LGL Partners Investment Brief

The cost of dollars

May 2011

Summary

The US Dollar (USD) has traditionally been regarded as the international reserve currency, a robust store of value, and a welcomed medium of exchange from Omaha to Azerbaijan. But, after rounds of so-called Quantitative Easing, deficit spending, and various bailouts, the luster of the USD has dimmed, its value has fallen relative to other trading partners, precious metals, and other commodities, and the long-term outlook is not favorable.

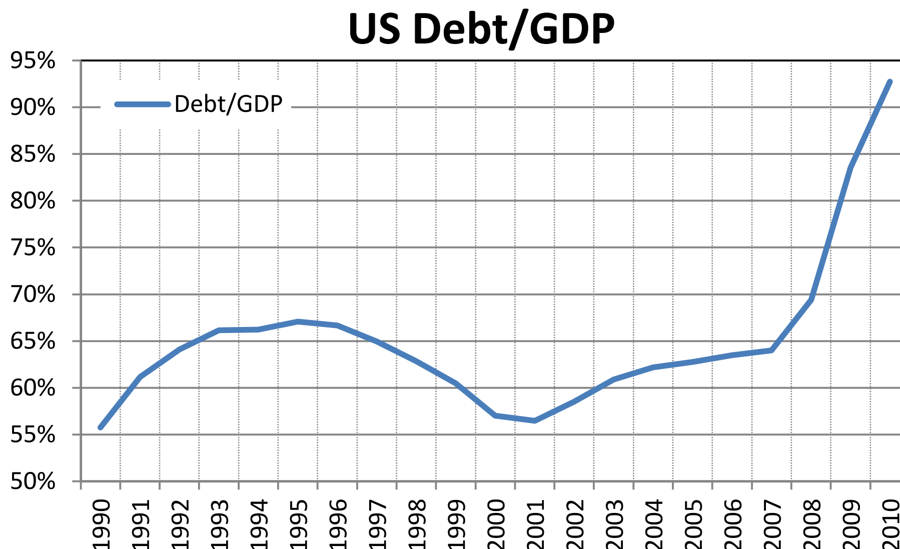
This investment brief takes a near-term and long-term look at factors impacting the USD. We suggest that there is a meaningful relationship between fiscal policies and the level of the USD. Given what we know about prevailing US Federal fiscal conditions, we can establish expectations of future USD movements.

We also take a longer term view to quantify the implicit inflation "tax" imposed on holders of USD. Insofar as holding USD is seen as having a call option on risky assets, it is important to consider the "premium" paid for that optionality.

Over the long-term this premium has been 3.5%; we expect that given current conditions, that premium is likely to be higher, perhaps significantly. We recommend investors looking to maintain cash optionality, or investors looking for money market yields, to consider non-USD alternatives and/or commodity assets denominated in USD.

Analysis

Prior to the last two years, US debt[1] to GDP has tracked in a tight range. However, we are well outside that band now, as the chart below shows.



Source: The Congressional Budget Office and the U.S. Department of the Treasury

[1] According to Federal Reserve Flow of Funds statistics, http://www.federalreserve.gov/releases/z1/current/, total debt (consumer, state, and local debt) to GDP is at a much higher 350%.

