

Portfolio Positions

The Falling Dollar

The river of money is flowing more swiftly, but the continued deterioration of the dollar raises worries about inflation.



BY **TONY CARIDEO**

Carideo (tony@carideo-group.com) is president of The Carideo Group, Inc., a Minneapolis firm providing integrated corporate communications. He's also a former securities analyst and research director.

➤ To torture a line from *Forrest Gump*—"stupid is as stupid does"—in economics, money is as money does. And money both is and does based on what the Federal Reserve decides to do with it.

For almost 30 years now, John Beuerlein, chief investment officer and chief economist for Marquette Asset Management in Minneapolis, has studied the money flowing in and out of the Fed's central bank coffers. Those rivers of currency—swollen in times of high liquidity and low interest rates, parched when money is tight and rates are high—have a profound effect on investors, markets, and the ways in which money is made and lost. With the relatively recent rate cuts, the river of money is flowing more swiftly. But the value of the U.S. dollar has continued to deteriorate, raising worries about inflation.

Beuerlein's work and his insights are a key component in the decision-making process behind Marquette's management of more than \$600 million for high-net worth individuals and institutions. His advice is also sought by Twins owner and banker Carl Pohlad and the people who manage his far-flung business interests.

{Q} IN THE CLASSIC SENSE, WHAT IS THE FEDERAL RESERVE BANK'S MODEL?

{A} The classic Fed model looks at forward earnings yields on stocks; the forward earnings yield is the inverse of the price earnings ratio. For round numbers right now, the forward projected earnings for the Standard & Poor's 500 is about \$100 a share. With the [S & P] index at about 1,500, the \$100 in earnings divided by 1,500 gives you about a 6.5 percent yield. Compare the earnings yield to the risk-free rate, which on the 10-year Treasury is about 4.4 percent or 4.5 percent. Money

tends to go where it's being treated the best, so when you're getting a better return on your stock portfolio, you'll tend to overweight stocks over bonds.

{Q} HOW DOES YOUR FED MODEL DIFFER?

{A} I look at liquidity. When I got into the business in the late '70s and early '80s, I ran into a fellow who, at the time, was chief of research for Goldman Sachs. He told me not to worry about research reports, but to understand the people who control the money in this country, and that's the Federal Reserve. He suggested that I look closely at the St. Louis Fed, because they have records on different measures of liquidity going all the way back to 1920. What those records show is that when liquidity starts to expand, economic activity, not too long after, starts to expand. Conversely, when liquidity contracts, after a lag effect, so will economic activity.

{Q} IS THAT STILL THE CASE?

{A} Yes. The current Federal Reserve, from the early 1980s on, has studied this very thing. That's why [former Federal Reserve Chairman Alan] Greenspan, and [current Chairman Ben] Bernanke are so aware of the liquidity situation. The studies showed that liquidity would shrink in a crisis, and until you started to see that liquidity expand, you couldn't get out of the crisis.



John Beuerlein,
Marquette Asset
Management

{Q} DO YOU BELIEVE THE FED IS ON THE RIGHT TRACK?

{A} The Fed's very charge is to try to keep the economy moving forward at a reasonable pace. They're going to say they're more concerned about the impact on the economy. Well, where does the economy begin and where do markets begin? They're both intimately tied together. The markets can't move ahead if the economy is grinding to a halt.

{Q} DO YOU THINK THE FED IS JUSTIFIED IN SUPPLYING LIQUIDITY IN INSTANCES WHERE MARKET PARTICIPANTS HAVE TAKEN AN IMPRUDENT AMOUNT OF RISK, AS IN THE CASE OF SUBPRIME MORTGAGES, HEAVILY LEVERAGED HEDGE FUNDS, AND ALL THE REST?

{A} It is not appropriate for them to be bailing out investors who have taken on imprudent amounts of risk. That's their conundrum: Bernanke realizes that if he improves liquidity, it will ease the pain of those who invested in those areas. On the other hand, if he doesn't do it, the situation could spill over and affect other parts of the economy, which then really does come under the purview of the Federal Reserve. They have to react once it becomes apparent that it could impact economic activity.

{Q} DO YOU FEEL THE FED HAS ACTED APPROPRIATELY IN THE PAST FOUR TO SIX MONTHS?

{A} I do. But to answer that question, you have to look at what the Fed has been up against. The problem they have right now is that there is a huge pool of liquidity outside of their direct regulatory authority: in foreign hands, in the hedge funds, and private-equity funds. Even though in the past couple years they were trying to slow things down by raising interest rates, this huge pool of money was out there looking for yield. It's that pool of liquidity that caused the subprime situation.

{Q} WHY IS THE VALUE OF THE DOLLAR SO CLOSELY TIED INTO ALL OF THIS?

{A} People need to realize that the value of a currency is not like a stock. It's a relative value. So if the dollar drops, another currency appreciates in value. In today's global economy, nobody wants a super-strong currency, because that makes them less competitive on the world market. They'd prefer to have a relatively stable currency. That is one reason why at times that you've seen some fairly substantial downdrafts in the U.S. dollar. Central banks worldwide tend to step in to support the dollar and to push down their currency a little bit, just so they don't price themselves out of the global market.

{Q} WHAT DOES A WEAK DOLLAR MEAN TO A U.S. INVESTOR?

{A} At some point in time, our imports are going to become more expensive. So far, the only import that has been affected has been oil. But it could eventually affect other goods. For instance, the Asian countries have been very careful to try to keep their prices stable in terms of dollar value. But at some point, that's going to become an issue, and that in turn will become an inflation issue.

{Q} SO HOW DOES THAT HELP OR HURT INVESTORS?

{A} If you're an investor in the United States right now, you should be looking at companies that have exposure overseas, because many economies overseas have greater growth prospects than we currently do. Plus, they also have appreciating currencies, so you get a double whammy there—two hits for the price of one. The companies in the United States that are really under pressure are those really dependent on domestic spending.

{Q} YOU'VE TOUCHED ON THE SUBPRIME MESS. WHAT ABOUT THE POTENTIAL RIPPLE EFFECT? WHEN PEOPLE AREN'T BUYING HOUSES, THEY AREN'T BUYING REFRIGERATORS, BEDS, OR GOING TO MENARD'S EITHER. DO YOU THINK THAT THE MARKET'S CURRENT LEVEL FULLY REFLECTS THIS ASSUMPTION?

{A} It is extremely important to me. I don't know if it's fully priced in yet. Now that the Fed has changed its policy from raising interest rates to lowering rates, typically when that happens, the two sectors that perform extremely well are consumer discretionary stocks and financial stocks. Those two areas have eroded. That suggests that 'ripple risks' may not yet be fully priced into the market. The bigger question is whether the consumer discretionary stocks and the financial stocks are telling me something more worrisome about our economy.

{Q} DO YOU THINK THE FED IS WORRIED THAT THIS BROADER POTENTIAL IMPACT COULD BE A TRUE DAMPER ON A BIG CHUNK OF THE ECONOMY?

{A} Yes. This subprime situation is really more deflationary than inflationary. Any time you start to have people defaulting on loans, that's a deflationary phenomenon. Nobody has really talked about that. The core personal consumption expenditure is running at about a 1.8 percent per year increase. It doesn't take much of an impact to have that figure slip into negative territory. Then you're talking deflation, and that's a problem that scares the bejeebes out of the Fed. They know how to control inflation. But how do you control falling prices? It's like pushing on a string. **TCB**