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Monday Morning Outlook

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Dollar Danger

Every discussion about the global economy must address the sharp decline in the US dollar – it's a huge story. Since its peak in 2001, the US dollar has lost roughly 40% of its value versus the Euro and the Canadian Loonie and about one-third of its value versus the UK Pound. The dollar is even down 45% against the Albanian Lec – which is like Michigan losing to Appalachian State every Saturday for six years.

No matter how many times US Treasury Secretary Henry Paulson or his predecessors have said the US is committed to a strong dollar policy, the foreign exchange markets have ignored them. Some are suggesting the Treasury should say it louder and more frequently and possibly even intervene by buying the dollar on foreign exchange markets.

But none of this will help because the value of the dollar is determined just like other commodity prices – by supply and demand. When the price of pork bellies changes, everyone knows the reasons must be related to either supply or demand. But for some reason when it comes to the dollar, people seem to forget this fact.

Some blame the decline in the value of the dollar on the trade deficit or the budget deficit, while others blame it on a lack of confidence in President Bush. Linking these issues to dollar ***demand*** may be theoretically possible, but these links are very tenuous.

The U.S. still imports substantially more than it exports, but the trade deficit is falling fast and most forecasts suggest it will continue to do so. Yet the dollar's decline has accelerated in recent months.

The federal government still has a budget deficit but, at 1.2% of GDP in Fiscal Year 2007, it's low versus historical averages and lower than at a similar point in the 1990s business cycle, when the dollar was strengthening. True, due to prescription drug legislation, President Bush has presided over the largest expansion in entitlements in a generation, but that law was enacted a few years ago. Lately, government spending has been growing slower than GDP.

Finally, the theory that global dissatisfaction with President Bush is a catalyst for dollar decline is pretty much ridiculous. The drop in the dollar has accelerated since the 2006 election, which handed control of Congress to the Democrats. Moreover, it is widely believed that a Democrat will win the White House in 2008. As a result, if one is worried about *demand* for the dollar, a more credible explanation for recent dollar weakness is the possibility of tax increases starting in 2009, particularly on income from capital. This would make the US less attractive to foreign investment.

However, we believe the main reason for the dollar's weakness is due to ***supply***, in this case the over-supply of dollars by the Federal Reserve, the entity that has ultimate control of the printing presses. The Fed was too loose for far too long early in the current business cycle, raised interest rates too slowly, stopped too soon, and now it has cut rates multiple times before it ever got tight enough to bring down inflation. The dollar has lost 5% of its value versus the Euro since the Fed reversed course in September.

In the weeks and months ahead, expect more public pronouncements from prominent officials – both US and foreign – that attempt to bolster the dollar. It could be that there is even some intervention. But none of this will have any long-term impact on the dollar. Its fate is ultimately in the hands of the Fed. Without a change in policy by the Fed, any intervention gets mopped up immediately. In the end, if the Fed gives in to markets and cuts rates again, the dollar will keep falling. If it stands its ground and eventually retracts recent "emergency" rate cuts, the dollar will rebound.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-20 / 7:30 am	Housing Starts - Oct	1.170 Mil	**1.171 Mil**		1.191 Mil
11-21 / 7:30 am	Initial Claims - Nov 17	330K	**330K**		339K
9:00 am	U. Michigan Confidence - Nov	75.0	**75.0**		75.0
9:00 am	Leading Indicators - Oct	-0.3%	**-0.3%**		+0.3%