SISR Strategic International Securities Research Inc.
An Independent Research Firm

Economics and Stocks

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Dollar Likely to Strengthen Against Major Currencies: Looking for Banking and Brokerage Rebound

Key Points

The U.S. Dollar closed today near an all time low against the Euro, and a multiyear low against several other major currencies, like the Pound, and the Canadian Dollar. Last week's economics numbers were the strongest set of major indicators in quite some time leading us to believe that the U.S. economy will be stronger going forward and with it the dollar should rebound significantly. There are six major factors that lead us to believe that the dollar will strengthen against all major currencies in the near future:

1. **The Federal Reserve is unlikely to lower interest rates unless the economy weakens significantly.**

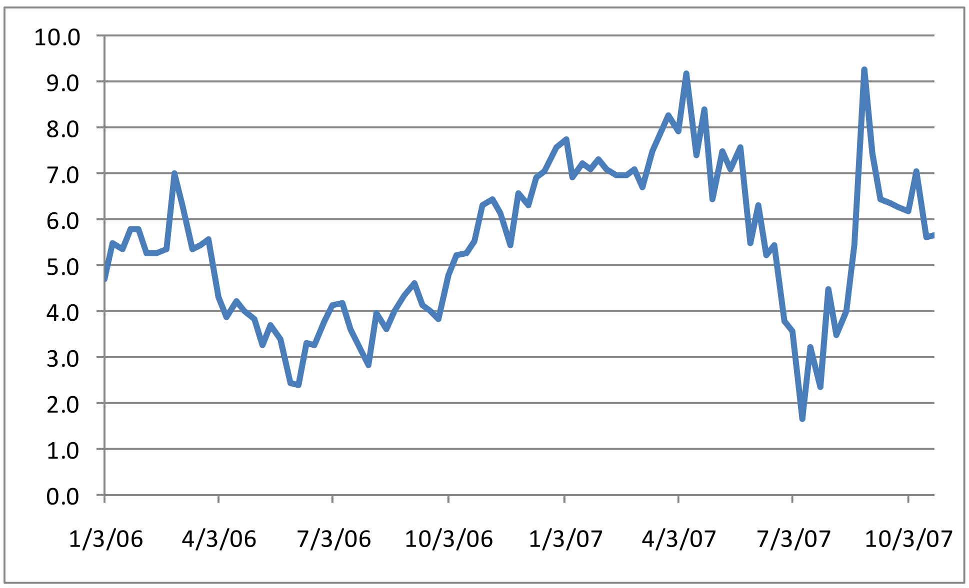
The Federal Reserve lowered the fed funds rates last week by 25 basis points to 4 ½ percent. In lowering the key interest rate the Fed changed their statement to read that: Today's action, combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy." In September they said that there was "increased uncertainty surrounding the economic outlook." We believe that the fed will not reduce the fed fund rate throughout this year unless the economy appears to be faltering in ways we do not currently anticipate. In prior work we have argued that the bias of the Federal Reserve is to use money supply (M2) to manage the economy as opposed to the interest rate instrument (**SISR**, *Money Supply and the Federal Reserve Policy*, July 2, 2007).

<u>Implication</u>: If the interest rate remains at these levels the dollar should stabilize particularly if other countries are lowering their rate in anticipation of a softer international economy. Additionally, we believe that Bernanke is attempting to keep interest rates as stable as possible as a means for creating a stable long term housing sector, which in the long term should help the banking and brokerage sectors.

2. **Money supply growth (M2) after declining for several months has been increasing over the past couple of months.**

When Bernanke became the chairmanship of the Federal Reserve Board on February 1, 2006, the Federal Reserve continued the Greenspan program. They raised interest rates 3 more times, at each of the open market committee meetings, until August 8 2006 when it took no action on interest rates. The committee had been raising rates based on inflationary concerns. Once the inflation appeared to abate the fed began to increase liquidity starting in early June of 2006 fearing that the economy may be slowing. They continued to increasing M2 until April of 2007 when money expansion peaked at a three month rate of change of 9.2% annualized, as shown in Figure 1. At the March 21, 2007 meeting the fed stated that: "core inflation has been somewhat elevated," leading to the decrease in money supply from the April highs. As the economy slowed the fed tried to head this off a slowdown by increasing money supply and in August 7th they recognized that: "downside risks to growth have increase somewhat." Currently we are again seeing elevated growth in M2 which is highly correlated to the markets, and to positive economic growth.

Figure 1: Three Month Change in M2 Annualized Jan 2006 to Oct 2007



Source: Federal Reserve Board; SISR

<u>Implications:</u> If the fed continues to increase or sustain M2 growth at these elevated level of 7% plus annualized, we would expect that growth would continue while keeping the dollar strong and even putting upside pressure on interest rates, which would also help the dollar. If the Fed is able to support the economy as the housing correction and the subprime issues correct themselves this would be positive for banking, brokerage, and the dollar.

