Tom Sowanick
Co-President
Chief Investment Officer
tom@omnivestgrp.com
Tel: +1 609 921 7939

The Dollar Needs 19 Friends

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The weak nature of the US dollar and the surrounding calls for intervention will not work unless such action is coordinated via a collective effort of the newly created G-20. The G-20 was created to recognize the new world order of economic powers and replaces the former G-7. A coordinated intervention is the only reasonable solution to reversing the secular downtrend of the dollar.

Today, the Central Bank of India took its first step to remove its record monetary stimulus efforts. This required banks to increase their statutory liquidity ratio from 24% to 25%. Devoid of a coordinated policy action by the G-20, the move by India's central bank to tighten monetary policy will likely not help bolster the US dollar.

Brazil took action a week ago by imposing a 2% tax on capital inflow. This move was intended to slow foreign capital flows into Brazilian capital markets and slow or even halt the appreciation of the Real. The lack of coordination illustrates several points:

First, emerging economies have weathered the financial crisis well and are in much better shape than developed countries. Therefore, emerging countries are more likely to unwind stimulus programs before or even in tandem with developed countries.

Second, there are conflicting views within the central bank community about taking pre-emptive steps to include financial assets as part of their respective inflation measures. This is clearly the case with Australia's central bank which raised interest rates 3 weeks ago citing the considerable rise of the Australian dollar. Wholesale prices in India have now risen for a 6th consecutive week. India's Sensex Index is now up 70% from the start of the year, and up 92% over last year. The combination of rising inflation expectations and asset inflation has prompted India to take action.

Third, emerging economies experienced their own financial crisis in the late 1980's and have worked diligently since then to improve financial conditions in the public sector and increase savings in the private sector. Conversely, developed economies were overly exposed to financial market risks due to poor underwriting standards and unknown 3rd party risks.

Unfortunately, the lack of synchronized economic growth and synchronized inflation pressures will almost assuredly keep the G-20 from moving in unison to intervene on behalf of the US dollar. Hence, it is premature to look to the dollar to reverse its downward trend. A consequence, due to lack of intervention, will be the continued use of the dollar as a funding source for the global carry trade. As a result, global equities should continue to appreciate, even as central banks begin to reduce and eventually cease their stimulus programs.