1. Summary

- The dollar enters its fifth consecutive year of appreciation against the world's major currencies, with the trend in domestic economic fundamentals remaining highly supportive. But all rallies must climb a wall of worry and the dollar is no different.
- The two primary concerns that investors have regarding the dollar are the record deterioration of the U.S. current account and the continued bubble-like performance of the U.S. equity market. Because of those concerns dollar gains are likely to come grudgingly.
- There has been a surge in foreign-investor interest in U.S. equities during the past two years, which, it could be argued, could simultaneously trip up both the dollar and the stock market should a sudden reversal of capital flows occur. But the bulk of foreign portfolio investment in the U.S. continues to be dominated by debt instruments, with purchases of equities accounting for only 15%-20% of total foreign portfolio flows into the U.S. each year.
- Nonetheless, a U.S. equity market slide and a subsequent decline in U.S. aggregate demand would likely have a profound impact on global aggragate demand. But with the Federal Reserve likely to respond to an economic slowdown with more vigor than the European Central Bank, the U.S. is still likely to fare better than Euroland. Hence, any gains made by the euro would likely prove to be transitory, just as they were in the autumn of 1998, when the U.S. stock market declined sharply.
- The fact is that the U.S. equity market continues to roar ahead, and it remains debatable whether the U.S. equity market is traveling along a bubble path or not. What is clear is that the trend in U.S. economic fundamentals remains excellent, particularly relative to the weak states of economic activity in Euroland and Japan, and the dollar looks set to enjoy a fifth consecutive year of appreciation.

Featured Articles

Key Currency Forecasts

Currency	Exchange Rate	Latest Spot Rate	Forecast Horizon 3-Mo.	6-Mo.	12-Mo.
U.S. Dollar	FRB Index	99.66	101.51	103.58	105.03
		-	-	-	-
Euro	US$/Euro	1.0847	1.07	1.06	1.06
	-	-	-	-	-
Japanese Yen	¥/US$	120.25	130.0	145.0	160.0
	¥/Euro	130.44	139.1	153.7	169.6
British Pound	US$/£	1.6135	1.60	1.58	1.55
	£/Euro	0.6723	0.67	0.67	0.68
Canadian Dollar	C$/US$	1.4922	1.48	1.46	1.44
	¥/C$	80.59	87.8	99.3	111.1
Aust. Dollar	US$/A$	0.6355	0.65	0.66	0.67
	¥/A$	76.42	84.5	95.7	107.2

Key Interest-Rate Forecasts

Market	Maturity	Latest Yield(%)	Forecast Horizon 3-Mo.	6-Mo.	12-Mo.
U.S.	3-Month	4.96	5.00	5.25	5.25
	10-Year	5.05	5.35	5.40	5.45
Germany	3-Month	2.57	2.60	2.70	2.80
	10-Year	3.79	4.00	4.10	4.25
Japan	3-Month	0.06	0.25	0.25	0.25
	10-Year	1.48	2.00	2.00	2.00
U.K.	3-Month	5.20	5.10	4.80	4.80
	10-Year	4.39	4.70	4.70	4.75
Canada	3-Month	4.52	4.85	5.10	5.10
	10-Year	4.91	5.40	5.45	5.50
Australia	3-Month	4.62	4.60	4.60	4.60
	10-Year	5.17	5.65	5.65	5.65

2. Outlook and Strategy

Overview

This week the dollar celebrated the completion of its fourth consecutive year of appreciation against the world's major currencies. Exhibit 1 shows that the trade-weighted dollar hit a cyclical trough in April 1995 and has been rising ever since. As we look ahead to the dollar's fifth year of appreciation it is important to consider what could possibly go wrong to trip the dollar up. In a previous report (see *Currency & Bond Market Trends*, March 18, 1999) we considered what impact a widening of the U.S. current-account deficit might have on the dollar's value. We argued that a significant portion of the 1998-99 U.S. current account deterioration was due to a serious economic downturn abroad, and did not reflect intrinsic U.S. weakness. Hence, we felt that the sizable U.S. current account shortfall did not pose a serious threat to the dollar. In this issue, we consider what impact a major slide in the U.S. equity market's value might have on the dollar's value.

It is widely felt that the dollar could come under serious downward pressure if, at some point in the future, the U.S. equity market were to lose considerable ground. We got a brief glimpse of what could possibly happen last autumn when the dollar lost considerable ground following the sharp slide in the U.S. equity market during the July-October 1998 period (see Exhibit 2). However, since last fall both the stock market and the dollar have recovered strongly. Indeed, the U.S. stock market has risen to levels that many observers now consider to be heavily overvalued. As Exhibit 3 shows, the average price/earnings ratio of the Standard and Poor's 500 Index is now close to double its historic average. We do not want to get into the debate over whether the U.S. stock market is fairly valued or not. What we want to consider is what impact a U.S. stock market slide might have on the dollar's value.

