Prudential Financial

RESEARCH

May 12, 2003

IS THE WEAK DOLLAR A PROBLEM?

Topical
Study
#60

All important disclosures can be found at the end of this report.

Dr. Edward Yardeni
(212) 778-2646
ed_yardeni@prusec.com

I. Fear Of Falling

The significant drop in the foreign exchange value of the dollar over the past year has heightened fears that foreign investors may no longer be willing to buy enough U.S. financial assets to offset America's huge trade deficit. Of course, the balance of payments always balances, so net capital inflows must always equal the current account deficit, which consists mostly of the trade deficit.[1] In other words, as the trade deficit has increased so have capital inflows. However, the evidence suggests that an increasing percentage of the capital inflows are coming from central bankers, especially in Asian countries and particularly in China, who are buying dollars to keep their currencies from appreciating (Figure 1). The Asian central bankers are doing so to keep their exports competitive in the United States. European central banks have resisted supporting the dollar, which is why the euro, the British pound, the Swedish krona, and the Swiss franc have been so strong over the past year, rising 24%, 9.6%, 27% and 20%, respectively (Figure 2).

The currencies of countries that export commodities priced in U.S. dollars have also been strong over the past year. A strong euro means that dollar-priced commodities are cheaper in euros. In theory, this should increase the demand for these commodities, which also drives up the currency value of the commodity exporting country. The Canadian dollar, the Mexican peso, the Brazilian real, and the Australian dollar are up 11.4%, 7.8%, 22%, and 17.7%, respectively, over the past year (Figure 3). Consequently, the trade-weighted dollar is down 12.1% from a year ago to the lowest level since January 2000 (Figure 4).[2]

The U.S. trade deficit is likely to continue widening over the next year or two. Further weakness in the dollar is possible over the rest of the year and even next year. Of course, late last year and early this year, the trade deficit widened because soaring oil prices boosted the cost of petroleum imports. In the short-term, the deficit is likely to narrow now that oil prices are down again. However, U.S. fiscal policy is likely to become more stimulative once Congress enacts another round of tax cuts. The federal deficit is likely to widen. At the same time, export markets in Europe are likely to remain weak. They might get weaker as a result of the depressing impact of strong European currencies on their exporters. SARS could depress export markets in Asia. If U.S. growth exceeds overseas growth, then imports could rise faster than exports despite the increasing competitiveness of U.S. exporters attributable to the lower dollar.

The good news is that the weaker dollar has mostly bullish consequences for the economy, pricing, and earnings in the United States. U.S. manufacturers are more competitive in overseas markets as the foreign-currency prices of their goods and services fall. They are also more competitive at home as import prices, in dollars, are rising again in recent months after mostly falling from 2000 through 2002. The first-quarter earnings of U.S. multinationals were boosted by the currency translation of profits earned overseas. Figure A provides a list of the S&P 100 companies that report their exposure to European markets.

---

[1] The current account is equal to the difference between exports and imports of goods and services, overseas income receipts less payments, and unilateral transfers.
[2] The currency charts included in this study are updated daily in our "Daily Global Markets" posted on www.prudential.com/yardeni.

Figure A.: S&P 100 Companies Reporting Sales Exposure To Europe

Company	Percent of Sales Exposure To Europe*	Company	Percent of Sales Exposure To Europe*
Dow Chemical	33	Oracle Corp.	15
McDonald's Corp.	33	H. J. Heinz	15
Altria Group	32	Delta Air Lines	14
Xerox Corp.	28	Campbell Soup	14
Lehman Brothers	27	Unisys Corp.	13
Du Pont	26	Baker-Hughes	13
Computer Sciences	26	Allegheny Technologies	13
Goldman Sachs	25	Halliburton Co.	12
Black & Decker	25	Sara Lee	12
Tyco International	23	American Electric Power	12
Intel Corp.	23	Alcoa	12
Ford Motor	22	National Semiconductor	11
Colgate-Palmolive	21	Boeing Co.	11
Johnson & Johnson	21	Walt Disney	11
Avon Products	20	International Paper	11
United Technologies	20	Exxon Mobil	9
Texas Instruments	20	General Dynamics	9
Honeywell International	19	General Motors	8
General Electric	19	American Express	8
Medtronic, Inc.	18	PepsiCo	4
Morgan Stanley	17	Weyerhauser Co.	3
Rockwell Automation	16	HCA Inc.	3

* Including Great Britain.
Source: Factset; Compustat; EDGAR; and Prudential Securities Investment Strategy Research.

The bad news is mostly for the strong-currency countries. In effect, the U.S. is exporting deflationary pressures to Europe. The deflationary impact is magnified by the fact that the Chinese and other Asian central bankers are pegging their currencies to the dollar. This means that the euro is strong in the U.S. and in Asia. Ideally, this development could force the European Central Bank (ECB) to lower interest rates to stimulate domestic demand and imports from the United States. The ECB official interest rate is currently at 2.5%, well above the 1.25% federal funds rate.

Of course, lower interest rates in Europe might not revive economic growth sufficiently. Short-term interest rates are down to zero in Japan. The ten-year bond yield is currently at 0.6% over there. Yet Japan remains in a chronic recession. In the United States, the federal funds rate is down to only 1.25% and economic growth has been relatively slow. The members of the Federal Reserve's monetary policy committee expressed their concern about the risk of deflation in a statement released after their May 6 meeting. Ironically, this statement triggered another drop in the dollar, which helps to offset the deflationary forces, in effect, by exporting the problem to strong-currency countries.

II. No Shortage Of Capital Inflows

Given the weakness of the dollar, many interested observers might be surprised to learn that foreign capital inflows into U.S. financial assets rose to a record high of $563 billion over the latest 12-month period through February, according to data compiled monthly by the U.S. Treasury Department.[3] Over this same period, the merchandise trade deficit also rose to a record of $490 billion (Figure 5).

There seems to be some relationship between the trade-weighted dollar and the gap between the trade deficit and capital inflows. From 1989 to 1995, the dollar was weak while the trade deficit exceeded capital inflows. During the second half of the 1990s, capital inflows tended to slightly exceed the trade shortfall and the dollar was mostly strong.[4]

The recent weakness of the dollar seems hard to explain using the available data, which show that capital inflows exceeded the trade deficit by $73 billion over the 12 months ended February 2003. The Treasury's data show that capital inflows from Asia rose to a record $238 billion over the past 12 months. Inflows from Europe and the rest of the world totaled $223 billion and $102 billion, respectively (Figures 5 and 6).

Here is a quick rundown of the key components included in these numbers:

1) **U.S. Equities.** The fear that foreigners will stop buying U.S. securities is most realistic when it comes to U.S. equities. Their purchases peaked at a record $188 billion during the 12 months ended January 2001. Over the latest period, they bought only $39 billion. Asians purchased $23 billion over the last 12 months. European investors' net purchases were only $21 billion over this period, down dramatically from a record $170 billion during the 12-month period ended October 2000 (Figure 7). European investors obviously contributed to the stock market bubble of 1999 and 2000, and apparently still regret having done so.

2) **U.S. Treasuries.** During the second half of the 1990s, foreigners were significant buyers of U.S. Treasury bonds and notes, with purchases peaking at $273 billion during the 12-month period ended June 1997. Then they lost their enthusiasm for these securities at about the same time that they got turned on to U.S. equities. During 2000 and 2001, foreign investors were modest net sellers of Treasuries. Over the 12 months through February 2003, they were buying again. The total was $95 billion, with virtually this entire sum attributable to Asia (Figure 8). Last year, foreigners accounted for 38.6% of the demand for Treasuries, according to the Fed's Flow of Funds Accounts.

---

[3] The source of the capital inflows data is the U.S. Treasury Department's website www.treas.gov/tic/ticsec.html. The data are available with a two-month lag, usually at the end of each month. The database includes time series for foreign purchases of U.S. Treasury bonds and notes, Government Agency bonds, U.S. corporate bonds, U.S. corporate stocks, foreign bonds, and foreign stocks.

[4] This analysis is a bit incomplete because the current account includes more than just the merchandise trade deficit, as noted above, and the Capital Account in the Balance of Payments (BOP) also includes capital inflows into direct investments as well as capital outflows, which include U.S. purchases of foreign securities as well as direct investments abroad. I don't believe that the complete picture is much different from the one I paint in this study. Charts for the other BOP variables can be found in our "Flow of Funds Chartbook," which is updated quarterly at www.prudential.com/yardeni.

3) **U.S. Government Agencies.** While foreign investors have cooled to the U.S. stock market, they can't seem to get enough U.S. Government Agency bonds. These are mostly mortgage-backed securities. Indeed, their appetite for these securities has been growing steadily and reached a record high of $210 billion during the 12 months ended February 2003, with record highs of $110 billion and $71 billion for Asians and Europeans, respectively (Figure 9). So foreigners have become a significant source of funds for the U.S. housing market. Last year, they accounted for 22% of the demand for Agencies.

