WORLD CLINGS ONTO THE DOLLAR

Recently we have witnessed heightened demand for the dollar which has strengthened relative to the euro by over 12.5% since 17 July 2008. This may seem slightly strange considering that the US is also the main source of current global financial woes. However there is a simple explanation for this apparent paradox – the crisis on credit markets has triggered the unwinding of carry trades in the national currencies of low interest-rate economies, particularly the yen. This is clearly shown by US$/EURO and US$/JPY exchange rate dynamics and the strengthening of the yen relative to other major currencies.

Carry trade unwinding. Investors who borrowed in yen and then put funds on deposit in dollars with banks with high credit ratings are earning money based on the difference in interest rates. These funds then make their way into the interbank lending market in euro or risky dollar assets. But, plunging securities market have triggered a reversal – credit limits have been closed to cover securities portfolio losses resulting in the dollar and yen demand we have witnessed since the middle of the summer. Obviously, Central Bank cash injections will be used to unwind carry trades, a process which is likely to continue right through to the end of the year.

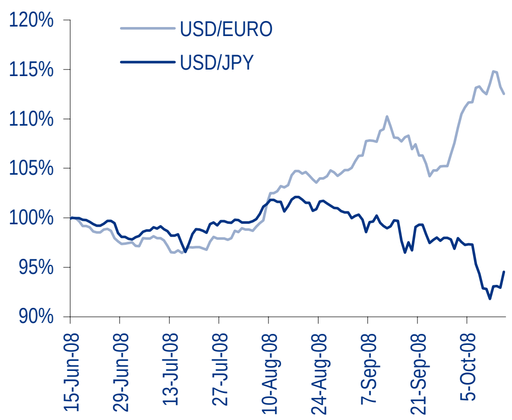
Shrinking credit market leading to recession. As carry trade positions are unwound liquidity stops flowing into credit markets (Central Bank cash injections are intended to ease liquidity strains not to support lending). This is naturally resulting in a reduction of financing available to the real economy. The current crisis is also likely to result in a substantial increase in the regulation of financial institutions by Central Banks and even make the invisible hand something that only historians argue about. Though we do not expect a full restoration of Bretton-Woods system of monetary management.

Global contagion. The outcome of the current credit market crisis and heightened regulation will be recession, first in the US then followed by a chain reaction leading to recessions all across the world. The US is the world's main consumer and the first to suffer the full negative effects is likely to be China. We believe that China will be unable to compensate for export losses with growing domestic and Asian demand over the medium term. And as the Chinese economy slows this will have a knock-on effect on natural resource and goods markets.

Financial world remains hostage to the US dollar. As the saying goes, When the US catches a cold, the world gets the flu. The reason why is that the entire global financial system is set up in such a way that the US effectively controls global money supply and all other countries are, like it or not, in effect hostages of the US currency. Particularly at risk are countries heavily dependent on imports without sufficient foreign exchange reserves to see them through the current crisis. Russia is only moderately dependent on imports and has extremely large foreign exchange reserves (third largest in the world) and so is more protected from the effects of a global recession. At the other end of the scale is Iceland which is extremely dependent on imports and is now in the midst of a serious financial crisis

No viable alternative to the greenback in the short term. At the moment the majority of global transactions take place in dollars. Dollars also dominate the world's national reserves and painful memories of the recent commodity bubble collapse have deterred an investment shift into other assets like precious metals and oil etc.

USD/EUR and USD/JPY Dynamics



Source: Bloomberg, URALSIB estimates

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The dollar is supported by all the countries of the world since it is the main reserve currency. Other national currencies on the other hand (excluding the euro which is supported by the entire Eurozone) are only supported by their national economies. As a result, other countries are set to suffer more than the US.

As for the euro, the Eurozone economy is too tied into the global financial system to suffer less severely than the US. Also, the European Union is less able to respond and introduce measures quickly in a crisis since this requires the agreement of all member countries.

More dollars inevitable. As the gaps in the balance sheets of the world's largest banks grow, it is becoming increasingly clear that the $700 bln allocated is simply not enough. Various estimates put the amount required to resolve the crisis on financial markets at $3000 bln. But where will this money come from? There are not enough free reserves in the entire world. The answer is obvious. The US will print more dollars some of which will of course be issued as US treasuries.

Inflation risk minimal. Under normal circumstances, an increase in dollars would hike inflationary risks but these are not normal circumstances. The crisis on the world's credit markets is rapidly slowing the circulation of dollars which will offset the effects of an increase in global money supply. At the same time, the looming recession in the developed world is pushing down prices for raw materials, goods and services and creating deflationary rather than inflationary pressures.

The dollar is likely to retain its status as the main reserve currency and a safe harbor in times of heightened risk, at least in the medium term:.

- **We forecast continued dollar appreciation relative to the euro despite a possible temporary decline due to technical factors;**
- **In view of the anticipated issue of US treasuries we forecast growth in yields at the long end of the UST curve in spite of deflationary risks in the medium term perspective. The most recent bubble on global financial markets, which is held in US treasuries, is likely to burst in the medium term perspective resulting in yield growth. In the near term we anticipate high volatility for risk-free assets.**

Long term prospects for the greenback. In our view an entirely realistic scenario is that large exporters will begin to gradually shift to payments for goods and services in their respective national currencies. However this will require a co-ordinated approach by all net exporter nations (i.e. political will) and favorable market conditions since falling prices create a buyer's market. We believe that the global economy may well gradually shift away from the dollar when the looming recession, which could last several years, has passed its peak. Also in the aftermath of a recession the US may discover that it has lost its kingpin position in the advent of a new global economy.

10Y UST Dynamics

Source: Bloomberg

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