Currency Update

Monthly Focus Topic

VERSO

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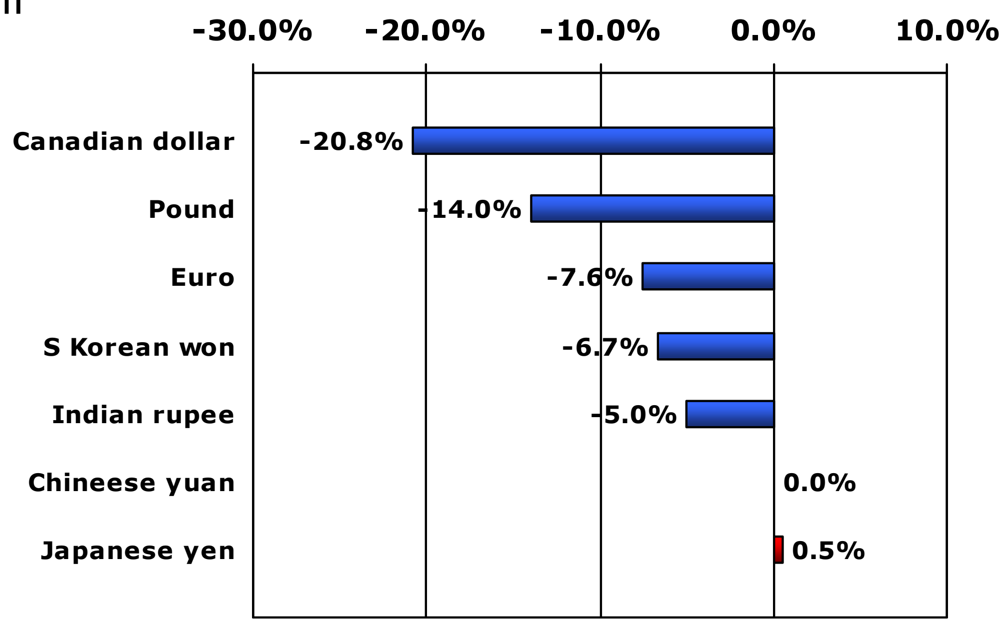
The USD has been sliding compared to most foreign currencies through 2009

The slippage in the value of the USD to foreign currencies YTD is fairly dramatic and represents a return to the level it was at before the Lehman Bros. bankruptcy filing in Sept 2008 (thought to be the leading contributor to the economic recession turning into a global panic).

- A weak dollar would be a problem if it contributed to inflation by increasing the cost of imports, or if it got so low so fast that it caused the Fed to raise interest rates

+ A weak dollar is a significant boost for the US in terms of stimulating manufacturing by offering them an advantage when selling off shore

