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Special report: Strategies to Survive Dollar Devaluation

Probabilities of devaluation

Arguments in favor of devaluation:

- **UCB professor Barry Eichengreen said it would be devalued 20% over the next ten years**
- **China's Yuan is undervalued by 40% and needs to go up to ease their inflation problem**
- **The goal of the Federal Reserve is to devalue the dollar to stimulate a new bubble to get out of the housing slump**
- **The U.S Treasury debt is so huge that devaluation is needed to make it easier to pay off the debt**

Arguments against devaluation:

- **Other nations would have competitive devaluations because of their need to generate exports, thus no net devaluation would occur**
- **China would insist that the dollar not be devalued because they don't want their gigantic holding of T-Bills to be devalued.**
- **Other nations, including China and the Euro zone, also have problems and are no better than the U.S. so there is no other large country for capital to flee to as part of a capital flight from the dollar. Even the currencies of Canada and Australia may go down in value when the commodities boom ends**
- **The governments of the world depend on continuing trust in fiat money as opposed to the public losing trust and fleeing to ownership of physical gold buried in people's backyards. Thus all governments have a vested interest in coordinated policies to stop one nation from a huge devaluation.**
- **Devaluation would make it harder for the U.S. Treasury to issue more debt; it frequently rolls over short term T-Bills with new issues of T-Bills, so it must not offend foreigner creditors with a devaluation**

The world needs to keep any one large nation from devaluing too much because that steals business away from other countries and disrupts world trade. Further the world needs its reserve currency (the dollar) to be stable so the world has a vested interest in propping up the dollar. An analogy would be the giant U.S. banks that are deemed to be "too big to fail" are treated more leniently by bank regulators so that they are allowed to function even though should have been shut down by the FDIC. Another analogy would be when

regulations were changed in 2009 allowing banks to stop marking non-performing loans to market value and instead report those loans at book value. In both cases the government is trying to cover up the weaknesses of the large, unhealthy banks in order to avoid the catastrophic cost of shutting them down. In the case of the world's capital markets and governments they have a vested interest in *pretending* that U.S. government Treasuries and the dollar are as good as they have been in the past.

- **There is no realistic alternative to the dollar as a reserve currency. The Euro is not up to the task, because its debt market is a lot smaller than the dollar, has a lot of hidden risk and may break apart. The ECB may break its mandate to have sound money and engage in a desperate act of money printing should a chain reaction of sovereign defaults occur in Europe. The Renminbi will gradually become an international currency over many decades but may not be ready to be a reserve currency for another 30 years. Gold can't be used in lieu of the dollar because there is not enough gold to act as a substitute for the dollar's role as a reserve currency. Using SDR's from the IMF is a fantasy because SDR's are fiat money based on contributions of fiat money from the very governments that caused this imbalance, so why would an SDR be better than a basket of shaky Euros, Yen, and the dollar? SDR's are analogous to mortgage backed securities that were a blend of poor quality mortgages that somehow were repackaged as AAA quality debt. How can a blend of various shaky, deteriorating currencies inside of an SDR be any better than simply buying the ingredients of an SDR on your own?**
- **The dollar's unique position is like what Winston Churchill said about democracy: it is the worst system in the world, with the exception of all others.**
- **So the U.S. dollar and Treasuries are in a unique situation where the world has a vested interest in propping them up above fair value.**

EM countries want to keep their currencies from rising:

