

November 2, 2010

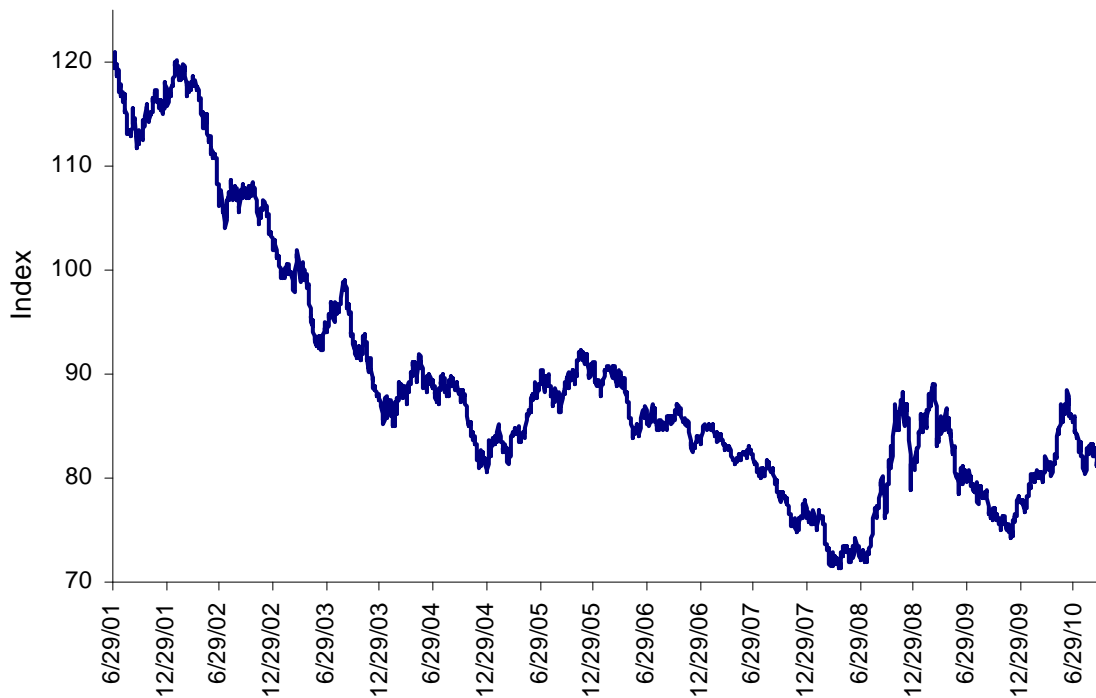
Election Impact on the Dollar

We expect big Republican gains in today's elections. That's mostly priced into markets including foreign exchange markets, as is renewed Fed monthly purchases of Treasury bonds. **If Republican gains are stronger than expected and Republicans take control of the Senate, we expect the dollar to appreciate materially.**

Three factors pushing dollar down:

1. The Fed's intention to purchase more assets. This is a major departure from central bank principles and the Fed's past authorities and explains much of the dollar's plunge since mid-year. We'll be interested in the tone of any dissents in tomorrow's FOMC announcement at 2:15pm.

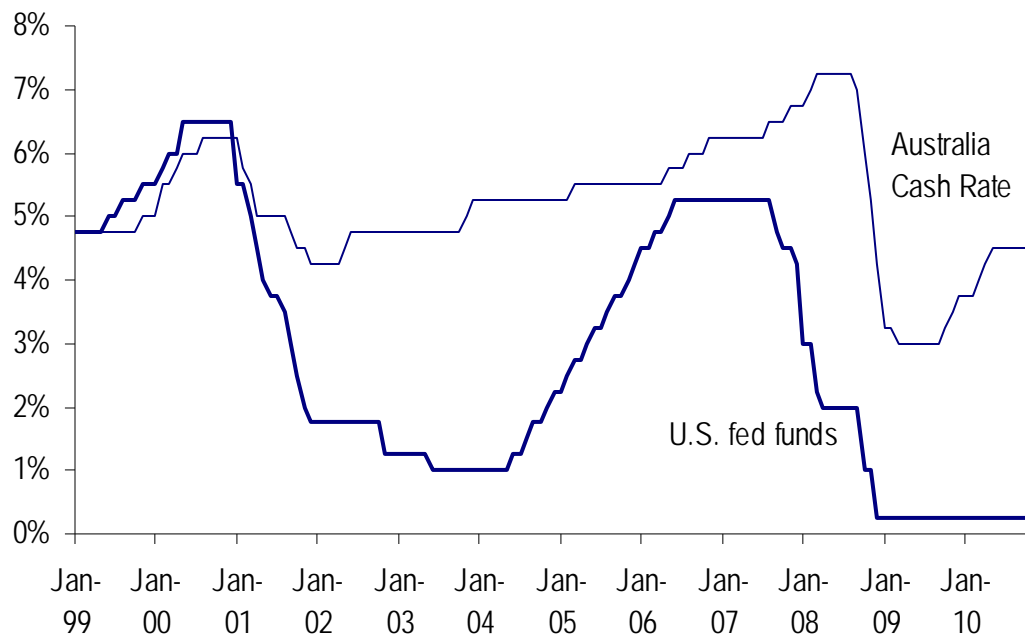
DXY Dollar Index Weakening (last obs. November 2, 2010)