Based on historic relationships, one might conclude that a U.S. stock market slide should have no meaningful impact on the dollar's value. As illustrated in Exhibit 4, there has been little co-movement between the trend in the dollar's trade-weighted

Exhibit 1

The U.S. Trade-Weighted Dollar Index

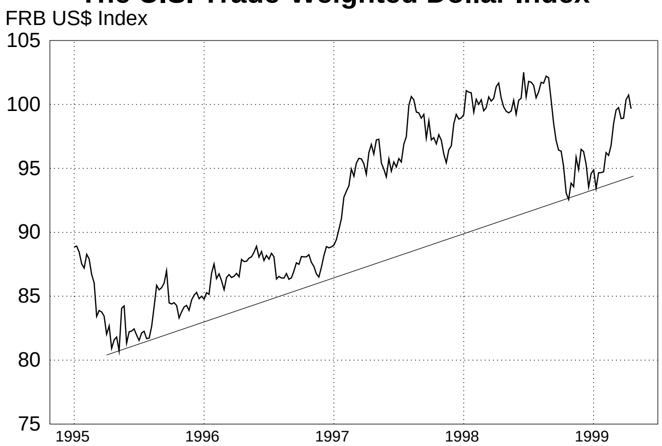


Exhibit 2

The U.S. Dollar and the Stock Market

(June-October 1998)

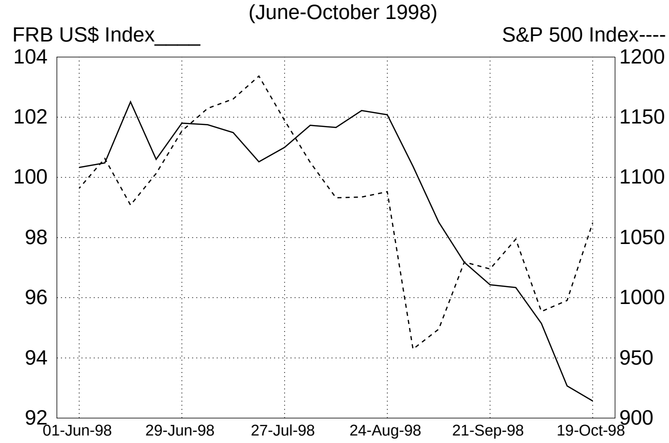


Exhibit 3

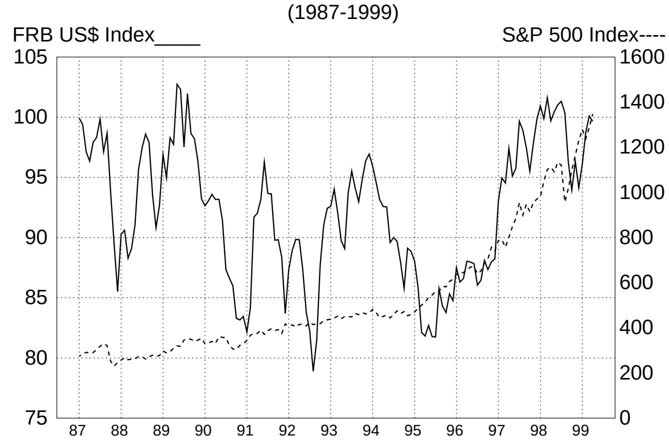
S&P 500 Price/Earnings Ratio

(1969-1999)

Exhibit 4

The Dollar and the U.S. Stock Market

(1987-1999)



value and the trend in the S&P index in the past 12 years. Indeed, the movement in the S&P index explains very little of the variation in the U.S. dollar index ($R^2 = 0.08$). The reason for the absence of significant positive correlation should be obvious. The dollar's trade-weighted value has been largely range-bound for the past 12 years, while the value of the S&P index has soared.

One could argue that there has been a surge in foreign-investor interest in U.S. equities during the past two years and should a sudden reversal of capital flows occur, this could trip up both the dollar and the stock market at the same time. As shown in Exhibit 5, foreign purchases of U.S. equities were fairly modest over the 1985-1996 period, but then picked up strongly in 1997-1998. Indeed, the 1997-98 increase exceeded the combined net foreign purchases of U.S. equities over the 1985-96 period by over 40%.

