Special Report:
Weighing the Risk of Dollar Devaluation Against the Risk of Dollar Appreciation

During the Great Recession of 2009 people feared that the dollar would be devalued as had happened in the Great Depression. People feared the Federal Reserve would increase the money supply leading to inflation which would trigger devaluation. Now that the U.S. has the world’s best economy and the political pressure to repeat the government stimulus programs of the Great Depression have faded it is unlikely that the government/ Federal Reserve will engage in inflationary policies. Therefore it is unlikely the dollar will be devalued since other major countries have more challenging problems.

The dollar is now trading at 94.5 for the DXY index on 11-10-2017. It has ranged between 70 and 100 for most of the past 40 years, with the exception of two outlier periods. These outliers were in the early 1980’s when U.S. rates were very high and the dollar was at 160 and in the 1997-2000 tech bubble when the dollar reached 121. The dollar index in 40 years has been going down against other countries at less than 0.75% a year, so it is not a cause for concern. The index is usually published in charts starting in 1971 when the U.S. went off the gold standard. There were three bubbles in the value of dollar since WWII. The first was a result of winning WWII which lasted until the mid-1970’s. If we assume that the era before 1976 was a currency bubble caused by WWII then we should truncate that era. Also truncate the dollar bubble caused by ultra-high interest rates in the 1979-1986 Volcker Fed era, and truncate the third dollar bubble in the dotcom tech bubble of 1997-2000. Once these areas have been truncated then the dollar has traded in arrange between 100 and 70 with a loss of about 20% in the past 40 years (0.6% decline a year), Assuming the Euro, which is now at $1.165, is truly only worth its original value of $1.1743 in 1999 then this implies the dollar is at least worth a minimum of its current DXY-y value of 94.5. I anticipate that the other member country components of the DXY index (Japan and the Euro) will get weaker than the U.S. and thus the dollar could regain its highs. Thus the greatest currency risk maybe owning foreign currency.

The four major currencies are the dollar, the Yen, the Yuan, and the Euro. Of these, the dollar is the healthiest. There is considerable risk that Japan’s Keynesian stimulus program may lead to serious inflation and a decline in value for the Yen. The risk is significant that the Eurozone will try some inflationary money supply increase to help the southern region become healthy. The risk is great that northern Europe’s banks will be hurt by further weakening of loans they made to southern
Europe causing great strain on the Euro currency. China also has risks that it has done too much debt fueled stimulation that is not paying off in proportion to the debt incurred. Thus China, the Eurozone and Japan all could need to devalue their currency. The other countries with healthy currencies are too small for international investors to diversify into, except for Britain. In addition, what investors want when they invest in foreign currency is to buy foreign Treasury bonds and the countries with the best currency (except the U.S.) usually have very small debts and thus there aren’t many Treasuries available to buy. The best countries are often small with a population under 10 million like Switzerland, New Zealand, Norway, Sweden, Finland, Singapore. They are too small for giant investors to invest in local Treasuries. That leaves the U.S. as the best place for foreign investors and foreign Central Banks to buy Treasuries. As the U.S. economy improves then political climate will become more favorable to business and there will be less risk of becoming an ever-increasing welfare state, thus helping make the country more solvent. As the economy improves then the Federal Reserve will raise interest rates. Interest rates are a key driver of the dollar’s value, so the dollar will go up.

One of the major paradigms of the past decade were that China’s economy would grow forever at a fast pace, creating demand for commodities and that commodities are a hedge against inflation. That paradigm is about to be disproved (or already has) which will result in investors leaving commodities and moving into dollars. As China’s inflation and impact on global demand for commodities cools down then investors will invest in the opposite of commodities which implies investing in dollars. As the dollar’s real interest rate rises (on dollar denominated loans) then people will sell off gold and move into the dollar and gold will go down. Gold and silver are not a substitute for the dollar because they have experienced extreme fluctuations in value and they incur significant costs for brokerage, storage, assay, insurance, safe transportation, etc. Precious metals pay no yield and incur annual maintenance costs. They are the ultimate form of a negative interest rate bank account (metaphorically speaking), except that you can’t sell gold and get back a guaranteed amount of money compared to an insured bank CD. If gold drops below $1,000 it may become a very unpopular investment for a long time and that will help the dollar.