Source: Bloomberg; Encima Global

- Evidence that U.S. monetary policy is increasingly out of step with global inflation trends and the rest of the world's monetary policy. Australia hiked its interest rate again today (to 4.75%) to respond to inflation. It has hugely outperformed the U.S. in terms of equity markets, investment, jobs, and living standards. India and China have been hiking to combat inflation. The ECB has its overnight rate at 1%. Yet the U.S., with a much weaker dollar than those economies (and therefore more pent-up inflation) has rates at near-zero and is still claiming a deflation risk. TIPS-based inflation expectations are rising, and the ISM showed a price-paid index of 71. (Japan has rates set like the U.S., but it has a very strong yen, has suffered severe past deflation and still has negative 0.6% year-over-year CPI versus plus 1.1% for the U.S.)

Policy Rates Australia and US (last obs. November 2, 2010)



Source: Bloomberg; Encima Global

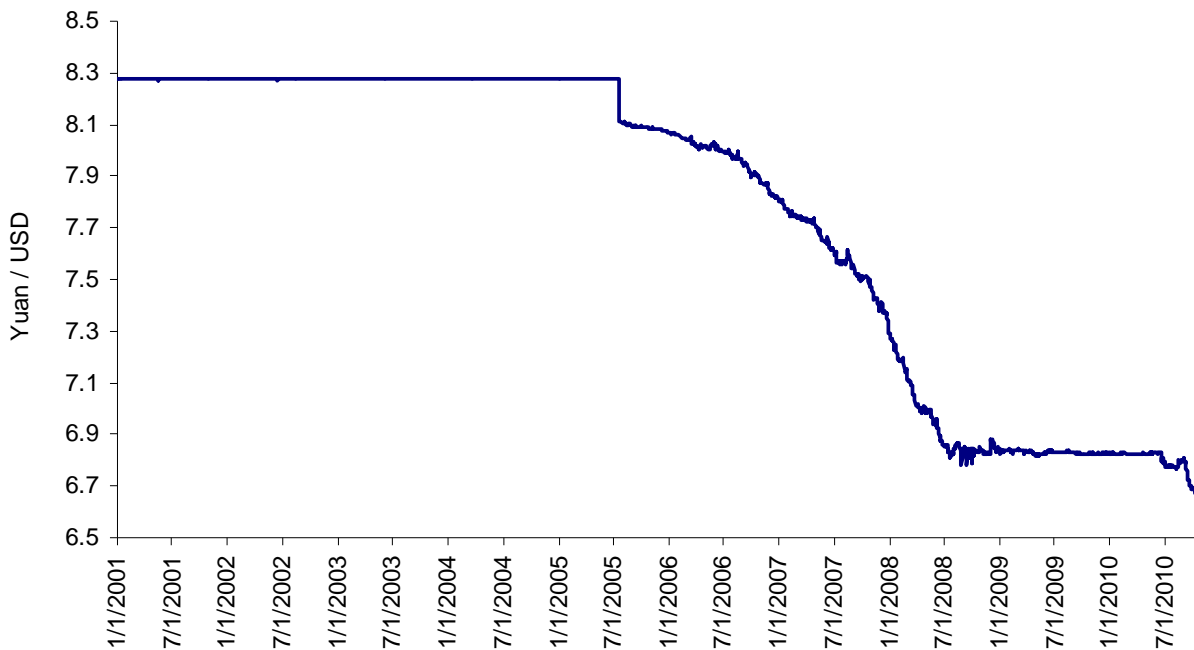
- The U.S. weak-dollar policy. In recent speeches, Treasury Secretary Geithner has repeated the key weak-dollar phrase of his predecessors (John Snow and Hank Paulson) that currencies should trade up and down with economic fundamentals. Since the dollar is a key economic fundamental for attracting global capital, and is weakening, use of the phrase reinforces the dollar's downward momentum. Meanwhile, the Fed has ignored the value of the dollar in its FOMC announcements, inflation analysis and public consideration of asset purchases, giving strong implicit support to the dollars downtrend.

Election impact on the dollar:

We think the consensus expectation (Republicans take the House but not the Senate) will be mildly dollar-supportive. 1) Many of the Republicans gaining power in key House committees and subcommittees are more dollar-favorable than the Democrats. (There's a union aspect – the weak dollar helps manufactured exports, which tend to be unionized.) 2) The new Congress is certain to be more fiscally conservative.

If the Republicans win more than the consensus, taking control of the Senate, we think it will be strongly dollar supportive and we would expect the dollar to retest some of the mid-year levels. 1) There may be a movement to reduce Fed asset purchases on limited government grounds. 2) Rand Paul (Congressman Ron Paul's son) will have won a Senate seat in Kentucky, bringing another sound money advocate to the Senate. 3) Sen. Chuck Schumer's central role promoting strong yuan/weak dollar will be diminished. 4) Congress will be very fiscally conservative.

Yuan / USD (last obs. November 2, 2010)



Source: Federal Reserve; Encima Global

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