While the recent increase in foreign investor participation in the U.S. equity market is impressive, the bulk of foreign portfolio investment in the U.S. continues to be dominated by debt instruments. Foreign purchases of U.S. debt instruments (U.S. Treasuries, agencies, mortgages, and corporate bonds) have dwarfed foreign purchases of U.S. equities, with purchases of equities accounting for only 15%-20% of total foreign portfolio flows into the U.S. each year (see Exhibit 6).

Given the absence of any significant positive correlation between changes in the dollar's value and the stock market, plus the fact that foreign portfolio investment into the U.S. tends to be dominated by debt flows, and not equity flows, one would think the international investment community should be concerned more about the behavior of the U.S. bond market than the U.S. equity market to assess the dollar's potential vulnerability in the future.

However, it is possible that the behavior of the U.S. equity market might be of greater importance than the portfolio flow data suggest. Exhibit 7 shows that the U.S. net international investment position has deteriorated dramatically in the 1990s. The U.S. net external debt now stands at an estimated $1.5 trillion, or 17.5% of GDP, and is likely to rise sharply in the years ahead. Up until now the U.S. has not faced any serious difficulty in attracting foreign investors to buy and hold this huge and rising stock of outstanding debt. Indeed, as illustrated in Exhibit 8, the increase in demand for dollar-denominated debt (shown as a rightward shift of the B^d curve to $B^d{}_1$) has exceeded the rising stock of dollar-denominated debt (shown as a right hand shift of the B^S curve to $B^S{}_1$). The result is that foreign investors have not demanded a higher risk premium to induce them to buy and hold the stock of outstanding dollar-denominated debt.

A key reason that the demand for dollar-denominated debt has been so strong is that foreign investors embrace the notion that the U.S. represents the world's most powerful economic engine. Where the U.S. equity market comes into the picture is as a barometer of the U.S. success story. So long as the U.S. equity market continues to rise to new heights, the interna-

Exhibit 5

Foreign Purchases of U.S. Equities

(1985-1998)

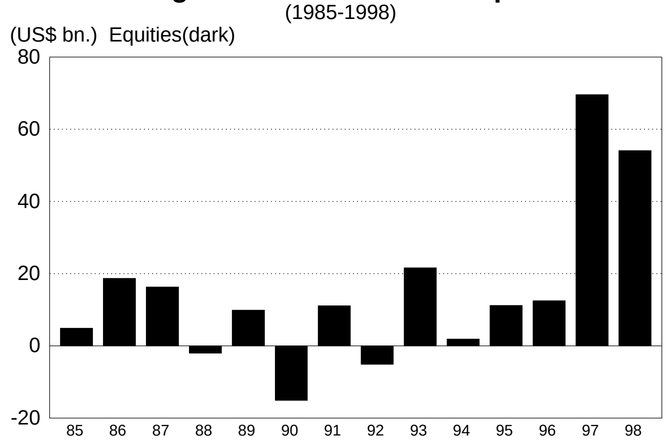


Exhibit 6

Foreign Purchases of U.S. Equities and Bonds

(1985-1998)

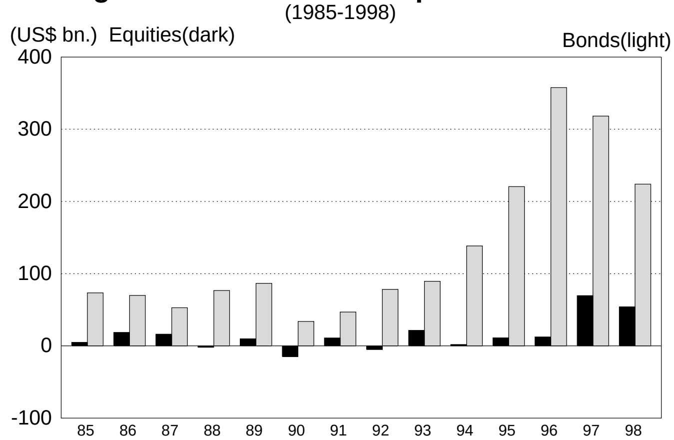


Exhibit 7

U.S. Net Investment Position

(at Current Cost and Market Value)

