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Investor Info
Investment Commentary

Are fallen dictatorships weakening the USD?

The current Investment Commentary addresses the question of why the US dollar continues to weaken alongside the events in the Middle East and North Africa.

The world has been watching the events in the Middle East and North Africa with great interest. Analyses of these events vary depending on the interests of the observer. A majority of the world's population clearly welcomes a political upheaval in the Arab world, especially since the revolutionary changes set in motion by the middle of society are decades overdue. Like never before, the world is united in the belief that monarchies and autocracies belong in a chapter of world history that should have been closed long ago.

Impact on oil prices

From the perspective of the oil supplies, the importance of the current changes in North Africa is becoming clear. Although the volatility of the price of oil might suggest otherwise, based on numbers from the end of 2009[1], North Africa's role in terms of energy supplies appears to be minor. While the region currently in turmoil exported around 2.8 million barrels of oil a day in 2009, the figure for the Middle East was an impressive 18.4 million barrels of oil, representing a third of all oil exports worldwide. In comparison, Western Europe and the US imported around 13.5 million and 9.5 million barrels of oil per day, respectively, in 2009. Add to that the fact that, at the end of 2009, around 57% of all oil reserves were still located in the Middle East, suggesting that the region will remain relevant to the world economy in the future regardless of the tapping of alternative energy sources.

The largest oil exporter in the Middle East is Saudi Arabia with an export volume of 7.1 million barrels a day. Should popular anger cause this monarchy to falter as well, we could very well see the USD 200 per barrel prices rashly predicted by Goldman Sachs in 2008. High volatility in the price of oil would then be thoroughly justified.

[1] See: BP Statistical Review of World Energy, June 2010

The US dollar still a safe haven?

Parallel to the events in North Africa, an unexpected development has emerged on the currency markets. Over the last several years, the USD has gained against other currencies due to risk aversion on the part of market participants based on globally relevant negative events. This time, however, the safe haven effect has been notably absent. On the other hand, we are seeing it again in the CHF and JPY. The US has apparently lost its appeal as a safe haven, at least in this case. But what might be the cause of this development, and is it temporary? I see two plausible arguments in this case.

1. Inflation risk

First, the inflation risks of the USD appear to be the subject of greater focus now than at other times. This comes especially as a result of comments made recently by Pimco, the world's largest bond investor. Pimco increasingly fears that the US may attempt to decrease its debt load especially through inflation, among other strategies. This would force all holders of US dollars to take part in coping with US-specific problems. According to Pimco CEO El-Erian, the vast amount of liquidity being pumped through the US economy as a result of bond purchases by the Fed is spreading quickly in all directions, including developing countries.

A quick look at the figures shows that inflation is in fact growing worldwide, with very few exceptions. Certainly, inflation growth is not solely the result of the Fed's policy. Still, Pimco's statements are not likely to be entirely false. Understandably, some investors are not currently keen on fleeing to a currency that is at risk of devaluation.

2. Loss of power

Like in the economy, unsustainable imbalances are being seen in the area of world politics as well. The second major reason behind the reduced appeal of the USD may be the result of such an imbalance. The importance of the USD as a safe haven currency depends directly on the United States' role as the dominant world power. The more influence the US loses, the more likely the US dollar is to lose its importance at some point. The developments in Africa point in this direction. The fact that an Iranian warship passed through the Suez Canal for the first time in 30 years could not be more symbolic of the United States' loss of power.

Conclusion

The ARVEST Investment Committee assumes that the new trend triggered by the events of September 11, 2001, in which political circumstances increasingly impact the markets, remains intact. Therefore, incorporating geopolitical aspects into market analyses will continue to be essential. The events of recent history have further strengthened the Investment Committee's belief that the weakening of the USD as a safe haven currency may not be a temporary phenomenon.

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