



A Declining Dollar Implies...Sharply Rising Commodity Prices

BY GARY ALEXANDER

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A year ago, all the talk was about a commodity price bubble: Oil was near \$150 per barrel, gasoline cost \$4 a gallon, copper hit \$4 a pound, silver reached \$21 an ounce, and corn soared to \$6.30 per bushel in the wake of the ethanol craze. Grain prices then soared even higher during the Midwestern floods last June.

Now, with 20/20 hindsight, everybody calls last summer a classic bubble in commodities, but commodity prices were not rising so sharply in euro terms, or in Swiss francs, or Canadian dollars back then.

If you live and invest within a dollar-based economy – most notably, the United States – you go about your daily life (and your investing) oblivious to how the rest of the world measures these dollar-based bubbles. In this report, I want to take you back a year in this war between commodities and U.S. dollars.

DOLLAR SWINGS IN THE LAST 12 MONTHS



Currency	Mid-2008 Peak	Early-2009 Low	Recent Price	(Gain)
British pound	\$2.02	\$1.35	\$1.55	(+14.8%)
Canadian dollar	\$1.02	\$0.76	\$0.87	(+14.8%)
Swiss franc	\$1.00	\$0.81	\$0.90	(+11.1%)
Euro	\$1.60	\$1.25	\$1.36	(+9.2%)

Source: Yahoo! Currency Converter

Last July, the U.S. dollar dipped to parity with the Swiss franc for the first time ever (i.e., one Swiss franc was briefly equal to \$1). At the same time, the euro reached \$1.60, its all-time high. Even the Canadian dollar was worth more than the U.S. dollar a year ago. In simple terms, the middle months of 2008 do not represent a commodity bubble as much as a major dollar collapse, reaching a post-World War II low.

The U.S. dollar index (DXY) compares the greenback to a basket of six major currencies, using 1973 as an index standard (100). By that measure, the dollar bottomed out on March 17, 2008 at 71.18. Not by coincidence, that was the same day gold set its all-time high of \$1,032 per ounce. Four months later, on July 14, 2008, the DXY tested its March lows, dipping to 71.91 before rising sharply into early 2009. In the first week of March 2009, the DXY dollar index peaked at 89.20, for a net 25.3% gain.*

* The Dollar Index (DXY) is dominated by the euro (with 57.6% weighting), then the Japanese yen (13.6%), British pound (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%) and Swiss franc (3.6%). The glaring omission is the Chinese yuan, but it is based on a basket of six currencies, so its value is deemed redundant.



Dollar 200-Day Moving Average
Daily Data 5/16/2007 - 5/18/2009



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The dollar's sharp rise in late 2008 came as a surprise to most currency traders and analysts, since there was no fundamental reason for the dollar's rapid rise after an 8-year decline. As you can see from this chart, the dollar's rise was most dramatic during the 60 days from September 15 to November 15, 2008.

In 20/20 hindsight, the dollar was then seen as a safe haven during the global financial crisis, which escalated in mid-September with the demise of Lehman Brothers. Then, the dollar recovery fed on itself, due to the unwinding of the carry trade. (In the "carry trade," hedge funds and others borrow large amounts, often on margin, in currencies with low interest rates, like the U.S. or Japan, and then invest that money at higher rates in sound currencies with higher returns, like Australian or New Zealand dollars.)

