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Strong Dollar: Footprint of Better Policy

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The U.S. dollar has been in a multi-year freefall, plummeting over 40% since early 2002. Recently, it has seemed as though this multi-year move might be reversing itself as the greenback has enjoyed a tremendous rally, rising nearly 10% since the middle of July. Like us, many investors and market commentators applaud this upward move in our currency. However, many investors and commentators do not seem to understand what the move means or why it is happening.

Global currency markets are the deepest and most liquid trading markets in the world, yet investors often do not understand what currencies really represent or what makes them rise or fall in value. Currency by itself is just a near worthless piece of paper, but what a currency represents is something much more important. Currency is a promise. It is a long term promise by the issuing government that the currency will buy tomorrow the same that it will buy today. A currency's strength or weakness reflects the trustworthiness, or reliability, of that promise.

A country earns or loses that trust based on the policies it implements. A country with strong, stable pro-growth policies will garner trust from investors, thus creating demand for its currency and appreciating its currency value. Oppositely, a country with weak, volatile anti-growth policies will break any trust that the country will be able to honor its promises, thus creating less demand for its currency and depreciating its currency value.

These changes in currency value are measured in two ways. The first, and most common way, is to look at currency exchange rates. The problem with exchange rates is that they cannot tell you which country is gaining or losing trust. If the U.S. dollar rises against the Euro, as represented by the \$Dollar/Euro exchange rate, is it because the U.S. implemented better policies and gained trust or because the Eurozone implemented worse policies and lost trust? To answer this question and be able to see a currency's strength or weakness more clearly, one must measure a currency against some standard like gold, or another basket of "stuff."

A trusted currency neither inflates (falls in value) nor deflates (rises in value). Both are breaches in trust, and both cause "windfall" losses. In the case of inflation, the losses are to savers and lenders. In the case of deflation, the losses are to borrowers. The Fed plays a small but important part in making currency stable, but there is no Fed policy that can offset a massive drop in the demand for money caused by bad government policy.

We can now assess the recent dollar rally in terms of what it is telling us and why it is happening. The dollar index has risen nearly 10% since mid-July against a basket of nearly all currencies. Part of this short term move is likely due to the fact that investors are losing trust in Eurozone polices relative to the U.S. European economic growth continues to slow,

and the ECB insists on fighting the wrong enemy of inflation instead of addressing the global deflation by cutting interest rates.

However, the dollar has also strengthened against gold by nearly 20%. This tells us that there may be a fundamental positive shift in U.S. policies. Energy policy is improving, as the reality of U.S. offshore drilling becomes more likely. Monetary policy is also improving, as falling commodity prices are evidence that the Fed and Treasury should stop worrying about the wrong problem, inflation. Lastly, we do not think it is a coincidence that the dollar bottom against other currencies and gold coincides with a huge increase in McCain's odds to be our next president. Since July 14th, McCain's odds have surged in most national polls as well as in online political trading markets like www.intrade.com.

The dollar is reacting to the increasing possibility that the low tax, free trade, energy independent candidate will win, and it is beginning to regain investors' trust. McCain's pro-growth policies are mandatory for a sustained rally in the dollar. If we get those policies, the coinciding strong dollar will be joined by capital inflows to the U.S., employment growth and rising stock and bond markets

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