

Big Wave Commentary

The Declining Dollar Is Not Good For Anyone

When I first wrote about the coming subprime mortgage mess in June, it was with the intention of a warning. A warning that things were not all rosy and swell in “economics land” and that sublime defaults were a major problem looming for the economy. Since that column, the problem has revealed itself. There has been a lot written on the crisis and what effect it will have on the worldwide economy most of it on the negative side. But some positives have been written as well. Recently, columnist Ben Stein took a positive view pointing out in the New York Times that “there is still a long waiting list for Bentleys in Beverly Hills.”

Well, there may be a long waiting list for Bentley’s but the wait for Fords and Chevys is pretty short. The economy is in deep trouble. The credit market’s unwind is not over. In my opinion it is just beginning. The billions of lost dollars invested in toxic debt and derivatives are still months away from impacting economic numbers. This crisis will not be solved simply by the Fed lowering rates or the Treasury Department forming a new agency that will rescue the commercial paper market. It goes far deeper than that and is a much more complicated and technical problem that will be with us far into 2008. As this crisis goes forward, and the fed keeps lowering rates, a new crisis and bubble looms as a shunned US dollar keeps losing value and heading lower.

Most stock market analysts hail this lower dollar as a good development. Even Alan Greenspan says it’s OK that the dollar falls. Their argument is that this makes US goods more competitive and narrows our trade deficit. It will raise earnings for a lot of multinational corporations which in turn keeps price earnings ratios low and helps keep the stock market high. The low PE indicator is becoming an often heard bullish cry on the street these days, justifying the buying of large cap stocks.

In the 1960’s and 70’s this same argument was used to justify the bullish stock market case, except instead of the dollar, inflation was the catalyst for the bulls. Bulls said inflation was good for stocks because it meant companies could freely raise prices, which lead to higher earnings. As inflation climbed higher, company earnings would too and this would bolster stock prices. Anyone who invested in stocks in the 70’s based on this theory remembers how flawed it was.

Today, the very same argument is being made about the weakening dollar. The dollar declining is good because then all the multinationals will have better earnings, everyone can invest overseas and we will all earn more money. The Fed should keep lowering rates not only to save the credit markets but to keep the dollar down which lowers our trade deficit and makes the US far more competitive in a global economy.

I think this theory is as flawed as the one in the 70’s. Over the last 15 years, using cheap money to shore up the economy resulted in creating economic bubbles. The major problems were never cured, just shifted to a new asset class. These new bubbles were used to offset the pain of the previous popped one. The stock market bubble burst in 2001 and the Fed at that time threw money at the markets by lowering rates and created the housing bubble. Now that this bubble has burst, the Fed comes in and throws more cheap money at the market creating a new bubble which is foreign assets and emerging stock markets. The exodus out of dollar denominated assets and into foreign ones is beginning. And as the dollar keeps falling, and the US credit situation worsens, the speed of money flows out of the US will be exaggerated until a new bubble has formed.

And when this foreign asset bubble bursts, which all bubbles do, then what? After money has chased US stocks, real estate, and now foreign assets, where will

the next bubble be created? Some say that there won't be another. That the dollar is the end of the line and rough times will lie ahead. Others think that money will flow to commodities and that inflation will be the next bubble. And yet others believe we are worrying about nothing and that Bentleys will still be very visible in Beverly Hills.

I do not know how it will all shake out. But one thing does seem clear. That again, the market is

underestimating the risk and ramifications of the lethal combination of excessive leverage coupled with bad debt. And by thinking lower interest rates and a lower dollar will offset that deadly duo, they are overestimating the prospects of higher corporate profits and therefore pricing stocks higher than they should. The question for investors now is when will the markets recognize this historically flawed analysis and how much market exposure do they want to have as it starts to unravel.

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