4) **U.S. Corporate Bonds.** Overseas investors have also been big buyers of corporate bonds in the United States recently, accounting for about a third of the demand last year. Over the past 12 months through February, they purchased $197 billion, with Europeans, Asians, and others accounting for $120 billion, $30 billion, and $46 billion, respectively (Figure 10).

III. It's Official

So given these tremendous capital inflows, why has the dollar been so weak over the past year relative to most currencies (with the exception of many Asian currencies)? The answer seems to be that foreign central banks have been an increasing source of the capital inflows, as foreign private investors have lost some interest in buying U.S. securities, especially equities, at the same time that the trade deficit has soared into record territory. Central banks—especially in Asia—are buying U.S. securities, particularly Treasuries and Agencies, to prop up the dollar, since a weak dollar would hurt their competitiveness.

Here are some of the recent data on central bank foreign currency transactions and holdings:

1) The Federal Reserve Bank of New York (FRBNY) reports weekly data on marketable U.S. government securities held in custody for foreign official institutions. Over the past year, these holdings rose by over $100 billion to a record of about $700 billion. This series had been hovering around $600 billion from 1997 through 2001, after increasing dramatically from 1990 through 1996, when the dollar's value was mostly dropping (Figures 11 and 12). Of course, foreign central banks are not required to hold their dollar reserves at the FRBNY. They have plenty of reserves elsewhere.

2) The Fed's Flow of Funds database shows that foreign official accounts purchased $45 billion in Treasuries and $35 billion in Agencies during 2002, with most of the buying occurring during the fourth quarter.[5]

3) The International Monetary Fund (IMF) compiles monthly data on central banks' international reserves (Figures 13, 14, 15, and 16).[6] Over the 12 months ended February 2003, non-gold reserves soared $409 billion to a record $2.6 trillion, led by Japan (up $92 billion) and China (up $86 billion). China's non-gold reserves are at a record $313 billion; ten years ago they were only $21 billion (Figure 16).

[5] "Flow of Funds Accounts of the United States," Table F.107, www.federalreserve.gov/releases/Z1/current/z1.pdf
[6] Every month, we update numerous charts showing the IMF data on non-gold international reserves on the web site, www.prudential.com/yardeni.

My assumption is that most of the recent gains in international non-gold reserves were invested in dollar-denominated securities, particularly U.S. government securities. It is possible that some of the recent weakness in the dollar is attributable to some central banks' adjusting their reserve portfolios to include more euros and fewer dollars. More likely is that foreign private investors have been making this switch and that central banks have had to go the other way—i.e., buy more dollars—to keep their currencies from appreciating too quickly, or at all, in the case of many Asian countries.

The most obvious private-sector currency switching has probably occurred in the Middle East. After the 9/11 attacks, the United States sought to freeze and even seize the assets of suspected terrorist groups around the world. Middle Eastern investors may have concluded that it might be safer to have more of their assets in non-dollar assets to avoid becoming entangled in this net. This certainly helps to explain the jump in gold prices last year. This argument is less compelling today, in my opinion.

IV. SARS & The Dollar

Since China has become such a significant force in the market for international reserves, what might be the consequences of a SARS pandemic? In such a scenario, China's export business might be negatively impacted. U.S. companies might be forced to find alternative suppliers in other countries in Asia that have managed to remain relatively SARS-free. Presumably, their central banks might then become bigger buyers of U.S. securities. South Korea's international reserves may not be growing as rapidly as China's, but they are up to a record $123 billion from only $20 billion at the end of 1997 (Figure 16).

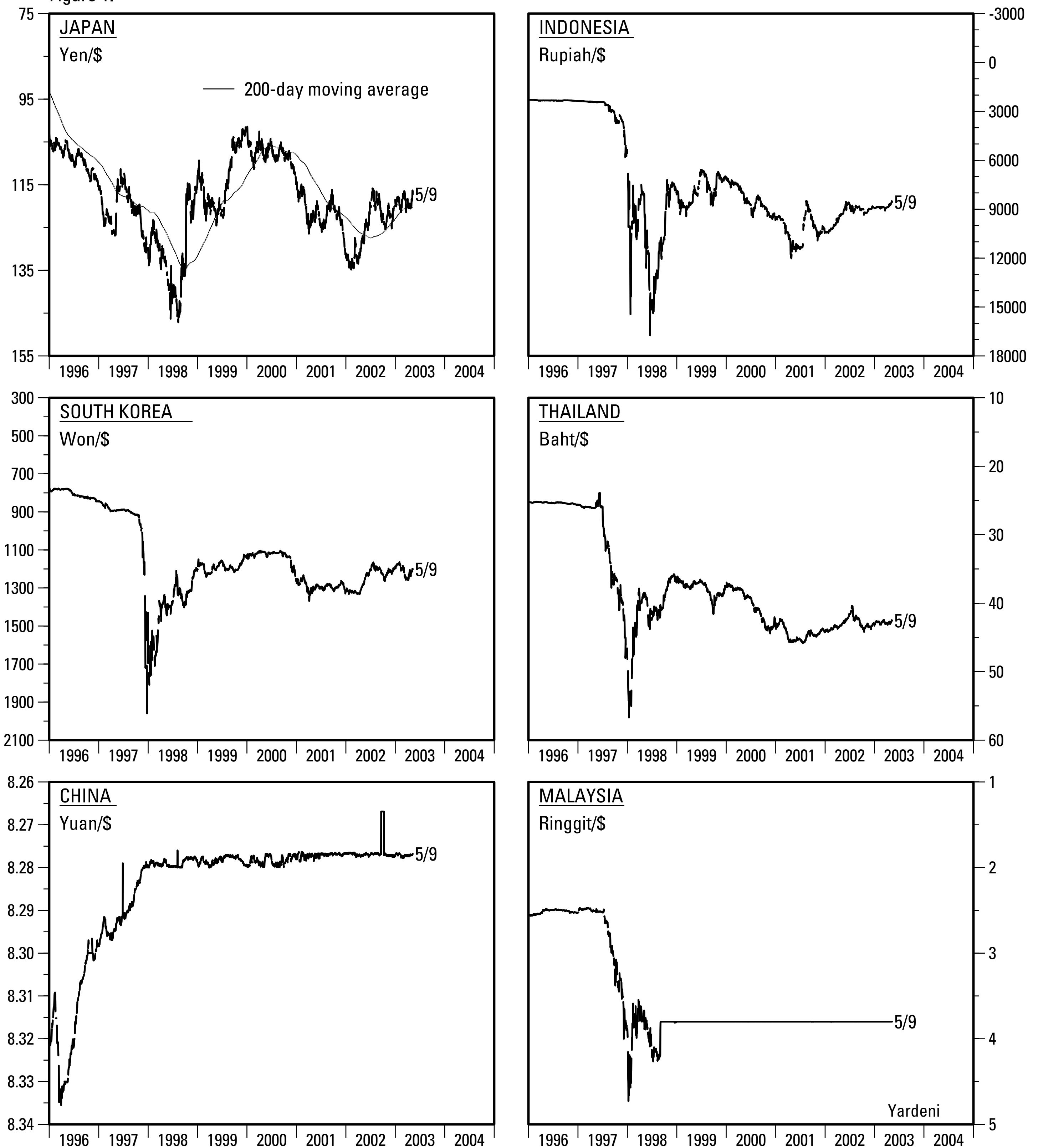
On the other hand, U.S. companies spooked by SARS might seek alternative suppliers outside of Asia. They might go back to Mexico or even increase their orders to vendors in the United States. In this scenario, the trade deficit might conceivably narrow and the dollar might strengthen.

Of course, a SARS pandemic in China would also depress domestic demand in China. This would be very bad news for the global economic outlook, since most economists have been counting on Asia in general—and China, in particular—to boost global economic activity. A SARS-induced recession in China would depress all of Asia, especially Japan. In this scenario, the yen might weaken relative to the dollar. Demand for commodities would be depressed, too, and the currencies of countries that are big exporters of commodities might weaken.

