

Dollar is king but beware regime change

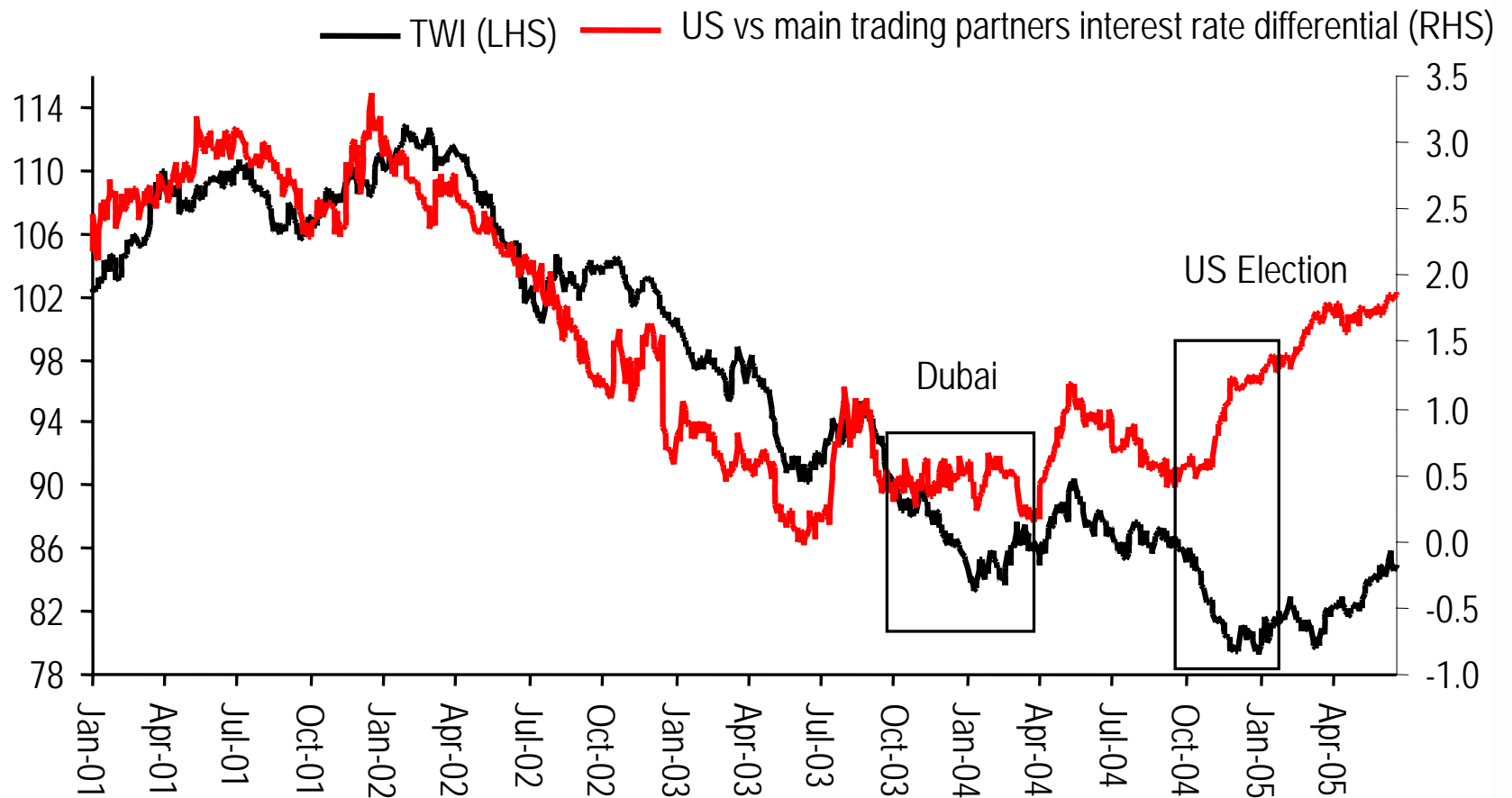
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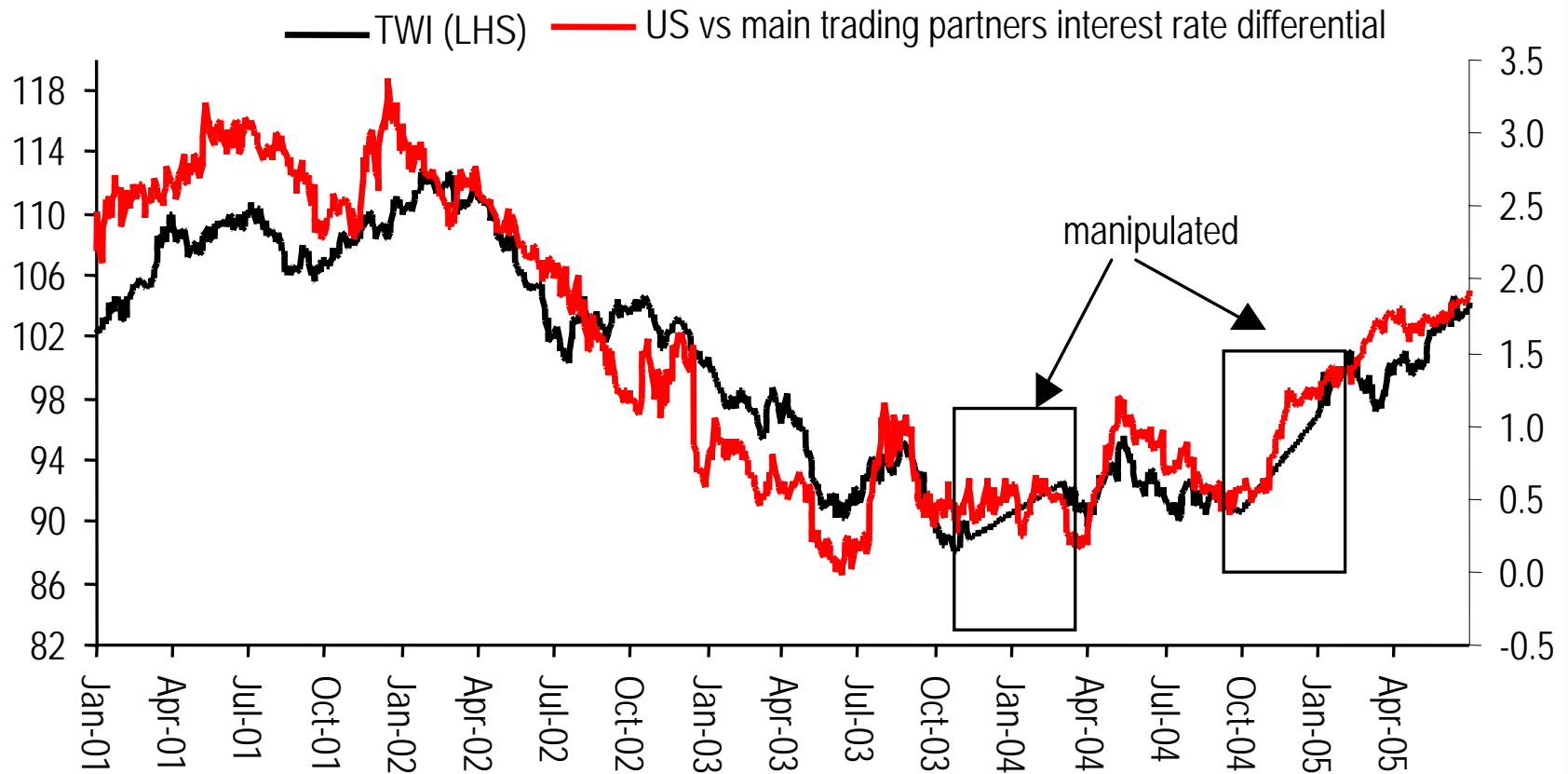
2. Regime Shifts

