The MAMIS LETTER

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## SPECIAL REPORT

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### WHAT WE DON'T KNOW MIGHT HURT US ... BUT WE DON'T KNOW WHAT IT IS WE DON'T KNOW

We don't know anything about the currency markets, but we're not sure anyone else does, either, although they may talk a good game. Everyone believes that everyone else is bearish on the dollar ("everyone" is only a slight exaggeration) and, indeed, recent statistics showed all time record lows in the % of $ bulls. But many, if not most, of those reported as bearish are trend followers, which is a rather superficial way to trade currencies (or anything, for that matter), making it hard to evaluate the significance of what is surely a considerable bearish contingent, while being sensitive to such traders willing to change their collective minds on any breeze. Something's going on, of course, for it has become *de rigueur* for CNBC reporters, as they do their year-end/year-ahead interviews, to ask every patient being examined how he (or she) feels about the currency. Many times, they are too timid to use the word "dollar," as if cautious that Washington may think the word "dollar" borders on the salacious (compared to the euphemism of "currencies"). But what is interesting is how many interviewees, convinced that everyone else is bearish, speak out for a contrary opinion -- "this is a bottom," or "it's been weak long enough," or "it's not a problem -- let it be weak if it wants to be, you can see that it isn't hurting anything" (spoken by a man who probably doesn't even have a passport). So what we know about sentiment is that the prevailing notion is that the dollar is weak but tolerably so. It's Alfred E. Neuman stuff all over again.

Apparently, the only market where "weak" can be considered a positive is the Forex. (Short-sellers, of course, are delighted with weak in any market.) However, to the man in the street, "weak" is, well, weak, and no one likes "weak" whether it is the local football team or an overly timid husband. Mr. Milquetoast was the hero of a comic strip as the very personification of "weak," contributing his name to the language, but one couldn't have such a gently poking fun kind of cartoon in today's culture ... not when Grand Theft Auto is the prevailing game. To the administration, "weak" doesn't exist -- they believe weak is strong, or good for business, or else it is the market's fault/responsibility, and has nothing to do with them, like Kansas City not caring what team Randy Johnson is traded to. In large part, this is because much if not most of the blame for the weak dollar is placed upon the huge and growing ever huger trade deficit as a convenient excuse, if excuse it is. All they have to do is make yet another promise that they are already in the process of cutting the deficit in half, and some people will believe them. For a country that has assiduously been persuading young couples to buy homes with no money down/interest only/pay us back in 10 years, and so forth, talk of budget deficits only gets in the way of consumer confidence. To paraphrase what everyone's mother would say: “If you don't have something nice to say about the dollar, don't say anything.”

Others set forth the notion that the U.S. debt as a % of its GDP may be high -- indeed, we'll acknowledge that it is "high!!!" by historical standards, but, hey! it isn't as high as Japan's or Estonia's or what about Argentina? as if comparing the Yankees to the Toledo Mud Hens. And then, of course, there is the wondrous reality -- how can anyone prefer Euros? when the European economies are (to borrow Dennis Gartman's wonderful choice of words) sclerotic. Truth to tell, we slept through Economics 101 because it met at 8 a.m. (although we've always remembered the law of supply and demand), so we don't know anything about this fundamental stuff except what they tell us -- trade deficits are okay because ... or, when the dollar gets weaker, the trade deficit will ... or, the country can afford the debt as if those numbers are ethereal, even though one's own credit card company isn't so tolerant. That is, what we know is what we read in the newspaper or hear on CNBC, and because there are so many different takes on these issues, we can't even find an underlying opinion to be confidently contrary to. There have been times when a positive economy is accompanied by a strong currency, and there are times, such as now, when a reasonably growing economy seems unaffected by -- or is abetted by -- a "weak" currency. And there are times, allegedly -- the statistics are now being dragged out -- when a big trade deficit was a currency problem and times when such deficits were neglected to no ill effect. The list of comparisons -- proving either that the trade deficit will be the dollar's undoing, or that it doesn't matter whatsoever -- is seemingly endless. Once upon a time we believed that a strong currency was per se linked to a strong economy, but only because that was the trend at the time. Having been embarrassed in holding that belief at the next cycle when it wasn't valid whatsoever, what we have come to know is that there is no consistency to a currency in its relation to other aspects. Currencies, like stocks, are in the hands of buyers and sellers, with multiplicities of "reasons," emotions, and an occasional doubling up by a rogue trader desperate to make back a huge loss. Forex traders need to know what the margin clerk has in mind, more than any hoity-toity economics.