3. **The U.S. Economy is growing at a faster rate than most economists have been expecting with the BEA reporting a 3.9% rate of growth, after increasing at a 3.8% rate in the second quarter.**

GDP grew at a 3.9% rate for the quarter much faster than the expected 3.1% rate of growth. Part of this came from the GDP deflator with prices rising only 1.6% for the quarter as opposed to 3.8% in the prior period. With gasoline prices already up everyone is expecting a slower 4th quarter because of the deflator. However, real exports increased significantly as did expenditures on national defense, by 16.2 percent and 9.7% respectively compared with an increase of 7.5% and 8.5% Q/Q. The weak dollar will continue to help exports and in the last year of an administration the government usually attempts to influence the next two to three years of defense spending, given long term contracts to the defense contractors. As a consequence we expect even faster growth in defense spending going forward.

Implication: We expect growth to slow slightly, because as gasoline prices catch up to the crack spread parity with gasoline prices being higher (please see **SISR** *Price of Gasoline Expected to Rise to $4.00,* October 25, 2007) and the deflator increasing it will lower real GDP. We also expect, as the dollar gets stronger, exports will decline, but not as much as expected because of globalization and Asian, Indian, and Brazilian growth. If growth continues strong fueled by added liquidity in the system and international growth we expect that the dollar will get stronger, and major integrated oil companies will return to positive growth from a slow 3rd quarter.

4. **Nonfarm payrolls grew at twice the expected rate of 166K instead of the projected rate of growth of 80K with this report being one of the strongest reports in months.**

The Nonfarm payroll report is one of the most closely watched economic reports. Job growth occurred in professional and business services, architectural and engineering services and in management and technical consulting services, health care, and leisure and hospitality. Manufacturing employment continued to decline, and construction employment was unchanged.

Implications: Job growth is essential for economic growth and the growth in architectural and engineering services sector implies that simply because housing is down it does not imply that all construction is down; in fact total construction has made up the decline in the residential sector.

5. **Construction spending was up 0.3% when the market expected a decline of -0.4%.**

Total construction which includes housing has been stable over the past couple of years stabilizing the construction market, a point lost by many who have focused on the housing market. While we are all aware that residential construction is down -16.4% Y/Y, total construction is down only -0.8% or basically flat with last year. We believe that there has been too much focus on residential and not enough on overall construction, which includes pubic and nonresidential construction. For example private nonresidential construction is up 17.4% Y/Y.

Implications**:** The construction sector is stronger than many expect and despite the fact that housing is showing real weakness, other parts of the construction sector has been real strong. The big problem here is have we seen the end of the subprime problem, and what will be the impact on the market of billions of dollars being written off? We expect that we have seen more of these issues than we have not and in these kinds of situations there usually is some form of overreaction, with people usually expecting the worst. So filtering the overreaction with what has not yet been reported, we believe we are close to having seen the total impact of this problem.

6. **Factory orders came in well above expectations with an increase of 0.2% as opposed to the projections of -0.5%.**

The factory order report is the second most informative report following the nonfarm labor report. The labor report, new factory orders, and money supply made up 4 of the 10 components of the leading economic indicator index (2 components come from the labor report). In the factory orders report new orders for: Ventilation, heating, air-conditioning and refrigeration equipment; and Turbines, generators, and other power transmission equipment were up 17.6% and up 21.9% M/M respectively, both areas central for building. Shipments for Construction equipment Y/Y is down -26.5% but over the last three months it has been up 5.9%, 2.5% and 2.1% from July through September. Many of these products may be ending up overseas; however, they are being produced in the United States.

<u>Implication</u>**:** New orders for factory equipment, particularly in the construction areas, were a real surprise last month. This supports the data that even though housing is down, total construction has made up much of the loss. With lower interest rates we would expect that the housing correction will be expedited, especially if the economy continues to grow at faster than expect rates.

Conclusion

Key components of the leading economic indicators came in this month unexpectedly high, leading to the belief that the economy is stronger than most expect. With no reduction in interest rates expected, we believe that the dollar will begin to rebound, the housing market will continue correcting, but with long term stable interest rates the housing correction should be expedited. We have tried to show that key factors that have lead to the weakness of the dollar are actually getting stronger, and this strength has been unexpected.

As the dollar gets stronger we would expect the price of oil which is priced in dollars will decline from its current highs, moving back to the high $70 to $80 range with the price of gasoline at the pump increasing as the crack spread goes back to parity. The resilience of the consumer is a wild card but if exports of services and professional services continue and there is job growth in those areas as we have seen, we content that it is likely that we have seen the lows for the dollar against most major currencies, with the exception of China. In addition, if our Bernanke effect thesis is correct (**SISR**, *Money Supply Ibid)* with respect to his preference for highly stable interest rates, we would expect that in the long run this would be a very beneficial outcome for the banking and the brokerage industries.

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Price Chart:

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