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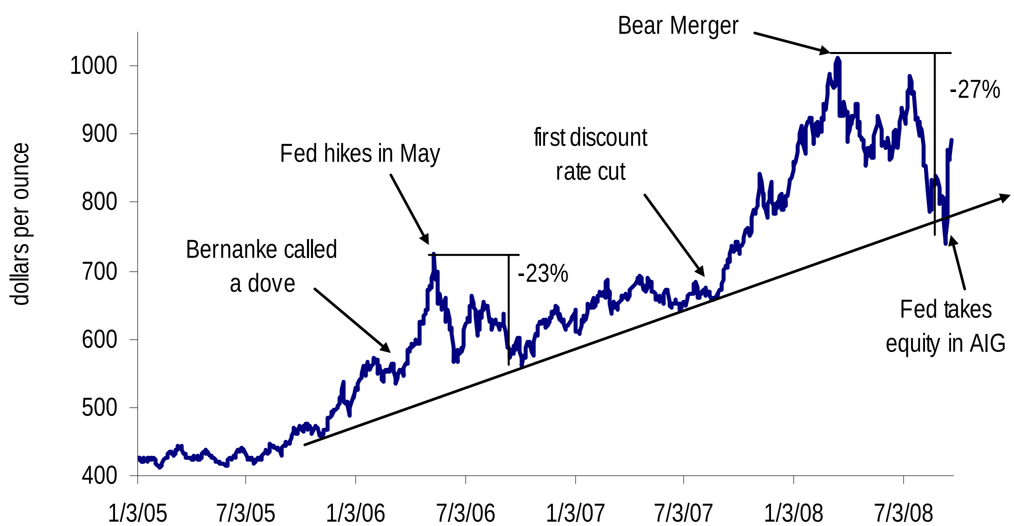
Dollar Crisis Adds to Problems Facing Treasury Facility; Conference Call Replay

The dollar weakened sharply today, driving gold and oil up and equities down. Due to the Administration's weak-dollar policy, we think the recent dollar strength was a correction from an oversold condition, not a change to a lasting uptrend (see Dollar Strength: How Good? How Long? August 8.)

- Reflecting temporary dollar strength, gold fell 27% from its peak in March through the trough in September. This was on the same scale as the 23% gold downturn in May-June 2006. In the absence of a change in the Administration's weak-dollar policy, we think both occasions were corrections in a general (and harmful) downtrend in the dollar's value.

Dollar Price of Gold (last obs. September 22, 2008)



Source: Bloomberg; Haver; Encima Global

Several recent developments are undercutting the dollar:

- The Federal Reserve took an equity interest in AIG around September 16 without firming up its dollar policy. This triggered a sharp upturn in gold and downturn in the dollar. Over the last year, the Fed has gradually changed the composition of its assets from Treasury securities to bank loans and now equity investments. We think this is a powerful tool, but requires positive confirmation of the Fed's interest in a stronger and more stable dollar.

- Former Fed governor Frederic Mishkin's September 18 opinion piece in the Wall Street Journal carried a headline of "Don't Worry About Inflation."

- Treasury again ignored the dollar in its September 18 proposal to create a massive debt facility. We're skeptical of the feasibility of the facility (see below), but it's clear that achieving the facility (or failing in the attempt) will weaken the dollar unless Treasury leans hard toward a stronger dollar. The Bush Administration has only once called for a "stronger dollar", in President Bush's March 12 PBS interview, leaving global investors cautious about owning dollars. He said that he would absolutely like the dollar to strengthen, complaining that the weak dollar contributes to high oil prices and inflation. By the morning of March 13, however, Treasury and the White House clarified that there had been no change in dollar policy.

- One contrast -- though it got little press given the financial crisis, Senator McCain's September 19 speech suggested a change in dollar policy: "The Federal Reserve should get back to its core business of responsibly managing our money supply and inflation. It needs to get out of the business of bailouts. The Fed needs to return to protecting the purchasing power of the dollar. A strong dollar will reduce energy and food prices. It will stimulate sustainable economic growth and get this economy moving again."

Other Commodities May Rise

We think gold generally leads increases in other commodities because it reflects dollar weakness and has less inertia from supply/demand factors. With the dollar weakening and gold rising, we expect renewed strength in other commodities, especially given our view that the world is not falling into a deflationary recession.

- Oil has risen sharply in recent days. We think this reflects dollar weakness, an oversold oil price, a possible Israeli response to Iran's nuclear weapons program, and Russia's increasing influence over oil pipelines. Regarding Iran, we note Israel's selection of a new prime minister and the view that it would want to carry out a response to Iran prior to the U.S. election, especially if polls shift toward Senator Obama.

West Texas Crude (last obs. September 22, 2008)

Source: Bloomberg; Haver; Encima Global

New Debt Facility, Conference call replay

Washington's emergency measures stopped last week's sequential bankruptcy spiral, but they didn't address the multi-year dollar crisis or the broken mark-to-market accounting rules.

- It is unclear how a centralized Treasury facility will divvy up the windfall profits from buying bank assets above their market value. Treasury will have to pick specific instruments, providing profits to specific banks, states and congressional districts.

- The analysis underlying the proposed Treasury facility seems to be that the U.S. faces a Japan-like malaise of deflationary bad debt which would be helped by the injection of Treasury resources.

- Japan's bad bank debt was non-performing from a cash flow standpoint during a period of high real interest rates and a super-strong yen. In contrast, the U.S. banks hold debt that is generally still performing during a period of low real interest rates and a super-weak dollar. The debt has been written down in an accounting sense, undercutting bank equity capital but not cash, the opposite of Japan's deflationary condition.

- Opposite of Japan, the U.S. has a severe accounting and regulatory problem on top of a weak dollar and inflation. Adding $700 billion through the Treasury facility doesn't really get at any of these problems (though the new funding should be big enough to head off some of the bigger bankruptcies.)

- Nevertheless, we think Congress will be able to create the facility fast by conveying enough current and future benefits on incumbents to secure the necessary votes.

- The replay of our 11 am September 22 conference on these topics is available through September 30 at 800-332-6854 conference ID number 683-42.

Notes

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