- In equities, bonds and commodities, shifts in thinking are powerful but rare
- Equities new paradigm 1996-2000
- Bonds - risk of deflation 2003
- Oil price shocks - structural demand for oil
- These structural shifts are rare but powerful...
- ...in foreign exchange they can and do happen often...
- Starting point is to ask - what regime are we in?

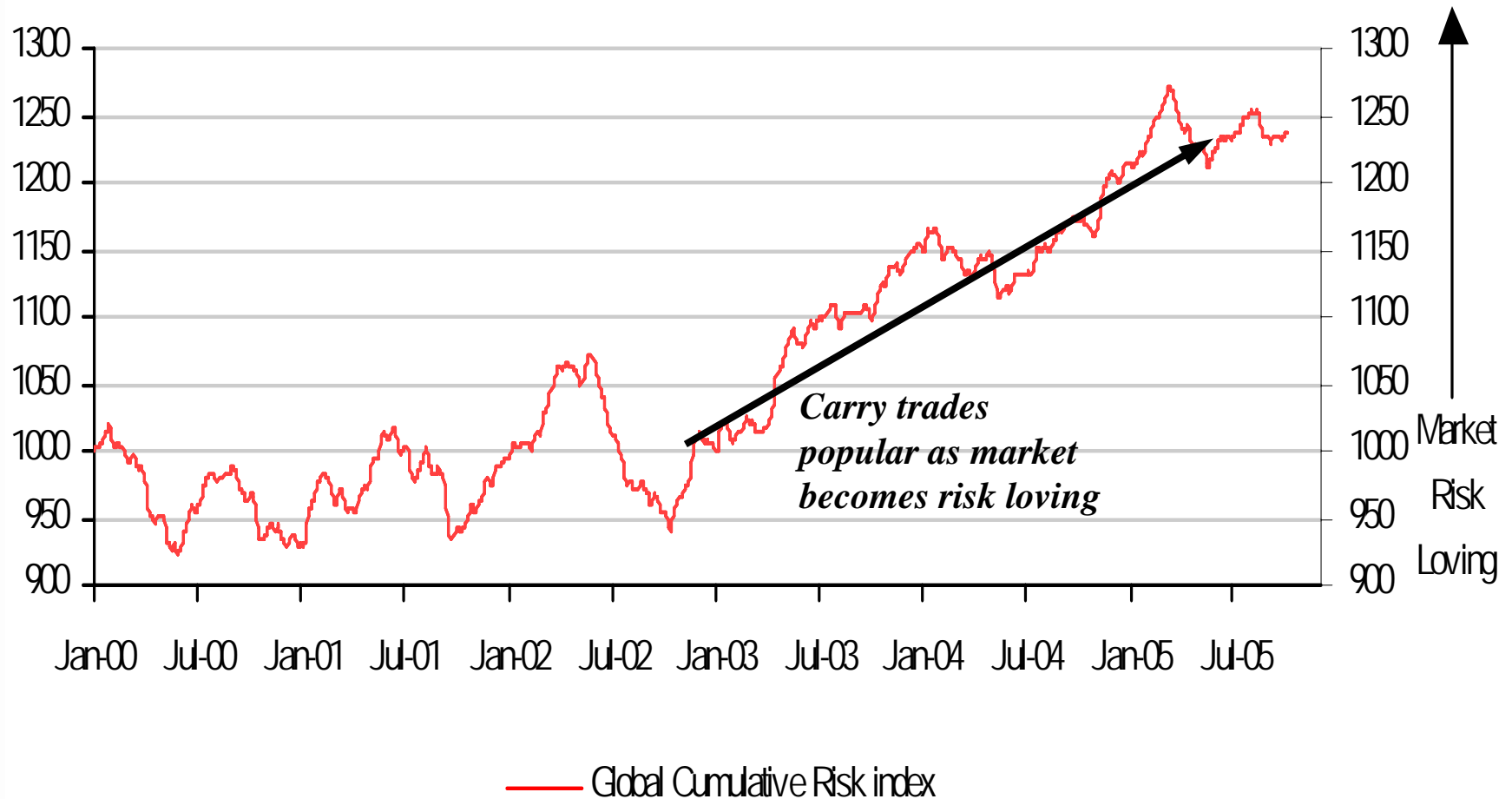
3. Interest rate differentials (Carry) works well until... ...the draw-downs - which can be huge



