

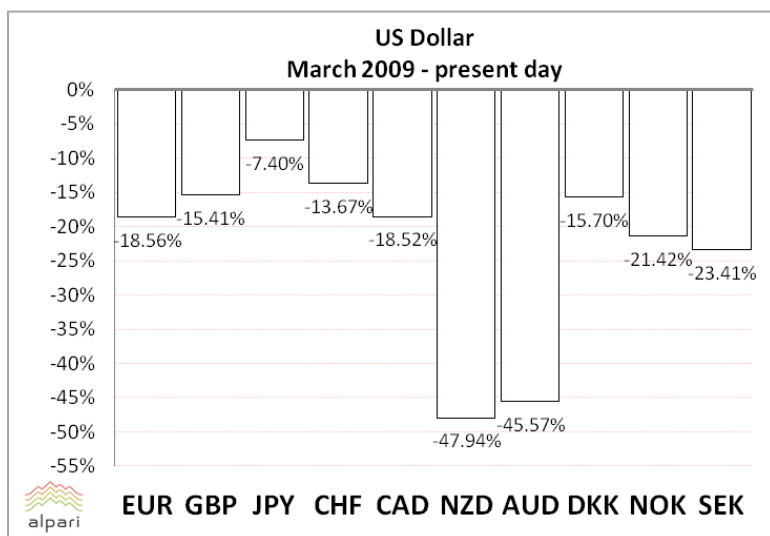
Market Insight

Dollar crisis or bearish Dollar?

The US Dollar has experienced two substantial changes in sentiment since 2007, brought about by the causes and effects of the financial crisis. From late 2007 through to 2009, a severe failure in US credit markets precipitated problems for all market participants as lenders, intermediaries and borrowers hurried to de-leverage, avoid counterparty risk and most importantly, preserve wealth. One of the biggest casualties of the crisis was trust and confidence in the most established banks and financial institutions. The net effects of the crisis were huge falls across all asset classes with growth, investment, employment, production and trade all suffering.

The Dollar rose with the crisis, and is now falling with the recovery as risk motives continue to normalise and investors begin to come out of their shells. The Dollar was in extremely high demand throughout 2008 as investors panicked and looked to the most secure, trustworthy currencies available which in many people's eyes were the Dollar and the Yen. Capital invested overseas was repatriated back to the US alongside foreign safe-haven inflows. The US Dollar was the currency of choice for investors attempting to mitigate risk.

Since March of this year, sidelined US Dollars have been gradually re-deployed into equities, commodities, emerging markets and other higher yielding investments, putting severe pressure on the Dollar. Downward momentum has increased not only in the short-term but possibly in the long-term as well because reserve managers have begun to diversify their portfolios away from US Dollars into Euros, Yen, Sterling and Swiss Francs – threatening long-standing Dollar hegemony. The Fed's ultra-loose policy framework including low rates and asset purchases has arguably been supportive for



the US economy whilst also putting a negative bias on the Dollar because the added liquidity has forced yields lower thus discouraging capital inflows.

The rate of decline has been very aggressive; double-digit declines in

almost every pair over a 6 month period. However, panicked presumptions of a Dollar crisis seem premature because a true Dollar crisis is only likely to occur alongside falls

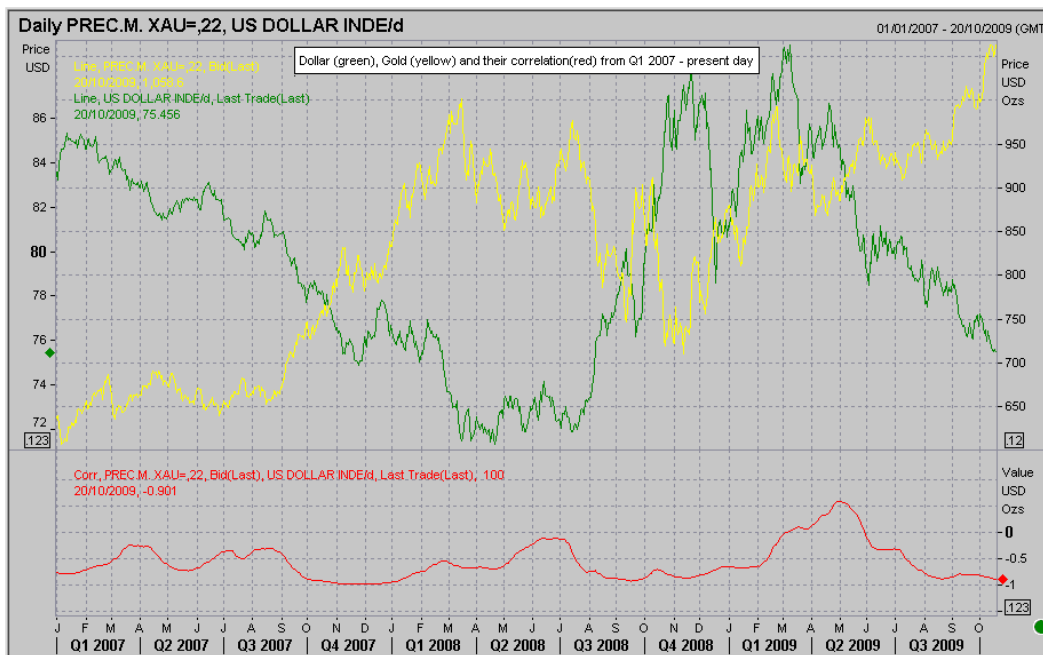


Market Research

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in equities, bonds and property simultaneously. So far, this has not been the case with US equity markets trending higher, resilient demand for US debt and a gradual stabilisation in property prices. It would also be reasonable to expect huge demand for precious metals in this scenario because if confidence in the Dollar disappears, investors are almost certainly going to consider precious metals as a prime store of value and even a medium of exchange seeing as no feasible replacement currently exists.



Gold prices for example, have spiked to record highs of \$1,070 alongside strong demand for equities, bonds and commodities. In many respects this highlights a concern over inflation rather than fundamental Dollar value. Investors are worried about inflation inducing a Dollar devaluation at some stage in the future but not necessarily anxious about an imminent Dollar crisis. Against Gold, the Dollar has re-established its longstanding negative correlation in Q3 2009 in contrast to having almost zero correlation for much of 2009.

The likelihood of a mass exodus out of Dollar denominated assets is incredibly unlikely despite fiscal, monetary and credit problems festering in the US. In some aspects, Dollar reliance has become Dollar dependence for those with high exposures to US assets so any desire to reduce Dollar exposure will have to be indulged gradually.

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