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GLOBAL MARKET COMMENT: IMPLICATIONS OF A FALLING US$

June 2002

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Implications of a Falling US$

The long-predicted depreciation of the overvalued US$ is finally underway, and the questions now are: How fast? How far? And what are the likely ramifications?

The US$ has been on a roller-coaster ride since the breakdown of the Bretton Woods agreement led to the US$'s being floated in 1973. In that first inflationary period, it depreciated by 23% (in real trade-weighted terms, 1973-78), but after Paul Volker launched his decisive attack on inflation in the late 1970s, it rose sharply (appreciating 53%), steadily eroding the competitive position of U.S. exporters and leading to the 1985 Plaza Accord, in which the major developed economies agreed to mount a concerted effort against the greenback. This resulted in a cumulative decline of 34% over the next decade, setting the stage for the most recent rebound, from 1995 to 2002, during which the currency appreciated 31%. (See the following table.)

Despite the headlines, which have focused on the US$'s 18% depreciation against the euro, the real trade-weighted US$ has declined only 3% since its peak in February. If the preceding two downshifts are representative, we might expect a further 20% to 30% decline, spread over much of this decade. By and large, this is what the consensus expects: estimates of the US$'s overvaluation range from 15% to 25% and most commentators warn that currencies tend to overshoot fair value at both ends of the scale.

The effects of a gradual decline over several years would be generally benign. As Steve Roach of Morgan Stanley has written, the US$'s strength has resulted in (or from) an imbalanced global economy, in which everyone else (it seems) has focused on selling into the huge, wealthy U.S. market, leading to an unhealthy dependence on the United States as the sole engine of global growth. A weaker US$ would not only improve the competitive position of U.S. companies, which has again eroded badly as the currency has risen, but would also stimulate other countries to work on the development of domestic demand, helping to reflate a world economy perilously vulnerable to deflation. Under this scenario, the U.S. current account deficit (currently 4.3% of GDP and heading for 5.0% over the next 12 months) would gradually shrink as imports became more expensive and exports less so, the U.S. economy would probably grow at a slower rate than those of other developed nations, and US$-denominated assets would underperform. Not the best of times, but tolerable. For global investors positioning themselves for this outcome, the obvious moves are to underweight US$ assets, overweight non-US$ assets, and tilt equity portfolios towards sectors likely to benefit from reflation (e.g., energy) and away from those heavily dependent on U.S. consumer demand.

However, we should not ignore the far bleaker possibility of an old-fashioned run on the US$, which would wreak havoc in the global economy and financial markets. The US$'s strength in recent years has reflected not only the global preeminence of the U.S. economy, but also foreign investors' appetite for US$-denominated assets. The huge trade imbalance, which creates the current account deficit, has been readily financed by foreign purchases of U.S. companies (direct investments) and U.S. securities (portfolio investments). Foreign ownership of U.S. Treasury and corporate bonds, for example, are both at record levels, representing 40% of the Treasury and 24% of the corporate bond markets, respectively. All told, foreign investors now own 11.7% of the total U.S. credit market (double the level of a few years ago) and 13.0% of the U.S. equity market ($1.75 trillion). Foreign purchases of U.S. securities averaged $173 billion per year from 1990 to 1999, but soared to $514 billion in 2001. Meanwhile, U.S. purchases of foreign securities totaled $98 billion in 2001 (a decline of 20% from 2000), which meant that the net inflow of $416 billion more or less matched the U.S. current account deficit for that year. At the same time, of course, foreign investors were also buying U.S. assets directly, to the tune of a record $301 billion in 1999, declining to $288 billion in 2000, and only about $150 billion in 2001 (just about matching U.S. direct investments overseas, which have averaged roughly $155 billion during this three-year period).

There is mounting evidence that the bloom is off the U.S. rose, as far as foreign investors are concerned. Direct investments have dried up as the M&A boom has bust, and foreigners have also become increasingly reluctant to add to their already record holdings of U.S. securities, with investments of just $27 billion during the first two months of this year and a decline of 40% in first quarter 2002 compared to first quarter 2001. If the weak equity market, sputtering economy, corporate fraud, and global insecurity cause foreign investors to suspend or reverse their purchases of US$ assets, the US$'s decline could readily accelerate as anti-US$ sentiment gathered momentum.

The result would be a swift decline in the U.S. equity and bond markets that would ripple around the world, and a wrenching adjustment in the global economy as the terms of trade shifted in favor of foreign exporters whose own currencies are more-or-less tied to the US$ (e.g., Hong Kong, China, Malaysia) and against those who are heavily dependent on selling into the U.S. market (e.g., Japan, Taiwan, Korea, Singapore). Global trade would contract and corporate investment freeze, while unemployment, sociopolitical tension, and investor risk aversion would all rise sharply. In the United States, rising import prices would stimulate inflation, but the need to continue pulling in foreign capital to finance the $450 billion current account deficit (even as it shrank) would result in higher interest rates despite a weakening economy. Stagflation could ensue, exacerbating investors distaste for US$ assets.