What's more, even the one thing we seemed to know, or had been persuaded to know -- <u>that the dollar had gotten grossly oversold</u> (to go along with the conventional belief that sentiment had gotten grossly bearish and perhaps even hostile) -- doesn't seem to matter, even though oversold *and* overly bearish customarily is a potent combination. Nor does it make sense to sane investors here that other investors elsewhere would rather own the euro, regardless of the EU's jumble of weak economies, as compared to the dollar, with our relatively strong economy. And yet, the dollar has been weak, plainly and simply weak, to the degree that we, and others, began to swear that it was oversold, and that at least a short-term rebound was becoming due. This apparently easy call of a contrary opinion to what seemed like pervasive bearishness -- that is, an oversold dollar bounce -- was given additional credence by the appearance of a magazine cover indicator (originally dubbed the *Sports Illustrated* cover jinx -- but in this instance recently appearing as the cover of *The Economist*) deriding the weak dollar. Every time the dollar seemed about to rebound against the Euro -- the Yankees, so to speak, vs. the Red Sox -- we would call out plausible targets of 1.30 and 1.27 ... but the Euro would hold instead, not only hold, but lately has been increasing its strength into new high ground. (The trade-weighted dollar chart has also been weak, making lower lows, almost as if the Mafia had attached cement to it, and tossed it in the Hudson, while the dollar vs. the Yen has meandered more sideways than down, of interest only because it used to be of interest.) The $'s anticipated rally would seem to start, and then evaporate, couldn't produce a recovery for more than a day. *Why has $ weakness returned? What's going on here?*

"Normal" is not reliable now.

In our world -- that of equities -- when a stock gets grossly oversold (by definition, *when there is no one left to sell*) -- it rallies. Sometimes it rallies only so far as to reach a price level at which holders will be willing to sell; at other times, it can be a major reversal. Sometimes it manages to rally across its long-term moving average line; at other times, however, it gets only up to the underside of that long-term trend-line and then quits. *When it is supposed to rally but doesn't rally, or rallies so feebly that it fails, that tells us that there are still sellers around* ... and it often turns out that those sellers know something else is involved -- "inside" information, if you will ... another shoe still to drop, although occasionally it is because they're smarter than everyone else, or more experienced, and have discerned something particularly meaningful within what every one "knows." (See MRK, for example, or Enron's classic descent.) There is a finite number of stock shares, and a relative although fluctuating finite number of interested parties, and *when a stock does something different than what its chart says it is supposed to do, it is doubly significant.* But currencies can be virtually infinite -- governments can always print some more-- and the weapons of central banks are enormously greater than that of the largest hedge funds... except, of course, central bankers don't know how to usefully wield that power, are clumsy giants, often able only to try to jawbone change ... except, also of course, that there may be no clever way except to let the trend run its course.

Those of us in the audience know so little that we can't tell the difference between the *futures* market, where hedgies play, and traders try to discern a trend from moment to moment, listening to comments by authorities as if they are smarter than professors, and the *actual* market which is the province we suppose not only of central banks but also the poor benighted tourist trying to understand the French on a Parisian ATM machine. One would think that big shot corporations would "risk" hedging their currency risks, but they don't. It invariably strikes them as either too risky, or something they shouldn't do ... as if they can be ruthless in the boardroom but meek when faced with currency risks (consider how easily airlines could have hedged their energy costs, and never did). The rub is, of course, that they have to do it well. We wouldn't know how to advise either the U.S. Treasury or Japan's authorities (tourists we can tell to stay home). What's more, what works at one time, doesn't, at another. Markets are never easy, and the Forex market can't easily be beaten. But it seems to us, having reached this point in the discussion, that if it doesn't make "sense" for the Euro to be strong, if the dollar ought to have been able to have had at the least an oversold rebound, and everyone is blabbering about the trade deficit causing the weakness, or the debt, etc. etc. etc. then, just as in the stock market, what is so easily known, and so widely talked about, is already in the market, and we are being told that *something else is underlying the dollar's underlying weakness.*