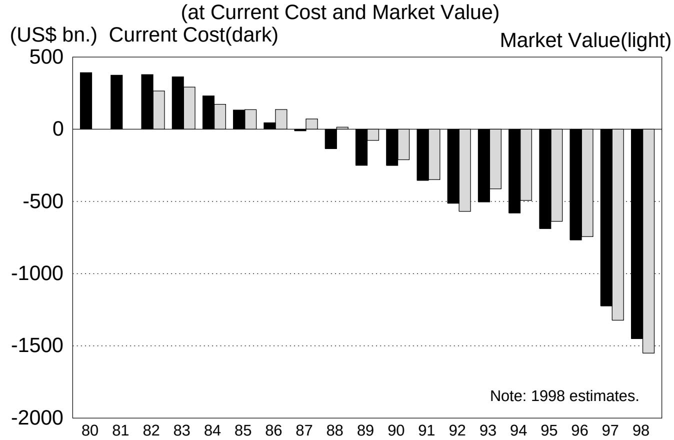
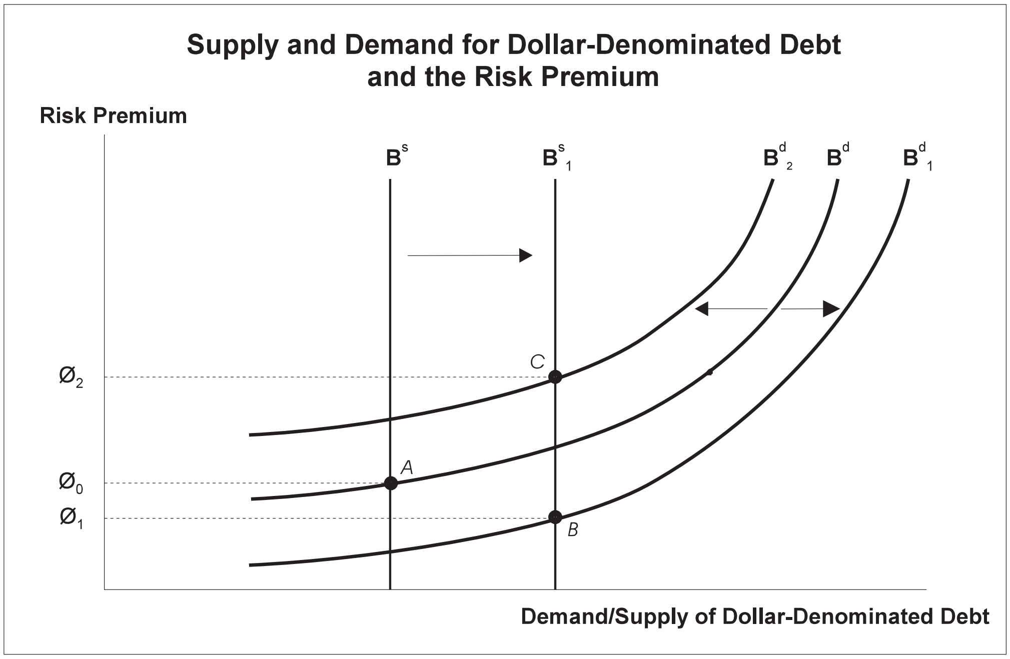


Exhibit 8



tional investment community is comfortable that the U.S. success story remains valid. In other words, a favorable trend in the U.S. equity serves as an "all clear" sign for investors to stay overweight the dollar and dollar-denominated assets.

An unfavorable trend in the U.S. equity market would send a signal to international investors that "all is not clear." In such case, the demand for dollar-denominated investments could fall sharply (shown as a leftward shift of the B^d curve to $B^d{}_2$). International investors would then demand a higher risk premium to buy and hold the existing supply of dollar-denominated debt. That would mean that either U.S. interest rates would need to rise sharply relative to interest rates abroad and/or the dollar would need to fall sharply.

A U.S. equity-market slide would also have a negative impact on the dollar through its effects on U.S. wealth, aggregate demand, and interest rates. As illustrated in the flow diagram in Exhibit 9, a significant decline in the U.S. equity market would result in a sharp decline in net wealth, which, in turn, would sharply curb aggregate demand. This wealth-induced decline in U.S. aggregate demand would affect the dollar in two ways. First, it would lead to a decline in U.S. import demand and thereby improve the U.S. trade and current-account balance. This would be positive for the dollar. Second, the decline in U.S. aggregate demand would likely elicit a swift response by the Federal Reserve in the form of a significant easing in monetary policy. The result would be a major decline in U.S. interest rates, with the U.S./foreign interest-rate differential narrowing accordingly.