However, the invisible hand of the free market wants to make Emerging Market countries currencies go up against the dollar, even though the world's governments don't. Ultimately the markets are stronger than governments so the EM currencies value will increase against the dollar. People have enquired about thoughts on dollar collapse from experts, because the want investing advice about foreign currency. One expert is Pimco mutual fund which has said the dollar won't collapse because of a concept called Mutual Self-Assured Destruction (MAD), like that risk of nuclear World War III during the Cold War. In that situation the conflicting parties needed to avoid starting a war in order to avoid destroying themselves. Today China holds a huge amount of U.S. Treasuries. If China became angry at the U.S. they could refuse to rollover the short term Treasuries when they come due and this could cause a catastrophe. Conversely if the U.S. devalued the currency then that would deprive China of the full value of its $ three trillion of U.S. Treasury holdings. So both sides need to be careful not to do anything that would destroy the system and throw the world into a depression. Everyone has seen from the bankruptcy of Lehman how important it is for governments to avoid doing something that would create a financial panic. Lehman's debt was only 6% of the U.S. government's debt, so U.S. Treasury default would be an economic event 16 times bigger than Lehman. It would be an unimaginably huge crisis, so both sides simply have no choice but to use careful diplomacy and slow gentle financial movements to avoid a crisis. Both sides have an interest in keeping the dollar from collapsing, as do other countries. Thus it would be highly unlikely for the dollar to collapse.

Reframe the debate:

The debate about dollar devaluation assumes that it must be replaced by another developed country's currency. I would reframe that question and ask: should the dollar and other developed country currencies all be devalued against EM currencies? The answer in theory is yes, but the EM countries are on a mission to force you, the American consumer to buy their goods. To accomplish this mission the EM countries need to keep their currencies from appreciating.

Regarding the possibility that the world will use other nation's currency to replace the dollar: the other developed nations are mostly similar to the U.S. in that the voters love to pressure politicians to promise more benefits than can be paid with taxes collected, thus causing a deficit. Is there really much difference between the various developed countries? It is correct that Europe has about a 6% of GDP deficit vs. 10% for the U.S., but once European bad debts are paid by taxpayers and Europe's accrued future retiree benefits are fully treated as an expense then European annual budget deficits may be the same proportion of GDP as the U.S. deficits. Further, the U.S. has room to cut its defense budget.

"Groundhog Day" starring Bill Murray:

The talk about dollar collapse and the attempts by the Fed to re-inflate the economy by weakening the value of the dollar remind me of the movie "Groundhog Day" where Bill Murray plays a character who tries to kill himself everyday but can't. Every day it seems, metaphorically speaking, that the Fed tries to kill the dollar by increasing the money supply, or by "Quantitative Easing" (to devalue it), or by lending money to insolvent financial entities during the crash of 2008.

Yet no matter how hard they try they just can't kill the dollar. Foreign governments have a need to prop up the dollar to fight competitive devaluations (currency wars) and they need to keep the value of the dollars that their Central Banks hold as reserves from declining.

However, the best analogy for the dollar maybe the British Pound that slowly depreciated after 1945. So the best solution to a weakening dollar is to diversify into other currencies, but do so with a cautious attitude and not with a hysterical attempt to flee from it. Despite a long standing paradigm that the dollar will always be propped up, there is the possibility that with enough attacks on its value that its support level will eventually crack and it will fall through support levels in a slow motion cascade failure entering a new paradigm and trade at a lower value.

Using purchasing power parity theory to predict devaluation:

The purchasing power parity theory holds that a currency must be adjusted by the invisible hand to make prices in one country similar to those in other countries. Today prices in the U.S. are lower than in other developed countries. This implies that the dollar needs to go up in value against the currencies of the other developed countries.

Investors worry that the dollar will go down and so they seek a safe haven to invest. The fear is that Bernanke will create inflation leading to a decline in the value of the dollar. If no inflation occurs then devaluation would be unlikely. So let's review the three ways that inflation may be created.

First: The 1970's type of inflation was caused by an increase of the money supply from bank lending combined with a tight unionized labor market during a pre-globalization era. The type of labor market that existed then is different by 180 degrees. Today we have ruthless globalization and deunionization and most importantly plenty of excess capacity.

Second: The Federal debt is monetized by the Federal Reserve. This would involve increased deficit spending by congress during a time when the Treasury had trouble selling Treasury bonds. To get to that point would require a Congress that wants to increase spending instead of cut spending. It remains to be seen as to whether or not Congress will be able to cut spending during the next two to four years. It is possible that Congress will make drastic cuts in spending rather than have the Fed monetize newly issued debt.