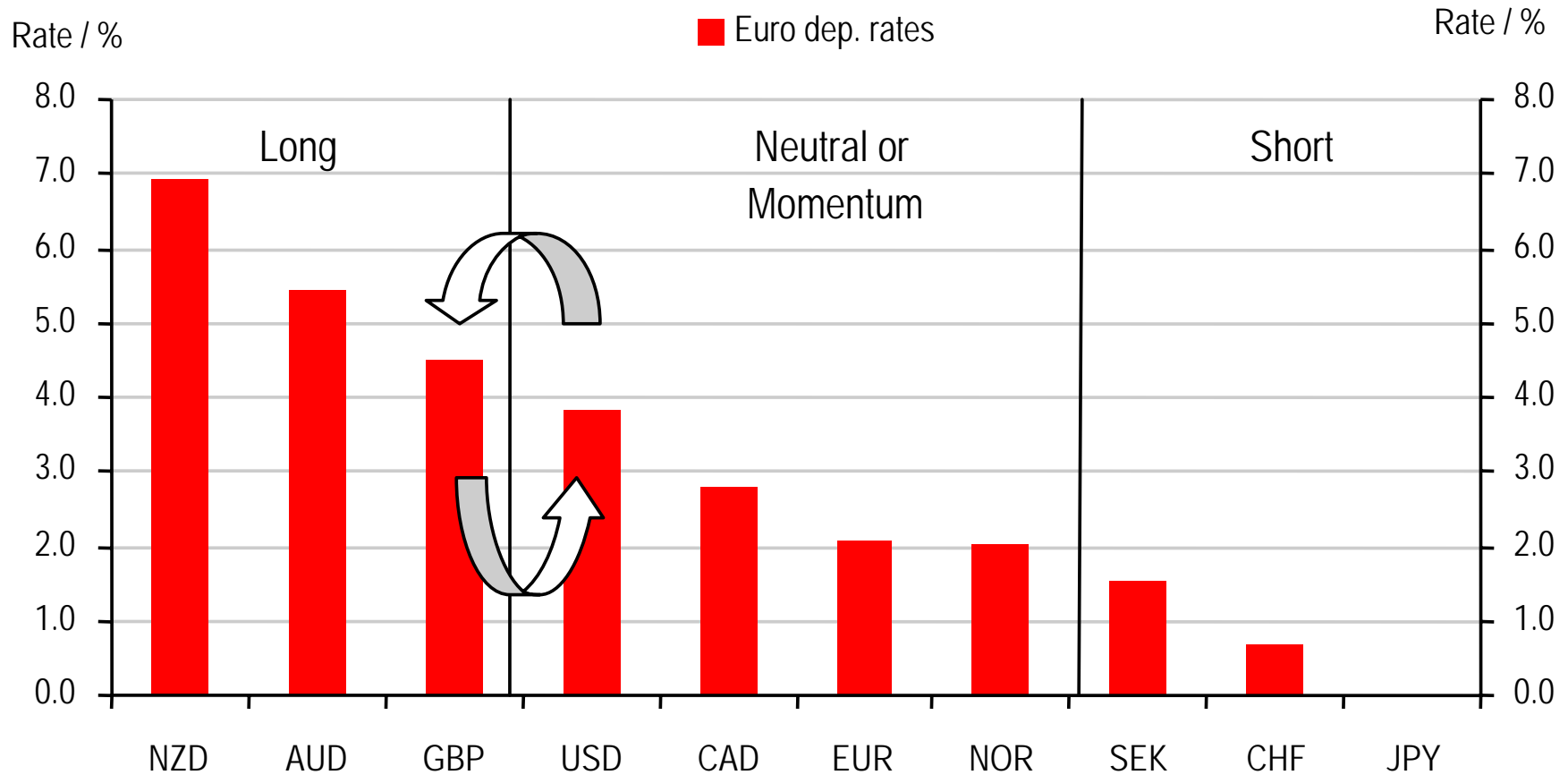
4. It seems as though Carry is King most of the time



