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PDV *OBSERVATIONS*

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Dollar's Reserve Status

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With the media relentlessly warning that the U.S. dollar is likely to lose its status as the world's primary reserve currency, we thought we would update our Fall 2009 article on dollar devaluation.

What are the consequences if the U.S. dollar loses its reserve status?

If our currency loses its reserve status:

1) Interest rates will go up;
2) Inflation will rise; and
3) Investors may prefer financial assets denominated in stronger currencies and invest money in those markets over the U.S. market.

Counteracting these negatives are at least the following:

1) Our exports will grow; and
2) Many U.S. companies with global operations will report higher profits from their overseas operations, as those profits are translated back into weaker U.S. currency before reporting.

Will the U.S. dollar lose its reserve status?

This question is impossible to answer ***definitively***. Different economic problems ebb and flow; when some problem is highlighted by the media and discussed repeatedly, it tends to stay in our collective consciousness, until perhaps the problem is replaced by some other concern that is more immediate.

There are many good reasons to worry about our currency; in fact, right now it may be as vulnerable as it has ever been. Our ballooning national debt is widely cited as one of the most damaging factors to the U.S. dollar. Related to this is our serious budget deficit

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problem. With reduced tax receipts and ever-growing spending, the U.S. budget deficit is projected to be $1.645 trillion for 2011, which equals about 10.9% of our estimated gross domestic product (GDP) for 2011 (this percentage is the highest since 1945). In view of the current political gridlock in Washington, it is not difficult to picture both the deficit and national debt staying at elevated levels for years to come.

To fund deficit spending and keep interest costs down, the U.S. depends heavily on the willingness of other countries to buy and hold U.S. Treasury securities. This reliance on foreigners becomes more pronounced as our government continues to spend more than it takes in. As with any fiscally irresponsible debtor, foreign (and domestic) creditors will increasingly demand higher rates for lending or perhaps drastically cut back on lending at some point. Many are therefore justifiably worried that the time will come when our foreign creditors will stop obliging us. Over time, less demand for U.S. Treasuries will devalue our currency and raise interest rates, resulting in a whole host of political and economic problems.

China represents one of our most important foreign creditors, whose long-term demand for U.S. Treasuries critically impacts our currency and level of interest rates. Over the past several years, our currency has periodically sold off every time China publicly voiced its concerns about soaring U.S. spending, huge budget deficits, and the potential for higher inflation down the road. The prospect of China potentially dumping Treasuries en masse seriously undermines confidence in the U.S. dollar.

However, you should not accept without challenge the simplistic connections drawn by the media, commentators, and economists who espouse their sound-bites for 30 seconds of fame. The one thing we've learned in observing the markets over 25 years is that a lot of things that are predicted with high certainty to occur end up not occurring at all or they happen in a way different than originally predicted. For every intelligent, informed, and thoughtful person who predicts an eventual loss of our reserve status, there is one equally smart person arguing the opposite, notwithstanding the current state of our country's fiscal situation. For example, Warren Buffett is bullish on our country long term and does not expect the dollar to lose its reserve status.

The reality is that the strength of our currency depends on a number of complicated and interconnected factors. It is easy to draw *linear, one-dimensional* conclusions, when the media focuses on just one factor or a few of these factors. With so many variables in play, the relative weight of each factor undeterminable, and a change in one or more of these factors disturbing the equilibrium of all the factors as a group, the above legitimate concerns do not inevitably lead to a significantly weaker U.S. dollar. Here are a few reasons why.

First, currencies must be viewed in relative rather than absolute terms. The concept of a strong or weak U.S. dollar only has meaning *relative to some other currency*. This means the strength of the U.S. dollar depends on how our economic growth rates, political stability, level of interest rates, rule of law, trade flows etc., compare with the same conditions prevailing in

other countries. For the U.S. dollar to lose its reserve status, some other currency has to be preferred by the world to take its place, based on confidence, liquidity and depth of markets etc.

