KEEL POINT

INVESTMENT BULLETIN

Volume II, No. 4
April 2013

8065 Leesburg Pike, Ste. 300
Vienna, VA 22182
www.keelpoint.com

Greenback Q & A

If you're like us, you probably had never paid much attention to (or heard of) bitcoin until this month. It's a digital currency that has been in existence since 2009 and its dollar value crashed in April after starting the year on fire. The story is interesting for a number of reasons, not least of which the idea of a new currency that does not exist in paper form or have central bank backing. Both of those characteristics obviously describe the US dollar and even though the greenback has certainly not been on fire lately, we talk to many folks who have questions about whether it is destined for a crash. We thought we would use this opportunity to record some of our thoughts on the topic.

What is our view on the dollar?

It's tough being the greenback. There are a lot of things working against it right now. The Fed, via multiple rounds of quantitative easing (QE), is busy pumping more dollars into the system in an attempt to stimulate the economy. While the new dollars have largely stayed in reserve form (because banks are not lending them into the real economy), the ability of the Fed to remove them from the system without weakening the dollar in the meantime is suspect.

The QE program has driven yields on US bonds to historic lows. Per the Fed's recent guidance low yields are here to stay until unemployment bests a 6.5% reading. Eventually rates will rise, but it's worth wondering if the government will intervene to put a ceiling on them. With debt-to-GDP in the 100% neighborhood there is a limit to how much interest the budget can bear. Low yields today and maybe tomorrow reduce the incentive to hold dollars.

Figure 1: Trade Weighted US Dollar Index
March 1973 = 100
Source: Federal Reserve Economic Data

Further, the American economy buys more from trading partners overseas than it sells. This trade deficit has improved since 2006 ($753 billion) to $540 billion. Further improvement can be achieved by an increase in American competitiveness versus the rest of the world or with a declining dollar. We have confidence that US will continue to achieve the former, but are realistic enough to recognize the latter is far easier. The prospect of helping US exporters is a headwind for the US dollar.

Judging by the trend shown in Figure 1, the dollar has been in decline, when measured against its trading partners, since the eighties. Our view is that this longer-term trend will continue. In the short-term the dollar will rally in "risk-off" periods when investors yank their capital out of stocks and high yield bonds, but these will be blips on a longer term downward trend line.

The risk to this view is the observation that everyone else is trying to weaken their currency too. True, but we think some are playing the game less enthusiastically. China, for instance, has allowed their currency to appreciate against the dollar in recent years. They are in the midst of an enormous shift away from an export-driven towards an internal consumption-driven model for economic growth. A stronger currency is actually helpful in achieving this goal.

How long will the dollar remain the reserve currency?

Certainly not forever. One hundred fifty years is about the maximum any country has held onto reserve currency status since the 1400s and the US is approaching the end of its first century of monetary supremacy. But right now the dollar does have the advantage of a lack of competition. Former challengers such as the euro, yen, and pound are all suffering from the same afflictions discussed above. All but the European Central Bank are involved in a quantitative easing program.

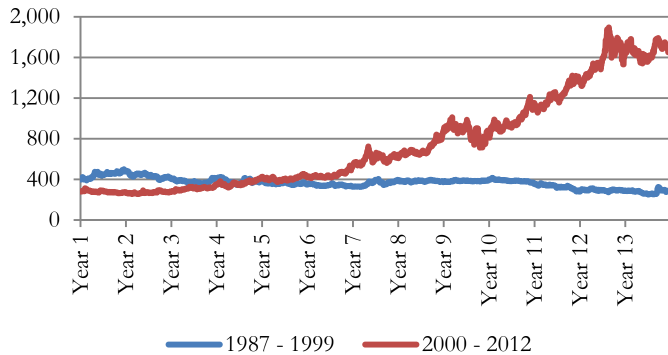
The mantle of reserve currency printer, as you might expect, falls to the world's superpower. For that reason, the speculation is that the Chinese yuan renminbi will take over for the dollar. While we have seen signs that China is opening up their economy to allow for the rise of the renminbi, they are still a ways away from building the kind of dominance in international transactions that the dollar enjoys today.

Are there better stores of value?