Exhibit 9

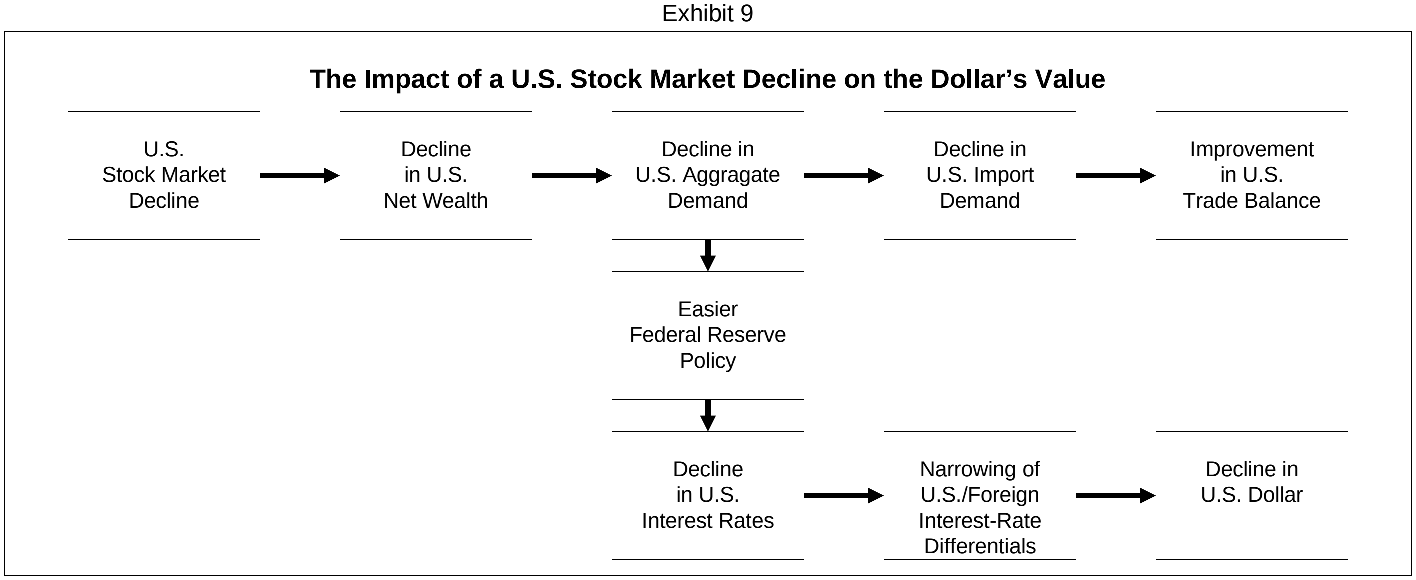


Exhibit 10

Correlation of U.S. & Global Equity Markets

(1990-1999)

(Correlation with Dow Jones Industrial Average)

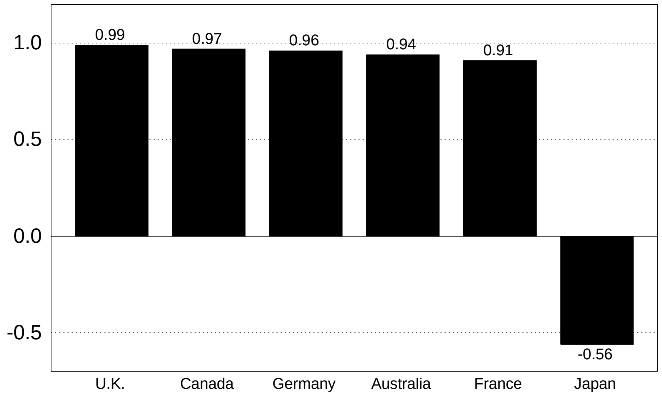
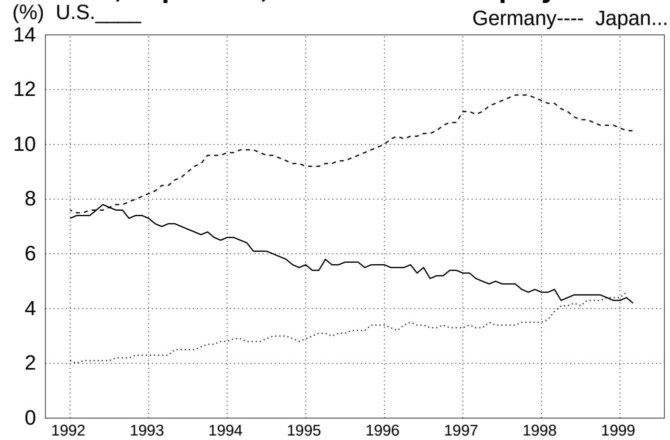


Exhibit 11

U.S., Japanese, & German Unemployment



The narrowing in U.S./foreign interest-rate differentials would be negative for the dollar and likely would dominate the beneficial impact to the dollar created by a narrowing of the U.S. trade and current-account deficit. This is pretty much how the U.S. equity market, interest-rate differentials, and the dollar played out in the fall of 1998.

