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Greenspan's Head-Scratching and the Theatre of the Dollar

At Allen Trust, our stock investing approach is grounded in company-specific analysis rather than a "top-down" macroeconomic approach. In other words, we look for companies with sustainable competitive advantages and low relative valuations, and with long-term prospects we deem bright across a variety of economic environments, not just the current one.

Nonetheless, economic context influences how we enter new equity positions and how we exit existing ones, and it weighs heavily on our fixed income decision-making in particular. So I'm devoting this month's letter to some macroeconomic issues I consider essential.

Greenspan's "Conundrum"

The big man himself is stumped: Fed Chief Alan Greenspan has called the tenacity of long-term bond prices in the face of eight consecutive Fed rate hikes a conundrum, or paradox. We share his perplexity, as the 10-year Treasury hovers around a 4% yield vs. a 3.7% yield on the 2-year note. While flat yield curves (where yields are similar across maturities) have been seen before, a flattening yield curve with rates so low defies easy explanation.

Possible Interpretations

Perhaps the bond market is pointing toward tame inflation and softening economic performance; but forward commodity prices and modest-but-steady indications of GDP growth (+3.5% real Q1, Argus estimate) give these arguments the lie. Alternatively, it can be argued that the Fed's rate hikes are dispelling inflationary forces before they can gather; but this presumes that a 3% Fed funds rate isn't accommodative, whereas Greenspan himself implies it's not even a neutral policy stance, much less a restrictive one. Still another possibility is that confusion in the junk bond market is spurring a "flight to quality" whereby nominally risk-free

assets command a heightened premium; while this could stimulate a jump in Treasury prices, I don't see how it alone could sustain a bond rally in the face of economic growth and robust commodity trends.

So what's going on?

Whether or not they're causative, I don't know, but the following factors seem to be part of the conundrum:

Stimulating Consumption, Not Investment

Americans are avid borrowers. Once a latent and growing store of value, Home Sweet Home has transformed into a veritable Automated Teller Machine via serial refinancing, and our government is similarly inclined. Taken alone, we'd expect these factors to raise long-term interest rates.

But wait a minute. All this debt-fueled liquidity begets spending on manufactured goods. And since America doesn't manufacture like it used to, either in quality or quantity, the proceeds of our debt go to pay for super-cheap Chinese consumables, better value Korean electronics, and superior Japanese automobiles. *Hyperliquidity can coexist with moderate domestic inflation because so much of the cash pumped into the system gets diverted overseas.*

What's especially interesting is how the foreign countries recycle their reserve surpluses into US government debt... *effectively lowering long-term US interest rates and making it all the easier for US consumers to, well, consume.*

Interdependence vs. Co-Dependency

The old saying is that, if you owe the bank a million dollars, the bank owns you; if you owe the bank a hundred million dollars, you own the bank.

In the short-term, the US and its "banks" are interdependent. For the privilege of satisfying the American borrow-and-buy cycle (which in turn keeps foreign factories humming), the creditor countries are willing to carry significant reserve account surpluses invested in US Treasuries. Neither party quite owns the other. But this seeming interdependence rests upon a flawed



framework. Each party retains a sort of “nuclear option:”

The US has the power of debt monetization, tantamount to a *de facto* partial default. To pay off America’s collective debts, the Treasury could push its virtual presses into overdrive, voluntarily devaluing the dollar. (Clearly, this possibility is not reflected in a 4.3% 30-year Treasury yield.) That would be a fine scenario for the most aggressive US borrowers, private side and government alike, insofar as they’d be repaying in depreciated currency. But it’s a self-defeating option not just because it would provoke dire inflation, but also because it would suck all financial flexibility from our economy and force the US to rely again upon its own atrophied resources for production. And all that stuff we bought from abroad on credit? It won’t have much in the way of residual or productive value.

Meanwhile, the creditor nations have the option not to lend us any more money (i.e. to stop buying US securities), or worse yet they could bolt for the exits, dumping their dollar-denominated holdings and revaluing their own currencies higher. This could be self-defeating for them in that their dollar positions have become so large that they cannot be liquidated at face value — a rush from the Theatre of the Dollar would either jam the exits or bring down the roof before anyone got all the way outside.

At its core, it’s an unwholesome relationship, more of a pathological co-dependency than a symbiotic interdependence. *That, however, is not enough to be its undoing.* While it’s an imperfect analogy, consider how the US and USSR were able to co-exist decades in a similarly precarious stalemate of mutually assured destruction. Indeed, recent events in Europe may prolong the situation.

Cracks in European Economic Unity

Last week French and Dutch voters resoundingly rejected the proposed EU constitution, undermining the Euro’s prospects for becoming a global reserve currency alternative to the US dollar. While this doesn’t do anything to resolve the fundamental problems detailed in the previous sections, it does ensure that the dollar’s

global franchise is secure for now. And it has hit a 9-month high against the Euro accordingly.

Oil and the Dollar

Moreover, while high oil prices (\$55/bbl as of this writing) exacerbate the US trade deficit (since we import most of the oil we consume), they have a countervailing effect insofar as they force foreigners too to spend more dollars for oil. *Oil remains denominated in US dollars*, and as prices escalate along with demand abroad, so does the necessity for foreign countries to keep circulating more of our currency. This provides a stabilizing effect having nothing to do with the overall American “balance sheet” which underlies the dollar.

There have been threats to this special position the dollar enjoys *vis a vis* petroleum: In late 2000, Iraq began selling oil in euros, and Iran too has moved toward defecting from dollar-denominated sales. OPEC has discussed pricing oil not in any one currency, but in relation to a basket of currencies. Venezuela in some instances is now bartering with its oil instead of taking dollars for it.

So while the dollar looks more secure than it did two weeks ago, there remain threats to its security that French and Dutch voters won’t be able to undo.

Conclusion (for now)

My apologies for writing at such length. Let me just close by saying that there has been no point in the last century when one couldn’t competently argue that the world stood with its toes curled over the edge of a macroeconomic precipice. Great risks are always present; the key is to recognize them and not expose yourself to them without a commensurate possibility of reward.

We remain optimistic about the future, though the ride there may get bumpy, and we are still finding good long-term investment opportunities. I’ll tell you more about them next month.

Bill Harris

Next Month: Mid-year Market Review