Given its success this decade, many would say the answer is gold. The yellow metal has been recognized as a store of value for centu-

ries, a longer run than any currency currently in existence can claim. The problem with gold as a store of value is that its price is so volatile. Figure 2 below plots the spot prices for gold in two consecutive thirteen year periods. The red line represents the last thirteen full calendar years, those that support the view of gold as a high performing asset.

Figure 2: Thirteen Years of Pain vs. Thirteen Years of Gains
Gold Spot Prices ($)
Source: London Bullion Market Association



The blue line, however, represents the thirteen years immediately prior: 1987 through 1999. The slope of line is downward for most of the period; had they invested over the entire time period, investors would have lost 28% of their money. Moreover, that is a nominal figure. The store of value story gets worse when you adjust for inflation during that period.

While gold certainly passes the longevity test, we cannot say it is an ideal store of value due to the price risk. The disappointing answer to the question posed at the beginning of this section is that there really are no ideal stores of value in today's world. Savers are forced to take some risk in order to maintain the real value of their capital.

What does a declining dollar mean for me?

If you buy the longer term declining dollar argument, you may wonder about the consequences. The most obvious effect is inflation. Many of the goods and services you buy are traded internationally. If the value of the dollar is declining, the cost of those goods and services, in dollar terms, will increase.

The potentially larger problem is finding buyers for our debt. The US Treasury reports that as of February 2013 $5.7 trillion dollars of US debt was held by foreigners, roughly one-third of the total outstanding. China and Japan alone account for $2.3 trillion. The value of these holdings deteriorates from the foreign perspective if the dollar is in decline. Should foreign appetite wane, the US would then have to either fund a greater share of the national debt with domestic savings or go through a painfully quick fiscal rebalancing much like southern Europe is experiencing today.

To be sure we do not expect these consequences to appear overnight and they are certainly not a fait accompli. We have high hopes that a grand fiscal bargain could lower the trajectory of our debt and render the previous paragraph moot. If only high hopes translated to a high probability.

Is there a way to protect against this?

Absent the grand fiscal bargain, an intelligent portfolio needs to protect against the possibility of a declining dollar. The simplest way to do this is to own non-dollar assets. Non-US developed and emerging market equities fit the bill assuming the foreign currencies are not hedged back to the dollar. It's also worth considering what foreign currencies you do own via your overseas equities. Assets denominated in euros, for instance, will likely not protect well because many of the same deficiencies the dollar faces are present in the euro system.

Foreign currency bonds offer a more direct way to capture overseas currency appreciation against the dollar. Emerging market bonds are especially attractive over the long-term. The strategy requires finding liquid bonds denominated in local currencies (many are in US dollars) and at an attractive price (spreads tightened significantly in 2012 driving down yields and making the bonds less attractive relative to historical prices).

Real assets may offer some protection as well. Investments like real estate have traditionally protected against inflation, a byproduct of the declining dollar. Farmland could also make sense if food prices are rising.

US companies may also make sense even if you take the declining dollar view. Exporters' products will be cheaper relative to the products made in foreign countries. And multi-nationals would persevere as well to the extent their revenues and assets are earned and owned in foreign currency and their costs and liabilities are paid and owed in dollars. □

This material is distributed for informational purposes only. The investment ideas and expressions of opinion may contain certain forward looking statements and should not be viewed as recommendations, personal investment advice or considered an offer to buy or sell specific securities. Data and statistics contained in this report are obtained from what we believe to be reliable sources including the Federal Reserve, London Bullion Market Association, US Census Bureau, and US Department of the Treasury however, their accuracy, completeness or reliability cannot be guaranteed. An index is an unmanaged weighted basket of securities generally representative of a certain market or asset class. An investment cannot be made directly in an index. Our statements and opinions are subject to change without notice and should be considered only as part of a diversified portfolio. No conclusion should be drawn from any chart, graph or table that such illustration can, in and of itself, predict future outcomes. You may request a free copy of Keel Point's Form ADV Part 2, which describes, among other items, risk factors, strategies, affiliations, services offered and fees charged. Past performance is not an indication of future returns.

Keel Point Advisors LLC is an independently owned registered investment advisor. Securities offered through WFG Investments Inc, Member FINRA and SIPC.