* * *

US$ Forex Rates: Asia

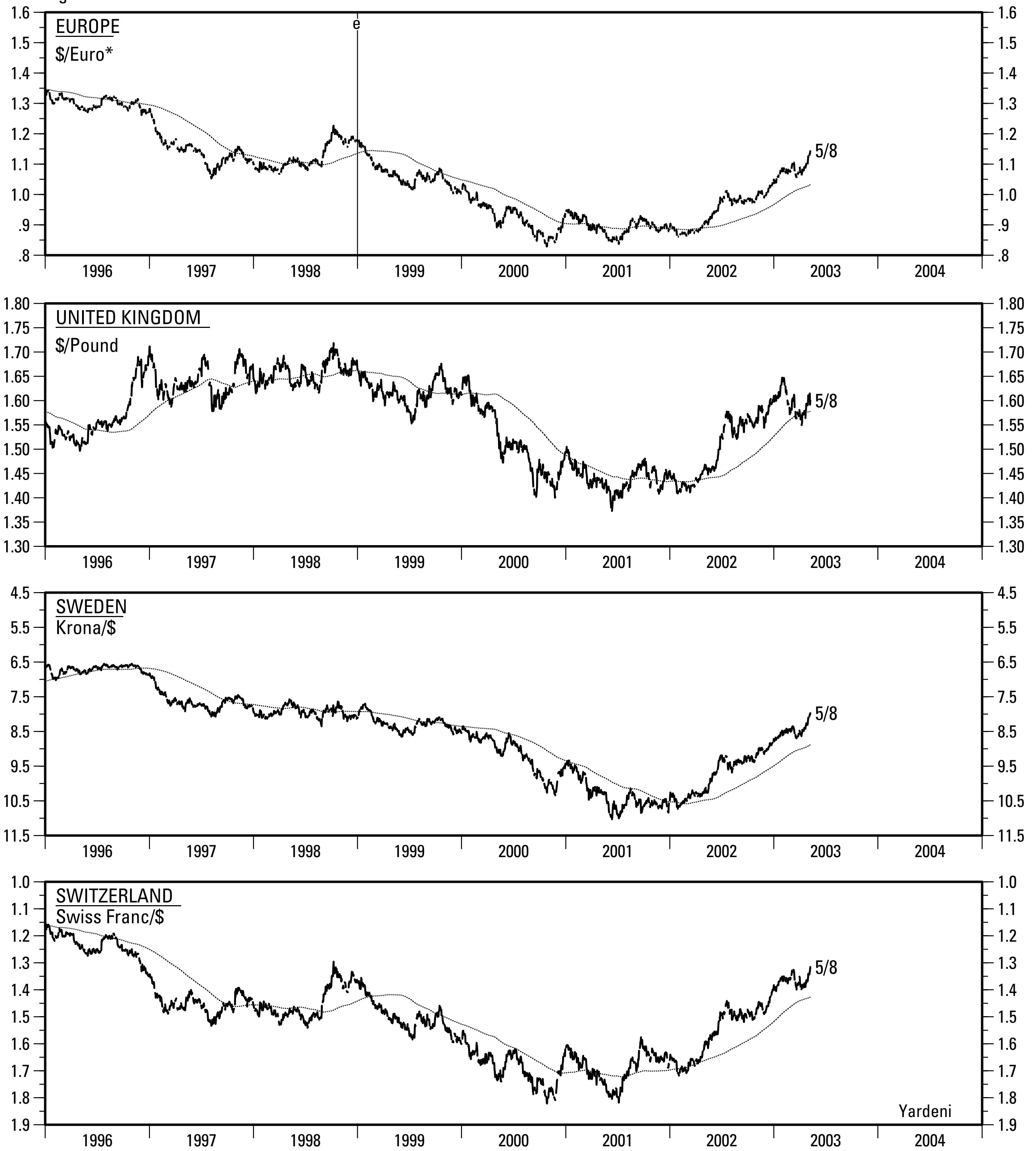
Figure 1.



Source: Morgan Stanley Capital International.

US$ Forex Rates: Europe

Figure 2.



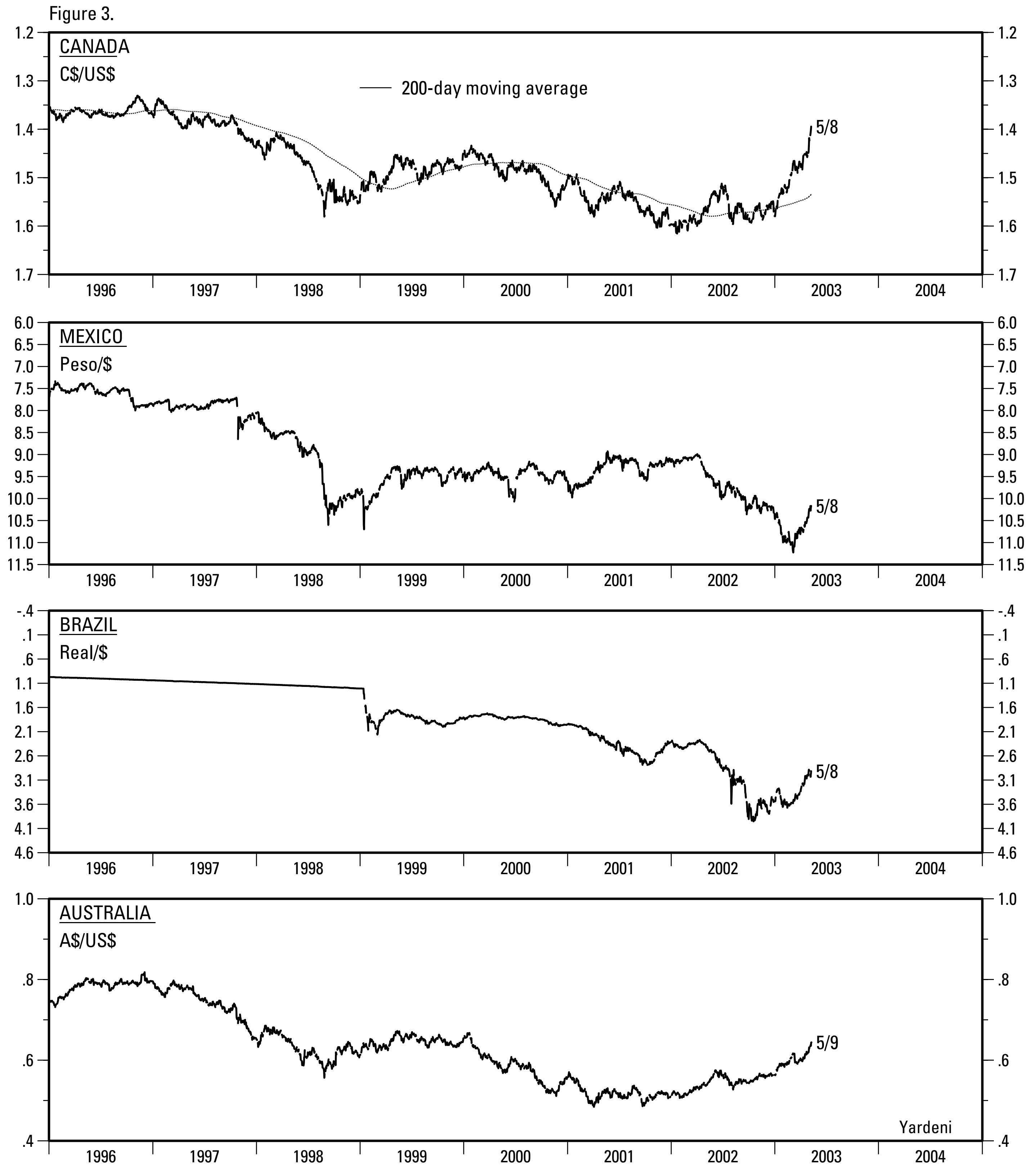
—— 200-day moving average.

* e = Date euro was introduced. Data prior to 1999 are derived from European currencies.

Source: Morgan Stanley Capital International.

Commodity Exporters' Currencies

Figure 3.