Third: The Fed manages to increase the money supply using Quantitative Easing, leading to the dollar gradually become devalued, thus making imported goods more expensive, which would incite domestic inflation. This is difficult to do because other countries want to have a competitive devaluation so the U.S. attempts to devalue may not succeed. Further, since imports are 17% of total consumption, then a 20% devaluation of the dollar would be only a one-time inflation surge of an extra 3.4%. The best data set to examine is the history of the dollar's value for 35 years. Except for the Volcker Fed era from 1979-87 and the dotcom bubble of 1997-2000 the dollar index has been relatively close to a range of about 80 to 90 and was recently at 74.2 on April 21, 2011. It got in the low 70's in 2008 and then went up. So if inflation is subdued and no worse than other countries then how can the dollar be devalued?

Another theory about foreign currency is the "real" interest rate differential between countries will make a currency rise or fall to compensate for a high or low interest rate. So if inflation a country is 10% and bank deposits in that country pay 11% then you are really only getting 1% "real" interest and so the currency should drop so that new buyers will get a higher rate of return. The trouble with this theory is that retail investors are so over-eager for high yield nominal rate of interest that they don't worry about foreign inflation and end up investing based on nominal rates instead of real rates. The FX market is very inefficient because of government intervention, naïve retail investors, and non-economic reasons for FX transactions such as a fun vacation rather than a business-like reason to import something.

Summary of forecast:

If the dollar needs to go down 40% against the Renminbei and zero against developed countries then as a rough guess perhaps it needs to go down 20% on average. If Americans import 17% of their purchases then 17% times 20% devaluation is a one-time 3.4% increase in prices which is not the end of the world. Don't panic about dollar devaluation and don't expect to make a windfall trying to protect yourself, but do (as a metaphor) buy a deluxe fire insurance policy on your home. When you buy insurance you do not hope to make a profit, instead you seek to protect yourself from a catastrophe. Don't overpay for insurance (meaning don't buy bubbly, overpriced commodities and precious metals) or buy insurance from an insolvent vendor.

Ways to protect yourself

An alternative technique to protect from a possible collapse of the U.S. dollar one should consider investing in foreign currency.

How does one invest in foreign currency?

- **Open a bank account denominated in foreign currency. It is now possible to open a bank account denominated in Renminbi with a China based bank that has offices in the U.S.**
- **Buy U.S. based actively managed mutual funds or ETP's that invest in foreign currency**
- **Buy U.S. based actively managed mutual funds or ETP's that invest in foreign currency denominated bonds**
- **Buy commodity futures contracts for foreign currencies**
- **Buy options on foreign currency**

All of these have risks. The least risky may be actively managed U.S. based open-end mutual funds because the management tries to forecast the risks and make changes. By contrast a passive investment has no one other the individual investor to manage the risks. ETP's have the risk of counterparty default and tracking error, which can be a concern. Options have counterparty risk and risk of expiring worthless. Futures are highly leveraged and have risk of negative yield roll, Backwardation and Contango. Few U.S. banks offer foreign currency denominated accounts. One that does appears to have artificially low interest rates. By buying mutual funds that hold bonds denominated in foreign currency the investor is getting investment management from the mutual fund and interest earned on the bonds and may get appreciation of the assets. Of course there is risk that the bonds could default. Many Emerging Markets bond mutual funds have a "BB" grade credit quality for their holdings, which is one notch below investment grade, meaning it is junk bond grade. There is always risk in investing. The good news is that a carefully selected portfolio of bonds in a mutual fund that has holdings rated an average of "BB" or "BBB" has had a standard deviation (a measure of risk) of 13 which is better than the U.S. stock market's Standard Deviation of 20. Compared to a domestic intermediate term bond mutual fund with a BB credit grade, that type of fund has a median 3 year standard deviation of 6.4. A domestic bond fund with assets rated BB with an intermediate term maturity has a median Standard Deviation of 14.8, so the risk is roughly the same as foreign currency bond funds with a BB or BBB rating. Past performance is no guarantee of the future.

Every family should have awareness of the risks of devaluation and a contingency plan.