5. We try and spot these periods by modelling risk

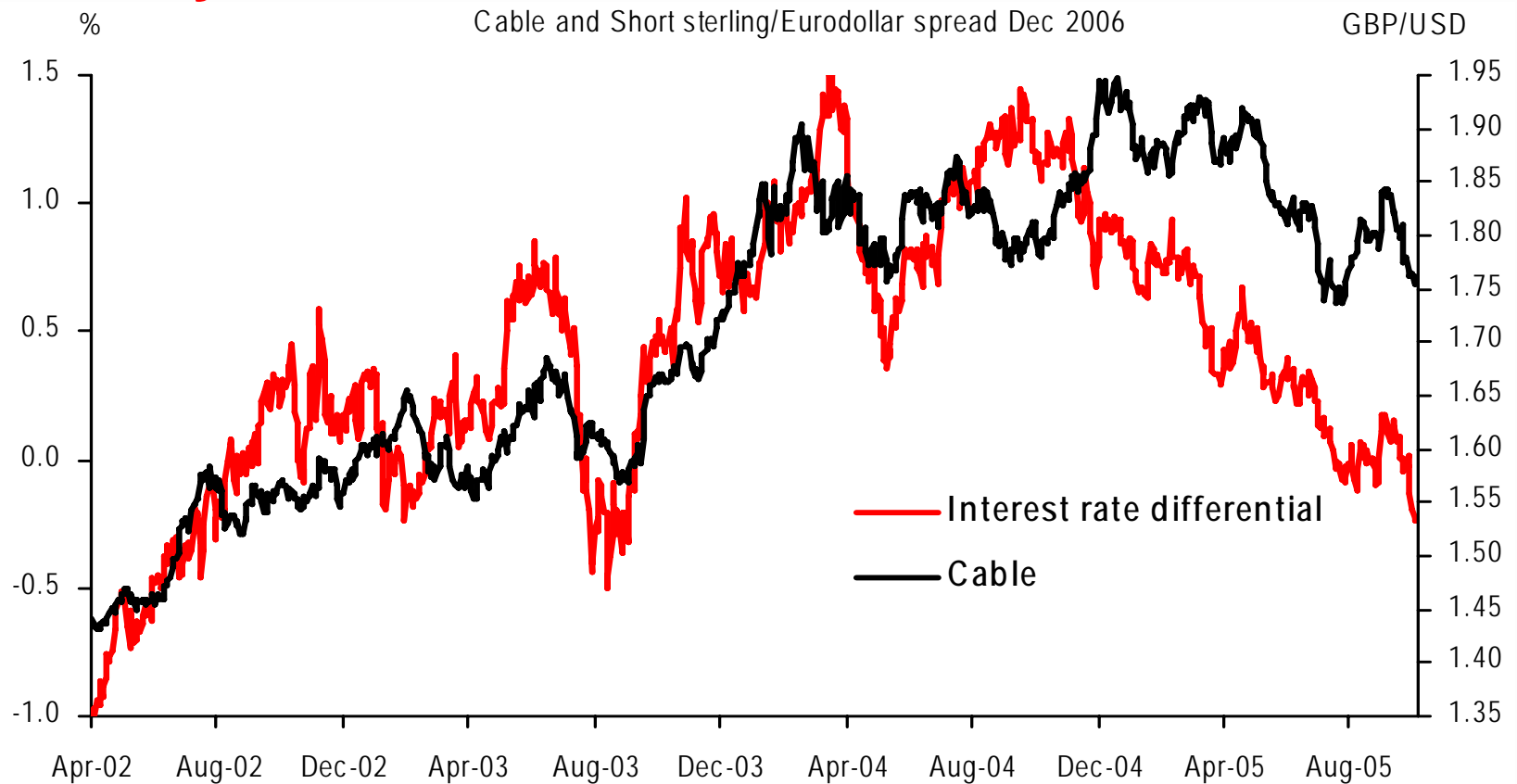


6. Carry baskets are increasingly popular - with a switch - momentum also matters

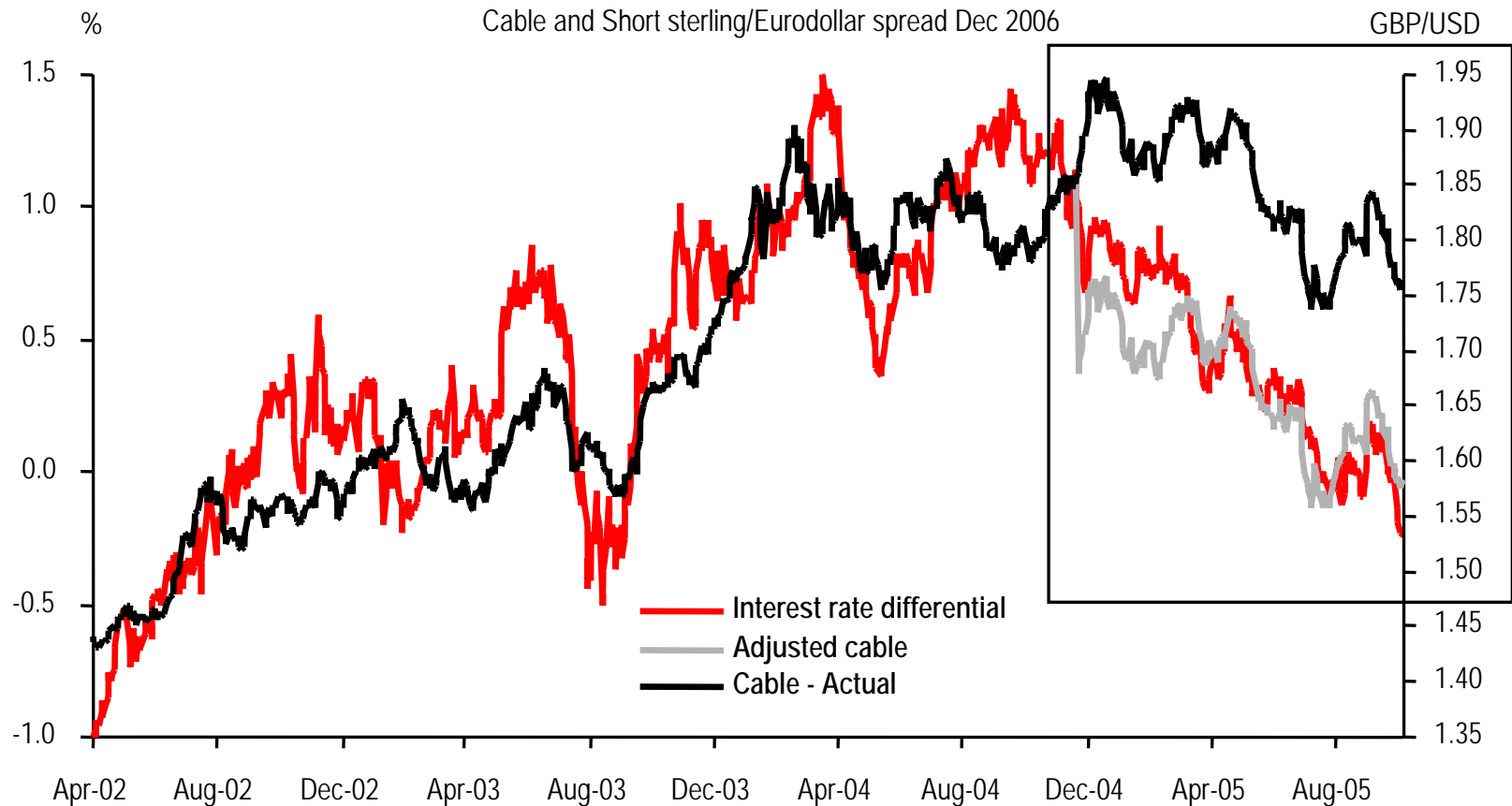


FX appreciation goes with higher yield, not the case in bonds or equities

7. Cable (sterling against the dollar) - it seems as though the interest rate differential broke down last year



8. Cable still moves with interest rate differentials but at a 20 big figure premium - it is at risk



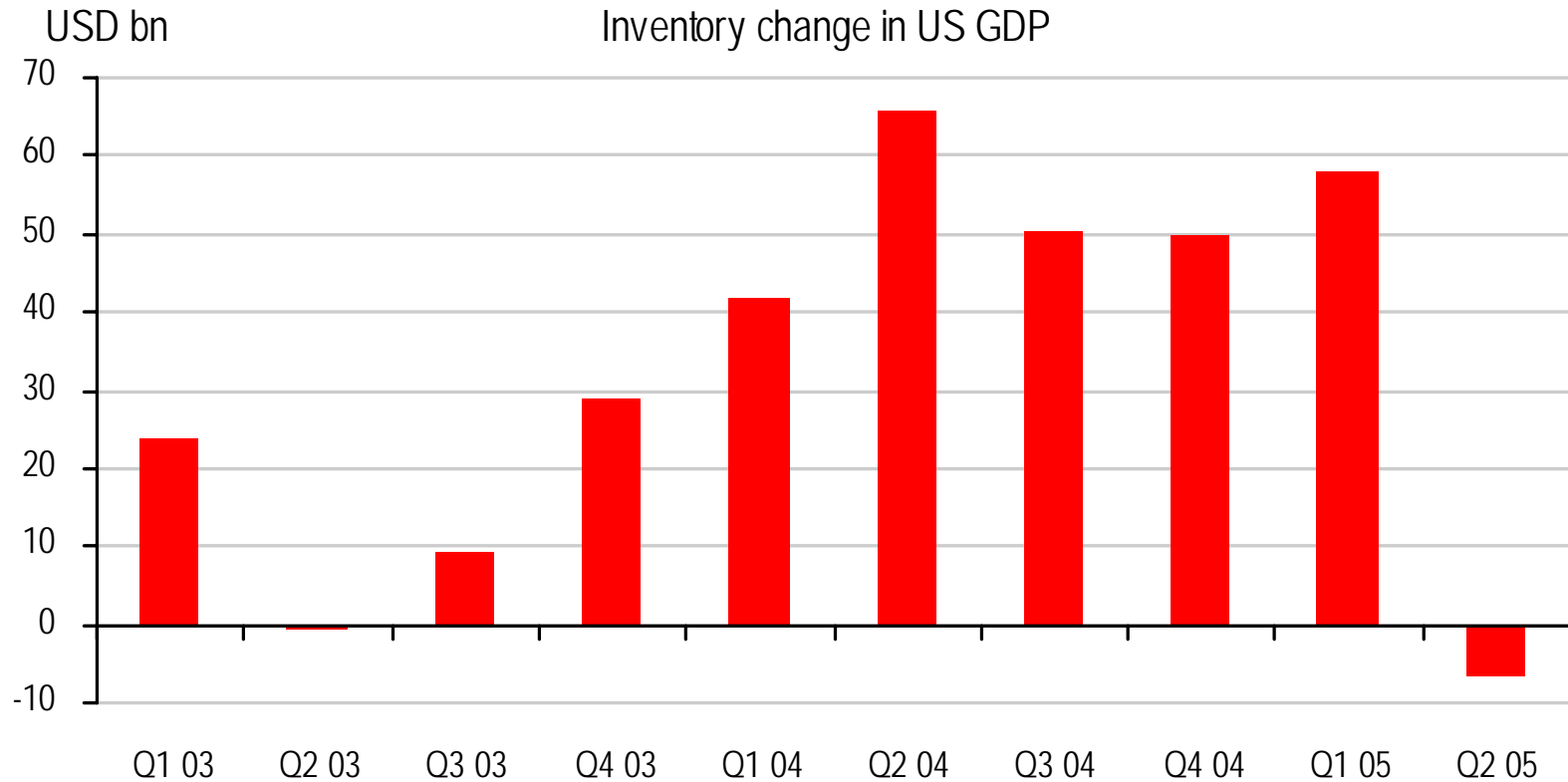
9. 2005 H1 Dollar's Purple patch - a period of extraordinary good luck and good fortune