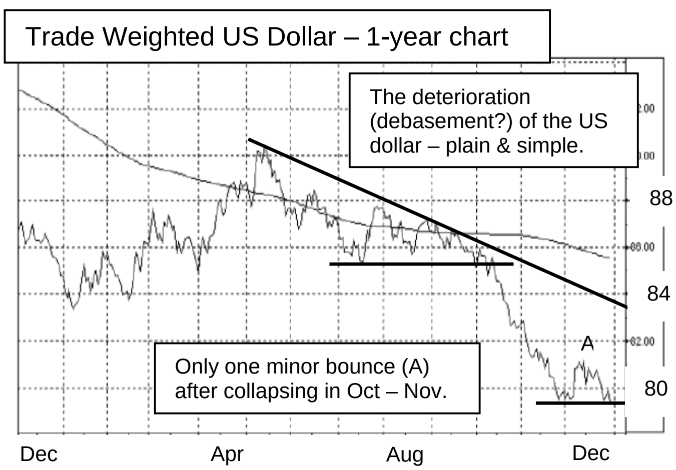
It may be that the dominant Forex players have taken Mr. Greenspan and Mr. Snow at their (implied) word ... that the dollar should be 30% lower.

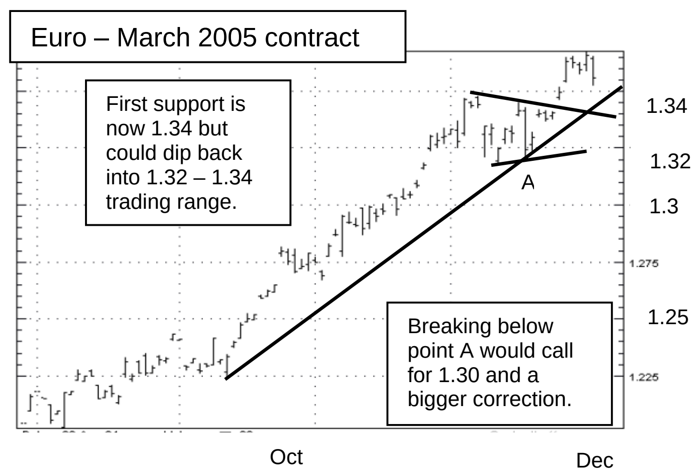
(However, that conflicts with the conspirators' theory that the primary reason for the Fed raising rates has not been to ward off inflation -- after all, the commodities that have been most inflationary are the most admired -- but has been to defend the dollar. A series of semi-serious wisecracks can be made if it turns out that the economy gradually weakens to the extent that the Fed stops raising rates, which in turn would add to the underlying trend of dollar weakness, which would therefore eventually compel the Fed to raise rates to protect the dollar, thus weakening the economy even more, and so on.)

If one is to believe that the Forex market serves an actual economic function, as one has come to accept about the commodity markets, then one has to believe that the sellers are those who have come to possess excess dollars rather than the market being driven by those who are eagerly flinging money at Euros. All of a sudden we are in the real world. One of the interesting realities is that it is very difficult to strengthen a currency -- to turn it around, like the proverbial ocean liner in New York harbor, as if it were a bottoming equity that had finally reached "value" -- and once strengthened to keep it strong. However, it is quite easy to weaken endlessly, and ultimately to destroy, any vulnerable currency. *The Economist's* flagrant cover of "The Disappearing Dollar" discussed their view that *"the dollar is not what it used to be." But we all know that*, and a goodly number of those "we"s are not worried about the weakness. After all, we're not going touristing to Europe -- even if we'd like to -- and a weak currency has the positive effect of supporting manufacturers who can export. (That is becoming more and more of an excuse. So much manufacturing is now done abroad, rather than shipped abroad, that this virtue is not nearly as great as politicians would like to think it is.) The notion that "weak" is not to be worried about reflects the fact that nothing has changed here at home; indeed, consumers can pay less for imported trinkets, and who notices whether the price of toilet paper or toothpaste is a nickel higher or not? The dollar, in everyone's neighborhood, is still a dollar, and that same phrase is what we remember hearing during the prior bout of dollar weakness, when the $ was out-matched by the strong Yen, and melons in Tokyo cost $50, except who went to Japan, and melons at the supermarket were only $2.75. Indeed, to many, the only flaw in having a "weak" dollar is that Americans don't like that word "weak." This is more Alfred E. Neuman stuff.