THE CURRENCY MARKET: A GLOBAL DISCIPLINARIAN

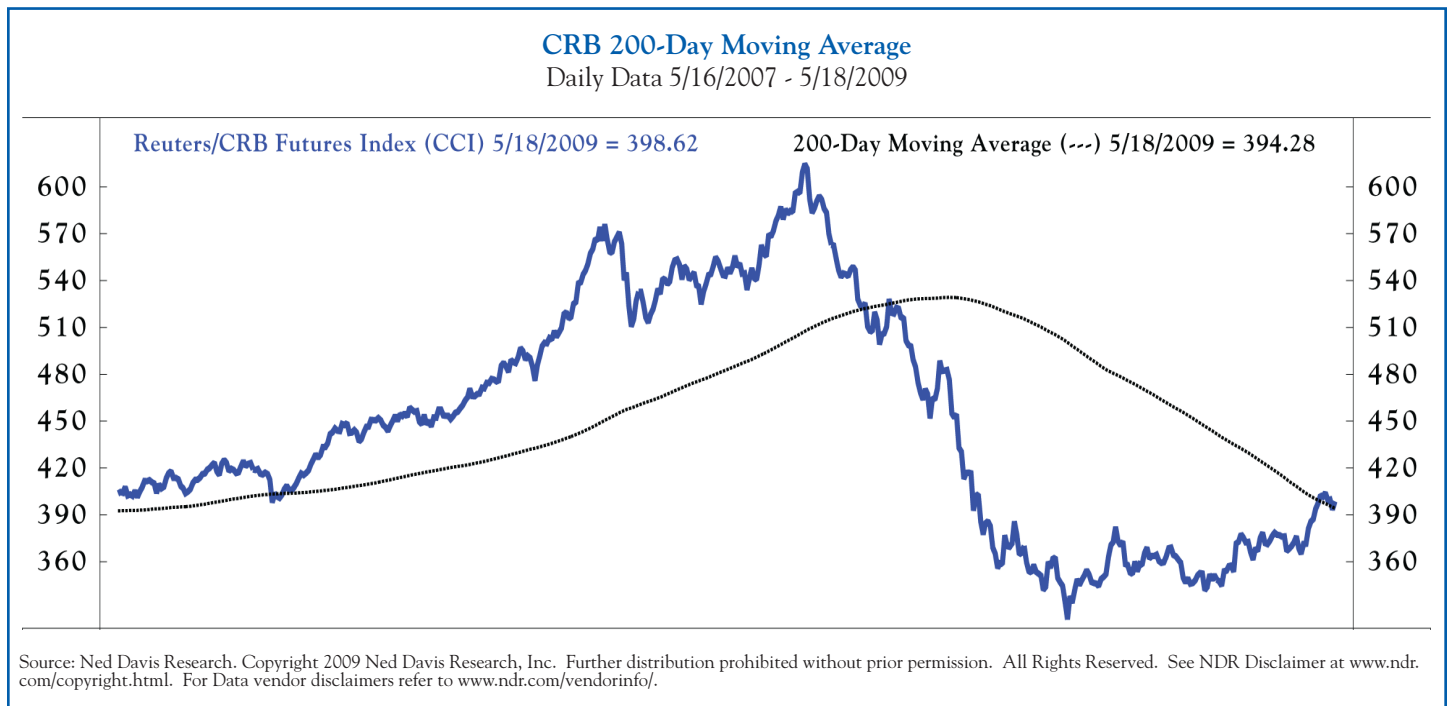
Currency markets are open 24-hours-a-day and trade \$2 trillion daily. The currency markets are stronger than any one central bank or a cabal of minor central banks. The currency markets discipline governments for their profligate policies – and they do so long before monetary inflation can turn into price inflation. The U.S. dollar is still considered the world's reserve currency, and the dollar still dominates global currency trading, with 89% of all currency trades including the dollar on one side of the trade.

Gold is one example of the negative correlation of commodities to the dollar. Over the last eight years – the length of the current bull market in commodities and bear market in the dollar – the negative correlation between the U.S. dollar and gold has ranged from -0.3 to -0.7, averaging -0.5. A perfect correlation is 1.0, so this means that roughly half of gold's price moves are based on a mirror-image reaction to the dollar's moves.

All the other fundamentals – gold's supply and demand, inflation hedge buying, panic ("crisis hedge") buying, safe-haven buying, jewelry demand, India's wedding season, and all the rest – account for the other half of gold's moves, up or down. In this sense, gold is an approximate mirror image of the U.S. dollar, although the two dance partners obviously don't mirror each minor move.