What impact would a U.S. equity market slide have on market developments around the world? A major slowdown in U.S. aggregate demand would likely have a profound impact on global aggragate demand. The U.S. economy in recent years has accounted for nearly 50% of the increase in total world demand, even though the U.S. accounts for only 20% of world output. So, for instance, a sharp fall in U.S. domestic demand would seriously hamper the ability of the emerging-market economies to recover from their recent economic downturns. In addition, assuming a significant decline in both U.S. and global demand, commodity prices would likely come under renewed downward pressure. That would obviously be negative for the key commodity-based currencies: the C$, A$, and NZ$.

A U.S. stock-market slide would negatively affect Euroland in three ways. First, given the strong correlation between U.S. and European equity market trends (see Exhibit 10), a U.S. equity market slide would likely coincide with a similar slide in European equity markets. A slide in European equity markets could seriously dent European consumer and business confidence, the latter of which has been shaky of late. Second, should U.S. and therefore global demand weaken, this would seriously hamper growth prospects in Euroland in general, and Germany in particular, which is highly dependent on foreign demand to sustain growth. Third, assuming U.S. interest rates move lower and U.S./Euroland interest-rate differentials narrow, the euro would likely gain on the dollar. Unfortunately, a stronger euro would aggravate a foreign demand-induced slowdown in Euroland.

Given the negative effects that a U.S. stock market slide might have on European economic activity, one has to seriously question whether any gains made by the euro resulting from the narrowing of interest-rate differentials will prove to be permanent. Eventually, the ECB would have to respond and cut short-term interest rates to spur growth. But in all likelihood, the ECB would respond more slowly and with less vigor than the Federal Reserve. In the longer run, a more forceful Federal Reserve would put a firm floor under any U.S. economic downturn. We are less confident that the ECB would act as forcefully. This suggests to us that on the basis of long-run growth considerations, the U.S. is likely to fare better than Euroland. Hence, any gains made by the euro will likely prove to be transitory, just as they were in the autumn of 1998.

The above analysis is, of course, hypothetical. The fact is that the U.S. equity market continues to roar ahead, and it remains debatable whether the U.S. equity market is traveling along a bubble path or not. What is clear is that the trend in U.S. economic fundamentals remains excellent, particularly relative to the weak states of economic activity in Euroland and Japan. Exhibit 11 shows that the U.S. unemployment rate continues to decline to new cyclical lows, while unemployment in Japan has risen to a postwar high and the Euroland unemployment rate appears stuck at 10.5%. Exhibits 12-14 show that business confidence in the U.S. has recently picked up strongly, while business confidence readings in Euroland continue to decline. And while the downtrend in Japanese business sentiment appears to have stabilized for the moment, the outlook there remains quite fragile. As long as these trends remain positive for the U.S., which we believe they will, the dollar looks set to enjoy a fifth consecutive year of appreciation.

Exhibit 12

U.S. National Association of Purchasing Managers (NAPM) Index & Industrial Production

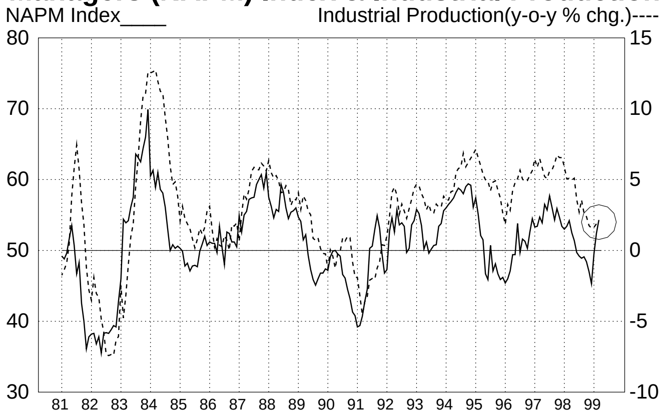
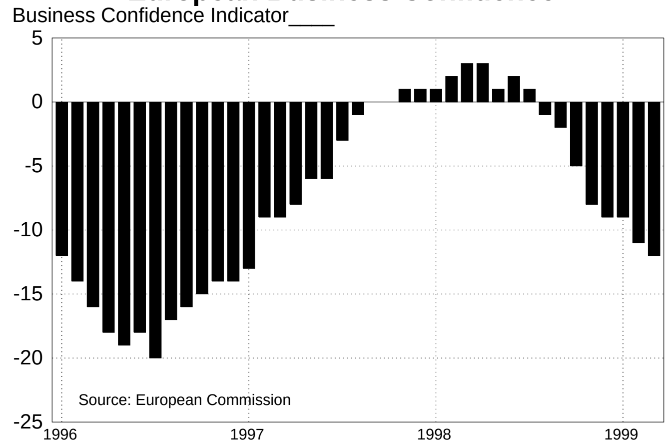