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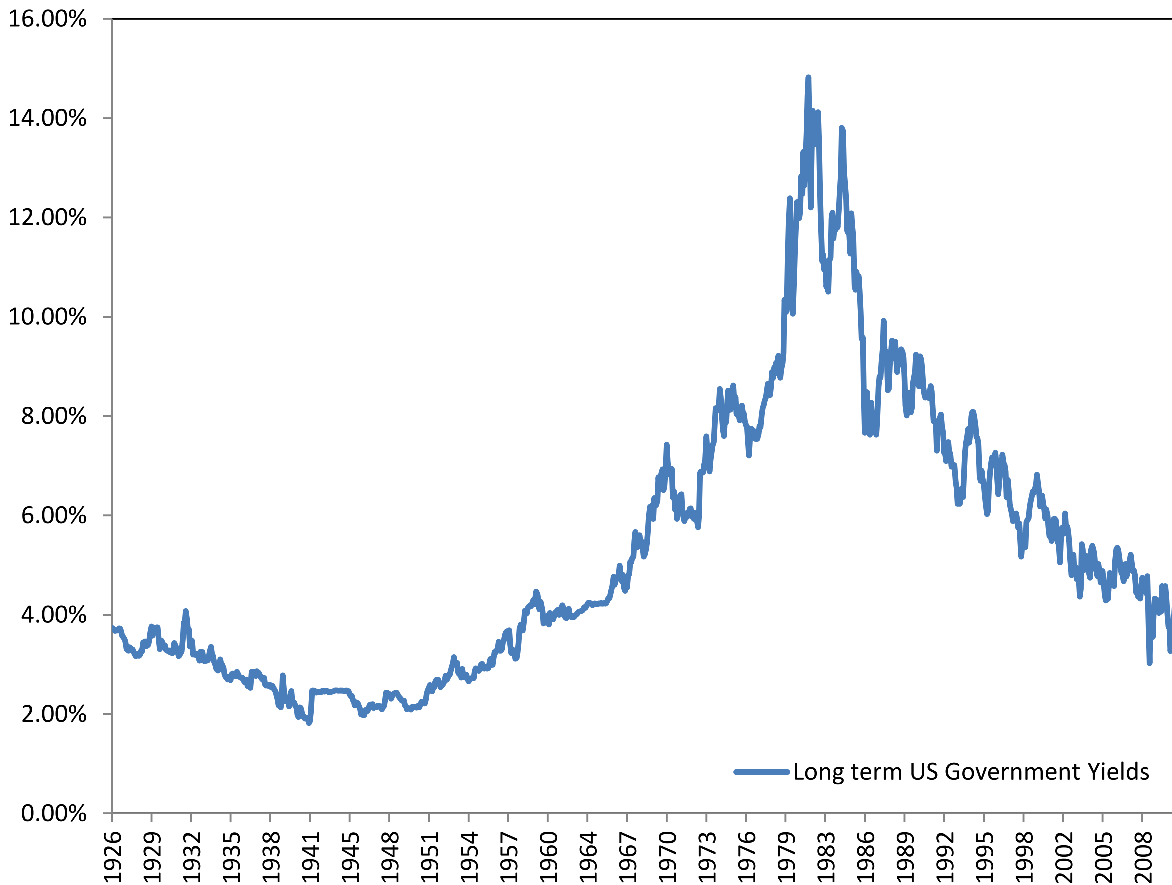
At current levels of rates for US government borrowing, debt service on US debt is about $400BB. It is manageable, but a few things to consider:

1) Rates are at a historically low level after a secular bull market in bonds. (See the chart, below.) What happens if rates balloon to 8% or 10%? As the US started to roll debt to market rates, interest expense would hit $1.5TT, or 70% of tax receipts. There is clearly no way that is sustainable.



Source: Morningstar

2) The Congressional Budget Office[2] projects $12TT will be added to the federal deficit over the next ten years, meaning that it isn't just current borrowing to worry about, it is known future obligations as well.

What to do? The government can raise taxes, but there is limited appetite for that. It can default, and while possible, that would not be in anybody's interest, or it can do what it is doing now: "monetizing" the federal debt through unprecedented purchases of Treasurys by the Federal Reserve, financed by printing money.

What impact does this have?

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[2] http://www.cbo.gov/ftpdocs/108xx/doc10871/frontmatter.shtml