- Normal cyclical service resumed...
- ...which meant higher rates = higher dollar
- Political problems occurred in the eurozone with the constitutional vote - *regime change*
- Through HIA (Home Land Investment Act - American Job Creation Act)
flow seemed all one way
- but now ... the dollar's one way street is closed

10. 1st Half vs Now

- 1st half - unrelenting Fed hikes
- Visibility of the peak will appear soon
- 1st half - better trade data
- Trade data to deteriorate due to inventory rebuild, higher oil prices and ports
- 1st half - budget deficit was shrinking
- Back to the balloon

11. Trade data better but because of a big inventory draw-down as growth surprised



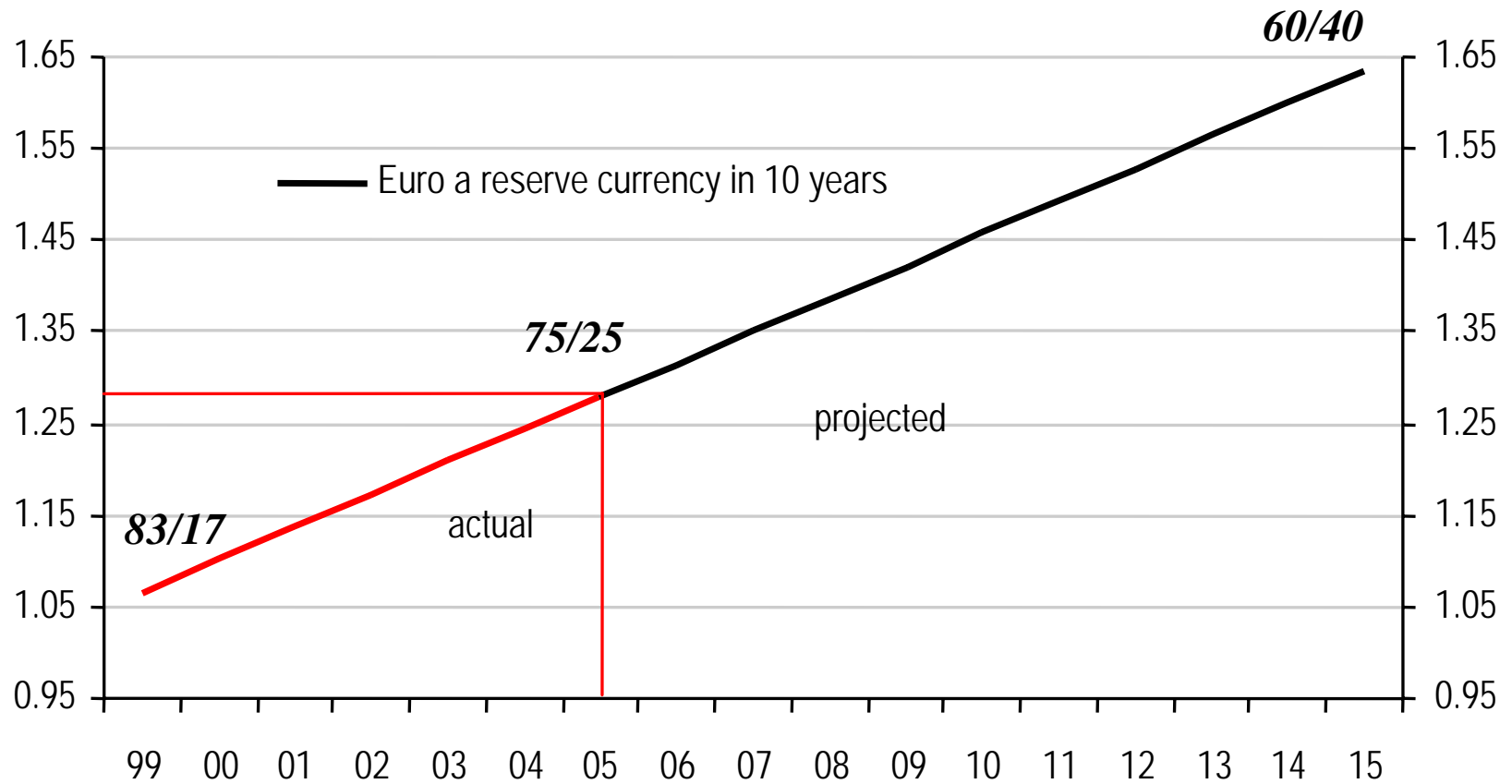
12.

