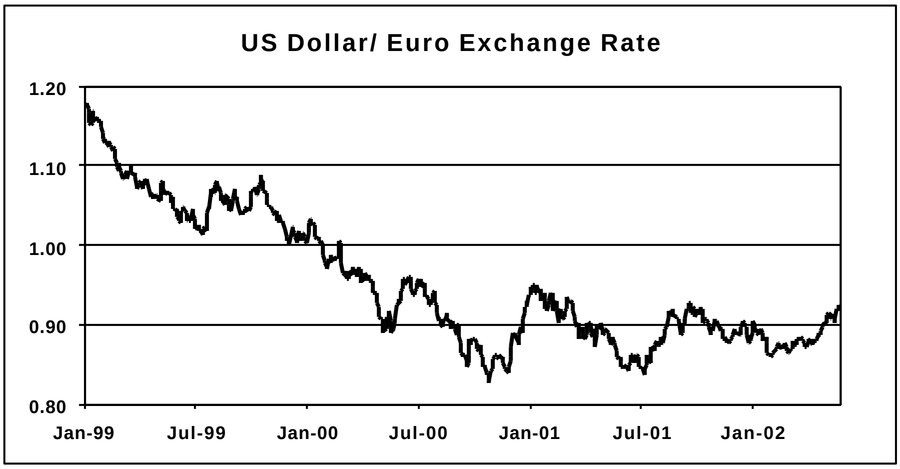
Dollar Alternative Don't Inspire

Over the past month the dollar has depreciated against all the other main currencies, falling to multi-month troughs against the euro, yen and sterling. As a result, the dollar's trade weighted index has fallen by some 3%. This shift in forex levels is principally a weaker dollar story that has been driven by fears that, amid concerns about the sustainability of the economic upswing, equity valuations and a rising budget deficit, the burgeoning current account deficit is finally catching up with the US.

To date, the current account deficit has not posed a major threat to the dollar as its expansion has been matched by significant investment inflows. However, capital inflows are now falling as investors predict a steady, rather than spectacular, US economic recovery. Net foreign purchases of assets reached $15 billion in February, up marginally from January. This compares with an average net monthly inflow of $51 billion in Q4 2001. The US needs to attract inward investment of over $30 billion per month in order to sustain its current account deficit.



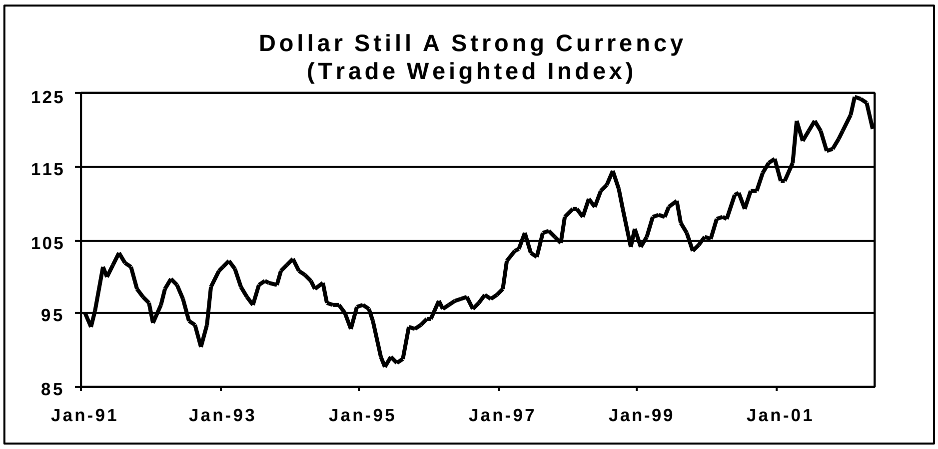
The biggest decline in demand for dollars has occurred in the purchase of US corporate bonds, possibly reflecting the Enron situation and the general uncertainty surrounding accounting practices. With equity price/ earnings ratios still high, foreign buying of US equities has also weakened. Overall, total portfolio inflows have fallen to their lowest levels since the LTCM crisis and the Russian debt default in the autumn of 1998.

Capital flows are driven by expectations for economic activity and interest rate trends. The US economy expanded by an impressive 5.6% (s.a.a.r) in the first three months of the year. However, the growth rate is expected to weaken over the balance of the year. Furthermore, there was another uninspiring set of corporate earnings reports for Q1. Against this background, expectations for higher interest rates in the US have been scaled back. US interest rate futures are now pricing in rate hikes of 1.00-1.25% by end 2002, compared to 2.00% earlier in the year.

As well as concerns about the economic outlook, perceptions that the US administration lacks commitment to a strong dollar policy has also soured sentiment. In the days of the Clinton administration, the US followed a "strong dollar" policy. At a recent testimony to congress, however, US Treasury Secretary Paul O'Neill did not forcefully restate this policy. The timing of the remarks could suggest a policy shift, particularly as the New York Federal Reserve President also recently stated that on a theoretical basis, the dollar was “a little overvalued”.

Meanwhile, the other leg of the ‘twin deficits’ that may be burdening the dollar is the deteriorating fiscal situation. Tax receipts are running well below forecast while government spending is increasing rapidly. Hence, the US budget deficit is expected to rise to 1.5% of GDP by next year, a big swing from the surplus of 1.5% of GDP recorded in 2000. Given the low level of private savings, this implies a need for external financing of the budget deficit, another millstone for the dollar.

Despite its recent losses, though, the dollar remains a strong currency. The euro is still 21.5% below its 1999 launch value against the dollar. The greenback also remains considerably higher against the yen and sterling than it was a couple of years ago, up a respective 11% and 12.5%. There have been bouts of dollar weakness before in recent years, but these proved just temporary setbacks for the currency.



The prospects for the dollar on this occasion, though, are much more finely balanced. The concerns over equity valuations, doubts about future growth prospects, emergence of a budget deficit, rise in the current account deficit to worrying levels and the wavering on the strong dollar policy have seen the currency come under increasing scrutiny.

On the other hand, our fundamental economic view is that we expect continued strong growth in the US, a return to relatively low trend growth in Europe, while Japan will remain weighed down by long-term structural problems. Thus, while the dollar may no longer be the shining star of the forex markets, the world’s other major currencies are not exactly that attractive either. Hence, if, as we expect, the US economic recovery proves sustained, then the current downward pressures on the dollar could well abate.

Thus, we would caution against being overly negative on the dollar. Sure, there are long-term problems weighing on the dollar which suggest the currency will eventually weaken. However, in the absence of a credible alternative to the greenback, we believe that the world’s major currencies will continue to trade in relatively narrow ranges for the foreseeable future.

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24 May, 2002