Year-to-date change in the value of the USD against various currencies



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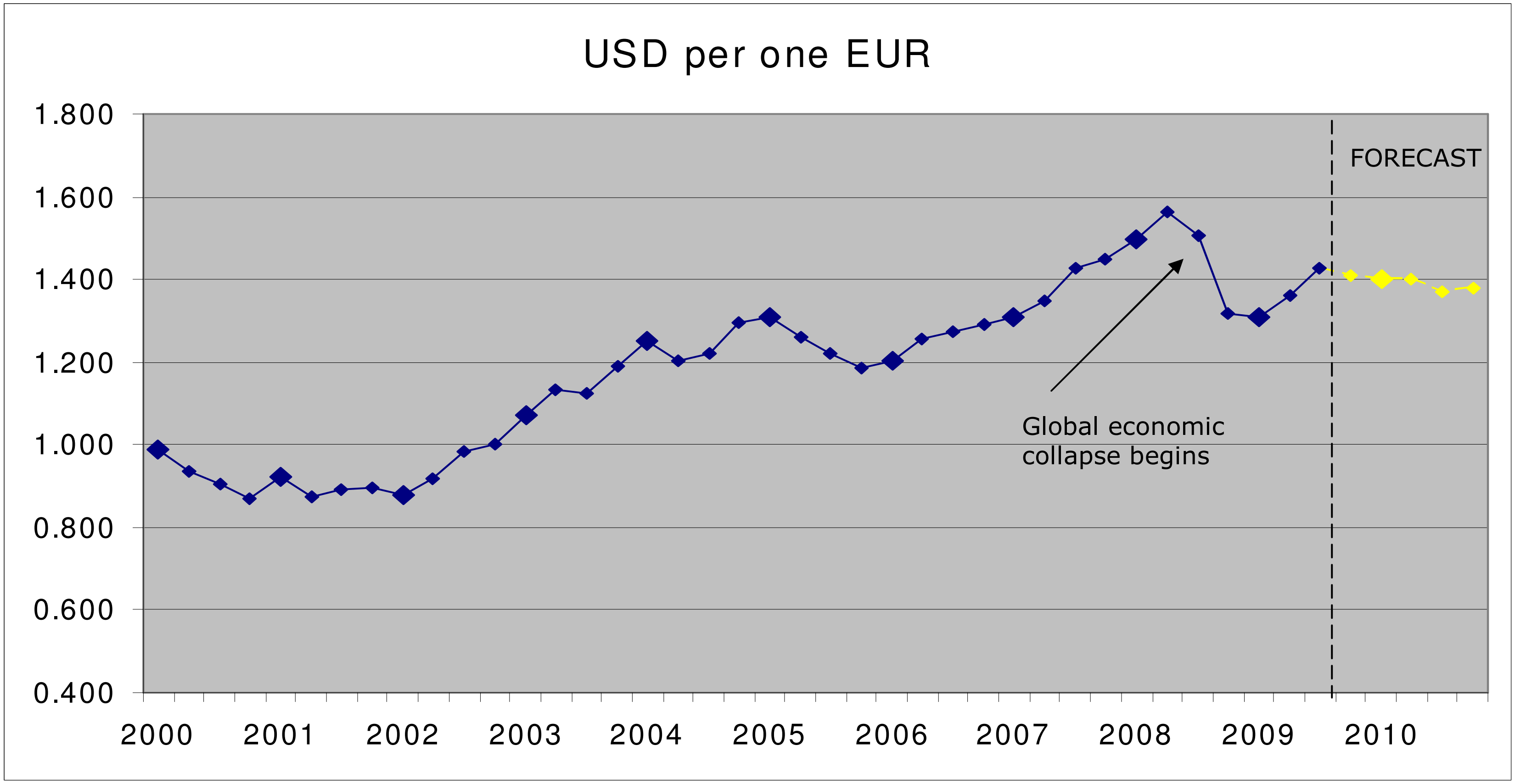
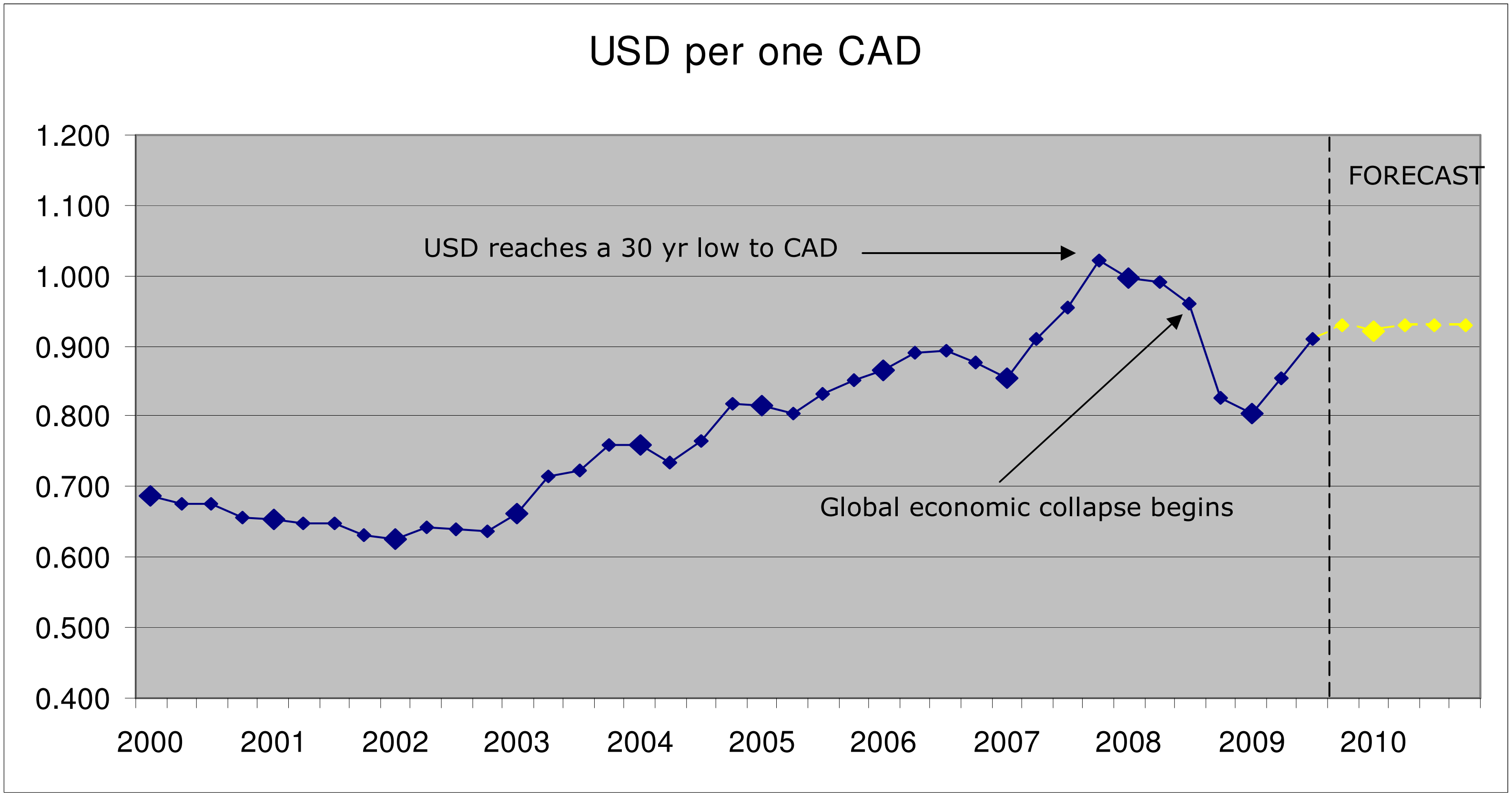
Source: Bloomberg News