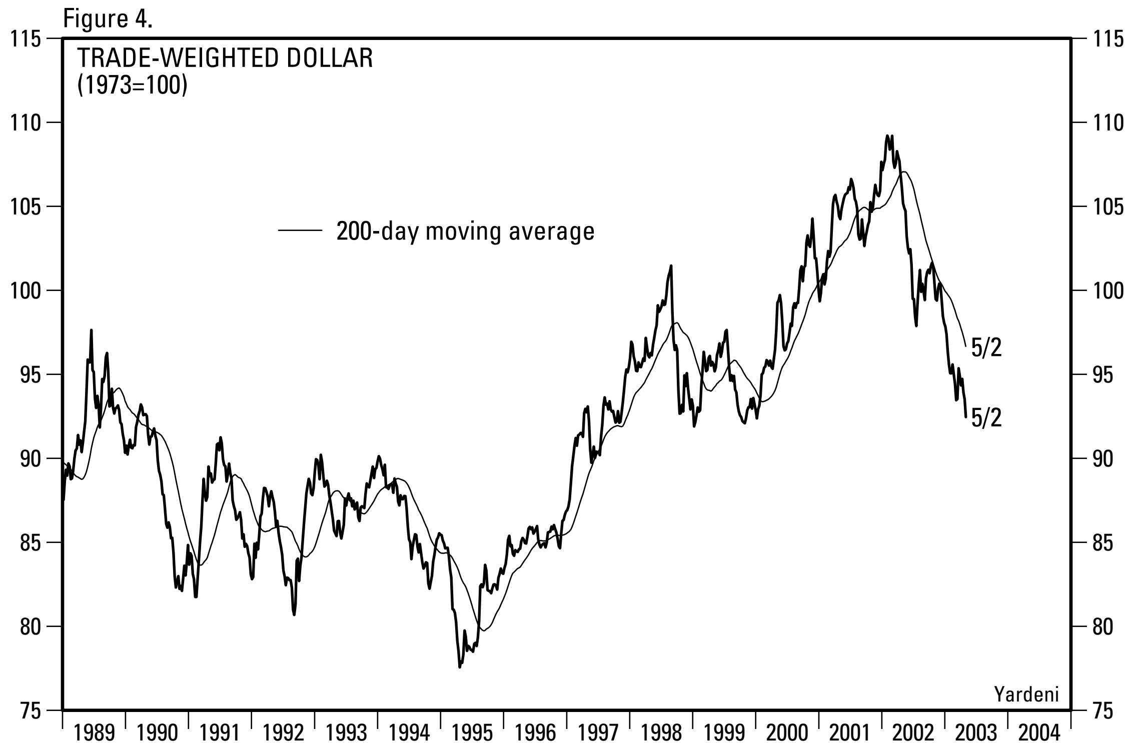


Source: Morgan Stanley Capital International.

The Dollar & Trade

The trade-weighted dollar is down 15.3% from its early 2002 peak.

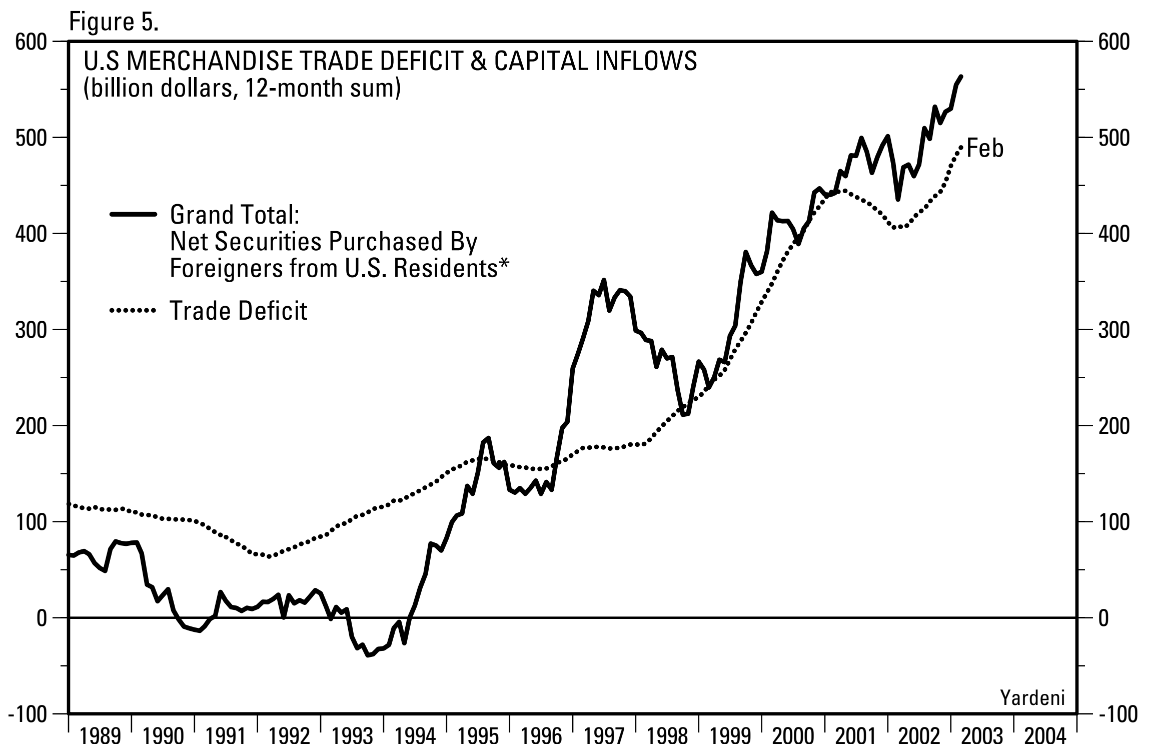
Figure 4.



Source: Board of Governors of the Federal Reserve System.

U.S. trade deficit is at a record high, but so are capital inflows.

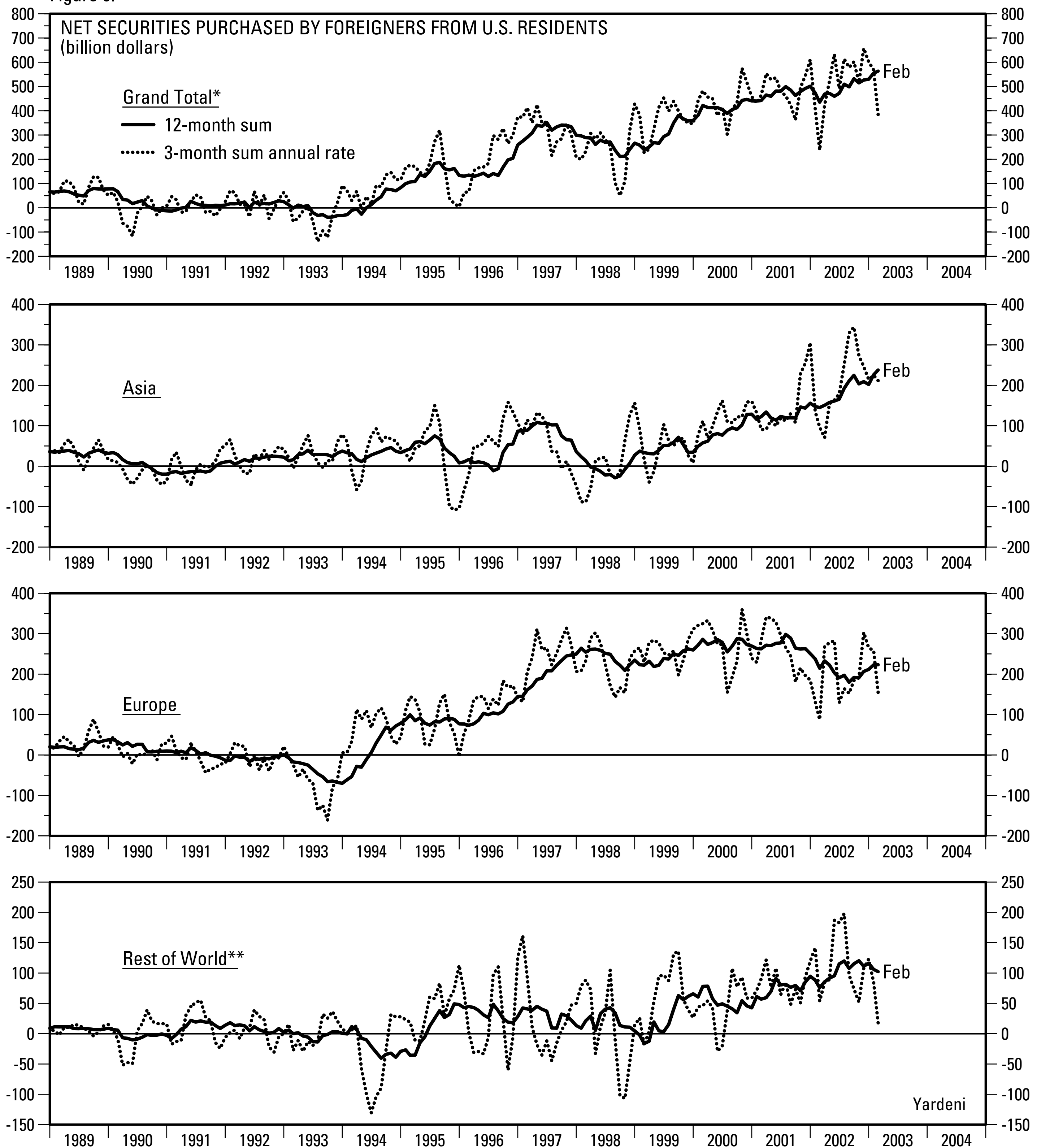
Figure 5.



* Includes Treasury bonds and notes, Government Agency bonds, U.S. corporate bonds, U.S. corporate stocks, foreign bonds, and foreign stocks.
Source: U.S. Department of Commerce, Bureau of the Census and U.S. Department of the Treasury, Office of International Affairs.

