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It's All Relative

It's the spring of 1963 and I'm in the boys' locker room of my alma mater, Woodland Junior High School. Yesterday, I brought my gym shirt home so that my mother could wash it but I forgot to bring it to school today. The gym teacher tells me that I have to wear a shirt during gym class and my only recourse is to borrow one from a classmate. Now, just like in every junior high school boys' locker room in America, my classmates' gym shirts fall into one of three categories -- smelly, rank, and god-awful gross. So, given a choice, I'd pick one from the first category. And that, gentle reader, is precisely why whenever a financial panic grips the globe, investors buy US dollars and US Treasury securities. Despite our well-known debt and deficit problems and what often appears to be a dysfunctional government, when the spaghetti hits the fan investors don't seem to care that U.S. Treasury securities and the greenback don't smell like a freshly laundered t-shirt.

The US dollar is the world's reserve currency. A reserve currency is selected by the banking community because of the strength and stability of the economy in which it is used. The British pound served as the reserve currency for much of the 18th and 19th centuries. Today, dollar denominated assets make up almost two thirds of the foreign exchange reserves held by governments and institutions. The dollar is used as the pricing currency for many products traded on the global market - such as gold and oil. Almost half of international transactions are conducted in US dollars. As the provider of the globe's reserve currency, the US is able to borrow money at lower rates than other governments because the global demand for dollars exceeds the demand for any other currency.

The dollar is not in any immediate jeopardy of losing its status as the world's reserve currency, despite what gold bugs and gloomsters may prophesy. It cannot be easily replaced because even if a more stable currency could be found, there would not be enough in circulation to serve as the global reserve currency or provide the quantity of debt instruments required by the global financial system. The dollar's status as the world's reserve currency has only been bolstered by the European debt crisis. No major country has any incentive to allow the dollar to decline significantly in value - the negative implications for the global economy would be too severe. The euro is likely to become an increasingly important reserve currency, especially in Europe, but this does not mean that it will surpass the dollar globally. The dollar's incumbency gives it a head start and declining populations in euro nations will lead to slower economic growth there than in the United States. The most likely scenario is an emergence of a reserve currency system based on multiple currencies. This would likely occur over a period of many years, as was the case when the dollar replaced the British pound following World War II. The more alternative reserve currencies that become available to central banks, the more politicians and policy makers in the US will be pressured to take the steps needed to maintain investors' confidence in the dollar. Given the proclivities of most of our politicians, this might not be a bad development.

A nation's ability to sell its bonds is influenced by the strength of its economy and the currency in which its debt is denominated. At the end of 2008, 45% of international debt securities were denominated in dollars compared to 32% in the euro, 3% in British pounds and less than 1% in Swiss francs. One reason that many foreign central banks hold dollar reserves is because it is the currency that they use to denominate their sovereign debt and conduct foreign trade.

In 2002, the dollar began a steady descent relative to many of the world's major currencies. By the middle of 2008 it had fallen nearly 50% against the euro, 30% against the British pound and 15% versus the Japanese yen. It became fashionable for the dispensers of conventional wisdom to proclaim that continued decline was inevitable and that tomorrow's best investments would be outside the US. The euro was the up and coming star currency of the world. Investors were advised to shun dollar-denominated fixed income investments. Higher yields were available overseas with the added potential of realizing a capital gain when foreign securities were sold and converted back to cheaper US dollars.

Then came the financial panic of 2008. Investors fled to the safety of U.S. Treasury securities because they are considered a safe haven in times of crisis. The dollar rose 35% vs. the euro, 35% vs. the yen and 40% vs. the British pound. At the center of this panic was the loss of liquidity in many markets. In layman's terms, liquidity is the ability to sell an asset quickly at the market price. Liquidity is different from marketability, which is the ability to sell an item without regard to market price. A marketable, illiquid security may have to be greatly discounted to find a buyer - as was the case with mortgage-backed securities in 2008. As liquidity in many markets dried up, investors sought refuge in the most liquid market in the world - the market for US Treasury debt securities. During the height of the financial panic, some US Treasury securities had a negative yield to maturity - they were selling at a premium to face value that exceeded the interest rate that they were paying. Once again, as so often before, return of principal became more important than return on principal.

As global markets stabilized last year and the financial panic subsided, the dollar bashers returned to the forefront. By yearend 2009, foreign investments were all the rage again. But once more, the unexpected happened. While sipping their New Year's Eve champagne, the predictors didn't foresee the Greek credit crisis, or Dubai World's inability to service its debt or new doubts about the long-term viability of the euro. Since the beginning of this year, the US Dollar Index (which measures the value of the dollar in reference to a basket of global currencies including the euro, yen, British pound, Canadian dollar and Swiss franc) has risen 12%. The European debt crisis and tepid European economic growth would lead one to believe that a recovery of the euro versus the dollar is not likely in the near term. Once again, as the unexpected reared its ugly head, investors panicked and purchased US dollars and US Treasury securities.

Like other currencies, the US dollar is not backed by gold or silver. But in the currency market, just like in the boys' gym, it's all relative. A currency's value is determined by the economic conditions and interest rates of the issuing nation. Despite all our flaws, problems and self-doubt, America is still the safest place to invest and, believe it or not, the greenback is still the safest currency in the world. If this was not the case, foreign investors would not prefer US Treasury debt over their own country's bonds during times of crisis. Perhaps they understand something the average American investor doesn't – the importance that a safe haven plays in risk management. Foreigners with assets to invest often need to worry about local banking systems that make ours look like a pillar of strength, nontransparent markets and political instability. Free-markets, property rights and enforceable contracts - three American miracles that we take for granted - remain potent attractors of capital. So, capital will continue to flow to the US because it is viewed as the world's safe haven even when returns are low. But safest does not mean completely safe. It's time we get over the naïve assumption that anything in this life is completely safe.