Exhibit 13

European Business Confidence



The gains that we foresee for the dollar are likely to be greater against the yen rather than the euro. We argued in our last report that the dollar's value versus the euro is gradually approaching fair value. Our estimate of fair value is based on a number of considerations. First, in terms of interest-rate differentials, U.S./German yield spreads are likely to stabilize around present levels following the larger-than-expected rate cut by the ECB. The ECB stated quite strongly that the rate cut will likely be the last one for this cycle. Since the euro's (or the Deutschemark's) value versus the dollar tends to move sympathetically with the trend in the U.S./German interest-rate differential, a stabilization of the spread should result in a stabilization of the US$/euro exchange rate around present levels (see Exhibit 15).

Second, on labor-cost considerations, average hourly labor costs in the U.S. do not appear to differ greatly from average hourly labor costs in Europe as a whole (see Exhibit 16). That suggests that, on a competitiveness basis, the euro is fairly valued versus the dollar.

But as Exhibit 16 also shows, average hourly labor costs in Germany (including direct pay, holiday pay, bonuses, benefits, social insurance and other taxes) far exceed (by 40%-50%) average labor costs both in the U.S. and Euroland as a whole. This places Germany at a competitive disadvantage and might explain why German GDP growth presently lags behind trends in U.S. and Euroland GDP growth. German's relatively higher labor costs may also be contributing to a gradual hollowing out of the German domestic manufacturing sector as German firms have stepped up their foreign direct investment abroad in the 1990s to take advantage of lower labor costs outside of Germany (see Exhibit 17).

If we have any concern about valuation, it is that a weak German economy inside Euroland could act as a drag on the broader trends in Euroland economic activity. (Germany accounts for more than one-third of the output in the Euroland economy.) If so, interest-rate differentials might continue to widen in favor of the U.S., which would then be positive for the dollar on a medium-term basis. Hence even though we be-

Exhibit 14

Japan's Business Conditions Sentiment and Industrial Production

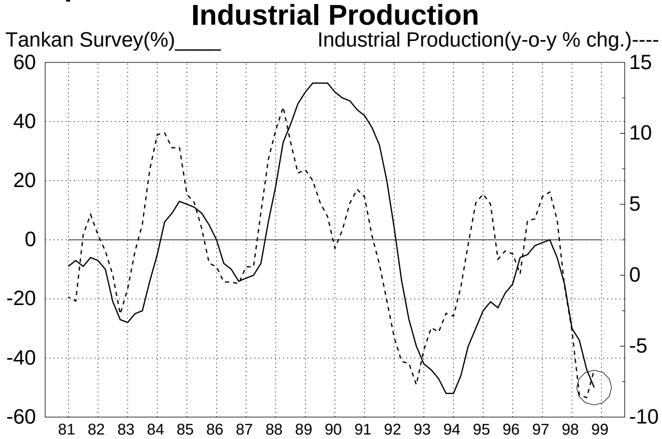
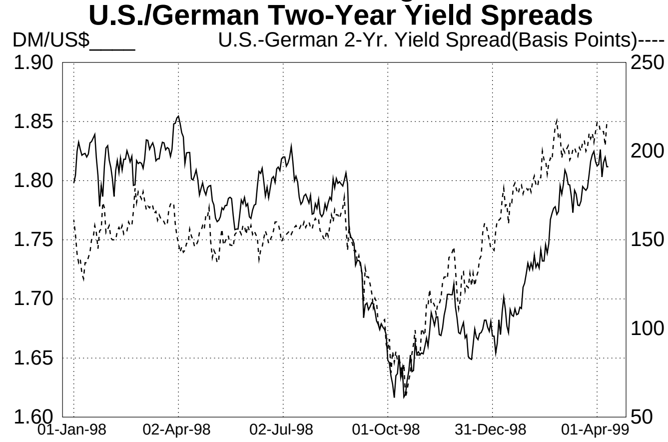


Exhibit 15

The DM/US$ Exchange Rate and U.S./German Two-Year Yield Spreads



lieve that the euro is approaching fair value, the risks appear to be tilted in favor of a stronger dollar. For this reason, we continue to favor a modest overweight position in the dollar and an underweight position in the euro.