This is true of most other commodities as well. Oil peaked near \$150 per barrel when the dollar was weakest, and it dipped to \$38 when the dollar reached its peak last March. A weakening U.S. dollar is also driving crop prices up. The Reuters/CRB Commodity index reflects this rough mirror image:



WHY THE DOLLAR WILL LIKELY CONTINUE TO FALL

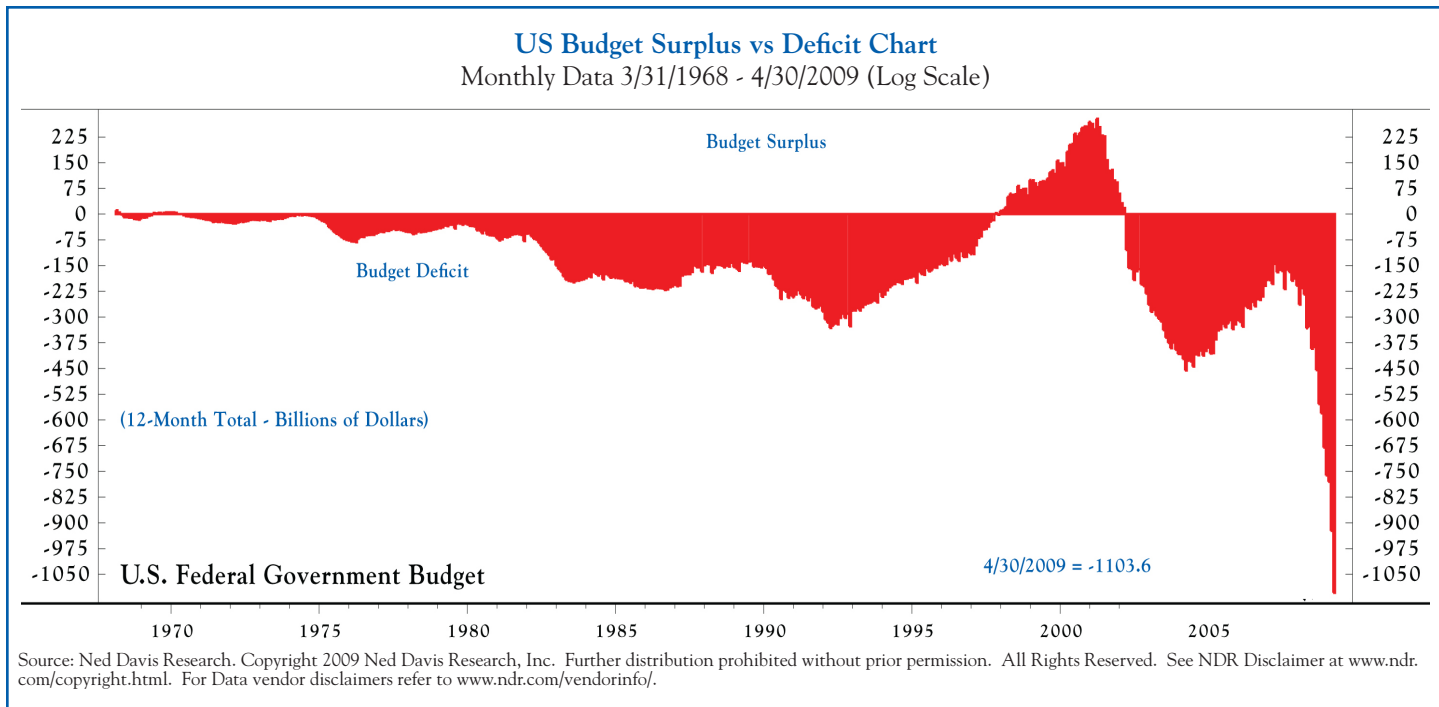


It's no secret: America has been trying to spend its way out of a serious recession and banking crisis. Printing trillions of new dollars, either as cash or credit, has serious implications for the future of the dollar. This year's budget deficit may top \$2 trillion – about four times larger than any previous deficit.

