

Market outlook

The future of the U.S. dollar

November 2009

Market outlook is a monthly publication to help inform your investment strategy



The U.S. dollar's 70-year-reign as the world's dominant currency may slowly be coming to an end. Powerful trends like high fiscal deficits and potential inflation are eroding the dollar's strength.

The U.S. dollar ("the dollar") has been battered lately, and it seems likely that it will weaken on a structural basis, according to Wealth Management Research (WMR). The government and current account deficits will continue to weigh on the dollar. Also, liquidity measures to unfreeze credit channels and thus boost economic activity will likely raise the risk of inflation expectations once the economy finally begins to operate on its own momentum. These longer-term inflation risks are higher in the U.S. than in many other developed economies.

Acute imbalances in international trade and capital flows persist and may even increase if the currencies of the export-driven economies remain artificially weak (artificially, as weakness is determined not by markets but by intervention from other countries). The U.S. is among the countries with the greatest projected increases in public-sector borrowing as a share of GDP and is now the largest international and domestic debtor, thanks to decades of accumulated borrowing to finance its current account deficit—now 50% of its 2008 GDP (see chart). It must still import capital from abroad to finance its ambitious public and private spending

and, should massive government spending programs continue, it will have to borrow on an even larger scale in the future.

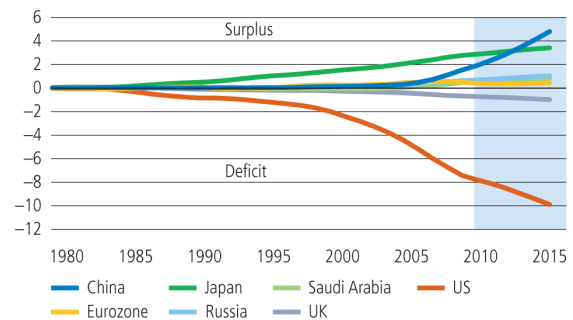
Everything is relative

The U.S. dollar is not bound to weaken simply because of the U.S. economy's structural problems; the situation has to be worse in the U.S. than it is elsewhere. WMR analysts think the acute global imbalances will weigh more on the dollar than on the currencies of most other advanced economies. Among the "big three" currencies—the U.S. dollar, the Japanese yen and the euro—the euro is relatively the most attractive. The dollar and the Japanese yen face huge challenges. Japan's debt-to-GDP ratio approaches 200%, and America's dependence on external financing of its fiscal deficit is daunting.

The euro currently enjoys the strongest fundamentals and therefore the best chance of appreciating. Of course, the Eurozone economies face their own difficulties in the aftermath of the financial crisis. The countries comprising the Eurozone remain vastly dissimilar, making a single monetary policy less than ideal. However, the region's combined debt-to-GDP ratio, comparable to U.S. levels and much lower than Japan's, remains mostly internally financed. The Eurozone's monetary stimulus will likely be removed as soon as its economy shows signs of a self-sustaining recovery, while the same is not the case for the U.S. or Japan, where national governments can more easily exert influence on their central banks, increasing inflation risks.

U.S. the largest international debtor

Accumulated current account positions, in trillions of USD



Note: Shaded area indicates IMF staff projections.
Source: IMF World Economic Outlook database (2009), UBS WMR

Economic conditions in emerging markets have improved in absolute terms and relative to the U.S., and many of their currencies have outperformed the U.S. dollar since 2001. WMR sees compelling reasons for many emerging market currencies to continue to appreciate, namely, a shrinking inflation differential, independent central banks with explicit inflation targets and the growing share of emerging economies' production in overall global economic output.

The dollar as a reserve holding

Despite the fundamental factors that are eroding the dollar's strength, the share of U.S. dollars in global foreign exchange reserves has remained stable. Over the next several years, the U.S. will continue to rely on foreign investment flows to finance its huge deficits, which means that any shifts in foreign exchange reserve holdings must occur gradually in order to avoid a dollar collapse, says WMR.

Presently, however, only a major geopolitical or economic upheaval could force the U.S. dollar to fall out of favor as a reserve holding. The reason for the dollar's strong grip, despite its myriad problems, is clear: the network effects of having a single, dominant reserve currency are of considerable value to the global economy. The fact that the dollar is not only the world's principal reserve currency but also its primary medium of exchange between countries goes hand in hand. Also, replacing a single, broadly accepted currency would be inefficient and very difficult to orchestrate.

Furthermore, there is no viable contender to replace the dollar as the world's reserve currency. Although the euro is the strongest runner-up, the Eurozone's heterogeneous political structure limits its chances. And emerging market currencies—while they are on a deep appreciation path—are still less liquid and more volatile, and are not expected to form a major part of central bank reserves for at least a decade, according to WMR.

Although WMR expects the dollar's dominant role as a means of transaction and unit of account for international trade to continue for the foreseeable future, it feels that a multicurrency reserve framework with the greenback playing a central role seems the most likely development down the road.

Currency shifts and your portfolio

WMR analysts advise investors to keep in mind that recent dollar weakness may continue for an extended period of time and that it would be wise to explore how to best insulate wealth from erosion or even take advantage of other currencies' strength. Although establishing currency benchmarks is challenging, many reasonable approaches exist as potential guideposts for establishing a portfolio's currency allocation.

WMR preferred approach is a portfolio that comprises a broad selection of currencies determined dynamically by the size of their GDP, including those of the largest emerging markets. Emerging market countries are undergoing a period of convergence with developed countries, and commodity producers are particularly advantaged. Therefore, these currencies could claim an increasingly larger share of a global GDP-weighted portfolio. Diversifying among currencies does help to maintain global purchasing power and, given the structural burdens the dollar bears, WMR believes a diversified portfolio should prove advantageous.

Let's talk about it

To explore how some of the insights in this issue of Market Outlook might bear on your portfolio, or to discuss additional research insights, please contact me.

There are two sources of UBS research. Reports from the first source, UBS Wealth Management Research ("WMR"), are produced by UBS Wealth Management Americas (the UBS business group that includes, among others, UBS Financial Services Inc. and UBS International Inc.), and UBS Wealth Management & Swiss Bank. The WMR report style, length and content are designed to be more easily understood by individual investors. The second source of research is UBS Investment Research, and its reports are produced by UBS Investment Bank, whose primary business focus is institutional investors. The research reports may include estimates and forecasts. A forecast is just one element of an overall report. Due to a divergence of opinions, there may sometimes be differences between the individual and institutional reports, with respect to interest rate or exchange rate forecasts. The analysts who prepare individual and institutional research use their own methodologies and assumptions to make their independent forecasts. Neither the institutional forecast nor the individual forecast is necessarily more reliable than the other. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc. In Canada, UBS Wealth Management Research is provided by UBS Investment Management Canada Inc. All other trademarks, registered trademarks, service marks and registered service marks are of their respective companies. As a firm providing wealth management services to clients in the U.S., we offer both investment advisory programs and brokerage accounts. Advisor services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. For more information, please visit our website at www.ubs.com/workingwithus.