In the first half - Politics hurt the euro

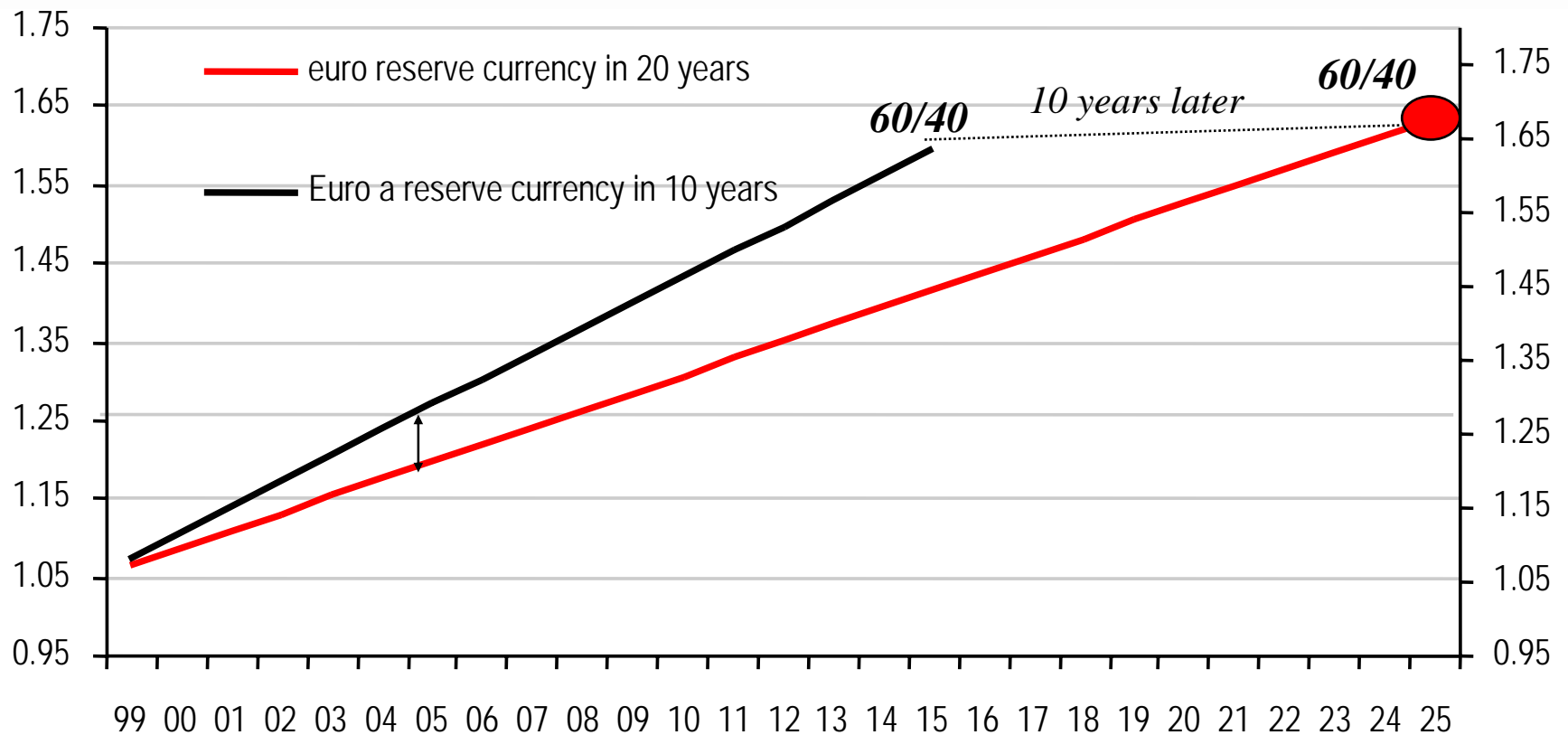
**Its aspirations as a baby brother reserve
currency took a knock**

We witnessed a regime shift

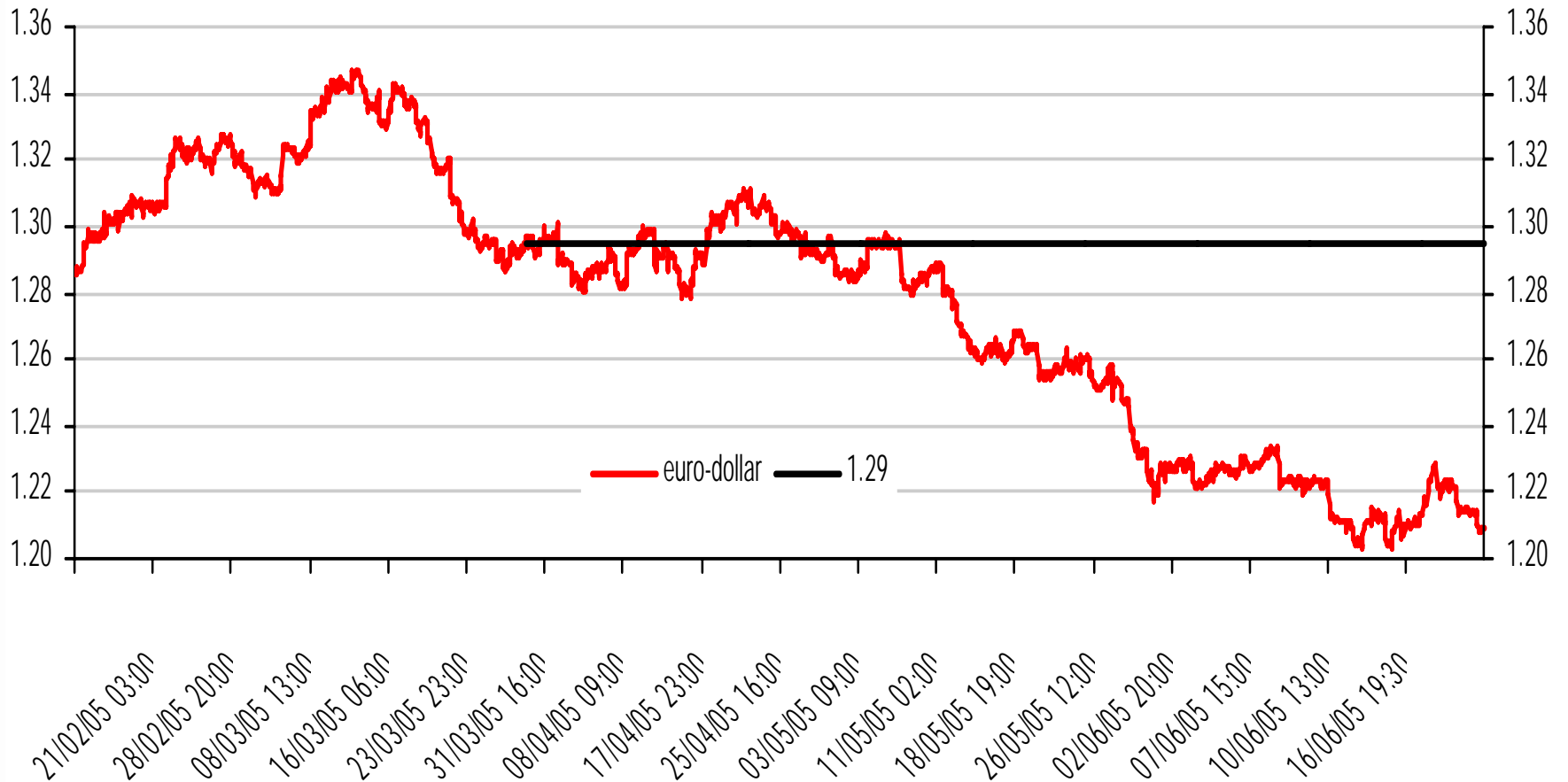
13. Linear view of the euro's projection as a reserve currency