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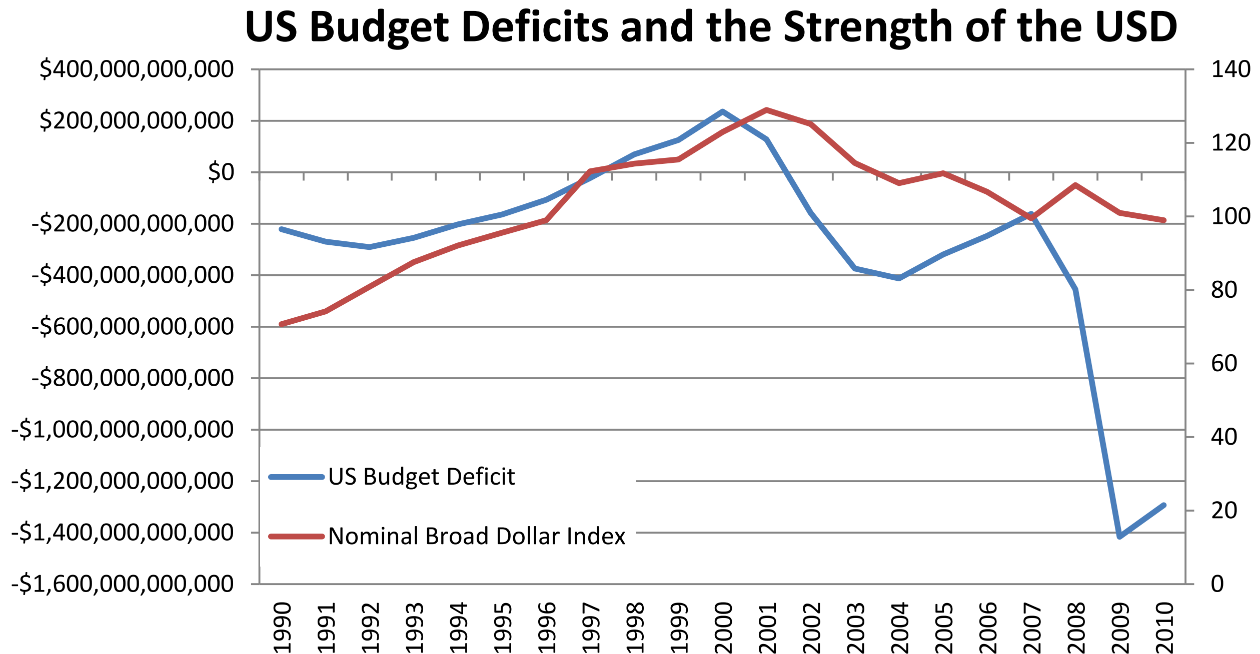
The following chart shows graphically that there is a strong correlation between US budget deficits and strength of the USD.



Source: The Congressional Budget Office and the U.S. Department of the Treasury

Also, moves or inflection points in US budget deficits tend to presage moves in the USD. Numerically, the change in the US Debt/GDP ratio has had a negative .3 correlation with the nominal broad USD index. This suggests that there is a fairly pronounced historical tendency for the USD to fall as debt increases.

Given the CBO estimates, it is expected that US federal debt will grow significantly over the short term. That is clearly not encouraging for the USD.

A longer term perspective and the option premium

Even if we were to discount the immediate deteriorating budget situation and just consider the longer run, there is still a cost to holding the USD.

Over the past three decades (since 1980), the USD has lost 25% percent of its value relative to other major currencies. And, inflation has averaged 3.5% per year. To maintain purchasing power, you have to do at least that well.

Many have looked to precious metals as an alternative. But, over the long run, gold, despite its recent moves, has not been a solution. It is important to remember that gold is not a factor of production—it is not consumed by industry or jewelry to any large degree. It is better to think of it as a substitute currency, and over the long run, it has held its value.

But, over the past 30 years, a diversified commodities basket (with energy, metals, and softs) has done much better. And equities better still.

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	Geometric Mean (%)	Arithmetic Mean (%)	Standard Deviation (%)	Ending Index Value	Maximum Decline (%)
S&P 500	11.46	12.83	17.49	29.71	-50.95
US Inflation	3.46	3.47	1.25	2.9	-4.43
London Fix Gold USD	3.29	4.85	18.4	96.67	-61.79
Morningstar Long-Only Commodity TR	7.74	8.94	16.2	10.28	-53.78
Nominal Major Currencies USD	-0.97	-0.69	7.46	0.74	-51.6

Source: Morningstar

The table above shows what has happened to the USD over the long run. You pay 3.5% every year for the "privilege" or optionality of holding dollars. But, that was before the fiscal situation took on its current urgency. The moves in commodity prices are a portent of what is going to have to happen for the US to dodge this bullet. Commodity volatility will remain high, but until the world starts to denominate commodities in prices other than dollars, oil, grains, and other consumables will continue to stay expensive, and the flip side—they will buy more dollars.

Conclusion

The USD has fallen over 5% on a trade-weighted basis in 2011. LGL's analysis of the relationship between budget deficits, GDP, and the level of the USD, suggest more may be in store. We appreciate the optionality inherent in holding cash, but that optionality commands a "premium", which can be considered as the cost of inflation, historically around 3.5% for the dollar.

Because of the secular trends against the USD and the ongoing cost of inflation, we recommend investors carefully consider their cash holdings, and diversify short-term cash or yield investments into other currencies, in addition to the USD. Finally, while gold has enjoyed a recent bull market, over the long-run, it keeps up with inflation, but doesn't provide the same scarcity effects as other commodities. Investors are better served with a diversified commodity basket than one where exposure consists of just gold and/or silver.

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