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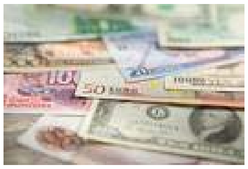

Economics & Financial Markets

United States Exchange Rates

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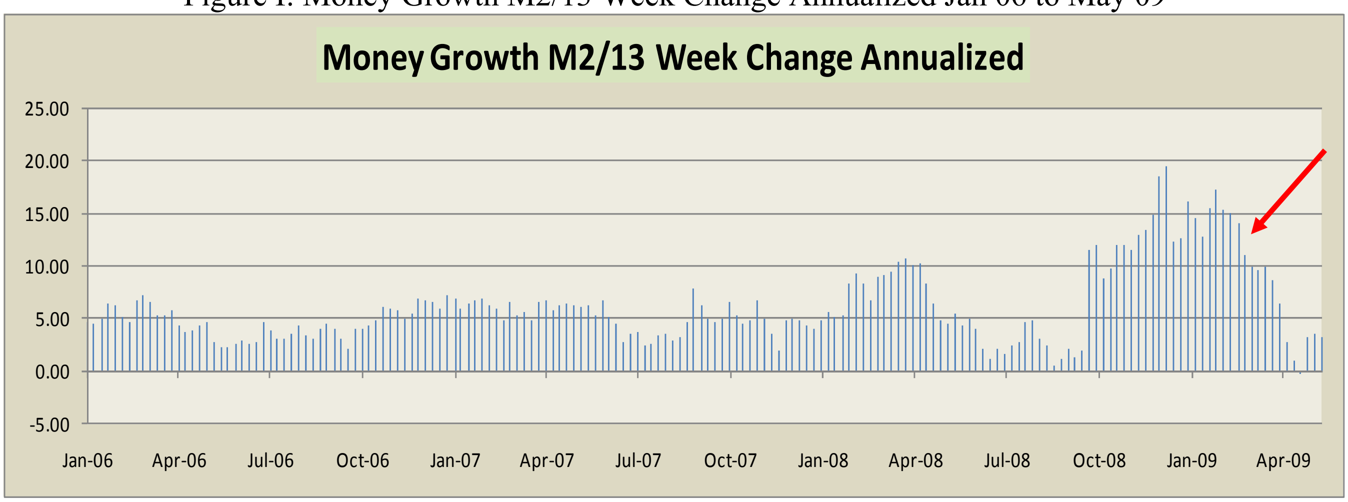
Dollar/Euro Declining, & Gasoline Increasing, Money Growth Has Stalled

I. **Introduction**

Since mid March the Dollar/Euro ratio has declined 12%, the price of gasoline has increased by 18%, and money growth has gone from a high of 18% based on 3 month change annualized basis to 10% in Mid March, and 3% currently. The slowdown in M2 growth is dramatic and likely indicates a tightening of credit (traditionally as the fed funds rates goes up M2 declines) and a possible slowing of monetary stimulus.

Figure I: Money Growth M2/13 Week Change Annualized Jan 06 to May 09



Source: Federal Reserve, U.S. Treasury, SISR

At the same time that the rate of M2 growth declined below 10%, the dollar began to decline relative to the Euro. This likely indicates that U.S. interest rates are likely to fall behind the EU rate of interest in the intermediate future. As the dollar began to fall the price of crude and gasoline began to rise.

II. Money Supply Collapses in Past Month

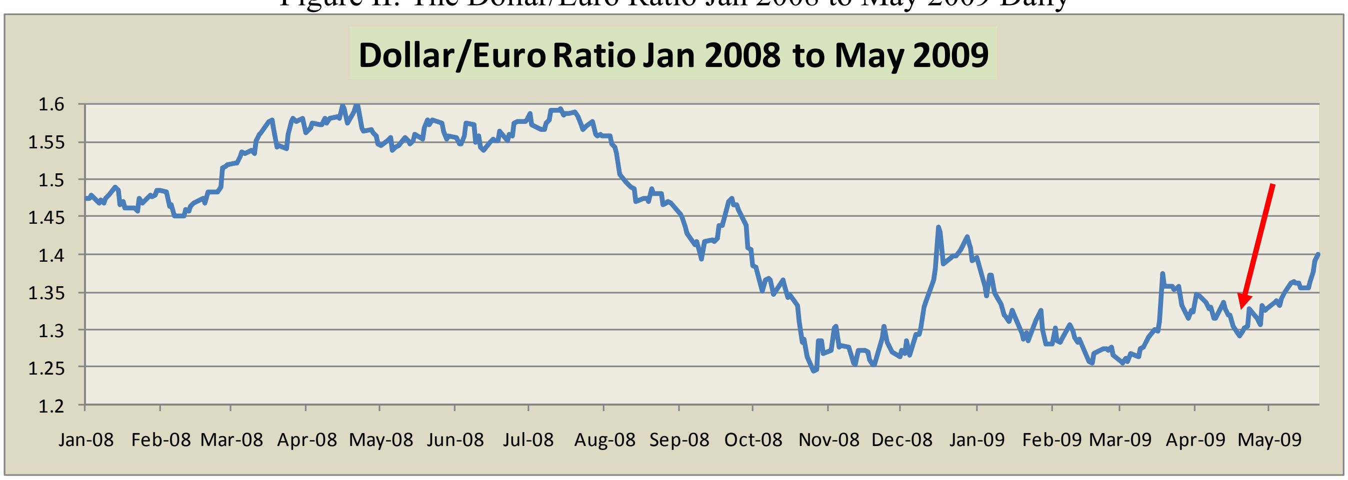
Beginning in March as seen in Figure I the rate of expansion of money growth fell below 10% on a 3 month change basis, annualized. We use the 3 M change because y/y changes are not sensitive enough to the changes in the rate of growth of money and one loses the intent of the FOMC policy committee. Late last year the entire discussion of M2 growth revolved around the very rapid increase in money growth which was accelerating at nearly 18% for a period of time. This had lead to an extensive discussion within the markets regarding inflation in the 12 to 18 month forward period.