The USD has lost strength to the EUR over the past two quarters and is forecast by RISI to continue near the current level (1.40 range)



In the last 2 quarters the USD has lost 47% of strength gained during period of Q2 2008 and Q1 2009.

The USD has also lost strength to the CAD over the past two quarters and is forecasted to continue at this level according to RISI (0.93 range)



In the last 2 quarters the USD has lost 49% of strength gained following the period of time when escalating oil prices pushed the CAD to a 30 year high vs. the USD.

Here are some of the major factors which impact the USD's strength and are key to forecasting

- Balance of trade and investment – probably the most influential. It represents the difference in exports and imports of capital.
- Economic theory – demand for dollars and money supply have significant impact on the value of the dollar. **The money supply situation is detailed on the next 2 slides.**
- Interest rates – foreign investors look for the best deal in currencies just like consumers do.
- Politics – Government policies can have a great impact on the value of the dollar as foreign investors monitor how the state of political affairs may impact our ability to service the national debt.
- Other countries – Trade, conflict, and consumption abroad can affect the dollar from outside our country.
- Entitlements – Significant government expenses which represent future commitments, such as social security and Medicare/Medicaid, can have a large impact on the way investors view the USD.
- Industry and economic Indicators – US manufacturers both affect and react to the value of the dollar.
- US capital markets – US stocks, bonds, and other investments can be appealing no matter where you are in the world. The performance of US capital markets can either attract or reduce foreign investment.
- Inflation – Inflation directly eats in to the value of the dollar. It is popular thinking that a nation's currency and its general price levels should move in opposite directions.
- Economy – The performance of the US economy signals to investors our ability to pay back debts as well as the profit level they may earn.