With all the European debt problems, their comatose economies, declining populations and renewed doubts about the euro's staying power, the situation here in the good old USA doesn't look that bad, relatively speaking. During the recession US companies acted more quickly to cut costs than their European and Japanese counterparts. Times of economic crisis accentuate our economy's competitive advantage -- its nimbleness and adaptability. Despite the long-term problems that the US economy faces, our economic recovery appears to be stronger than in other developed nations. The housing market is weak, debt and deficit levels are rising but compared to the rest of the world, especially Europe, the US is in relatively good shape. Our economic fundamentals are sound - manufacturing is up and interest rates and inflation are low. There are slow but steady improvements in employment. Retail sales have been surprisingly strong the first half of the year even as Americans paid down significant amounts of credit card debt. Japan is experiencing economic recovery but the pace is much slower than here. No one is sure when the economy will be strong enough for the Fed to begin raising interest rates – which should strengthen the dollar - but it seems likely that it will be before the European Central Bank, the Bank of England or the Bank of Japan will be able to do so.

The US is in the best position among the developed economies to deal with debt and deficit problems. The importance of America's high productivity can't be overstated. With only 5% of the world's population, we produce 25% of the world's economic output. High productivity tends to lower unit labor costs and boost profits. Improving productivity, a strengthening currency and rising equity markets go hand in hand. We are the only major industrialized country with a growing population. Even China, which enforces a one child per family national policy, has a declining population. As money flows into US Treasury securities, prices rise and yields decline which helps keep interest rates low here at home. The price of oil is denominated in dollars and with slower growth in Europe and a stronger dollar, US business and consumers should benefit from moderate fuel costs. As

US Treasury rates remain at historic lows, the yields on US corporate debt will look relatively attractive as US businesses raise capital by issuing bonds. This should give a boost to economic activity across the country.

Much has been made about the growth of emerging market countries. The large emerging market economies such as Brazil, India and China have increased their share of global gross domestic product in the last 15 years. Their expansion has come at the expense of Europe and Japan, not the US. 15 years ago the US accounted for 25% of global gross domestic product. Today we are still at 25% but Europe's share has fallen from 25% to 21% while Japan's has fallen from 18% to 9%. As emerging market economies continue to grow they will create a larger and more prosperous middle class, building a larger global market for US goods and services.

The US government will be issuing vast quantities of debt for the foreseeable future so it is prudent to prepare for a time when the dollar might weaken and higher inflation might occur. With unemployment close to 10% and global factory output running well below capacity, deflation may be a bigger worry in the near-term. But to defend against inflation and a weakening dollar there are several investment options that you might consider. An appropriate allocation to foreign stocks can act as a hedge against a declining dollar. Domestic US stocks can also act as an inflation hedge since a good portion of the earnings of US multinational companies comes from overseas. A weaker dollar would make US products more cost competitive. I'm a big fan of real estate investment trusts (REITs) as an inflation hedge since property values and rents increase during times of inflation. Treasury Inflation Protected Securities (TIPs) are an inflation hedge because their principal value increases with inflation. And, most surprisingly, short-term US Treasuries and money market funds have been excellent hedges during times of high inflation. When the Fed raises interest rates to combat inflation, the higher rates appear quickest in the shortest term paper -- short-term U.S. Treasury securities and money market funds. For the homeowner, there is no better inflation hedge than a 30 year fixed-rate mortgage at today's sub-5% rates.

It seems that any time something occurs to remind us that we do not live in Utopia, the media proclaims America's imminent decline. The recent financial crisis and deep recession produced the latest excuse to bash our free enterprise system. *The Economist* magazine conducted a survey asking Americans whether they were better off with a free market rather than a socialist economy "even though there may be severe ups and downs from time to time." Despite all the political blathering and media hype, 70% said yes. The great majority of Americans understand that our free enterprise system has created more wealth and lifted more people out of poverty than any other system devised by man. People might ask, “So why are the 30% running the show?” I believe that it was the economic crisis of 2008, not the promised programs and philosophies of current political incumbents, which led to the recent leftward swing in our national politics. To say that things have never been worse or that the end is near is, I believe, foolishness. It is contrary to reality, ignores the historical record and displays a lack of understanding about America’s place in the global economy. We are a free people with power to change things. In a strange way our national angst might be our best defense if it motivates us to stay engaged in the political process and reverse a pendulum that has swung too far in one direction.

There is no question that the US faces formidable long-term structural problems. Our mounting deficits and national debt result from a lack of discipline, not a lack of resources. The solutions to our problems are easy to identify but will be difficult to implement. We debate endlessly and fret about our profligacy and dysfunctional government. This fretting is a good thing - it’s much better than complacency. We have high standards and high expectations for our country and its leaders. It is the government's responsibility to be the guarantor of our freedom to create, lead and innovate. If it does so, it will ensure that the spirit of innovation and entrepreneurism that has defined America in past crises will prevail again and that our economy, the dollar, and our quality-of-life will maintain their preeminent position in the world.