Currently, 46¢ of every dollar that the federal government spends is borrowed, which makes each dollar worth less in terms of other paper money alternatives, or in terms of a basket of hard commodities.

The U.S. deficit is rising fast. The IRS just released the shocking news that it suffered a deficit of tax revenues in April – a month which has always provided the Treasury with a short-term surplus. Most Americans must pay their taxes by April 15, flooding the IRS coffers. Even those filing extensions must pay all their 2008 taxes by April 15 to avoid stiff penalties. Independent contractors and businesses must also pay quarterly taxes on April 15, so April is usually a surplus month for tax collections. Not this year.

This April tax deficit comes on top of a record high deficit in the first six months of fiscal-year 2009 (running October 1 to September 30). Through March 31, 2009, U.S. federal government outlays were up 33% to \$1.95 trillion, while receipts were down 14% to \$989.8 billion, for nearly a \$1 trillion deficit in the first half of this fiscal year. Due to the recession and layoffs, corporate income tax receipts were down 57% to \$56.2 billion, while individual income tax receipts were off 15% to \$429.7 billion.



As a result of record-high spending and rapidly shrinking tax receipts, the 2009 U.S. budget deficit is now up to 13.7% of GDP. Within two years, our cumulative federal debt will reach 100% of the annual GDP. While politicians may talk about defending the dollar, their actions reflect an all-out assault on the dollar. In particular, record-high deficits and profligate money-printing almost guarantee a declining dollar value.

For the time being, consumer price inflation is masked, because approximately 40% of the Consumer Price Index (CPI) is Owner's Equivalent Rent. Due to excessive inventories of empty apartments, condos, and homes, this component of the CPI is unlikely to rise anytime soon. However, there is no doubt that food and energy costs are now rising due to the fact that the U.S. dollar is fading fast, and U.S. Treasury auctions continue to be met with insufficient and indifferent demand, driving interest rates up.

CHINA IS NO LONGER SUPPORTING THE U.S. DOLLAR

Compared to the rising deficits in America, China's central bank just announced that its foreign exchange reserves rose by 16% in the previous 12 months, to \$1.9537 trillion as of March 31, 2009. Chinese reserves, already the world's largest, increased another \$7.7 billion in an otherwise-dismal first quarter.

Analysts believe that China continues to hold up to 70% of its foreign reserves in U.S. dollar-denominated assets, especially Treasury securities, but China may now be diversifying its foreign reserves, especially after Treasury Secretary Geithner accused China of "manipulating" its currency.



When Secretary of State Hillary Clinton recently went to China to urge the Chinese to keep buying U.S. Treasury securities, she said, "By continuing to support American Treasury instruments, the Chinese recognize our interconnection. We are truly going to rise or fall together." Hmm! That's not a very appetizing reason to buy dollars. Perhaps the Chinese can think of some other assets to accumulate!

Sure enough, China has been stockpiling copper and other commodities, partly for industrial usage but also due to the fact that China is promoting a currency-based currency system to replace the dollar. In the first quarter of 2009, China imported a record 937,034 tons of copper, up 32.9% from a year earlier.

China's yuan was once pegged to the U.S. dollar, until 2005, when U.S. politicians argued that this gave China an "unfair advantage" in world trade. As a result, the yuan is now based on a basket of currencies.

At the very least, China is now calling for the DXY or a similar "basket of currencies" to replace the U.S. dollar as the world's reserve currency. Coincidentally, this makes the Chinese yuan the ideal currency to replace the U.S. dollar as the world's new reserve currency. In fact, Nouriel Roubini, the perma-bear Professor of Economics at New York University's Stern Business School, argues that China is better prepared than the U.S. to provide a reserve currency for the 21st century because it has a large current account surplus, a more focused government, and few of the economic worries that the U.S. now faces.