Source: currencytrading.net

What is money supply and how can it impact the strength of the USD?

The money supply controls how much inflation we have

- The amount of money that is in circulation is measured and can have impact on the strength of the dollar. Fundamentally the more money that is printed and in circulation the more the dollar is devalued.

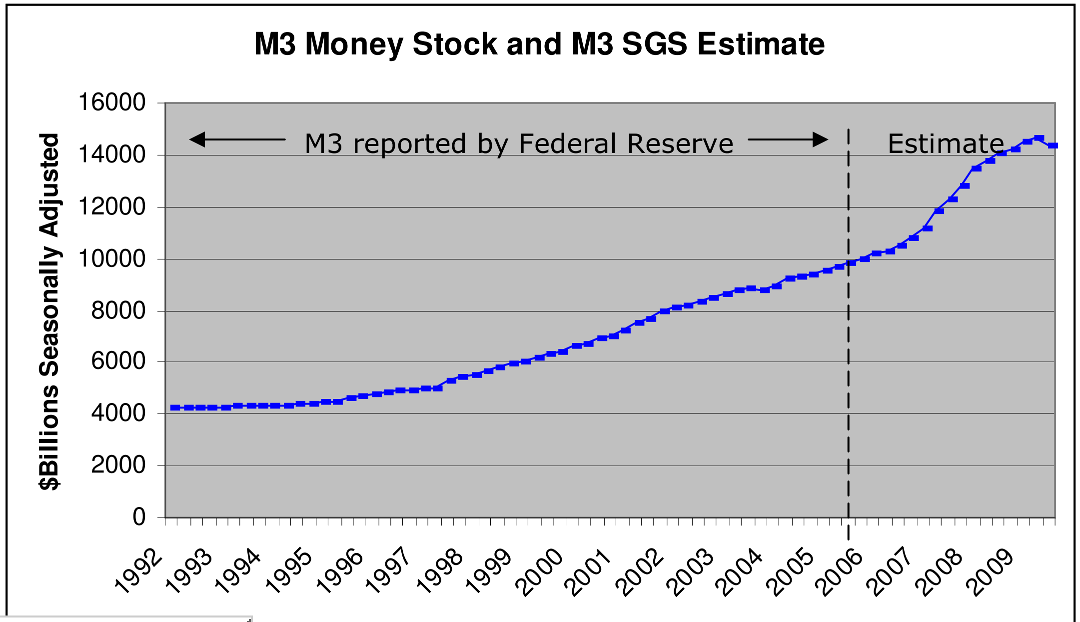
- The most recognizable broad measure of the amount of money in circulation is the M3 Money Stock. The reporting of this particular measure was discontinued by the Federal Reserve in March of 2006 with a significant amount of buzz as to the motivation for discontinuing this data (M1 and M2 are also measures of money supply although a narrower scope, and are still available). Since the M3 can be calculated from M1 and M2 and some additional data, it is still being generated by companies such as shadowstat.com.