Some people claim that Emerging Market economies grow faster than the Developed World and incur less debt than the Developed World so the implication is that EM countries are better credit risks and better currencies than the U.S. However, the EM countries face the risk of not being able to grow past the “Middle Income Trap” where countries that try to grow from poor to rich often flounder and stagnate. Basically the “Middle Income Trap” refers to problems caused by corruption, cronyism, lack of respect for free enterprise, the brain drain to the Developed World, etc. all act to make it hard for Developing countries to continue
their fast rate of growth and grow into Developed economies.

The real value-add of the Developed World is that it has greater capacity and potential to handle the complicated aspects of the new modern high tech economy and the EM countries as a result will not be able to grow as fast since they will end up working on low margin blue collar projects like volatile job shops that do contract manufacturing for developed countries. The EM countries have a disproportionate amount of the world’s commodity production and that industry is very volatile and is subject deep boom and bust cycles. The nature of a volatile investment can make it less valuable by subjecting its owner to more vicious boom and bust cycles, which may include being fooled during bubbles into thinking that expansions will last forever and then incurring too much unserviceable debt, which can lead to defaults. Thus there is a greater probability that EM economies and their currencies may underperform compared to developed countries.

As EM countries become more like the Developed world they acquire more debt including government debt and welfare spending projects that require more debt. Over time they will more closely resemble the Developed world’s high ratio of debt to per capita income thus reducing bond investors’ desire for EM sovereign debt.

It has been said by others that EM countries are better because of higher growth rates. But growth in and of itself has no value. What are valuable are profits and wages. If a business is growing but losing money then it really has no value except scrap value. If a business has profits those profits can be capitalized into an estimate of value. The same applies to countries. If a country has insufficient income to service its debt then growth alone is not the solution. Growth must be sustainable and it must involve profitable activities. If no profits occur then a country may need to default on debt or devalue the currency to stimulate exports.

The problem with investing in foreign currency is that some of a currency’s driving forces of its values are based on sudden political shifts (usually to devalue) that are inherently unpredictable. This induces a higher than compensated for amount of volatility and a lower Sharpe ratio making foreign currency intrinsically handicapped in terms of competing against other investments. The key to investing is to avoid excessive, uncompensated, hidden risk. Foreign currency is, in that regard, the worst type of investment.

People worry the U.S. will default on its Treasuries but as the economy moves away from the recession of 2009 then more people will be working and paying taxes and less people will be on welfare, leading to a smaller deficit. Special events such as Iraq and Afghanistan and the Great Recession created a huge deficit. The main risk of a future deficit is continued increases in government spending over the next 30 years for medical programs such as Medicare and the ACA subsidy, etc. If Congress can find ways to save on Medicare, such as medical tourism, or using Physician Assistants, etc. then that will help to turn the tide against this risk.
A popular myth is that if China or other countries got mad at the U.S. they could sell their Treasuries or simply refuse to roll them over when they mature. If they refused to roll them over then when they are due the Federal Reserve could simply pay China’s Central Bank by printing the money in dollars. The Federal Reserve would be lending the new printed money to the Treasury to pay China and then if China left the funds in deposit in the U.S. it would held in the Federal Reserve, and would be all done electronically rather than by printing documents. This is called “print and pay”. As long as the U.S. is one of the great nations it can simply do this to avoid default. If China had an enormous amount of dollars in the Federal Reserve after the Treasuries were repaid, then if they sold their dollars to buy Swiss francs, etc. the Franc would go up too much and the dollar would go down causing the Central Bank of China to lose money.

The U.S. has a history of keeping inflation low and stable during peacetime and low inflation is sign of a strong currency. Investors should focus on concerns other than the risk of dollar devaluation.

The risk is great that investing in exotic financial instruments like commodity futures contracts for currencies or currency ETN’s can have bizarre tracking errors that compound the other problems with foreign currency speculation. In addition, the tax code treats foreign currency as a commodity so the tax rate is 28% instead of 15% on Long Term gains. A successful investment strategy should focus on something with the fewest possible moving parts since you never know what part may break down and ruin an otherwise good strategy.

To subscribe for free to Don Martin’s blog go to www.mayflowercapital.com/blog. For a personalized consultation about investments please contact Don Martin, CFP® at Don@mayflowercapital.com or (650) 949-0775.
Follow Don Martin on Twitter @DonMartinCFP

This report is solely for information and education and is not financial advice. To obtain advice you must become a client, sign a contract, pay fees, and complete a detailed questionnaire, etc. Regarding your own personal finances, you should seek independent financial advice.