As it happened, *The Economist's* web site accompanied the availability of their cover essay with various references, one of which was an excerpt from *Paper Money*, "Adam Smith's" chapter on "The German Hyperinflation." We're not here interested in terrifying everyone with the boogie man, but one of the things that struck us while reading this piece was the description of how the Germans weren't worried even though their currency was already weak. "... bourgeois habits were very strong. Ordinary citizens worked at their jobs, sent their children to school, maneuvered for promotions ... and generally expected things to get better. ... However, there were complaints about the high cost of living ..." That is eerily similar to what can be said about today's American citizenry. The absence of concern is troubling; confidence about "weak" is not a virtue. Today's consumer trend toward "luxury, all is luxury" may be psychoanalyzed as an expression of "strength" -- to separate one's own conspicuous consumption from the weak currency, a sense of "see how powerful *my* dollar is."

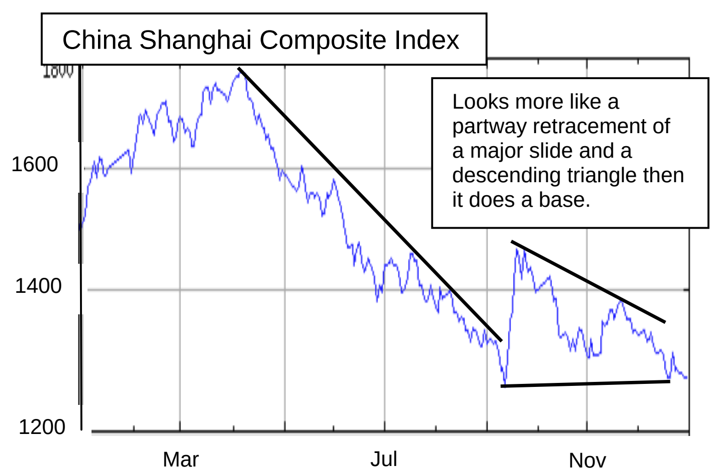
Is this simplistic? Are we being naive? Is there a disconnect between believing the "deficient" -- oops, deficit -- will be reduced, and the effect of the deficit on the dollar? At what level of reduction, if there is to be any, will the deficit become comfortable? (manageable, we believe, is the word) and if the deficit becomes comfortable, will that arrest the dollar's weakness? Or *does the continued selling* vs. the Euro (and the pound, and the Canadian dollar, et. al.) even as a rebound has been so widely expected, *tell us that there is more to the dollar's problem than excusing it as due to the spendthrift statistics*, as if Washington is a rich but profligate uncle, who is eventually going to leave us a decent sum in his will, if we only have some patience. Obviously, the deficit is tolerable now, but just as obviously, no one knows the future -- can one talk about Social Security refinancing and permanent tax cuts at the same time as reducing the deficit? is there a neighborhood tipping point? is there a degree of deficit that causes the dollar to snowball instead of erode? is that tipping point perhaps when the b of billions changes to a t? what's the emotional straw that could turn the great power's "world's most important reserve currency" into something irretrievably ordinary? *A great power does not let the market bear all responsibility for global financial stability... unless its power is waning.*




Does this not, then, shift the question to the issue of foreign (and particularly Asian) holding onto, and supposedly purchasing more of, U.S. paper? Why in the world they would do this when the currency is depreciating and they create their own losses is, well, silly, or mysterious, or has some secret virtue to it. It's akin to the old garment district joke about "making the loss up in volume." But perhaps there's nothing they can do about it. Where else are they going to go with their "investments? surely not to Japan; that era has passed, and only tentatively to the Euro, since other governments are free to believe that the EU's economy is in bad shape (especially when compared to the U.S. positives, including a slightly higher yield), and besides, if the Euro were the place to be (1) they've missed the market, and (2) why wouldn't the Russians and/or Saudis already have shifted the price for crude? (although perhaps they will, now that Putin has become another oil sheik). Besides, there's a certain virtue -- especially for the Chinese -- in using the dollar to support their economic growth. In the same way that U.S. money supply (excluding the cash component) finds its way to being lent by "local" banks to local businesses, and for mortgages, too, and those businesses in turn pay workers, who in turn spend at the mall, etc. and so on, China can use WalMart dollars to help local industries grow, and citizens spend, and that growth is at the root of Chinese economic growth, with the excess going to the central bank for investment here which therefore adds to the Treasury's debt and/or finances our own consumer spending. Foreign buyers must both hang onto what they own, and buy more, giving rise to the look of a house of cards. But the use of the WalMart money is profitable even if money is lost on the exchange rate. The whole business is incestuous -- or, more politely, you scratch my back and I'll rub your tummy.

