630-322-7756
www.ftportfolios.com

FIRST Trust ADVISORS L.P.

May 21, 2007 Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein - Senior Economist

Dollar Crash, Not in the Cards

For at least 25 years, a large and seemingly growing cadre of analysts, economists, journalists, and politicians, has been stubbornly bearish of the US dollar. A Google search for the phrase "Dollar Crash" returns 1,520,000 hits – many of which describe in intimate detail the lurking horrors awaiting America when the dollar finally collapses.

They fret about the trade deficit, the budget deficit, or a loss of respect for America; they worry about consumer debt, doubt the strength of the economy, and cringe at sub-prime loans.

Unfortunately, the dollar won't cooperate. Despite a 5% decline in the dollar versus the *euro* since January, the current $1.35/€ exchange rate is equal to the value of a synthetically-constructed *euro* from 1981, 1990 and 1995. Over the past 18 years, the dollar has climbed 20% versus the Japanese Yen and 50% against a trade-weighted basket of 36 major US trading partners.

It is clear from these longer-term trends that the US dollar remains a remarkably resilient currency. But this does not deter the pessimists. They continue to find reasons to short the dollar. However, most of these reasons have little to do with the value of the dollar.

The value of the dollar, or any currency, is determined by supply and demand. If the European Central Bank prints money with restraint, the *euro* will hold its value. If the Federal Reserve prints too much money, the dollar will fall.

This explains the movement in the dollar during recent years. Alan Greenspan and the Fed were following a very restrictive monetary policy in the late 1990s, and tightened excessively in 1999 and 2000. This created deflation in the US, and from early 1999 to July 2001, the dollar strengthened from $1.18/€ to $0.836/€. The *euro* collapsed and some predicted its demise as a viable currency

As deflation worsened, the Fed panicked and loosened dramatically. The funds rate eventually fell to 1%, while the dollar plummeted from its 2001 high to $1.35/€. It was not low interest rates that undercut the dollar, but a deluge of liquidity supplied by the Fed to hold interest rates down and fight deflation.

Then, in mid-2004, the Fed started hiking rates and slowed liquidity additions. The dollar began to stabilize, and actually rallied in 2005.

Now, with the market expecting Fed rate cuts to offset a faltering US economy - the equivalent of printing more money - the value of the dollar has slipped once again.

But in what will be bad news for the dollar bears, the Fed is much more likely to hike rates, than it is to cut them. The US economy is rebounding from a temporary slowdown, inflation is still on the rise and monetary policy is still loose. As a result, we believe the probability of Fed rate hikes are much greater than those of a rate cut.

Since the foreign exchange market has priced in a rate cut, it is vulnerable to a correction. As market perceptions of the Fed's future actions change, the dollar will find some significant support. Foreign rate hikes may keep the dollar from rallying, but a dollar crash is not in the cards.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-24 / 7:30 am	Durable Goods - Apr	+1.0%	**+3.1%**		+3.7%
7:30 am	Durable Goods (Ex-Trans) - Apr	+0.6%	**+0.3%**		+1.3%
7:30 am	Initial Claims - May 19	310 K	**310 K**		293 K
9:00 am	New Home Sales - Apr	0.860 Mil	**0.854 Mil**		0.858 Mil
5-25 / 9:00 am	Existing Home Sales - Apr	6.170 Mil	**6.047 Mil**		6.120 Mil
5-31 / 7:30 am	Q1 GDP Preliminary	0.9%	**0.9%**		1.3%
7:30 am	Q1 GDP Chain Price Index	4.0%	**3.9%**		4.0%
9:00 am	Chicago PMI - May	54.5	**58.3**		52.9
9:00 am	Construction Spending - Apr	-0.1%	**-0.2%**		+0.2%
6-01 / 7:30 am	Non-Farm Payrolls - May	+140 K	**+140 K**		+88 K
7:30 am	Manufacturing Payrolls - May	-14 K	**-20 K**		-19 K

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.