It's clear that China has grown tired of watching their trade surpluses deteriorate as the U.S. dollar decays. Chinese officials have bluntly stated that Beijing is worried about its massive investments in U.S. Treasury securities and agency debt after the federal government failed to adequately address China's concerns. China will not sell all its dollars at once – that would drive the dollar down too far, too fast. But if they merely fail to buy any new U.S. government securities, that would help push the dollar down.

Either way, China has no intention of losing money by adding to its dollar holdings. The Chinese have already increased their central bank gold holdings by 75% in the last five years. China will continue to invest in its strategic stockpiles, which will help drive copper, gold, and other commodity prices higher.

WORST-CASE SCENARIO: A RACE TO THE BOTTOM



With currencies, you have to think in three dimensions. All currencies are relative to other currencies, and then paper money itself is relative to hard commodities. The dollar may be down to the euro and other currencies, but what if the Euro Central Bank (ECB) goes the way of the Fed and begins inflating just as wildly? We are not under a Gold Standard, but we are under the discipline of global commodity markets if too many central banks decide to inflate their currencies at once. Politicians in several nations can argue that a weaker currency will boost their trade exports. That would result in a race to the bottom.

Fed Chairman Ben Bernanke gave a speech in 2002 (long before he became Fed Chairman or economic advisor to President Bush) in which he said that the devaluation of the U.S. dollar and the rapid increase in the money supply in 1933 and 1934 "ended the U.S. deflation remarkably quickly." He described this episode as an illustration of what can be achieved "when the nominal interest rate is at or near zero."

Seven years later, with Chairman Bernanke now at the controls and the nominal interest rate near zero, he may follow through on the devaluation scenario by encouraging a weak U.S. dollar in order "to end the threat of a deflationary spiral," especially now that the Fed cannot cut key interest rates any further.

China clearly wants to protect its exports. The euro zone wants to protect their trade, too. Japan is also an export-driven economy. Several smaller countries are devaluing their currencies right and left. This could generate a "tilt" mechanism in global currency markets, a "race to the bottom," with every nation seeking the lowest-priced currency, to stimulate domestic trade. The good news for holders of hard commodities or stocks in mining companies is that commodities can rise against all currencies. If all global currencies enter a mad race to see who can fall the most, the value of currencies (to each other) no longer matters.



This is not so far-fetched. The Asian Currency Crisis of 1997 came about when several Asian nations vied for trade supremacy. Soon, currencies in the entire region fell together. The next year, we saw the same kind of crisis when the Russian ruble imploded, causing the hedge fund crisis of 1998. Eventually, currency devaluations helped to spur economic recoveries in those regions by igniting an export boom, but the result was an incredibly high dollar. In commodity terms, the dollar was so strong that oil fell (in December 1998) to under \$11 a barrel, and gold fell to \$250 per ounce during the summer of 1999.

The dollar has been dying in slow motion for the last decade. The mirror image is the rise in commodity prices since the new millennium began. That process is continuing to this day. A weaker U.S. dollar since March is sending the price of crude oil, natural gas, soybeans, wheat, and other commodities soaring 30% or more in the past month; and an eroding U.S. dollar is also causing the prices of imported goods to rise.*

*On May 13, the Labor Department announced that the prices of imported goods rose 1.6% in April, the largest monthly increase since June 2008 and much higher than economists' consensus estimates of a 1% rise. Imported petroleum prices rose 15.4% in April, the largest monthly gain since March 2002. Higher inflation is on the way.

INVESTMENT IMPLICATIONS

The sinking dollar and rising commodity prices point to these potential investment opportunities:

- (1) Commodities and commodity-based stocks
- (2) Currencies in resource-rich nations, like Australia or Canada
- (3) Emerging stock markets, with an emphasis on resource-rich nations.

Best Stock Markets in 2009 (through May 13) *

China**	+53.3%
Russia	+50.0%
Indonesia	+44.0%
Brazil	+43.9%

*In U.S. Dollar Terms; Source: The Economist, May 16, 2009

**As measured by the Shanghai stock market's "B" Shares



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