The above paragraph reeks of "it doesn't matter ... until it does." Indeed, one might vary that to "what's the harm? until it hurts." A smart aleck remark can be made about a certain nation with which we are all familiar being addicted to consumerism, and yet if you follow that thought through -- the powers that be want us to spend, and the media hawks spending as if it is a virtue -- it loses its cleverness and instead of consumer confident spending being the solution, it becomes part of the problem. Being addicted to this life style, as comfortable as it is, makes it very hard to view it as excessive. But what about the people we are borrowing from? no one wants to spoil the party, but isn't it easy to see how reduced foreign buying of U.S. paper (which seems to have begun), could gradually become a withdrawal from buying U.S. paper, and then can move on toward a not so gradual redeeming of the paper they already hold, until one reaches the point of "Now it matters." Obviously, <u>when it matters is when the dollar is no longer the world's most important reserve currency.</u> "Ordinary" may be more upsetting to the American public than weak. But to central banks, who have felt they have no choice, the risk may finally become too great ... and perhaps the Euro continuing to rise, even when it was supposed to have a correction, is the first warning sign of such a shift in attitude, of the neighborhood tipping.


When we were leaving the NYSE to go to work at *Indicator Digest*, the editor at that time was an elderly (at least he seemed so to us) gentleman named Irving Reich. *Indicator Digest* was, at that time, the "hot" public stock market letter, and as it turned out we walked in the door at what proved to be its subscription peak (20,000+). Irving hastened to assure us that we shouldn't worry about our job because "it takes a long time for such a company to die, the way *it took a long time for the British Empire to die."* And as an aside, he added, presciently, "... and the New York Stock Exchange, too."

After a century of power, leading to the boast that "the sun never sets on the British Empire," the sun really did set. We leave it to historians to write about the rise and fall of the Empire in detail, but simplistic hindsight shows that the Empire was peaking just before World War I, with the war accelerating the downturn. Britain's then "reserve currency" wobbled through various post war turmoils (one web site stated it as "The British pound more-or-less retained its value until World War II.") But during that same period, the U.S. expeditionary force had a material impact on the bloody battlegrounds of the first World War, and like an upstart adolescent had its exuberant phase in the '20s, benefiting from youthful growth as well as distance from the Euro-centric focus. Power was gradually changing hands during and after World War II -- that post-war period saw the Empire peeled off like an onion into a grab bag of different independent countries, as the sun literally began setting. More important to this text: the Bretton Woods Agreement of July 1944 signaled the end of the British pound as the world's reserve currency. There followed -- in 1949 -- the need for a major devaluation (against the dollar) which brought the pound down to $2.80, and it was devalued again in 1967 to $2.40. By then it was an "ordinary" currency, even before the Bretton Woods agreement of fixed exchange rates collapsed in 1971. Weakness, in a long-term sense, begets weakness, like the flaws in an incestuous genetic pool.

History is much more complex than a few sentences, and surely there were many "reasons" for the end of the British Empire's "century," just as there were many interconnected reasons that led to the German hyperinflation. But it is clear to us that *"the reserve currency" is not a permanent appointment*. As the Empire was aging, and its currency was losing its world importance, America was growing up into what we now think of as the "American century." Maturity -- that is, being *the* world power -- came as this country emerged out of the second World War. Some elderly folk feared a post-war recession, but growth was immediate, sound, and persistent, spreading "America" around the world, and aggravating the Russians as it did so. (The Russians got back at us with Sputnik.) Broadly speaking, American power/global leadership ran into trouble because the world had become more complex. Just as the fall of the Roman Empire can be simply defined as "they had too much and couldn't keep it all under control," America's power began to wane when the inability to defeat the Vietnamese no matter how much bigger and stronger and richer we were took everyone by surprise -- we'd never lost a war before! It is not the purpose of this text to comment on the gradually increasing military vulnerability but we can point out that over time, and including intervening rebounds, the current "reserve currency" has become more vulnerable, too, is becoming weaker and weaker, to the extent that it hasn't even been able to rebound when the market says it "should." Although we doubt if they deserve such credit, perhaps Snow and Greenspan suggested or implied or hinted at a further 30% decline (that is, a devaluation masked as a "desirable" weakness) because they wanted to make a virtue out of inevitability.

