



## SPECIAL COMMENTARY

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# Implications of the Treasury's Plan for the Dollar

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### **Treasury's plan represents a short-term negative for the dollar.**

In our view, this weekend's announcement that the U.S. government will buy up to \$700 billion worth of bad debt from financial institutions is a short-term negative for the dollar. In order for investors to absorb the increased issuance of U.S. Treasury securities the returns on those securities will need to rise. From the perspective of a foreign investor there are two ways that returns can rise. First, the yields on the securities need to increase. Because the proposed program is equivalent to nearly 15 percent of the marketable Treasury debt outstanding, a rise in Treasury yields seems to be in the offing. The second way that returns to foreign investors can occur is via depreciation of the dollar. In theoretical terms, this is known as "overshooting." That is, the dollar depreciates a significant amount initially. A foreign investor who buys Treasury securities when the dollar weakens can realize a significant return if the greenback subsequently appreciates.

### **How does overshooting work in practice?**

Foreign investors initially shun U.S. securities, waiting for their yields to rise to more acceptable levels. Because the United States is running a large current account deficit (nearly \$700 billion over the last four quarters), reduced inflows of foreign capital are not large enough to finance it. Consequently, the greenback weakens. Once nominal yields rise "far enough" and the dollar depreciates "far enough", foreign investors become attracted to potentially outsized returns on U.S. Treasury securities. As foreign investors start to buy these securities, U.S. capital inflows strengthen and the dollar then begins to appreciate.

### **What happens to the dollar in the near term?**

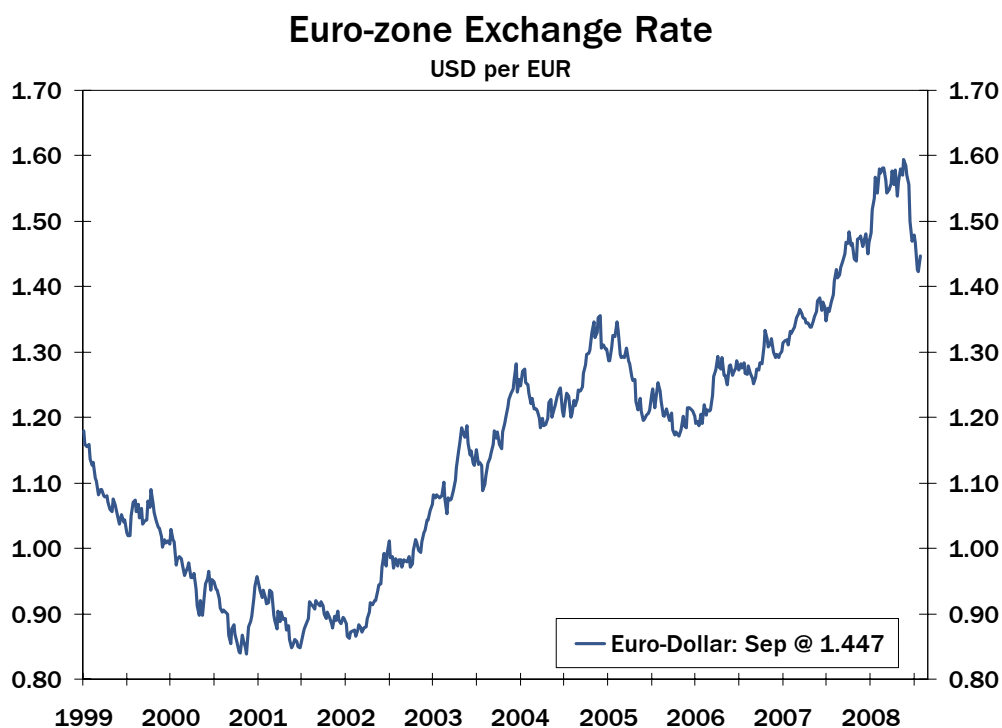
In our view, the greenback is most exposed to European currencies. Treasury's plan should reduce financial risk, at least in the near term. Because investors pile into the Japanese yen when risk aversion spikes, we are ambivalent about the near-term direction of the yen/dollar exchange rate. Therefore, we believe dollar weakness will manifest itself via European currencies. In terms of the euro, we would look for a near-term test of the 1.47 area. If resistance there breaks, a run-up to the 1.53 area seems likely. In a worst case scenario, a retest of the all-time highs of 1.60 could be in play (see Exhibit 1). In our view, dollar depreciation will play out over the next quarter or two as prospects for U.S. economic growth remain clouded.

*Treasury's plan to buy hundreds of billions of dollars worth of bad debt from financial institutions represents a short-term negative for the dollar.*

*The dollar must "overshoot" to raise expected returns to foreign investors.*

*The greenback will probably depreciate versus the euro over the next quarter or two.*

Exhibit 1



Source: Global Insight and Wachovia Corporation

*If Treasury's plan is successful in stabilizing markets and improving U.S. growth prospects, then the dollar should appreciate again next year.*

*Clients who are short dollars against most currencies should look for opportunities in the days and weeks ahead to buy dollars.*

#### Is the dollar doomed in the "long run?"

Not necessarily. If Treasury's plan is successful at stabilizing financial markets and improving U.S. growth prospects, then the dollar should bounce back. Obviously, the jury is still out on the effectiveness of Treasury's plan. However, we will toss our hats in the optimists' ring and say that the plan will ultimately be successful in stabilizing financial markets and leading to improved growth prospects in the future. There clearly are many details to be ironed out over the next few weeks and markets probably will ebb and flow as circumstances change. However, the administration has made the political decision to commit hundreds of billions of dollars of taxpayer money to fixing the problem. If \$700 billion is "not enough", it seems likely the administration will cough up even more. (In for a penny, in for a pound.) We're not political scientists, but we do not foresee significant political opposition from Congress. Nobody in Congress wants to be blamed for dragging his or her feet and provoking a collapse of the U.S. financial system only six weeks before Election Day.

#### Conclusions

The bottom line is that the greenback could experience some significant selling pressure in the days and weeks ahead. Expected returns to foreign investors, who own about 55 percent of marketable U.S. Treasury securities outstanding, need to rise to induce those investors to purchase the increased issuance of Treasury debt that will be forthcoming. Once the dollar weakens "enough", however, it should start to strengthen anew next year as growth prospects in the United States improve. Therefore, clients who are short dollars against most currencies should look for opportunities in the days and weeks ahead to buy dollars, especially if those clients have long-term dollar needs.

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