its near-term demise.

Calling for a continuation of easy monetary policy is not a radical view. (Policymakers have been mostly stimulative since Model-Ts were $190.) The Fed is an inflation machine. In the recent era, maintaining control of the US dollar and maintaining its global relevance have been its primary functions. It has had to supply money and credit to promote growth and to stabilize the declining prices of global goods, services and - in a finance-based economy - assets.

We suspect policymakers may finally be failing due to the many reasons cited in this paper. More importantly than that, however, we believe that regardless of whether they succeed or not, savers of dollars and investors in dollar-based financial assets will suffer. In fact, despite the feel-good times constantly drilled into the masses ("the latest record close for the Dow"!), we think true economic suffering has already begun. All seems well today in US dollar terms, but how does a Euro-based investor that bought the Dow in 2000 feel today? Not well to be sure. In Euro terms, the Dow is still 30%+ below its peak in 2000. Examples of misperceptions of real value like this abound. Future foreign funding of US investment assets seems dubious.

If inflation (money and credit growth) runs north of 10% annually - as we think it has started to do and will continue to do - investors will fall behind by receiving historical equity or bond returns (regardless of "inflation" price baskets showing 1% to 3% annual increases). Real returns generated by most levered and un-levered investors in dollar-based assets will not be sufficient either.

* * *

An investor's goal should be to consistently beat (or trounce) the rate of inflation of one's base currency or store of value. The problem with this has been that few actually know what inflation is or where it comes from. Most everyone senses that getting a 5% return in a 2% "inflation" environment hasn't increased their purchasing power, and in fact has set them back. Investors intending to spend the proceeds from their stocks or bonds on future items not included in the popular price baskets seem blithely unaware that they are locking in a significant decline in their future purchasing power (unless the Fed deflates the money supply – something it hasn't done since the 1930s and probably won't under Ben Bernanke, who became famous through his analysis of this very issue).

Bond yields in the US are synthetically low because demand for them is not based on the classic theory that their yields should be priced at some positive spread over anticipated inflation. (Again, buyers of bonds - bond and pension funds, foreign central banks and levered global arbitrageurs - don't care about maintaining their constituents' future purchasing power. They care about – in order - relative performance, trade policy and generating fees from yield spread differentials.) If US bonds were priced based on true inflation, as we've described, we think they would yield between 10% and 15%. We think owning bonds with positive duration is foolish – not out of fear that one day everyone will wake up and realize they need more yield (though that is a definite possibility) - but because bond coupons and yields trade at a deep concession to true inflation.

There is substantial US equity risk too. Have you ever asked yourself why US consumers pay US prices for Chinese made goods? Sure, Chinese made goods are cheaper than they would be had US manufacturers made them, but they are far more expensive than a person living in China pays for them – even adjusting for friction from export and tariff costs.

The answer is in the profit margins of US based importers. These "World is Flat" platform companies - that comprise the corporate growth engine justifying financial asset prices – have been able to distribute their goods and services to Americans made flush with credit and paper. American corporations that have no inventory or assets that directly produce inventory have no pricing power in an inflationary environment. The exporters of materials and finished goods do. We think profit margins of most American companies will be squeezed as time goes on.

If money and credit supply continue to grow at 10%, the future returns across markets would have to improve upon their long-term performance experience. An investor seeking to soundly

beat true inflation – even if aware of the proper performance bogey – will have difficulty finding popular US assets that offer real value or will have difficulty finding asset managers willing and able to pursue them. Most all managers – public or private - are pursuing nominal annual returns that either beat their peers or look good optically based on historical nominal returns.

The opportunity we see is effectively this: Own assets with value propositions not driven by a strong US dollar. Sell short assets that rely on the perpetuance of a strong US dollar. Opportunities abound across many global markets.

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