

Economic Insights

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Dollar Decline

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With the euro having gained ground on the dollar—even while the yen, until very recently, had lost ground—currency again has become a prominent topic of investment discussion. The still huge American current account deficit has dominated much of this talk, as it should. This imbalance has weighed on the dollar, and likely will continue to do so. But foreign deficits are not the whole story on currency. Investment flows also matter greatly. They help explain the divergent behavior of the yen and the euro. They also will likely moderate any dollar decline going forward.

These recent, divergent currency moves have attracted much attention because, typically, the yen and the euro move together against the dollar. They both began to rise against the dollar in early in 2002, and continued that mutual ascent through 2005. There was, however, a difference in *degree*. The euro during this period rose against the dollar by about 60 percent and the yen by about 25 percent, but clearly they had a common direction. Similarly in 2005, both currencies lost ground against the dollar: the euro by just short of 15 percent and the yen by just over 15 percent. But beginning early in 2006, these two key currencies parted company. Since first quarter 2006, the euro has risen about 11 percent against the dollar, while the yen (until this recent market turmoil prompted a yen rally) had lost just over 6 percent of its dollar value. Clearly, something else is happening in currency markets beyond the general U.S. foreign account deficit—and it has to do with divergent investment climates in Europe and Japan.

Euroland has an improving economic story. Growth is not, for example, good by Chinese standards, surely, or even American standards, but it has improved nonetheless. The eurozone's gross domestic product for fourth quarter 2006 came in more than 3 percent above its level of fourth quarter 2005. Germany seems to have weathered its increased value-added tax without the extreme consumption cutbacks many had feared. Both business and consumer confidence in Europe have risen during the past year—the former by a bit more than 15 percent, the latter by less than 10 percent. Investor interest in European equities has followed these improvements, driving up European equity markets during the past year faster than their American equivalents. That investor interest has, of course, brought money into the euro and pushed up its value against the dollar. Meanwhile, the improving economic fundamentals have allowed the European Central Bank to lift short-term interest rates relative to dollar-based rates, attracting still more money at the margin.

In contrast, Japan's economic fundamentals have disappointed. After showing signs of a good economic recovery earlier in 2006, Japan's economy has shown more recently that it seems incapable of rising much above a 2 percent annual growth rate. Even though the gross domestic product showed good growth during the fourth quarter, much reason remains to doubt the sustainability of the improvement. In particular, Japanese retail sales—considered all important for a sustainable Japanese recovery—continued to decline right through December (the last period for which data are available), and indicators for January show an even sharper decline. Meanwhile, the Bank of Japan (BOJ) has not raised rates enough to stem the flow of funds out of the yen seeking higher yields in dollar-based markets. What is more, the questionable state of Japan's economy leads most to conclude that the BOJ will not raise rates any further.

Looking forward, even though America's current account deficit will likely keep the dollar moving downward, these investment considerations will act as a limiting factor in that move. China's currency policy is key. Beijing, of course, has removed the rigid peg it once maintained between its currency, the Yuan, and the dollar. But it still manages the exchange rate to prevent much rise in the Yuan against the dollar. China's policy effectively means that any currency—the euro and the yen included—that rises against the dollar will also rise against the Yuan, putting those strong currency countries at an even greater export disadvantage to China than they already are. And since much of the rest of Asia takes its cue from China, any such euro and yen increase would extend that trade disadvantage to the rest of Asia.

Such disadvantages—especially since the eurozone and Japan are highly export-dependent—would present those economies with a damaging situation. The Bank of Japan would hardly let such a problem develop. If the yen were to rise too far, the BOJ would intervene in currency markets to protect Japanese exports by preventing too much of a yen rise against the dollar and, by implication, against the Yuan. The European Central Bank is not as prone to intervene in currency markets as is the Bank of Japan. But eurozone bankers and finance ministers would do what they could to talk the euro down and thereby hold back China's export advantage. Indeed, they are already beginning such a campaign, noting how recent euro strength against the dollar and the yen has damaged whatever competitive edge those currencies had against Chinese competition in particular and Asian competition in general. But if European officials were to fail in their efforts to stop the currency rise, a different governor would enter the equation. With weakened exports, Europe's export-dependent economies would start to show recessionary signs. Investment flows would respond by rolling out of the eurozone and the euro, in part into dollars, thereby moderating the dollar's descent and the euro's ascent.

The confluence of these considerations hardly makes for an exciting currency outlook. But a forward-looking picture of moderate dollar weakness against key currencies seems most likely nonetheless.

Milton Ezrati, Partner and Senior Economic and Market Strategist for Lord, Abbett & Co. LLC, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times*, *The Financial Times*, *The Asian Wall Street Journal*, *The Christian Science Monitor*, and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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