U.S. Capital Inflows: Securities

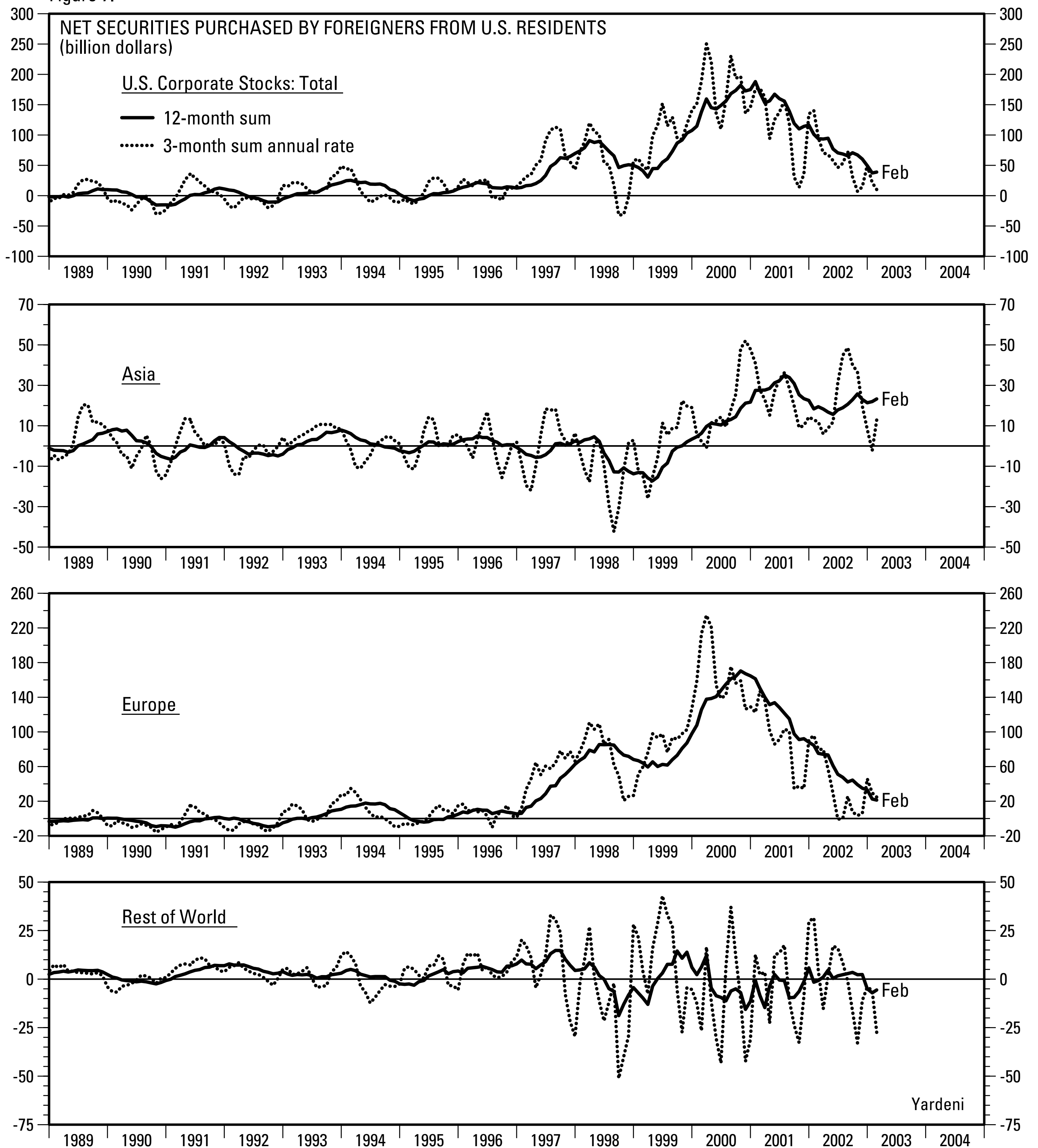
Figure 6.



* Includes Treasury bonds and notes, Government Agency bonds, U.S. corporate bonds, U.S. corporate stocks, foreign bonds and foreign stocks.
** Grand total minus Asia plus Europe.
Source: U.S. Department of the Treasury, Office of International Affairs.

U.S. Capital Inflows: Equities

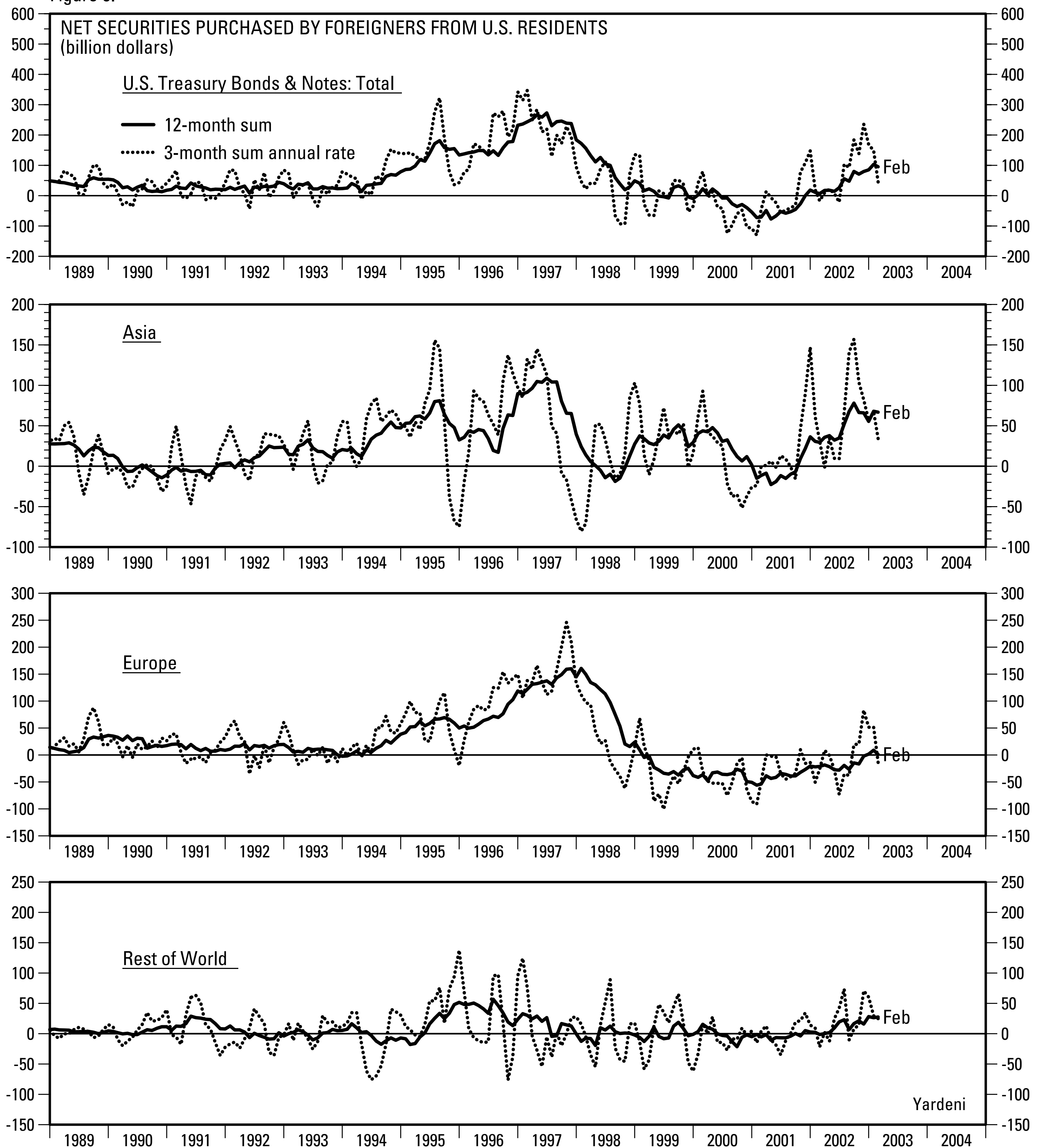
Figure 7.



Source: U.S. Department of the Treasury, Office of International Affairs.