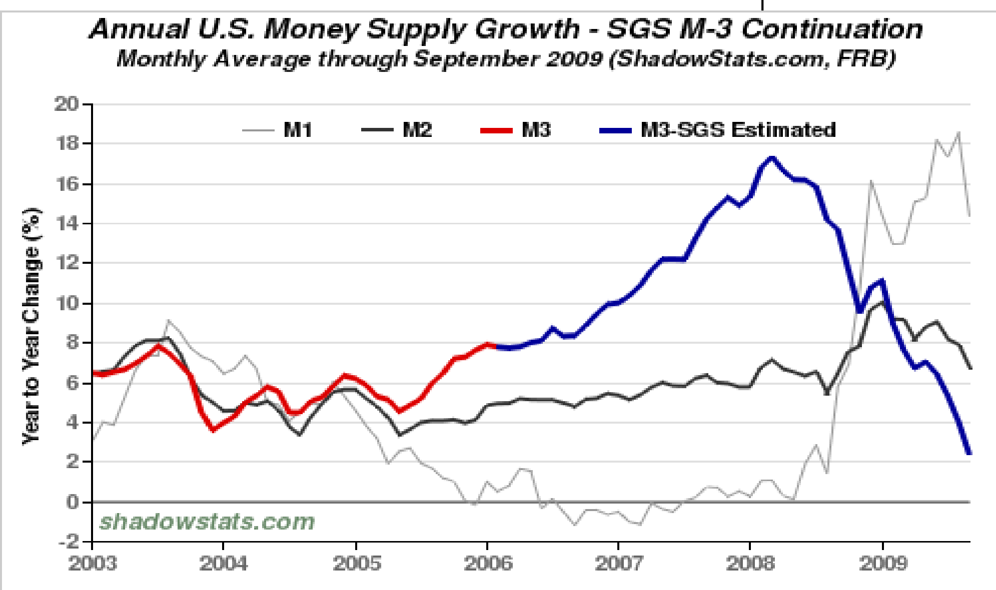
M1 includes	M2 includes M1 +	M3 includes M2 +
• currency outside Federal Reserve Banks, and the vaults of depository institutions • traveler's checks of nonbank issuers • demand deposits • other checkable deposits (OCDs)	• savings deposits • time deposits less than $100,000 • money market deposit accounts for individuals	• large time deposits (> $100K) • institutional money-market funds • short-term repurchase agreements, • other larger liquid assets.

- The data on the following slide shows the combination of the M3 from the Federal Reserve and the new estimate provided by shadowstat.com, in absolute terms and YOY comparisons.

What is the status of the money supply?

The graph at the right shows money supply for the last 17 years. Accelerated ramp up of money supply was reversed in early '08 and began to decline as banks were holding on to money and not lending to consumers and small businesses.





The graph of YOY changes in the US money supply (left) shows an inflection point at the beginning of 2008. Long runs of deceleration results in deflation while runs of acceleration results in inflation. The change in the rate of money reserves in early 2008 can be described as deflationary and was one of the causes for the USD's run up in strength.

Source: Federal Reserve and shadowstat.com

What trends are expected in the money supply? How will the value of the USD be impacted?

- The amount of money that will need to be printed to cover the US government's trillion dollar deficit will likely be a controlling factor leading to a return to growth for the estimated M3 money supply indicator for the upcoming months and quarters.

- The concern would be that this growth in the money supply would lead to an inflationary period and continue to put downward pressure on the value of the USD.

- As pointed out earlier, there are several factors which ultimately influence the strength of the dollar and of course the money supply is only one of them.

Could a prolonged and increasingly weak USD ultimately lead to its loss of status as a world currency?

The USD has been the common language of global financial markets since it supplanted the British pound more than 60 years ago.

62.8% of foreign exchange reserves worldwide are held in the form of USD (June '09 data). This is down from a high of 67.9% in mid-2004.

TWO BEST CANDIDATES TO REPLACE THE USD AS GLOBAL CURRENCY

- A formidable challenger to the USD might be the **Euro** as a global financial denominator. Although the Euro lacks some essential attributes. The European Union has a central bank but a central treasury does not exist, instead there are 27 European treasuries. The USD has the advantage of $4 trillion worth of treasuries with trading carried out around the globe 24 hours a day making it easy to move into and out of dollar positions in a hurry.
- Another contender would be the **Chinese yuan**. The Chinese economy will likely surpass the US some day which would put the yuan in a position to take the dollar's global role. Before the yuan could become the new global currency China would have to overhaul its financial system. Also there are strict limits in place on the cross-border movement of the yuan which would need to be revised.
- A more likely candidate to take the USD's place as the world currency might be a **new world currency** which does not currently exist. China, Russia, a United Nations panel and numerous smaller nations have all stated interest in this concept, which was a major topic at this years G8 conference.

Source: usa today.com, bloomberg.com