

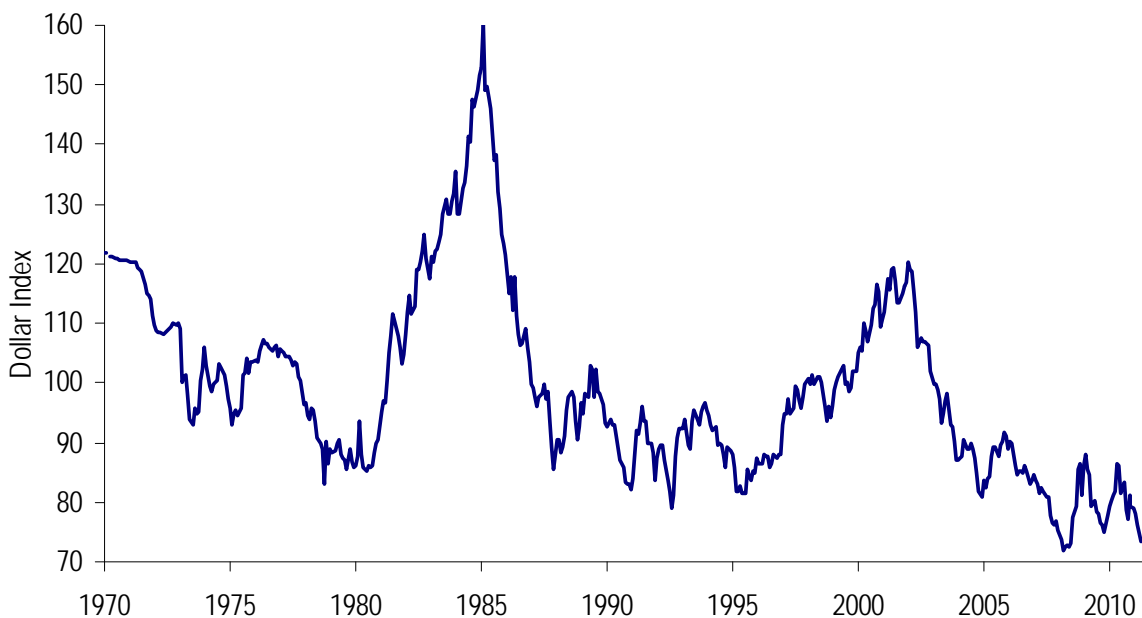
April 27, 2011

Bernanke Says Strong Dollar, But...

The FOMC statement and Chairman Bernanke's press conference were a bit more dovish than market expectations.

- The FOMC statement left intact the Fed's view that conditions "are likely to warrant exceptionally low levels for the federal funds rate for an extended period." It said the Fed will "complete purchases of \$600 billion of longer-term Treasury securities by the end of the current quarter", ruling out a tapering off of purchases or a delay related to the lack of headroom in the debt ceiling.
- At the press conference, Mr. Bernanke signaled clearly that the Fed wouldn't be raising rates soon. The dollar fell to new post 2008 lows during and after the press conference, while gold hit a record \$1529 per ounce and oil and other commodities rose. At 73.3, the DXY index is approaching the 70.7 record low set during the March 17, 2008 Bear Stearns collapse.

DXY – Dollar Index (last obs. April 27, 2011)



Source: Bloomberg; Encima Global

- Helping equities, Bernanke explained that the end of QE2 shouldn't have much impact on the economy (we agree).
- We expect loose U.S. monetary policy and fiscal policy to persist, harming economic growth and sustaining current market trends -- dollar weakness, capital outflows, high commodity prices and foreign outperformance. In effect, the U.S. is kicking the can hard down the road.

Strong Dollar, Weak Dollar

Chairman Bernanke used the phrase "strong and stable dollar" at least three times in his press conference, referencing it as a goal and the desired end result of a stronger economy. He said: "The Federal Reserve believes that a strong and stable dollar is both in America's interest and in the interest of the global economy."

- This isn't the first time Mr. Bernanke has used the phrase. In remarks on June 3, 2008, he said: "Over time, the Federal Reserve's commitment to both price stability and maximum sustainable employment and the underlying strengths of the U.S. economy--including flexible markets and robust innovation and productivity--will be key factors **ensuring that the dollar remains a strong and stable currency.**"
- Our view is that the U.S. has a weak-dollar policy comprised of near-zero interest rates, a relatively short effective maturity of the national debt (risking instability), an inflated Fed balance sheet and no apparent control over federal spending.
- A Bloomberg article today reported record bond issuance in China, with yields falling despite central bank rate hikes as capital floods to Asia. "Funds are flowing into China to profit from the prospect of currency gains, rising interest rates and economic growth," the story notes. It's a mirror image of the U.S., where the prospect of currency losses, low interest rates and mediocre economic growth are causing a capital exodus.

"Strong and stable" is our preferred phrase for an appropriate currency policy. We're glad the Chairman uses it. There remains a disconnect between the rhetoric and the policy, however, in that the dollar is neither strong nor stable and the U.S. hasn't supported it. For years, Treasury and the Fed have acted as if the current value of the dollar qualifies as "strong and stable." This severely undercuts the credibility of Treasury and the Fed on the dollar.

- Another problem with the rhetoric is that Treasury and Fed link the value of the dollar to the economy rather than to monetary policy. In today's press conference, Bernanke explained that "over the medium term where our policy is aimed, we are doing two things. First, we are trying to maintain low and stable inflation ... by maintaining the purchasing value of the dollar, keeping inflation low. That's obviously good for the dollar. The second thing we are trying to accomplish is getting a stronger recovery to achieve

maximum employment. Again, a strong growing economy will attract foreign capital and will be good for the dollar.”

- Since 1999, I've laid out in several Wall Street Journal articles the importance of countries providing a “strong and stable” currency regardless of their economic fundamentals, as was accomplished in Russia in 2000, Brazil in 2003, China in 1993 and so on. Linking the currency to the economy is pro-cyclical, meaning currency weakness hurts the economy and perpetuates currency weakness, without any particular limit.

To strengthen the dollar, the U.S. should say:

- We realize the dollar has been weak and is getting worse, harming the country. We plan to change that.
- We want a strong and stable dollar regardless of the strength of the recovery.
- We can accomplish this by choosing a monetary policy that is consistent with a strong and stable dollar. That will attract capital and jobs to the U.S., strengthening the recovery, maintaining price stability and fulfilling the Fed's dual mandate.

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