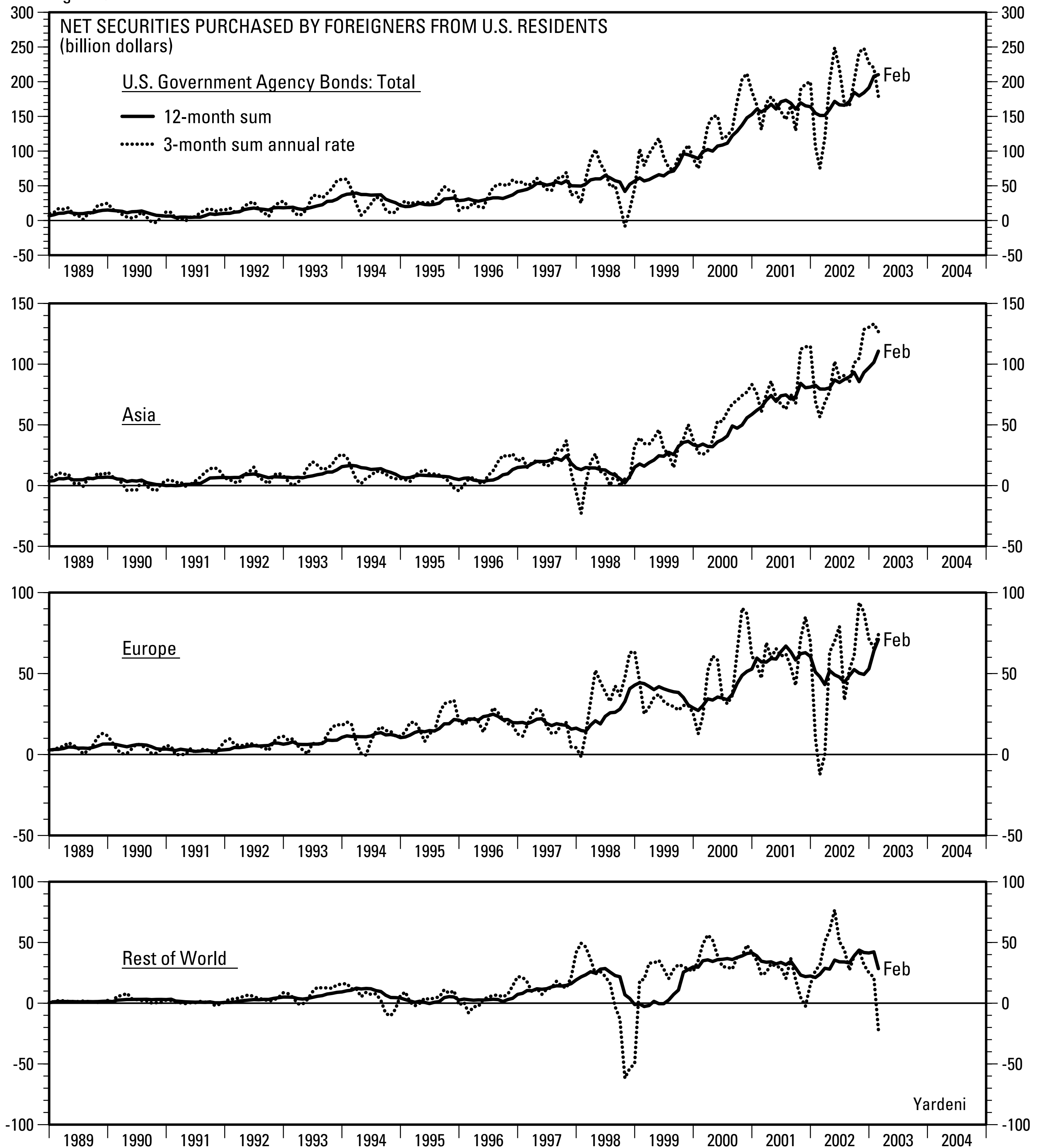
U.S. Capital Inflows: Treasuries

Figure 8.



Source: U.S. Department of the Treasury, Office of International Affairs.

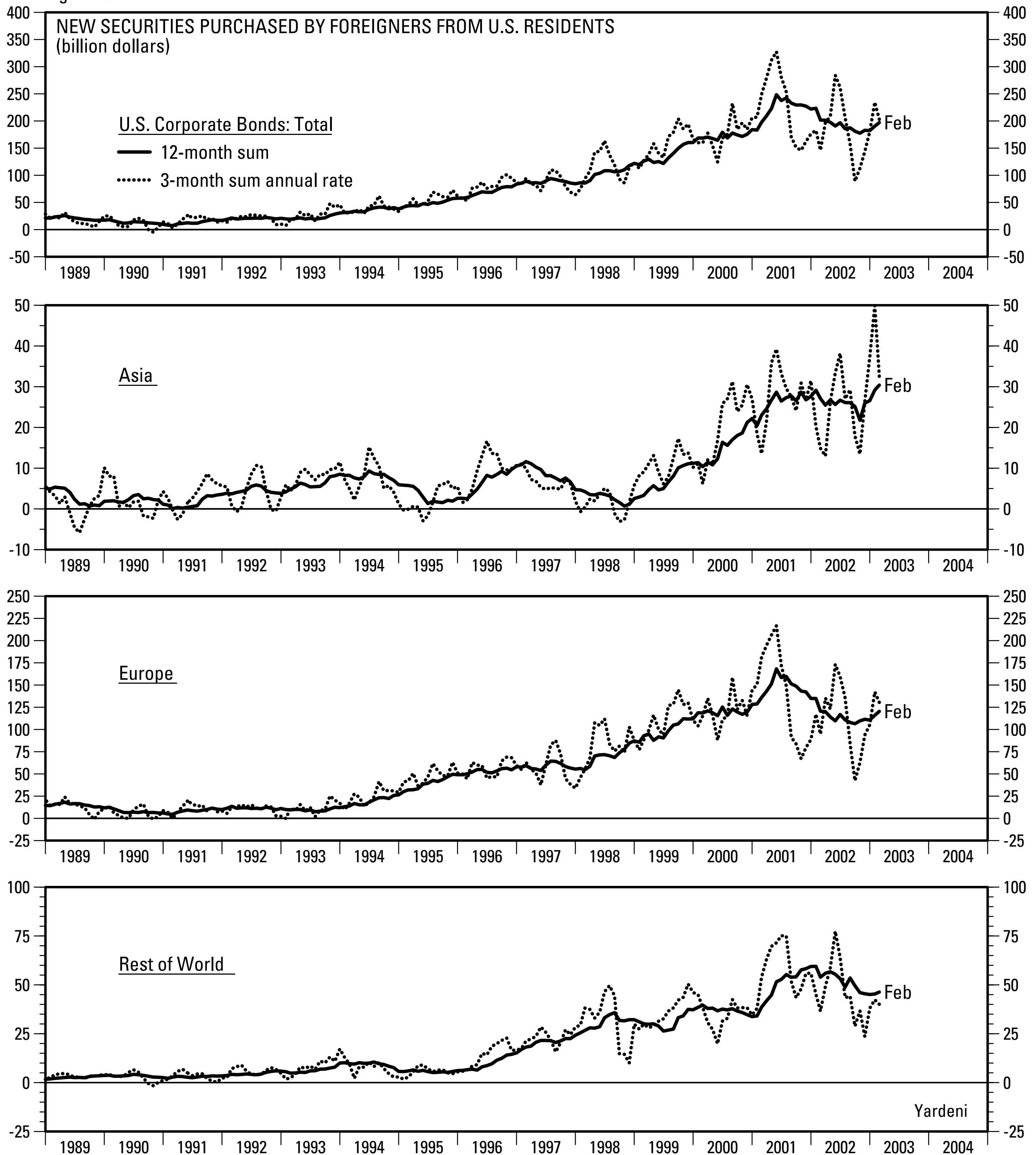
U.S. Capital Inflows: Agencies



Source: U.S. Department of the Treasury, Office of International Affairs.

U.S. Capital Inflows: Corporate Bonds

Figure 10.

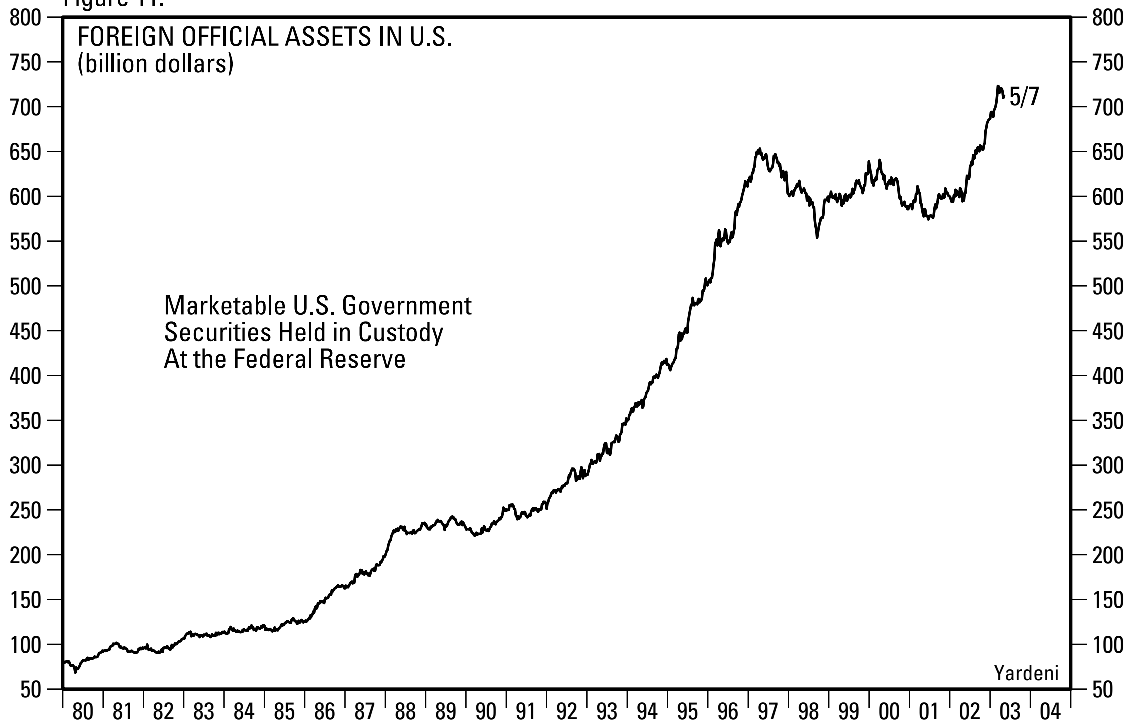


Source: U.S. Department of the Treasury, Office of International Affairs.

