zikkir

Business News Forum

Protect yourself from a dollar disaster

Posted by Bin Du | 20 October 2009, 7:01 pm

Don't kid yourself: US currency is going to keep losing value. The question is how far it will fall. Fortunately for investors, there are ways to play this trend.

As if high unemployment, huge government deficits and a shaky economic recovery weren't enough, the credit crunch may soon inflict another indignity upon the U.S.

We all may soon bear the enormous costs that would come about if the world stops using the dollar as a reserve currency — something akin to using U.S. chips in the global casino.

It's a worst-case scenario, and, of course, it might not play out. But it's worth a look to see how investors could protect themselves — and profit — from not just this scenario but the continued slide that could cost the dollar its favored position. The dollar has taken a beating, and it is going to keep falling.

Since January, the dollar has dropped about 9% against the euro, from $1.36 per euro at the start of January to $1.48 recently. Compared with a basket of foreign currencies weighted by trade, it's fallen 11%. (Click here to see how the dollar is faring today.)

I'll have some strategies and picks later in this column, but first let's look at what all this reserve-currency talk really means.

A status symbol
Since World War II, the U.S. dollar has held special status for a simple reason: The biggest players in the global financial markets prefer to park their wealth in the currency of the country that looks the most stable.

These players, including China, European governments and those of the oil-rich nations, have gone with the U.S. because of its military might, conservative budget policies, stable political system and rule of law. They

also use the dollar when they trade with each other.

Now, though, as concerns grow about the fallout from the enormous borrowing in the U.S. to fight the credit mess, this status may be slipping away. The potential impact is so high it could permanently impair growth prospects in the U.S. Here's why:

The dollar in demand

Currently, global demand for dollar-based assets pushes up the prices of U.S. Treasurys and other bonds. This reduces yields, the interest paid to people who agree to buy that debt.

"We can issue debt without having to attract foreign buyers with higher interest rates," says Andrew Busch, a foreign-currency expert with BMO Capital Markets in Chicago.

The savings these low rates generate are so big that if they went away it would slow U.S. growth to the point where everyone's standard of living would take a hit, says Mark Zandi, a co-founder and the chief economist of Moody's Economy.com. Signs that demand for the dollar is waning keep popping up:

* Big players around the world seem to be backing away. "The gap between the growth of global foreign-currency reserves and foreign official buying of U.S. assets is near a record high," says a recent report from currency experts at JPMorgan Chase. It looks like some may be avoiding dollar-denominated government debt to reduce exposure to budget problems in the U.S., Busch says.
* Last week, a British newspaper, The Independent, said oil countries in the Middle East along with China, Russia, Japan and France are plotting to substitute a basket of currencies for the dollar in oil trading. Many of the identified countries denied the report, but the buzz created by the article "just shows the vulnerability of the dollar," says Axel Merk, the manager of the Merk Hard Currency Fund (MERKX).
* In March, China caused a stir in the currency markets when it called for the dollar to be replaced as the world's reserve currency. Russia has said it wants a new "global supercurrency" to replace the dollar. And last week the United Nations called for a new global reserve currency to substitute for the dollar.

Despite these rumblings, the dollar's status could be safe for a while longer for a simple reason:

"The U.S. markets are the deepest and most liquid in the world," Merk says. No other currency market can handle the amount of cash that flows around the world on a daily basis.

“It is really the only ‘bank’ that is big enough to hold the transaction volume where people have instant liquidity and political safety on a 24-7 basis,” agrees Fred Dickson, the chief market strategist for D.A. Davidson.

But longer term, “everything is up for grabs,” Busch says. Much depends on how well lawmakers and the Federal Reserve can balance the risk of inflation with the huge debts run up trying to stimulate the economy.

Why the dollar will go down
However that all plays out, one thing is certain: The dollar is going to keep falling against foreign currencies.

Reason No. 1: The Obama administration wants a weaker dollar. The administration — like the Bush administration before it — wants a weaker dollar because it helps the economy by increasing foreign demand for U.S. goods.

Reason No. 2: Investors are skittish about government borrowing. The Obama administration is spending hundreds of billions of dollars to rescue banks and stimulate the economy, driving up the budget deficit to a record $1.4 trillion in the fiscal year that ended in September. Meanwhile, the Fed is “monetizing” the national debt — using government money to buy government debt as another way to inject dollars into the system.

Over the long term, these policies are a recipe for ruining a currency. They create inflation or at least worries about it, which erodes the value of the currency. People will sell dollars to avoid the damage. “Monetizing debt historically has always ended in disaster for a currency,” Busch says.

Reason No. 3: Interest rates are low in the U.S. compared with the rest of the world. Currency traders know it will be a long time before the Fed starts raising rates, given the high level of unemployment, says Leonard Kaplan, the president of Prospector Asset Management.

