FROM HERO TO ZERO:
Why Do People Fear a Decline in the US Dollar?

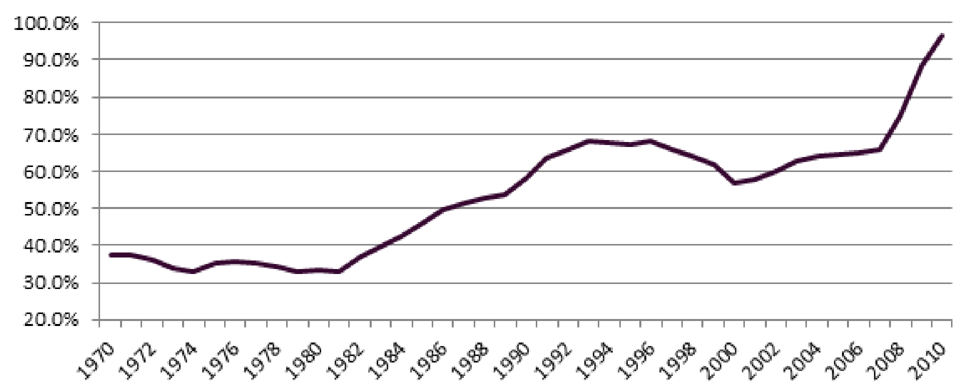
Timothy Atwill, PhD, CFA
Director — Research & Strategy

Historically the US Dollar has been seen as a pillar of strength in the currency universe. However, this perception has changed dramatically since the events of 2008. The dollar's unquestioned supremacy has been replaced in many investors' minds by growing fears of a long-term decline. When examining the arguments put forth for these fears, three main themes are frequently expressed. All three arguments rely on observations of economic imbalances which undermine investors' confidence in the long-term strength of the US Dollar. While no conclusions are formulated here, the below observations provide the underlying arguments for these three themes.

1) Fiscal Imbalances

The US Government does not seem to be able to live within its means. The below chart shows the total debt of the US as a percentage of GDP for the past 40 years. This ratio has reached levels which many commentators believe are not tenable over the long term. Furthermore, a large portion of this debt is held by non-US investors. If the US lost the confidence of such investors, the resulting flight from US debt would be accompanied by a decline in the currency, as these non-US investors attempted to repatriate dollar denominated assets into their local currency. The fears caused by these fiscal imbalances are further heightened by the publicly stated desire of China and other emerging market countries to own fewer US Treasury bonds.

Figure 1: Total Gross Debt, % of GDP, Source: St. Louis Federal Reserve



2) Monetary Imbalances

The US Federal Reserve (the "Fed") has the power to create money by purchasing assets. The following graph shows the balance sheet of the US Federal Reserve since 2003. Going into 2008, the Fed's balance sheet showed a balance of approximately $900 billion. The financial crisis saw the advent of many new asset purchase programs by the Fed (e.g. TARP, TALF), which dramatically increased the use of the Fed's balance sheet. In more recent years, the Fed's quantitative easing and "twist" programs involved further asset purchases. All in all, the Fed's balance sheet has been increased by over $1.9 trillion since the financial crisis. Due to some nuances on how these numbers are calculated, not all of this increase on the balance sheet translates into an increase in the money supply, but there is no doubt these actions have an upward impact. Because of this, the laws of supply and demand would suggest a downward adjustment of the US dollar versus the currencies of countries with less accommodating central banks.

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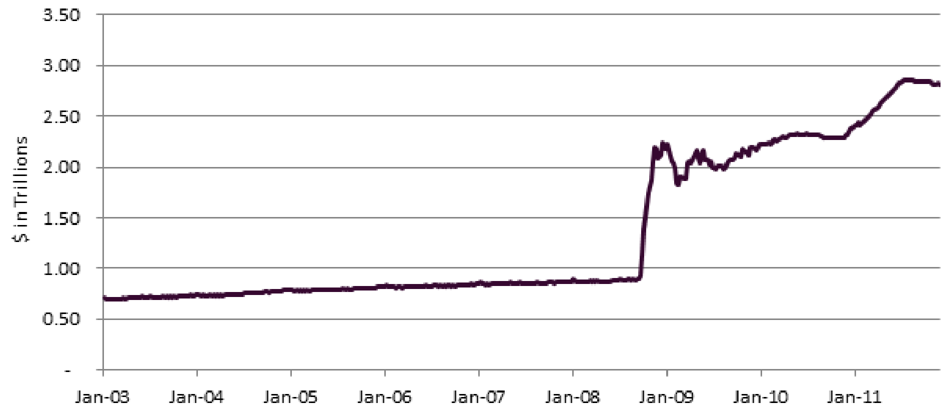
Parametric
1918 Eighth Avenue
Suite 3100
Seattle, WA 98101
T 206 694 5500
F 206 694 5581
www.parametricportfolio.com

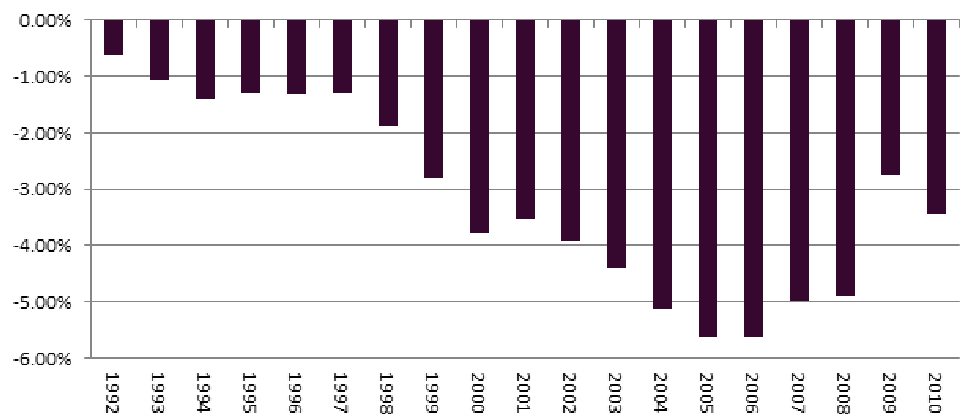
Figure 2: Federal Reserve Balance Sheet ($tn), Source: US Federal Reserve



3) Trade Imbalances

The below graph shows the United States' trade surplus/deficit as a percentage of GDP. For the last 20 years, the United States has imported more than it has exported. As foreign goods need to be paid for with foreign currency, US consumers have to sell dollars to buy their imported purchases, and foreign consumers have to buy dollars to buy US exported goods. Given the persistent trade imbalance shown below, it is simple to see that trade activity results in more dollars being sold (by US consumers) than are being bought (by foreign consumers). This dynamic places downward pressure on the US dollar versus other currencies. The impact of this has been mitigated in part by the "recycling" of dollars from our major trading partners, in the form of purchasing US Treasury bonds with the dollars received in trade, instead of repatriating them to their local currency. Given the declining interest among our trading partners in further purchases of US Treasury bonds, trade imbalances could have more impact on the relative value of the US dollar in the future.

Figure 3: US Trade Surplus/Deficit as % of GDP, Source: US Bureau of Economic Analysis



Summary

As in any market, it is impossible to know how much the above factors are already reflected in current exchange rates. Furthermore, currencies are priced versus other currencies, and none of the above themes touches on the relative health of other countries or currencies (e.g. the Euro). Regardless, all of the above themes are serious issues which will continue to impact the relative value of the US dollar, and none of these situations are easily solved. The concerns they raise should be given deep consideration by dollar based investors moving forward.

DISCLOSURES