Foreign Official Assets

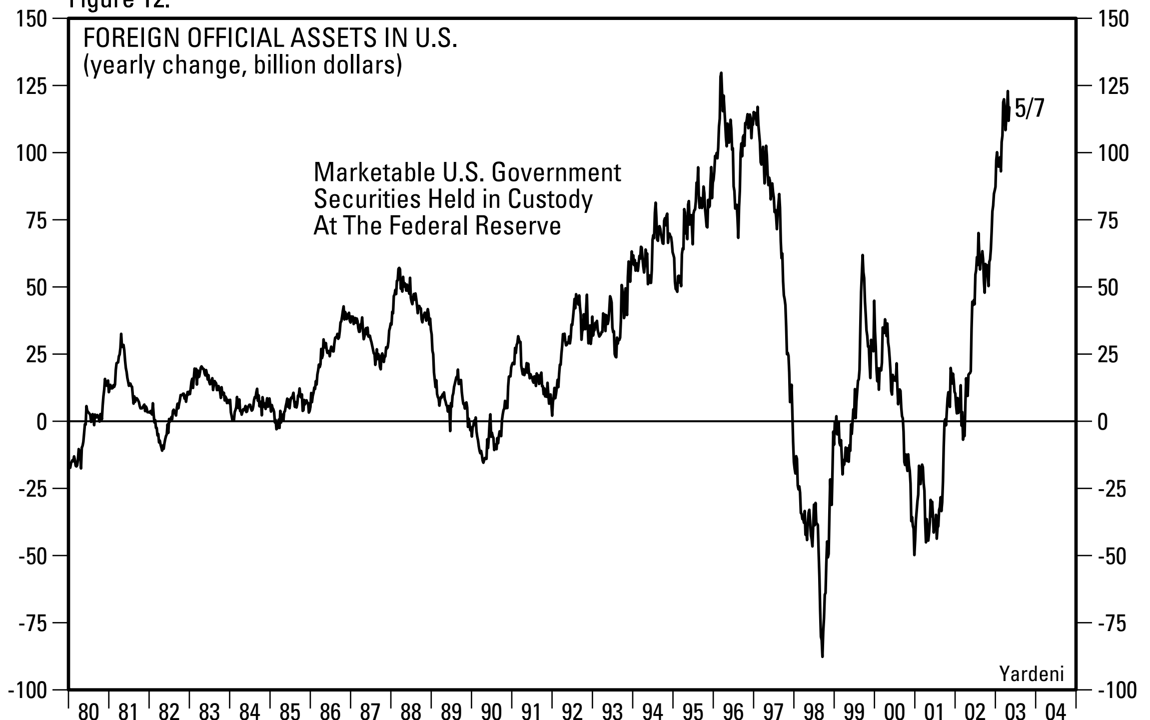
U.S.government securities held in custody for foreign central banks soared by $117 billion over the past year to a new record high of $712 billion.

Figure 11.



Source: Board of Governors of the Federal Reserve System.

Figure 12.

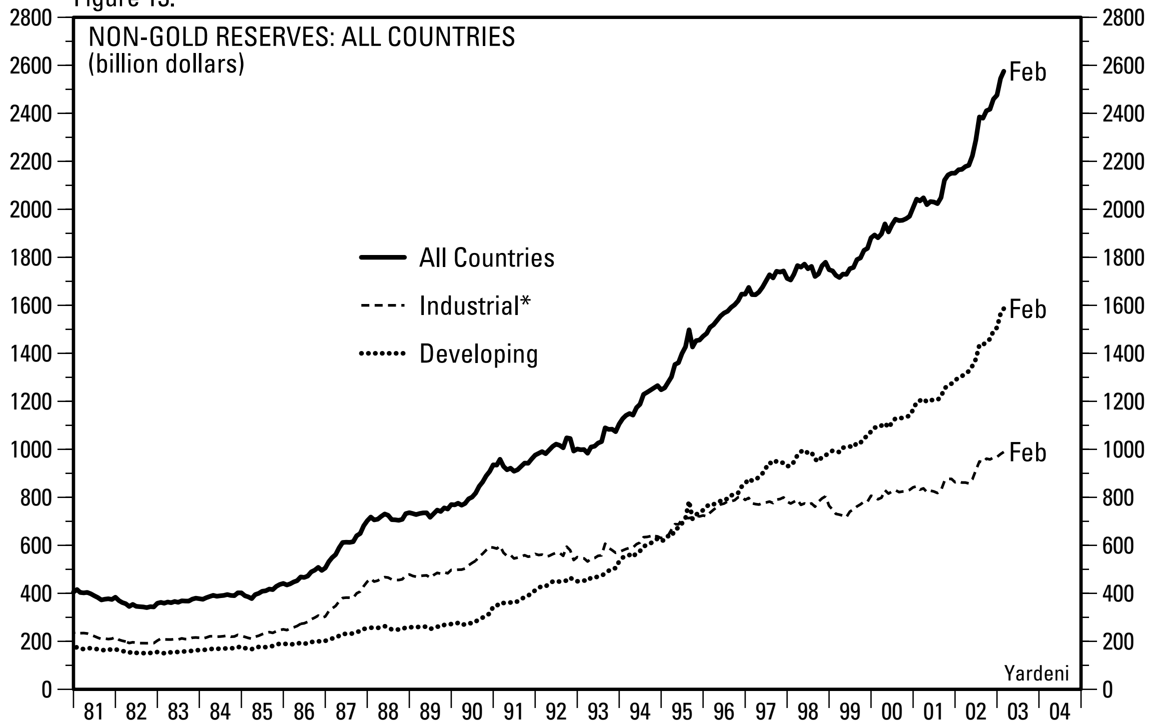


Source: Board of Governors of the Federal Reserve System.

Non-Gold Reserves

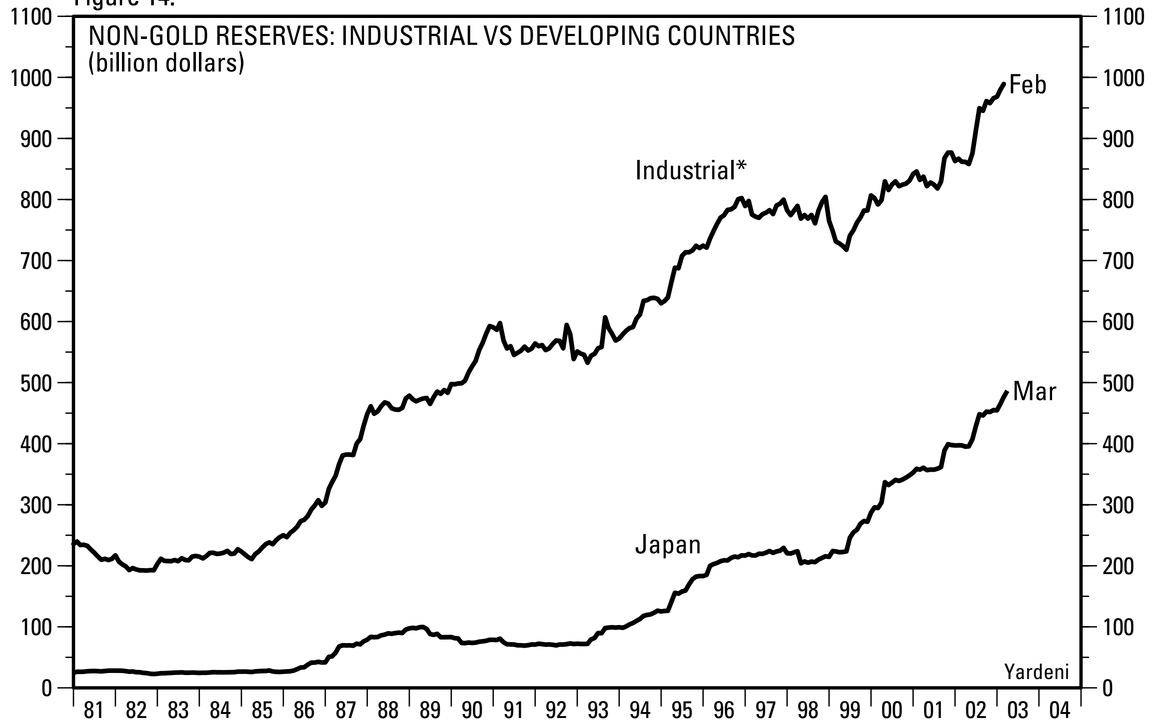
International reserves are soaring, led by developing countries. Among industrial countries, Japan's central bank continues to accumulate more reserves.