Let's start by considering the state of the U.S. economy relative to that of our primary trading partners. The U.S. is certainly facing many economic challenges, but so is the rest of the world. We are not alone in elevated spending. As slow as our economic recovery has been since the Great Recession, many other countries are in worse shape. In the Euro-area countries, persistent debt woes continue to linger and spook investors today. As for Japan, the country has the worst balance sheet among the major advanced economies, with debt above 200% of GDP. In fact, in the International Monetary Fund's latest update on world economic outlook, the projected 2011 U.S. growth is one of the highest for all major advanced economies.

As for China's periodic threat to dump U.S. Treasuries, you should recognize that a significantly devalued U.S. dollar is not in China's best interest. If China sells a substantial amount of Treasuries, it would decimate the value of its remaining holdings. According to CNN, 65% of China's $2.85 trillion foreign currency reserves as of the end of 2010 were held in dollar-denominated assets. At the same time, notwithstanding the success of its stimulus plan for improving the domestic economy, China remains an export-driven economy and continues to rely heavily on exports to the U.S. and other major economies. Significantly devaluing the U.S. dollar would raise the price of China goods in dollar terms and hurt their demand. The reality is that for all the talk about China's rising economic power, that country is very far from being in a position to take over currency leadership. Paradoxically, China's economy is widely viewed positively, and yet China does all it can to devalue its own currency! The two economies are in fact deeply interconnected, and China cannot dump U.S. Treasuries without seriously harming its own economy. With rampant wealth inequality between urban and rural populations and escalating discontent among the latter group, China is under intense pressure to keep its economy humming along.

China's attack from time to time on the U.S. dollar smells of political rhetoric. This may indeed be a case of action speaking more loudly than words. Empirically, China's holding of U.S. Treasuries remains historically high. According to the most recent data from the U.S. Department of Treasury, China's net purchase of U.S. Treasuries resumed in April, increasing its total holdings to about $1.15 trillion. That represents an increase of 28% during a 12-month period. The fact is that foreign investors are not abandoning our currency in any significant way. China and Japan, our biggest foreign creditors, are still buying U.S. Treasuries. And recent data from the International Monetary Fund show that more than 60% of the world's reserves are still held in U.S. dollar.

Notwithstanding the global bashing of our currency, if the world thought our currency was really at serious risk of losing its reserve status, the U.S. Treasury would not be able to continue borrowing money so cheaply. The yields on U.S. Treasuries have been trending down

(from already low levels) in recent months. Despite media reports to the contrary, over the past year China and other countries continue to snap up Treasuries and have been willing to accept ultra-low interest payments from us. Back in April when Standard & Poor's put a negative outlook on the U.S. AAA credit rating, the U.S. dollar actually rose against the euro, its key competing alternative. Most countries appear to view the U.S. as a relatively safe haven, continuing to buy our Treasuries at historically low yields. For the foreseeable future, there is just no reasonable substitute to the U.S. dollar as the primary reserve currency.

How to position your accounts to deal with a weakening currency?

Even if the U.S. dollar does weaken significantly from current levels, the following are some types of investments that will provide a hedge against a significantly weaker U.S. dollar:

- Stocks of U.S. companies that do substantial business overseas. These companies are likely to report higher profits, since their foreign profits must be translated back into a weakening U.S. dollar, boosting their reported profits in dollar terms. Higher reported profits tend to result in higher prices for these stocks.

- Foreign mutual funds that primarily invest in the stocks of companies based overseas. Stronger foreign currencies boost fund asset values and distributions denominated in weaker U.S. dollars.

- Bond mutual funds that have positioned the weighted maturity of their underlying bonds to address rising interest rates.

- Treasury Inflation-Protected Securities ("TIPS"). Typically, a significantly weaker U.S. dollar will be accompanied by inflation. TIPS will appreciate if inflation materializes.

Since no one can be sure that our currency will lose its reserve status, it is prudent to maintain a diversified portfolio of investments. Diversification helps mitigate extreme outcomes. While it is advisable to monitor the U.S. dollar, it is highly unlikely to lose its reserve currency status any time soon.

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