Outlook for the Dollar

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The Issues

• Trade Imbalance
• Budget Deficit/Debt
• Expensive Dollar
• Change in Foreigners’ Appetite for US Assets
Faults in the Assumptions?

• Remember Crowding Out in the 1980’s?

  - Large government borrowing would drive interest rates up and crowd out private investment
  - Foreigners have provided the needed capital, and private investment was not crowded out
Faults in the Assumptions?

• What Might Foreigners Do?
  ▪ Sell US assets?
  ▪ Cease to accumulate US assets?
  ▪ Slow accumulation of US assets?
Faults in the Assumptions?

• Sell US Assets?
  - What would they buy instead?
  - Who would be the buyers?
  - Dollar impact
  - Whose portfolio changes?
Faults in the Assumptions?

• Dollar still expensive?
  ▪ Dollar has already fallen
  ▪ What’s fair value?
Calculating Fair-value

$/£ Exchange Rate

Inflation was higher in the United Kingdom than in the U.S., so nominal exchange rate must depreciate to sustain real exchange rate.

Slope of these lines is determined by relative inflation rate.

Source: WM/Reuters
Is the Fall Finished?

US Dollar - No Longer Expensive

- Blue line: accounting for price adjustments only
- Pink line: adjusting for trade imbalance as well
Faults in the Assumptions?

- Dollar still expensive?
  - Dollar has already fallen
  - What’s fair value?
  - Tendency for assets to overshoot
Equity Flows Dominate
Flow of Investment Capital

Mean = 69%

Mean = 31%

Source: First Quadrant, L.P.
Who REALLY trades in FX?

2004 Update

Daily Turnover (Thousand Million)

- Bank-to-Bank
- Corporate Treasury
- Trade
- Portfolio Flows
- Currency Managers
- Central Banks
- Tourism
- M&A, FDI
- Other