

BCA recently penned article on the same, which I have attached below for your info. as it mirrors our own views. In summary, we expect the dollar to rebound in the short-term but ultimately continue to downtrend as the year progresses. However, this should not turn into a dollar rout and should prove to be a positive for US equities (non-US investors should hedge their exposure) over the intermediate term. The bigger risk to equity markets globally would be a significant rise in inflation. However, disinflationary forces in the global economy remain strong - tradable goods price deflation continues - which should contain input price pressures (rising commodity and energy prices). Consequently, if the current set back continues we will be looking to buy rather than sell into weakness. However, if individual investors have enjoyed strong returns over the past 3 years and have a high equity exposure, some profit taking might be prudent as market volatility is likely to remain high.

## **Article**

The drop in the dollar has progressed at a fast rate over the last several weeks, which has pushed most measures of market momentum to extremes. This suggests the drop in the dollar is reaching a near-term extreme. Typically, a rebound should develop.

There are also some very early signs that the dollar's recent weakness has begun to create some strain in the rest of the world:

- The Nikkei has been trading on the soft side since April when the yen began to rise. Korean auto stocks have collapsed as a result of a surging won
- There is also some economic weakness developing in Europe, as evidenced by German retail sales and industrial production.
- Asian central banks have voiced their increasing concern over strong currencies and the Asian export sector is beginning to under perform.

All of these responses are very preliminary in nature and the message from these developments is far from definite. More time is probably needed before the impact of a weakening dollar on the world economy can be fully understood. Our sense is that strengthening local currencies have not yet restrained business activities sufficiently to soften the overall policy stance. For instance, most Asian central banks are not happy with strengthening local currencies; they have also indicated that local interest rates need to be lifted. We suspect that a rebound in the dollar is already beginning but a more meaningful rally could come when foreign central banks turn dovish. This would require more economic weakness in the rest of the world.

The bigger issue is the general trend for the U.S. dollar for the rest of the year and its adjustment path. We expect the dollar to trade on the weak side this year, but that there is no case for a dollar crisis. First, the key force in the global currency market is competitive devaluation. Global traded goods prices have been falling steadily for years. This persistent deflation indicates that cheapening a currency is an effective way to derive growth at the expense of others, and that a country can do so without stoking up domestic inflation. The increasing unwillingness on the part of Asian monetary authorities to accept rising local currencies and the Bush Administration's relentless push to weaken the dollar suggests that competitive devaluation remains the key force dominating policymakers' thinking. Recent US trade data also suggests that the dollar's decline has impacted America's current account imbalance.

Second, the key bearish argument for the U.S. dollar this year rests with the fact that America has to borrow large amounts of capital to make up its current account deficit, which is over 6% for GDP.

However, Asia remains a region that produces too much and consumes too little. There is no lack of excess savings around the world. With business activities and underlying returns on capital firming in Asia, it is not surprising to see the dollar coming under some pressure. Nevertheless, the Asian authorities will not tolerate a sharp and precipitous fall in the dollar, which would seriously undermine Asia's manufacturing businesses and create strong deflationary pressure within the domestic economy.

Finally, interest rate spreads are still supportive for the dollar. The U.S. economy may begin to decelerate, but overall business conditions remain robust and healthy. Although short rates in the U.S. are very close to neutrality, it remains a distinct possibility that the Federal Reserve will tighten one more time before going on hold.

At the same time, the strengthening euro and yen will restrain the pace of business cycle expansion in both Japan and Europe and reduce the need for aggressive rate hikes in both countries. The dollar's recent downward move has been discounting relative shifts in the global policy outlook. For the dollar to move sharply lower, it will require an additional shift in relative policy dynamics with the Fed becoming dovish and both the European Central Bank and the Bank of Japan becoming more hawkish. This is possible, but not very likely in the near term.

Bottom Line: The dollar may rebound, but the currency should still trend lower for the remainder of the year. However, there will be no crisis. The slide in the U.S. dollar should be gradual and measured going forward.

Regards  
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