This hurts the dollar in two ways: First, investors take their money elsewhere to get higher interest rates. Second, in what’s known as the carry trade, investors borrow in the U.S. at cheap interest rates to invest elsewhere. This creates an excess supply of dollars as those investors sell borrowed dollars to invest elsewhere.

Of course, the dollar will bounce around and tick up at times. But overall, the above factors spell doom for the dollar for several years ahead. Merk thinks the dollar will decline 10% a year, on average, against most other currencies for the next several years. Busch expects a 7% annual decline over the next two or three years. And Dickson, at D.A. Davidson, expects an 8% dollar devaluation over the next 12 months.

Here are the five best ways for investors to play this trend:

1. Buy foreign currencies

It's complicated for individual investors to purchase currencies outright. One alternative is to invest in foreign-currency mutual funds playing the weaker dollar trend. Three to consider are the Merk Hard Currency Fund, the Merk Asian Currency Fund (MEAFX) and the Merk Absolute Return Currency Fund (MABFX).

Another option is to go with foreign-currency exchange-traded funds, or ETFs, such as CurrencyShares Euro Trust (FXE, news, msgs), CurrencyShares Australian Dollar Trust (FXA, news, msgs), WisdomTree Dreyfus Brazilian Real (BZF, news, msgs) and WisdomTree Dreyfus Emerging Currency (CEW, news, msgs). Merk advises against exposure to the British pound because he says it faces many of the issues plaguing the dollar.

2. Buy precious metals and other commodities

All of these things are priced in dollars. So as the dollar weakens, they look cheaper, and demand goes up. Plus much of the world is in a strong recovery, so demand for these things is stronger.

Tom Winmill of the Midas Fund (MIDSX) thinks gold, already trading near all-time highs, will keep rising and trade for $1,200 an ounce in the first quarter of 2010. You can get exposure to gold and precious metals through funds like Winmill's or through ETFs or exchange-traded notes such as SPDR Gold Shares (GLD, news, msgs) iShares COMEX Gold Trust (IAU, news, msgs), iShares Silver Trust (SLV, news, msgs) or ELEMENTS Rogers International Commodity Index Total Return ETN (RJI, news, msgs).

3. Buy gold stocks

Winmill likes Jaguar Mining (JAG, news, msgs), a Brazilian company that could increase production by 50% a year over the next two years, in part because it's going back into old mines with newer mining technology.

A classic gold mining play is BHP Billiton (BHP, news, msgs), one of the biggest and more financially disciplined players in the space.

4. Buy companies doing business overseas

Companies making their stuff in the U.S. will see demand increase because of a weakening dollar. And companies that produce abroad can buy more greenbacks when they bring their earnings home. This may seem like a mere accounting adjustment. But in fact they're really getting more money for what they sell — in dollar terms. So it's meaningful.

Credit Suisse, for example, just upped its earnings estimates and price target for beer can and packaging producer Crown (CCK, news, msgs) in part because of the weak dollar. About 74% of Crown's sales come from outside the U.S.

Some of the other classic plays on this theme are Coca-Cola (KO, news, msgs), PepsiCo (PEP, news, msgs), McDonald's (MCD, news, msgs), Johnson & Johnson (JNJ, news, msgs), Procter & Gamble (PG, news, msgs), Colgate-Palmolive (CL, news, msgs), Caterpillar (CAT, news, msgs), General Electric (GE, news, msgs), Boeing (BA, news, msgs), Intel (INTC, news, msgs) and other U.S.-based manufacturers. (Read "The myth of U.S. industry's demise" for more on this.)

Be careful if you try to play this theme using mutual funds, however. Some foreign stock funds participate in hedging, a trading strategy designed to negate changes in foreign currency compared with the dollar. A few funds that do this, says Gregg Wolper of Morningstar, are Tweedy, Browne Global Value Fund (TBGVX), Mutual European Fund Z (MEURX) and Pimco International StocksPLUS TR Strategy A (PIPAX). These three fund groups also run international funds that do not hedge.

5. Buy bond funds that park money abroad

When you invest in foreign bonds that do not hedge away the currency risk, you're "parking" money abroad. As the local currencies get stronger against a falling dollar, that parked money can buy more dollars, so wealth goes up. Plus the interest rates their money earns abroad will likely be higher than it would earn here.

Any global bond fund that doesn't hedge away currency risk can be used to play this strategy. Arijit Dutta of Morningstar says three of them are the Pimco Foreign Bond Fund (Unhedged) (PFBDX), the Pimco Global Bond Fund (Unhedged) D (PGBDX) and the Templeton Global Bond Fund A (TPINX).