As for our outlook for the yen, we remain as negative as ever on a medium-term basis. A growing number of forecasters have recently revised downward their projections for Japanese GDP growth in 1999. The most prominent of the forecast changes was the World Bank's downward projection of Japanese GDP growth for fiscal year 1999 from –0.2% to –0.9%. A Bloomberg survey of 27 economists at leading financial institutions in Japan found that the mean forecast called for Japanese GDP growth to contract by 1.4% in fiscal 1999, with the high forecast at –0.1% and the low forecast at –2.5% (see Exhibit 18). These forecasts stand in stark contrast to the government's official target of +0.5% for this fiscal year, which now seems overly optimistic. What is disconcerting is that GDP is set to contract for a third consecutive year despite the enormous sums of money spent on tax cuts, public works, loan guarantees, and a massive bank bailout plan, as well as an aggressive cut in short-term interest rates by the Bank of Japan toward the 0.0% level. The fact that the Japanese economy could still contract despite the enormous sums that have been thrown at it suggests that underlying economic conditions are extraordinarily weak.

The reason for the recent downgrades in Japanese GDP growth projections is that corporate restructuring, while positive for long-run profitability, is expected to exert a significant negative impact on Japanese domestic demand. According to the latest Tankan survey, capital spending is projected to fall by 9.5% in fiscal year 1999 as companies seek to unwind excess capacity. As firms seek to shed excess labor, the unemployment rate, already at a postwar high, should continue to rise to new record highs in the coming year. As unemployment rises and personal income contracts, household spending looks set to decline further. Household spending is already down 3.4% on a year-over-year basis.

With Japanese consumer spending and capital spending set to continue their declines in 1999, deflationary pressures are likely to build. Indeed, the Bank of Japan's deputy governor Yutaka Yamaguchi warned "that downward pressure on prices could intensify in the coming quarters." If deflationary pressures build while nominal short-term interest rates continue to hover around 0.0%, the level of real short-term interest rates in Japan will rise, and this will only serve to aggravate Japan's economic downturn. Inevitably, the Bank of Japan will feel compelled to take more forceful action and engage in a more aggressive quantitative easing of monetary policy. When the Bank of Japan moves in that direction, the yen will weaken in earnest.

Michael R. Rosenberg (212) 449-0204

Exhibit 16

Hourly Compensation Costs in 1997

(for Production Workers in Europe and the U.S.)

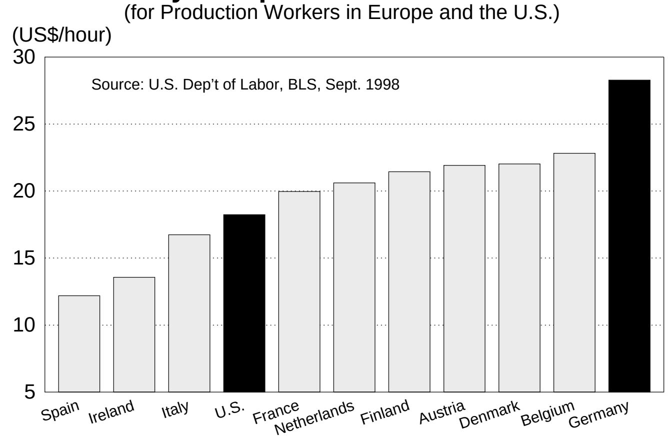


Exhibit 17

German Net Direct Investment Abroad

(Net Foreign Direct Investment, 12-Mo. Mov. Sum)

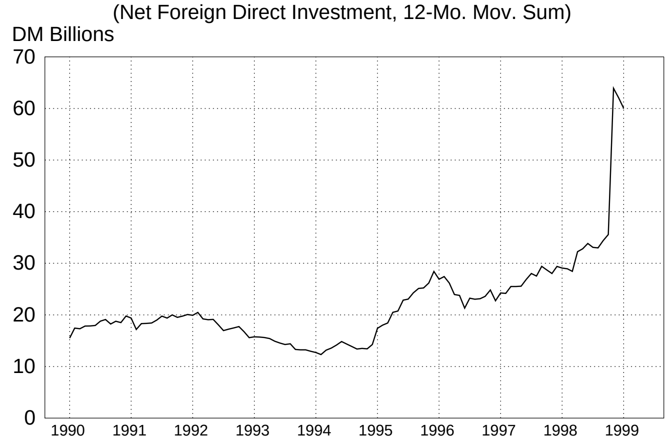


Exhibit 18

Forecasts of 1999 Japanese GDP Growth

(Bloomberg Survey of Japanese Economists)