Managing the decline of the US dollar

It seems that the lot of all currencies is to diminish in value with the passage of time. This has happened ever since trade moved on from the simple bartering of goods and chattels.

The once-mighty pound sterling declined impressively in real terms over the 20th century, and now it is the turn of the dollar.

Hopefully, politicians and economic gurus, despite some patchy performances over the past century, will get it right and let the dollar age gracefully as the rising stars of the east gradually take up the baton and lead for their alloted time.

In the meantime human aspirations have to be managed through the recurring cycles of inflation, rising debt and the more serious fundamental resource issues of the century – water, energy and food production, each of which is assessed by some monetary measurement, albeit flawed.

The dollar, stocks and gold

A few days ago the US stock market rose to another yearly high, according to the Associated Press "after Federal Reserve Chairman Ben Bernanke said central bank officials expect the economy to continue recovering."

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by Scott Younger

Indeed stocks soared as reported in the press, but ascribing this to a "recovering economy" is too simplistic. Perhaps the stock market is soaring because the dollar is losing value.

The more the dollar devalues, the more the US stock market witnesses gains. This inverse correlation makes perfect sense. This dynamic - falling dollar, rising stocks - is just another way of saying the stock market, in aggregate, has become little more than an "inflation trade".

Since a dollar bill will buy less tomorrow, savvy investors will use their dollars to buy almost anything today, including richly valued stocks.

US stocks, as an inflation trade, have performed adequately so far in 2011. It should also be noted that, over longer time frames, however, the US stock market delivers a much less effective hedge against the falling dollar. Gold's rise has highlighted this and, conversely compared with the results of the US stock market, gold continues to perform as a hedge against the steady decline of the US dollar.

The S&P 500 over the past 10 years has produced a cumulative total return of 33.7% when measured in US dollars. When measured in Australian dollars, however, this gain flips to a 35% loss

Most importantly, in terms of every major world currency, as well as numerous minor world currencies, the S&P 500 has been losing for the past decade. In terms of precious metals, the S&P 500 has lost heavily.

By simply exchanging dollars in April 2001 for any of the currencies or precious metals in the chart, a dollar-phobic investor would have received a greater total return than through buying US stocks. The chart does not include in its calculation the interest

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The US dollar, as a store of value, has been a disappointment for many years. Perhaps the critical question for investors is whether this trend will continue or reverse.

Statement by the Fed

During a recent press conference Fed Chairman Bernanke promised to continue pursuing inflationary policies, while also dismissing the inflation already created as a "transitory" result of "robust global demand." In other words,inflation is not a problem!

The longer he spoke, the more the financial markets seemed to realize he wasn't pussy-footing around on this inflation rhetoric. The US stock market - an inflation trade - rebounded from early lows to end the day at a new three-year high.

Meanwhile on the day, the classic inflation trades, gold and silver, rocketed from early losses to post huge gains. Silver jumped $2.36 an ounce to a new 31-year high of $47.84 (it is now flirting with $50 an ounce). Gold gained $21 an ounce to a new all-time high of $1,527.35.

And what about the dollar? Bernanke declared: "The Federal Reserve believes that a strong and stable dollar is both in American interests and in the interests of the global economy."

The foreign exchange markets seemed to ignore Bernanke's unsupportable comments on a strong dollar. The US dollar stumbled to a new two-and-a-half year low and continues to stumble. By contrast, the Australian, Canadian and Singapore dollars and Swiss franc are all hitting new all-time highs.

Obviously we shall continue to trade in dollars in the years ahead. It has been developed into the world currency for the vast majority of transactions and its convenience in use cannot be questioned. However, its future against the rise of the Far East economies and currencies, China and its currency in particular, are increasingly important world issues.

China must inevitably take on a more prominent role in world economics and trade, as it is gradually doing. For all of us, changes in currency emphasis must be as 'seamless' as possible, without prejudicing the more efficient use of key resources. On an individual basis, however, there are obvious opportunities for investors in following the value movements of key metals.

By William Gray and **Dr. Scott Younger** of the RIO Club