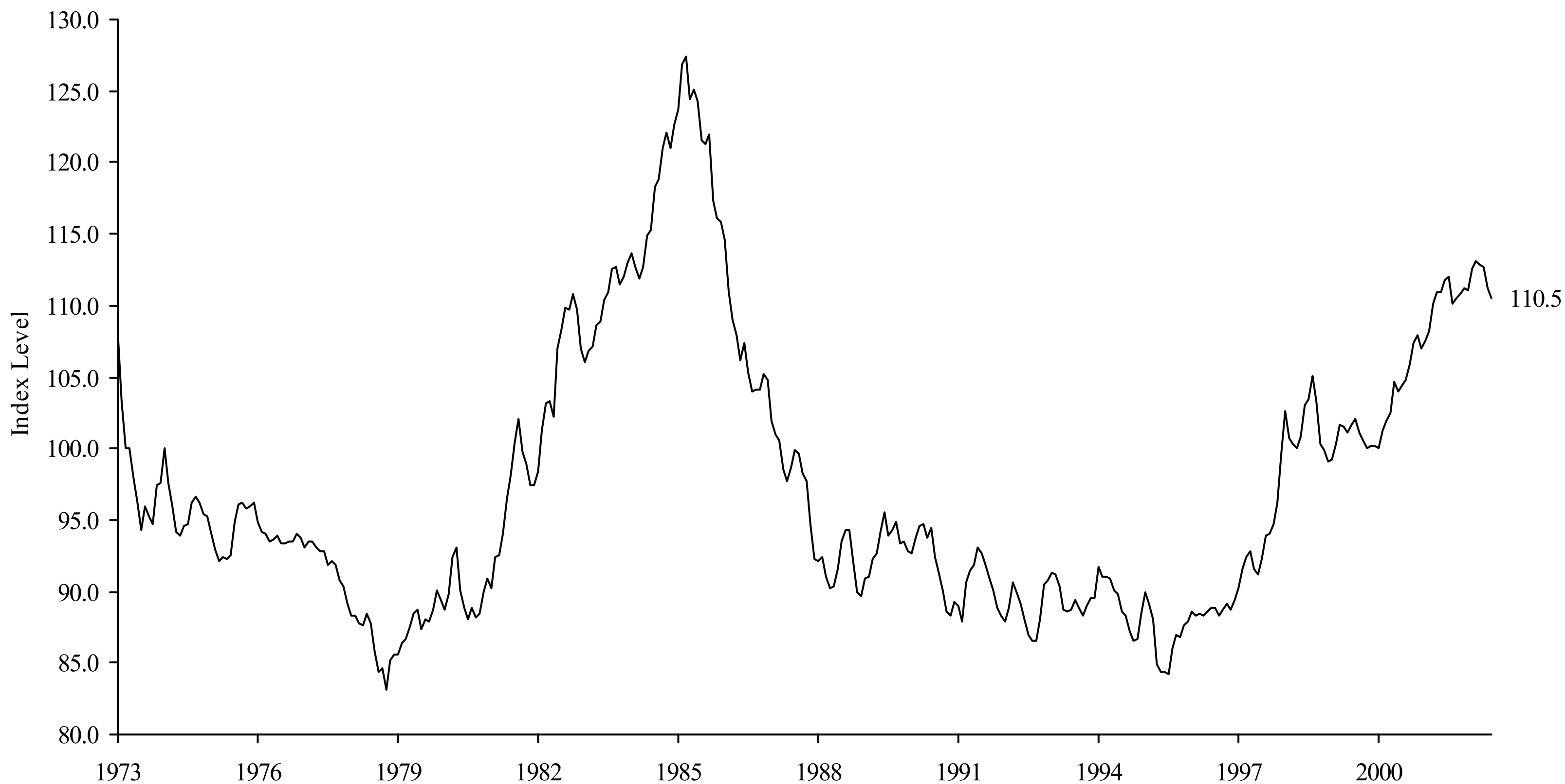
Investors would struggle to find safe havens. Gold, which has already risen sharply this year (14.9% to $317.75 on June 30, 2002), would be the prime beneficiary. For U.S. investors, Treasury bills would hold the line and TIPS would appreciate, but foreign investors would lose on the currency translation. Sovereign eurobonds would serve U.S. investors well, while euro-denominated investors might also benefit from a flattening yield curve as European economies weakened. European and U.K. equities would suffer both from U.S. equity market contagion and the damage inflicted by an overvalued euro. The British pound would probably appreciate in line with the euro, as global investors redeployed some portion of their U.S. Treasury bond holdings into other forms of sovereign debt. Similarly, the Japanese economy, still dependent on exports to the United States and Europe, would be stifled by contracting global demand and the ¥'s unwanted appreciation versus the US$. Emerging markets would be battered by investor risk aversion and their vulnerability to global economic contraction. In addition to gold, other traditional safe havens, such as Swiss francs and real assets (including property) would see substantial inflows.

Eventually, of course, foreign investors would see US$ assets as a bargain, as they did after the US$ plunged by more than 15% in 1987, contributing to the October stock market crash, and their buying would help stimulate recovery and a new bull market—but it's the getting from here to there that concerns us now. How likely is a US$ crash? Morgan Stanley estimates the probability at 15% (up from 5%), but the truth is no one can say. We would only repeat previous admonitions to the effect that a US$ crash is by no means improbable and its ramifications are worth taking into account as institutions review their asset allocation.

REAL TRADE-WEIGHTED VALUE OF THE DOLLAR

January 1, 1973 - June 30, 2002

January 1997 = 100.0



Source: Federal Reserve Board.

Note: The index is based on a basket of foreign currencies weighted by the dollar amount of trade with the United States.