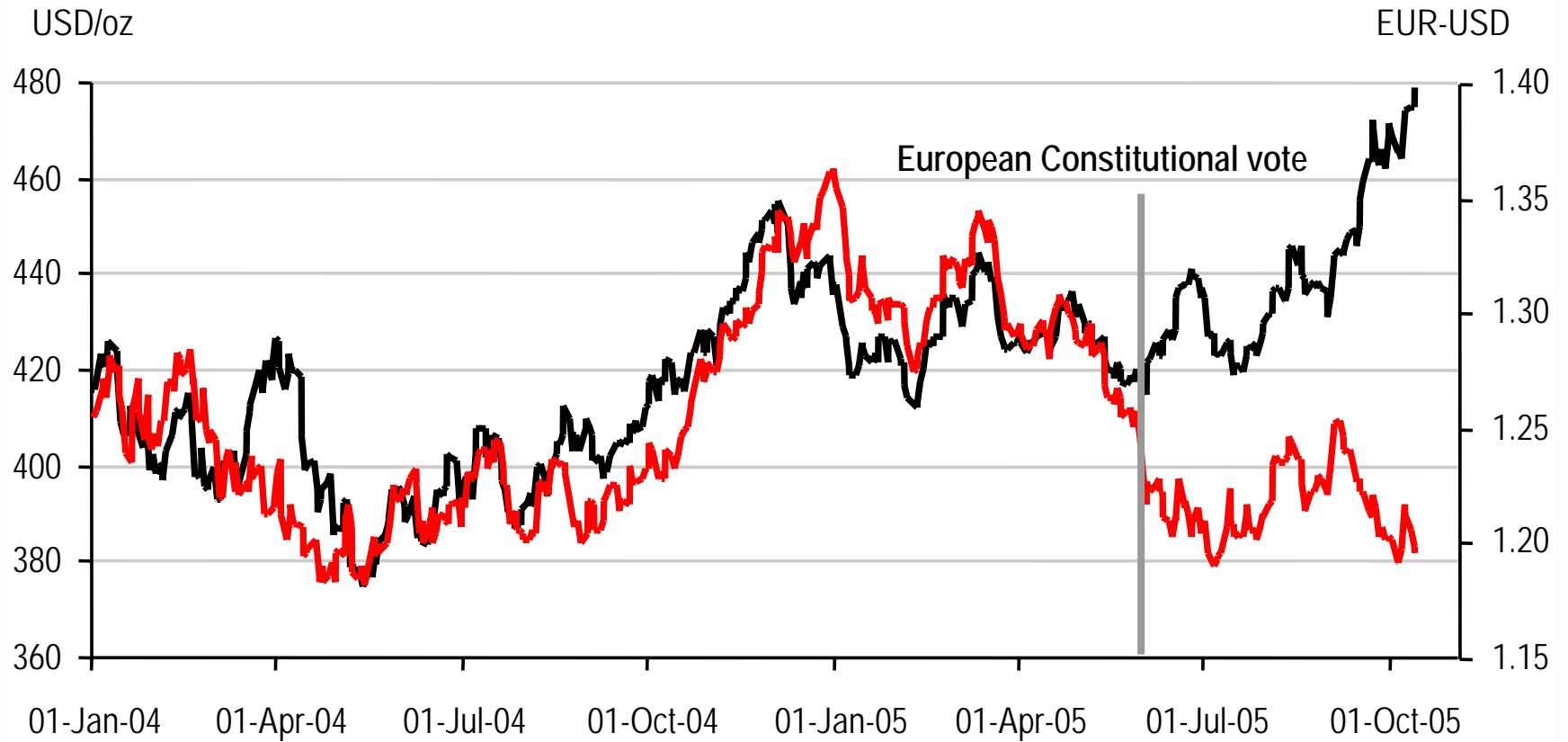
14. Assume the 'NO' has delayed the euro as a reserve currency by 10 years Then market bought too many euros



**15. Euro fall on referendum concerns started at about 1.295 fell to 1.2150 an 8 big figure fall
This is what foreign exchange is about**



16. Regime change - gold and the euro



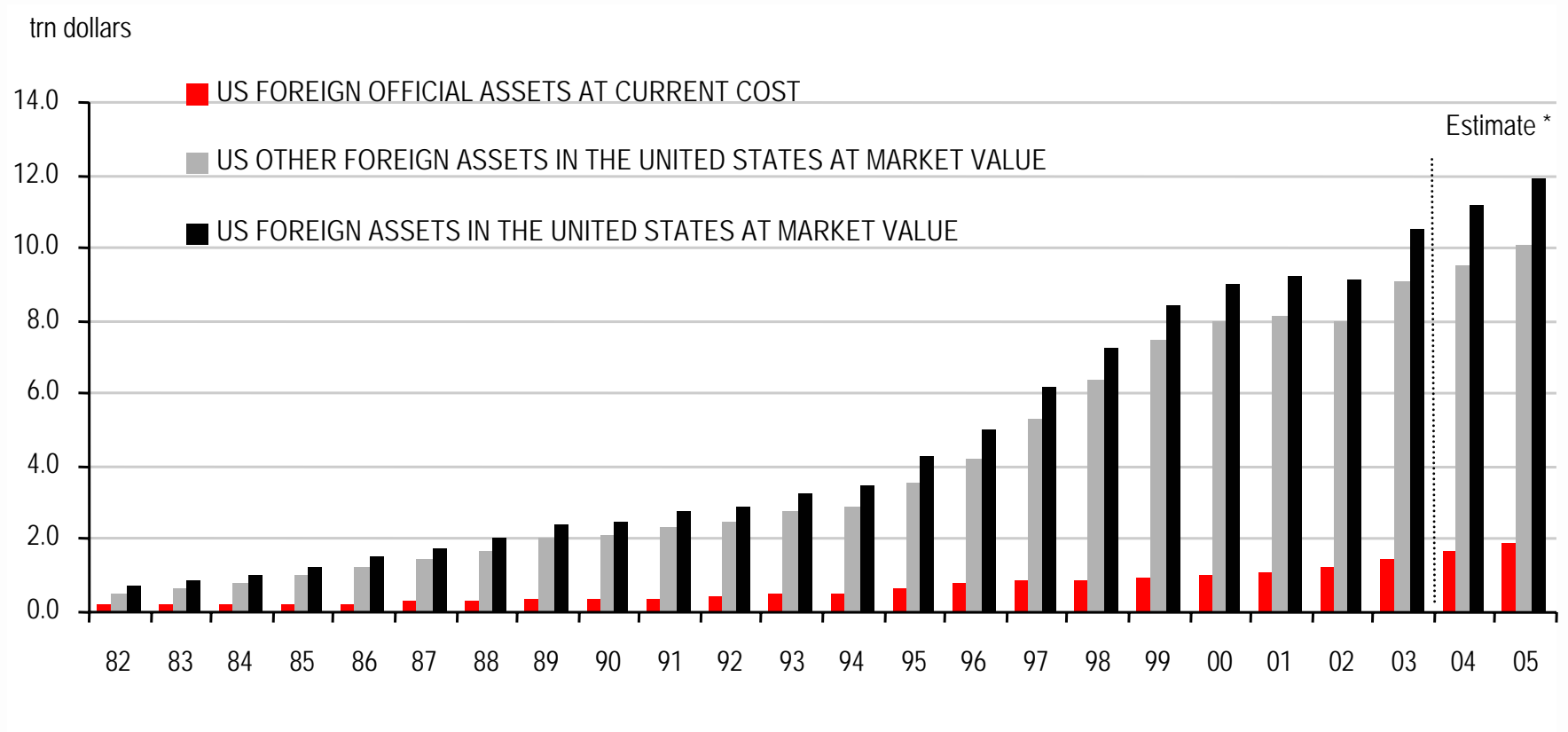
17. Italian comments in late July fail to hurt the euro - signalling an end to the euro constitutional "crisis" *and a move on to other issues*