Step three of passing the baton in this relay-type sequence is that in the same way a youthful America took over from an aging British Empire, a new adolescent -- China -- is coming along, as the American "Empire" loses its potency. One can't really talk about timing, or length of time, or pinpoint the moment, just that as the British Empire faded, the American Century came along, and now that this "world power" is similarly becoming exhausted (and going out in a burst of luxury spending) we can already see with some awe the emerging strength of China.

... not India. China is expansive; India keeps turning inward, remaining self-contained albeit growing within its boundaries. But today's China has its flaws -- there are riots in the streets, due to corruption and the first-ever opportunity to get rich, sort of the way American do-gooders on the outs become corrupt, too, when they become the ins. The Shanghai stock market -- and the "B" shares, too -- as we write this is trading on the precarious edge of making lower lows. China hasn't had its 1929 yet, nor its depression (both being part of the American Empire's Century), but what it does have is a dangerously worrisome excess of male babies and thus young males -- worrisome because the *customary rebalancing has always been a war.* But China's economic vitality has already exploded beyond being slowed very much, let alone stopped. It has all the ingredients -- size, population, location, the smarts -- to make this China's Century.

But there is more to this transition than merely China, as non-merely as China is. For there is an Asian sphere, including a currency connection, with China at its core, to be reckoned with. Whenever and however the yuan is eventually revalued, many other Asian countries will come with it. In the meantime, we're curious to see how China handles the natural disaster of the tsunami within its economic sphere, right around the Global corner, so to speak, because we haven't seen the name China on the front pages yet ... and comparatively how much strength, life, maturity, the American sphere is capable of rendering during this crisis ... more than just money. Is China being too timid about exercising some leadership of this unfamiliar nature? That won't slow its own growth but may compel us to pay greater attention to what is already happening economically elsewhere -- one reads in the business sections almost daily of China buying up something useful to their expansion, or announcing many long-term trade agreements with Brazilian steel and mining companies, and with many other countries and companies as well. Perhaps most tellingly, as we write this, may be the suggestion/expectation that China will take advantage of the Yukos seizure to make an investment (read: furnish needed capital) in the Russia oil industry. Such a linkage with Russia -- almost in defiance of the aggravation expressed in the West -- suggests the possibility, perhaps even the likelihood of Russia turning once again toward Asia, becoming more of what it has always been, an Asian power more than an old-Europe one, as it straddles both Europe and the East. A Russian-Chinese combination would beat the U.S. -- British team in any Super Bowl. Geopolitics aside, Washington's demands for China to let its currency float more freely may turn out to "help" the yuan/renmimbi eventually become the next "reserve currency" -- which surely is not what those folks in Washington have in mind. "Be careful what you ask for ..." comes readily to mind.

There is an expectation of instant gratification nowadays. So we must warn not to turn the next century's global changes into something that has to be evident in its entirety all at once -- or else denied. Nor will our concerns be proven instantly "wrong" just because the dollar finally has its oversold rebound. (The Euro chart depicting this latest surge feels relatively late, with another prolonged consolidation likely to come along before long -- nearby support is approximately 1.34. But the Euro is only, in the grand scheme of things, a stopgap strong currency; it may share the notion of a reserve currency for a while, like an interim coach after the failing coach has been fired ... but will not become "the" reserve currency.) What we are describing is *a sequence of a very-long-term weakness in the dollar, with intermittent and occasionally significant oversold rebounds,* albeit at least in theory if not yet in reality. But if this is to be so, then *the weak currency already may have become the dollar's second nature.*

At this juncture, we might customarily introduce a devil's advocate paragraph. But there is no devil's advocate case to make. What is an alternative? that the dollar is hunky-dory? that the underlying weak dollar trend will stop being weak tomorrow? *A currency can be weak with good reason, but a currency can be strong by default.* (Read "dollar" for the first part, and "Euro" for the latter.) We don't know enough about currencies to know whether that coupling is absolutist, under all circumstances, but we do know enough about the stock market, as it heads into a waning of the current intervening bull market, that this transition of global power, and the fading away of the dollar as the "reserve currency," may be the sneaky but inevitable arrival of the stock market's still missing, and still due, enema. Because the comparison with the "nifty fifty" peak still appears valid, a *final bear market cycle leg down a la '73-'74 may have at its root this weak dollar problem.* What began decades ago as "What's a million dollars here or there among friends" ... and grew into "a billion dollars here and a billion there and pretty soon you're talking about real money" ... is becoming "a trillion here and a trillion there, and one is not sure what one is talking about any more."