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ALL ABOUT THE (PLUMMETING) DOLLAR AND (SKYROCKETING) OIL
What Goes Up Must Come Down (and Vice Versa)

Welcome to another glorious summer. So, how are those vacation plans looking about now? Interested in a few weeks on the Italian Rivera or the South of France? Well, the (near) record low valuation of the dollar vs. the euro might just make that trip cost prohibitive. How about a nice cross-country family driving excursion to see the sites of the good ol' U.S. of A? Well, (near) record gas prices could put a damper on that pocketbook and force more than a few "meal deals" from the nearest local fast food joint. The dollar is weak; energy prices are high; the timing could not be any worse. Then again…welcome to another glorious summer.

A Dollar Doesn't Buy What It Used To…

While the dollar had been declining against the major world currencies for the past few years, the true devaluation began last summer as the subprime debacle and related credit crisis picked up steam. The Federal Reserve initiated a policy of cutting short-term interest rates with hopes of limiting the negative effects on the domestic economy. Subsequently, the fed funds rate fell from 5.25% to 2.0%, though many of the world's central bankers chose not to implement a similar rate cut policy. As a result, foreign currencies like the euro steadily rose against the dollar and many global investors moved out of dollar-denominated securities in search of higher yields abroad. In April, the dollar plunged to an all-time low of over $1.60 vs. the euro, a drop of over 18% from the valuation of the past year.

For months, many investors tried to downplay the downturn. After all, the U.S. had long been home to the strongest economy in the world and historically investors have sought the safe-haven of dollar-denominated securities regardless of its strength or weakness. Then again, investors these days can be a "greedy" bunch and, with profit as a significant motivator, many began shying away from securities that were tied to a currency being devalued more and more with each passing day.

Likewise, nervous investors began to focus on the dual U.S. deficits (budget and trade) and closely analyzed the daily economic releases as the domestic housing weakness began negatively impacting the manufacturing sector and labor market as well. Additionally, for the past few years, public sentiment in some global circles had turned against the U.S. based on certain political and trade policies and related actions. Suddenly, its standing as "global economic superpower" was in jeopardy as well. Once the euro surged above the $156 level, the combined GDPs of the 15 countries that use that currency actually exceeded that of the U.S.

…And Certainly Not As Much Oil As It Used to…

While the dollar has been on a steady decline, oil prices have followed in step with the rise in value of the euro practically to a tee. In fact, the correlation of the price of crude vs. the euro (per dollar) has been 0.96 over the past 12 month, an almost perfectly positive relationship.

Surely, political turmoil in Nigeria, South America, the Middle East and elsewhere have contributed to the rise in energy prices. Likewise, supply concerns have escalated and analysts anticipate a further rise in domestic demand over the summer months. While gas usage in the U.S. may be impacted by the higher prices, countries like China and India continue to experience dramatic growth and are greatly contributing to global energy consumption. For the time being, OPEC seems content to maintain its current production output and blamed failed U.S. economic policies for the dire domestic conditions. The cartel next meets in September and only recently gave slight overtures that an early consultation may be in the cards. And news that Venezuelan President Chavez had been supporting rebel forces in Colombia could bring sanctions against his country and prompt retaliation on his part in the form of reduced oil sales.

And yet, many analysts believe that greater forces are at work in the prolonged energy price surge than mere supply/demand issues. A weaker dollar helps propel the costs of oil and other commodities higher as U.S.-based producers and manufacturers demand more to help compensate for lost profits from the currency devaluation. In anticipation of these price moves, some investors speculate by buying commodities and engaging in trades to hedge against the dollar's weakness. These hedge funds may employ the use of leverage in purchasing oil and other commodities so the price movements can be even more dramatic. Technical traders jump in as charts reveal new buying patterns and prices move beyond prior resistance levels. And then come the "expert" market prognosticators.

Recently Goldman Sachs made a bold prediction that oil could reach $150 to $200/barrel over the next six to 24 months and prices again skyrocketed to record highs. At that time, crude stood around $120/barrel and had surged about 30% on a year-to-date basis and virtually doubled from last year's level. Energy analysts claimed that $150/barrel crude would suggest gas prices of over $4.50/gallon, a level few could have imagined months ago and one that would hinder many travel plans, domestic or abroad. Meanwhile, presidential hopefuls Hillary Clinton and John McCain pushed for a "gas-tax holiday," despite consensus economic views that such policy would benefit oil companies far more than consumers.

Fear Not: The Fed to the Rescue (Again)…

When the Fed lowered interest rates to 2.0% in late April, the accompanying statement implied that the latest 25 bps cut would be its last move for a while as the policy-makers sat back and gave the economic stimuli time to take effect. After all, over the past few months the Fed had engaged in a few other "creative" actions when investors were growing quite nervous about the ever-expanding credit crisis. Additionally, the dreaded "I" word was beginning to creep into daily water cooler conversations thanks to escalating oil prices, and further rate cuts could prove detrimental to the inflation picture.

Investors and (currency) traders alike welcomed the news from the Fed as a more stable interest rate policy would prove quite beneficial to the weak dollar. Suddenly they no longer would need to seek the new perceived safe-haven of euro-dominated securities as domestic rates would not be falling relative to their international counterparts. Additionally, certain economic releases offered signs that a potential rebound was drawing closer and the Fed's actions may be working as planned.

In light of the Fed's latest comments (and expected inaction), some analysts predict that the dollar could shift gears and begin to climb again with commodity prices falling in step. They believe that valuations are not reflective of current economic conditions or supply/demand issues, and sheer speculation had prompted exaggerated movements in recent months. Some investors may look to take profits from favorable energy and other commodity trades, while hedge funds may unwind levered positions that could result in significant price corrections. While the domestic economy has a ways to go before full-fledged recovery, some early signs have indicated that the worst of the news is now out in the open and the downturn may be close to rebounding. In other words, don't cancel that glorious summer vacation quite yet.