



# Weekly Market Commentary



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## The Dollar Takes a Dive

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#### Highlights

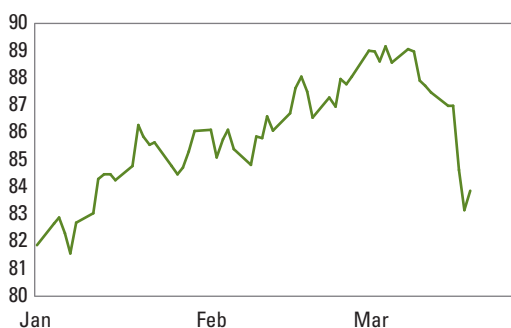
The measures announced last week by the Federal Reserve to boost the amount of money in the system caused the dollar to fall sharply. Market participants reacted with concern that the Fed's move will fuel inflation and erode the dollar's value.

An important change in the investment landscape may begin as investors' emphasis begins to shift from capital preservation to purchasing power preservation. While inflation is currently low and falling, at some point in the future investors' perception of the primary risk to their portfolios may make the shift to inflation.

We recommend increasing exposure to commodity price driven investments and minimizing exposure to Treasuries to both profit and protect from the potential that investors will begin to price in the return of inflation and a weakening dollar.

#### 1 Dollar Takes a Dive

*Value of U.S. Dollar versus Major Trading Partners*



Source: Bloomberg, LPL Financial

Last week, the relatively calm markets masked a provocative event. The Federal Reserve joined the Bank of England and the Bank of Japan with a plan to buy government debt. The measures adopted by the Fed and its counterparts in Japan and the U.K. are part of a series of tools known as "quantitative easing," because they tackle the quantity of money in the financial system rather than its cost, or interest rate. This approach is intended to boost economic activity by providing an abundance of nearly free money for lenders to tap, encouraging them to make more loans.

While quantitative easing can be a powerful mechanism for boosting growth, it comes at a cost. The move to boost the amount of money in the system through more than a trillion dollars in asset purchases pummeled the dollar with the biggest weekly decline since 1985, wiping out nearly all the gains for the year. Market participants reacted with concern that the Fed's move will fuel inflation and erode the dollar's value. [chart 1]

An important change in the investment landscape may begin to take place as investors' emphasis begins to shift from capital preservation to purchasing power preservation. While inflation is currently low and falling, at some point in the future investors' perception of the primary risk to their portfolios may shift to inflation.

Inflation is currently about 0%, and given abundant global labor and manufacturing capacity we do not expect inflation to rebound much before the end of 2009. However, investors' fear of resurgence in inflation may begin to rise at some point this year. When inflation does begin to rise, the Fed may be in a difficult position to contain it. Interest rate hikes might hurt the still fragile banks. Also, the Fed may be unable to promptly sell the mortgage-backed and other troubled debt that it is in the process of buying to boost the money supply without risking destabilizing the credit markets. The result may be the potential for inflation to rebound more forcefully than market participants currently expect, even with last week's moves.

There are many potential investment implications of a shift in the focus of investors to fear of inflation. Inflation erodes the value of financial assets, such as stocks and bonds, as it boosts the value of real assets, such as commodities. Rising fears of the return of inflation may have several implications:

- Commodity prices may be beginning to rebound after a 50% plunge since mid-2008. The move in the dollar was felt in the commodity market. Commodity prices rose 7% last week, measured by the Commodity Research Bureau Commodity Price Index. While some of this gain may



## Although the dollar may weaken,

One reason the dollar is unlikely to plunge relative to other currencies is that the Fed's action may put additional pressure on other central banks to announce similar measures. If the Europeans do not follow the lead of the Fed, Bank of Japan and Bank of England, the Eurozone countries face the prospect of a rapidly strengthening currency, which may hurt large component economies like Germany that rely heavily on exports. A stronger euro would make European exports more costly for global consumers, further hurting chances for an economic recovery.

be attributable to an improved economic outlook stemming from the additional monetary stimulus, the drop in the dollar was likely a more potent driver of performance. When the dollar falls, raw materials that have some global intrinsic value often cost more in dollar terms.

- From the early 1970s to the early 2000s 70% of the variation in gold prices can be explained by changes in inflation. However, in the 2000s the price of gold has been more driven by rising demand from the budding middle class in emerging market countries like India and China. In 2009, the positive forces for gold—currency devaluations around the world and weakening global economies—are balanced by the negative forces of falling inflation and declining emerging market demand. Over the long term, a gradual downward trend in the dollar is not enough by itself to warrant buying gold, since there is only a weak long-term correlation suggesting that the dollar is not a key driver or indicator of long-term gold performance.
- Many emerging market companies are producers of commodities. The stocks of these companies may benefit as commodity prices rise. Meanwhile, the emerging market nations of Eastern Europe may continue to languish in a capital drought. Many companies in emerging countries such as Brazil and Russia are leveraged to commodity prices.
- Over the long term, the value of real estate tends to adjust with the direction of inflation. However, we believe real estate prices remain elevated and will continue to fall in the coming quarters.
- Treasury bonds may suffer as interest rates rise—though they rose this week as the announcement of Fed purchases surprised the markets. The potential for losses could extend to TIPS. Although TIPS protect from unexpected inflation, they offer low real yields that could rise as “reflation” takes hold on the economy. Inflation is currently near zero, and expectations for future inflation have been very low as measured by the implied inflation expectation in government bond yields. However, investors are becoming wary of the potential impact of the monetary and fiscal stimulus in 2010 and may begin to price in an inflection point in inflation.

We recommend that investors increase exposure to commodity price driven investments and minimize exposure to Treasuries in their portfolios to both profit and protect from the potential for markets to begin to reflect the return of inflation and a weakening dollar. Of course, the impact of inflation is only one factor that can affect the performance of investments. We are watching events and data closely to assess the outlook for inflation as well as an emerging investment theme that intersects the themes of recession and credit crisis and may warrant tactical additional portfolio adjustments.

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The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, potential liquidity. There is no assurance that the investment objective will be attained.

Investing in Mutual Funds involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

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\*Such a plan involves continuous investment in securities. An investor should consider their ability to continue purchasing through periods of low price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.

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