Figure 13.



* Includes United States, Canada, Australia, Japan, New Zealand, Austria, Belgium-Luxembourg, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, the Netherlands, Norway, Portugal, San Marino, Spain, Sweden, Switzerland and United Kingdom.
Source: IMF International Financial Statistics.

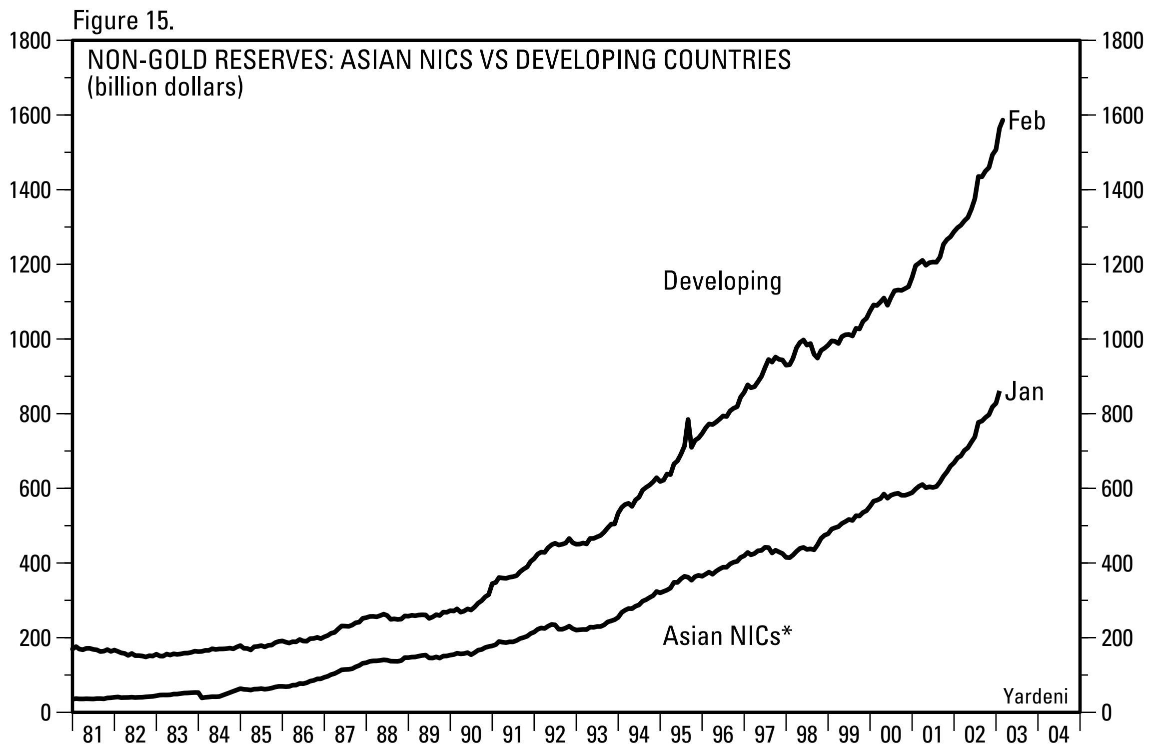
Figure 14.



* Includes United States, Canada, Australia, Japan, New Zealand, Austria, Belgium-Luxembourg, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, the Netherlands, Norway, Portugal, San Marino, Spain, Sweden, Switzerland and United Kingdom.
Source: IMF International Financial Statistics.

Non-Gold Reserves

Figure 15.



* Includes India, Indonesia, South Korea, Mainland China, Malaysia, Philippines, Singapore, Taiwan and Thailand.
Source: IMF International Financial Statistics.

Developing countries are increasing their international reserves at rapid pace, led by China.

Figure 16.

Source: International Monetary Fund.

For complete details on the stocks mentioned in this report that are covered by Prudential Securities analysts, please visit our Website at www.prudential.com or contact your Prudential Securities representative. To view charts associated with those stocks, please visit ***http://cm1.prusec.com***. In addition, the applicable disclosures can be obtained by writing to: Prudential Securities, 1 New York Plaza – 17th floor, New York, NY 10292 Attention: Equity Research

Rating distribution

	Prudential Securities Research Universe	
05/08/03	**Consolidated**	**IBG Clients**
Buy	39.00%	3.00%
Hold	57.00%	6.00%
Sell	4.00%	0.00%
Excludes Closed End Funds		
03/31/03	**Consolidated**	**IBG Clients**
Buy	39.00%	3.00%
Hold	57.00%	6.00%
Sell	3.00%	0.00%
Excludes Closed End Funds		
12/31/02	**Consolidated**	**IBG Clients**
Buy	38.00%	3.00%
Hold	59.00%	5.00%
Sell	3.00%	1.00%
Excludes Closed End Funds		
09/30/02	**Consolidated**	**IBG Clients**
Buy	40.00%	5.00%
Hold	58.00%	6.00%
Sell	2.00%	1.00%
Excludes Closed End Funds		

Firms IBG Clients: represents situations where companies have entered into investment banking transactions with Prudential Securities Incorporated.

When we assign a **Buy** rating, we mean that we believe that a stock of average or below average risk offers the potential for total return of 15% or more over the next 12 to 18 months. For higher risk stocks, we may require a higher potential return to assign a **Buy** rating. When we reiterate a **Buy** rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

When we assign a **Sell** rating, we mean that we believe that a stock of average or above average risk has the potential to decline 15% or more over the next 12 to 18 months. For lower risk stocks, a lower potential decline may be sufficient to warrant a **Sell** rating. When we reiterate a **Sell** rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

A **Hold** rating signifies our belief that a stock does not present sufficient upside or downside potential to warrant a Buy or Sell rating, either because we view the stock as fairly valued or because we believe that there is too much uncertainty with regard to key variables for us to rate the stock a Buy or Sell.

The research analyst, a member of the team, or a member of the research analyst's household does not have a financial interest in any of the stocks mentioned in this report.

The research analyst or a member of the team does not have a material conflict of interest relative to any stock mentioned in this report.

The research analyst has not received compensation that is based upon (among other factors) the firm's investment banking revenues as it related to any stock mentioned in this report.

The research analyst, a member of the team, or a member of the household does not serve as an officer, a director, or an advisory board member of any stock mentioned in this report.

Prudential Securities has no knowledge of any material conflict of interest involving the companies mentioned in this report and our firm.

Any analyst principally responsible for the analysis of any security or issuer included in this report certifies that the views expressed accurately reflect such research analyst's personal views about subject securities or issuers and certifies that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendation or views contained in the research report.

Any OTC-traded securities or non-U.S. companies mentioned in this report may not be cleared for sale in all states. 02-XXXX

Securities products and services are offered through Prudential Securities Incorporated, a Prudential company.

©Prudential Securities Incorporated, 2003, all rights reserved. One Seaport Plaza, New York, NY 10292

Prudential Financial is a service mark of The Prudential Insurance Company of America, Newark, NJ, and its affiliates.

Information contained herein is based on data obtained from recognized statistical services, issuer reports or communications, or other sources, believed to be reliable.

There are risks inherent in international investments, which may make such investments unsuitable for certain clients. These include, for example, economic, political, currency exchange rate fluctuations, and limited availability of information on international securities. Prudential Securities Incorporated, its affiliates, and its subsidiaries make no representation that the companies which issue securities which are the subject of their research reports are in compliance with certain informational reporting requirements imposed by the Securities Exchange Act of 1934. Sales of securities covered by this report may be made only in those jurisdictions where the security is qualified for sale. The contents of this publication have been approved for distribution by Prudential-Bache International Limited, which is regulated by The Securities and Futures Authority Limited. We recommend that you obtain the advice of your Financial Advisor regarding this or other investments.

Additional information on the securities discussed herein is available upon request.