- **Reduce your debt**
- **Avoid high risk investments**
- **Invest in high quality investments**
- **Invest in liquid things that are easy to sell**
- **Avoid illiquid things like real estate, rare art**
- **Diversify internationally into countries with the best economic health**
- **Learn to think creatively and be adaptive about survival**
- **Develop portable career skills that will be marketable if living in different countries**
- **Develop foreign language and cultural skills to be able to live abroad**
- **Don't worship your employer and assume they will never go out of business**
- **Be mentally prepared for career changes as the economy evolves**
- **Drive cars powered by natural gas or electricity made from natural gas or coal-avoid imported oil**

If the government became bankrupt they could refuse to pay bondholders and would use income from taxes to pay modest salaries to public safety employees to keep order. There was a book by economist Anatole Kaletsky that said that governments that default manage to eventually return to normal.

If the dollar collapsed it is possible that many things would continue as before except that:

- **People would not be able to afford a foreign vacation**
- **People could not afford imported goods**
- **Many people would sell their homes to foreign investors to get foreign currency and rent their house back.**
- **Many businesses would be acquired by foreigners and your ability to speak their language and dine with them and eat their native foods will help your career.**
- **Some areas in America could become special enterprise zones with special rules where foreigners might have a lot of "persuasion" over how the local government operates in return for increased creation of jobs by foreign companies. The constitution says that if the Senate approves a treaty then that overrides the constitution. So imagine a treaty with a foreign country creating a special enterprise zone for the foreign investors who protect their property rights with special courts and police that are not governed by the U.S. constitution.**
- **There would a huge amount of foreign tourism in the U.S. as they seek to benefit from a low cost dollar. Yosemite National Park and other popular places would cost $1,000 per day to visit for foreigners with subsidized rates for U.S. citizens. To encourage more visitors visa rules would be relaxed to the standard of "if you are rich come anytime".**
- **Americans will gladly accept jobs from foreign employers who will pay them in foreign currency. They will rent an apartment from a foreign landlord and pay them in foreign currency through payroll withholding.**

Of course, this does not need to happen because now that people are aware of it they can take steps to prevent a dollar collapse by urging the government to support a sound dollar, a government budget that leads to solvency, and a healthy economy.

Nuclear War Never Happened:

I remember as a child in the 1960's doing "drop drills" at school where we hid under our flimsy desks when a siren sounded so that we could prepare for nuclear war. It was important to cover our head with our arms, we were told, in case we got hit with an atomic bomb. Fortunately the Cold War ended peacefully. Let's hope that our government's leaders can arrange for a peaceful end to the fiscal irresponsibility that has made the topic of a dollar collapse worth worrying about.

To hedge against a falling dollar one investment technique is to use a portfolio of (from EM countries and a few developed countries like Australia, Canada, Switzerland, Norway, Sweden) foreign currency denominated bonds that are held by an actively managed open end mutual fund. Be careful to verify that they are "unhedged". Some FX bond funds are hedged back into dollars so you get no protection from a falling dollar. Be aware the other major developed countries currencies (Euro and Yen) may perform worse than the dollar.

There are some developed countries with good currencies in resource exporting countries, Scandinavia, Switzerland. The EM countries are experiencing high inflation and to deal with that they will raise rates which will make bonds go down in value but make the currency go up, thus

negating potential appreciation. If that occurs then being at the short end of the yield curve is best. Another problem is that EM bonds tend to be low credit quality around BB or B and I prefer to get A or better, but the highest are rated BBB. Also that asset class is poorly served by mutual funds with few funds being in business for over five years.

It is too hard to predict FX rates; instead one should diversify as a hedge against a dollar devaluation rather than attempt to seek a profit through short term trading. Many counterintuitive things happen in FX. March, 2011 Turkey lowered rates to make its currency go down even though they needed to raise rates to fight inflation; by April, 2011 they raised rates. There is the risk of future currency controls that would trap an investor's money inside of EM countries. Of course money could also be trapped inside of developed countries.

July 25, 2011