Yesterday, for the first time in 7 month the M2 indicator in the leading economic indicators measure was negative and was the largest single item of the 10 to be negative, even more so than permits. For some reason the Federal Reserve has significantly slowed money growth to a rate of change well under the target of 4 to 6% growth over the past few months.

This rate of contraction should be alarming to the extent that a contraction means that there is less liquidity in the system, which is what occurs when the FOMC raises the fed funds target to contract growth. Since the rate of M2 growth fell below 10%, the dollar has been sinking relative to the Euro. We expect that in large part this is based on the expectation that the U.S. economy may have a greater than expected period of recovery. We are confused about why when the economy is so fragile, would the fed, if they had control, be contracting money supply at this critical juncture. Our only explanation is with the fed funds rate at near zero they may have few options.

III. Dollar/Euro Ratio

Figure II: The Dollar/Euro Ratio Jan 2008 to May 2009 Daily



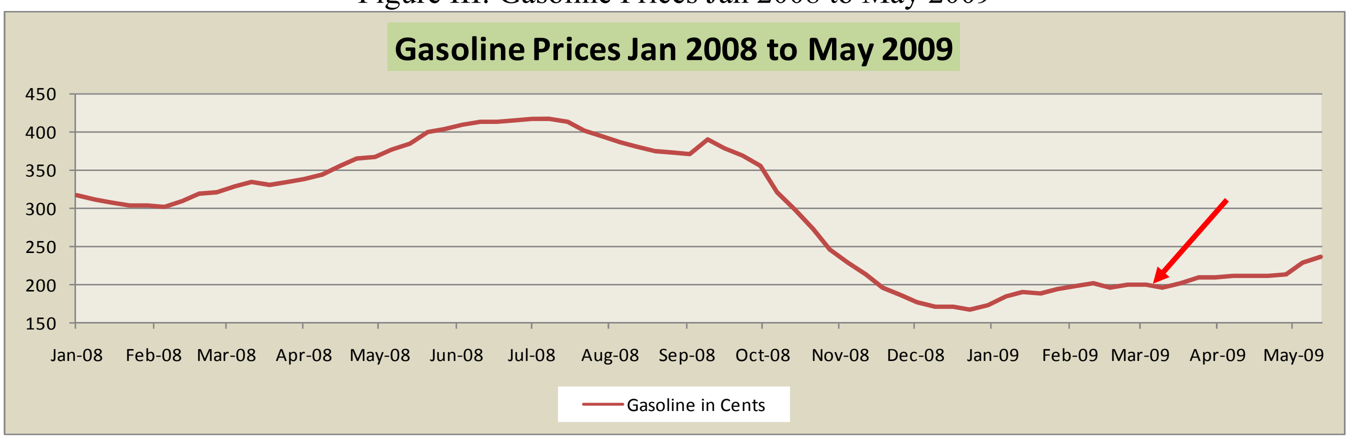
Source: Federal Reserve, U.S. Treasury, SISR

Since Mid March nearly the same time that the rate of money growth began to stall, the Dollar/Euro ratio began to decline. For much of the past 6 months it was believed that the U.S. would emerge from this recession sooner than Europe, and that the U.S. would again become a major world economic driver of growth. In the past two months we at SISR have noticed that while in January and February the economic data appeared to be significantly improved, over the recent months of March and April and even into May, the economic data has been surprisingly weak and unimpressive. The weakness in the data, the slowing of money growth, and the decline in the dollar relative to the Euro all have occurred nearly simultaneously.

It is not surprising that this would all be occurring if in fact the U.S. economy, as the Federal Reserve minutes indicates, the expected recovery from this recession was pushed back by several months in the latest forecast by the FOMC committee, particularly in light of some better economic data coming out of Europe. Yesterday we argued that the high price of gasoline was impacting the retail sector and that was one of the reasons that we were seeing worse than expected retail data. Today in expanding that concept we are arguing that the reason why gasoline prices and crude prices are higher is that the dollar is declining and there is a strong relationship between crude oil and the dollar. Crude is traded in dollars, indicating that when the dollar is weak the producing countries world purchasing power would decline if the price did not increase. We have studied this phenomenon at length and it is a fairly simple concept to document.

IV. Gasoline Prices

Figure III: Gasoline Prices Jan 2008 to May 2009



Source: EIA, SISR

Coinciding with the decline in the dollar, the slowing of M2 growth below 10% we are similarly finding that the price of crude which had stabilized at $1.90 per gallon has been slowly creeping up. By next week, based on the wholesale price, we expect the price will be well above $2.40 per gallon. This increase in the price of gasoline has stalled the retail sector, as more of the household budget and particularly discretionary expenditures is now going to the gasoline station, instead of the restaurants and clothing. In January and February this sector was beating expectations and now in March and April the sector is lagging expectations.

Conclusion and Implication

It is very surprising that the rate of monetary stimulus into the economy given where the economy currently is has become nonexistent. This fact in conjunction with the decline in the dollar and the increase in price of gasoline is clearing putting a rather clouded picture to this recovery. These factors one by one are consistent with each other, slow money growth, declining dollar, and higher gasoline, that is not the question, the question is why is this occurring at this juncture in the recovery, and what impact will it have on the recovery? Based on what we are seeing we cannot be very optimistic.

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