18. ...the structural issues will resurface

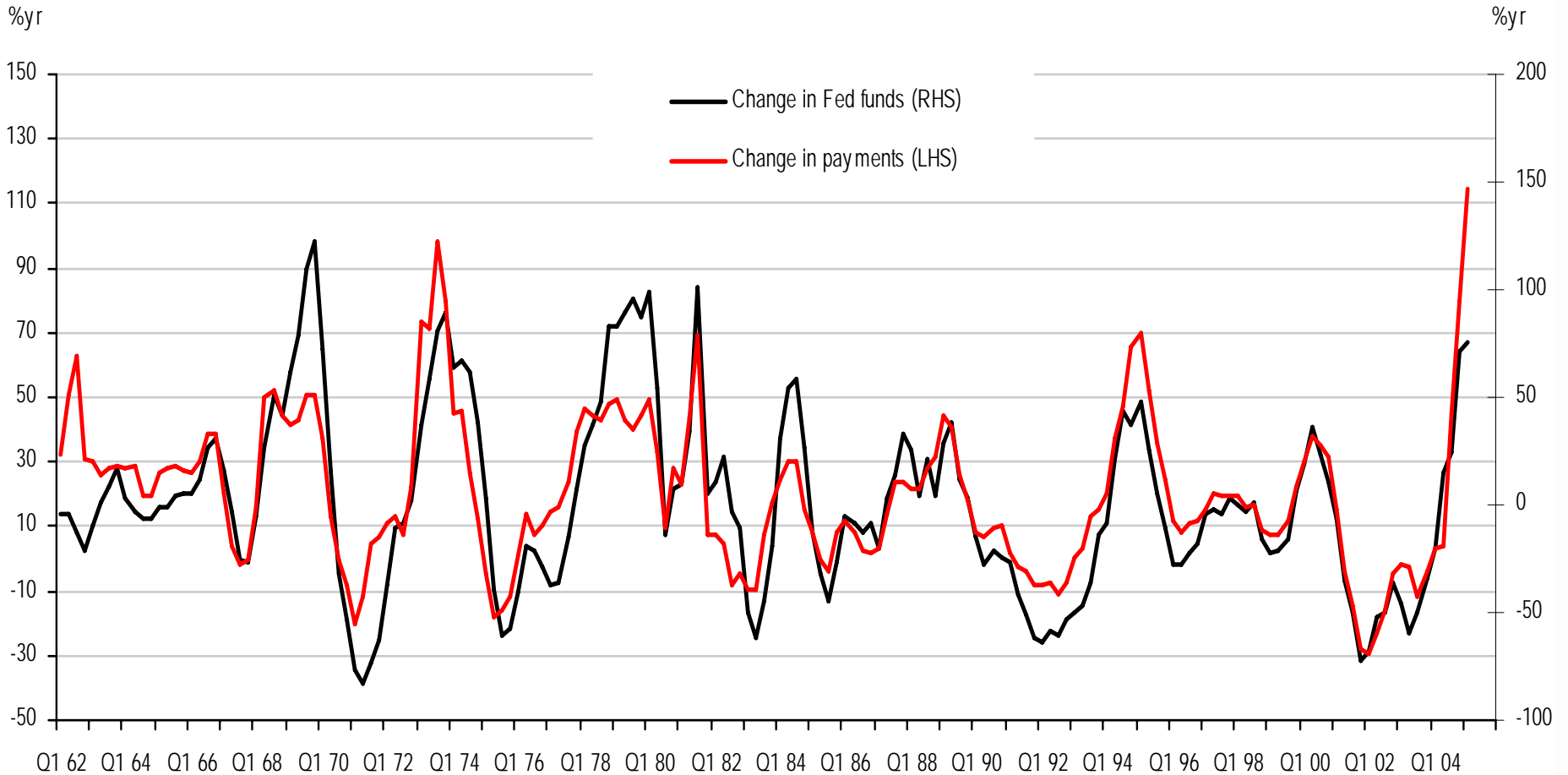
- When the US grows and cyclicality is paramount the dollar rallies
- All economies grow and they slow
- When the US slows this will re-ignite structural concerns...
- ...at that point we will get the large draw-down
- Who suffers from a lower dollar?
- US assets and liabilities do not have mismatch

19. World owns 12trn worth of US assets



Estimate based on C/A deficit of \$666 in 2004 and \$750 in 2005 and Dollars + 57% of total reserves

20. Now rates are rising - the payments will rise



21. Conclusion

- **The question is when will the market switch to a structural de-rating of the dollar**
- **This will happen when either the economy slows as consumers refuse to take on more debt or risk appetite declines for some exogenous reason**
- **Watch risk, volatility and a change in the normal pattern of trading...**
- **...do not rationalise them away by market positioning - these are the signals for the next big draw-down**

22. US personal savings have vanished

