

- USD volatility expected to rise further in the coming months.
- The structural external imbalance in the US, while it continues to grow, takes a backseat temporarily as market participants consider the interactions of the USD-“friendly” forces.
- USD weakness vis-à-vis the Asian regionals and JPY currencies could resurface in the coming months.
- The trajectory of the USD against the major currencies excluding the JPY should be driven primarily by on-going developments in the US rather than by external developments.

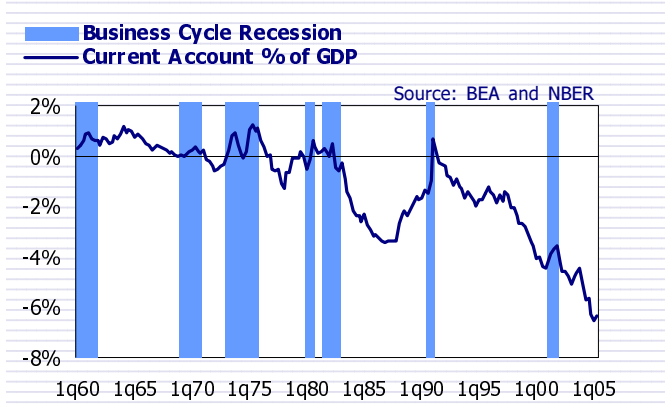
The Reactionary USD: Just the Tip of the Iceberg

Both the real broad and major trade-weighted USD indexes reached a peak in July and have fallen by about 1%-2% (the nominal indexes apparently slipped by slightly more) since then. Although the major currencies have on balance strengthened against the greenback, the degree of volatility--as evidenced by the rolling 20-day standard deviation--has also risen broadly, with the exception of the AUD/USD and USD/CAD pairs. The choppiness among the foreign exchange majors relative to the USD suggests that market participants, in view of the rising degree of global uncertainty, have not been willing to push the respective currency pairs convincingly in one direction or another.

Structural External Imbalances Still Persist

Since the beginning of the year, we have written quite extensively on the potential risks associated with the eventual adjustment process and the negative spillover effects of the US current account deficit on the broader economy. This presumably reflects an acute loss of confidence on the ability of the US to sustain a burgeoning current account deficit and/or attract inflows as risk-adjusted returns on USD-denominated assets diminish vis-à-vis other foreign currency assets. The resulting impact from the preceding development is that US financial markets could fall hastily and disorderly, which would reinforce a run on the USD and a sharp rise in interest rates. Surely, if the financial asset (a significant rise in yields would also affect the housing market) price declines proceed in an unruly and steep fashion, the wealth effect combined with the spillover into invest-

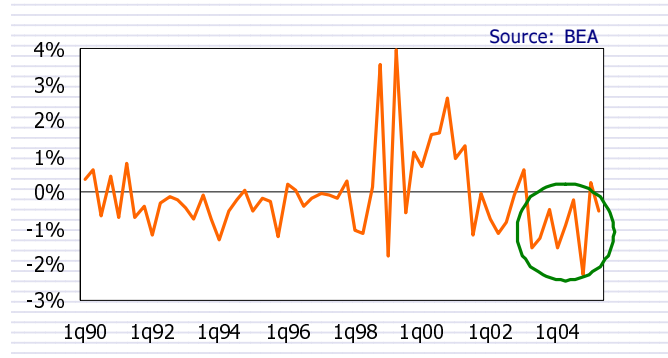
The Persistent U.S. Current Account Deficit



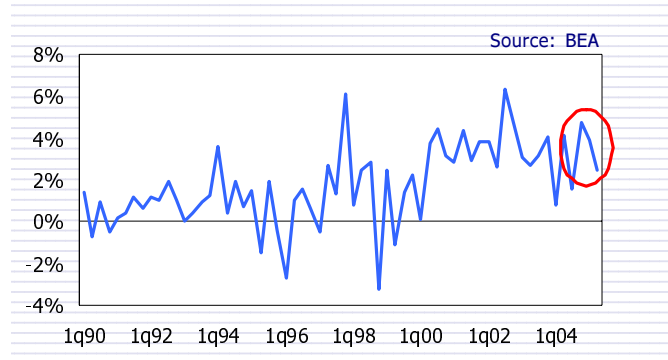
	2003	2004	2005F	2006F
GDP	3.0	4.4	3.6	3.0
CPI (y/y)	2.3	2.7	3.3	2.4
Unemployment (Q4 average)	5.9	5.5	5.1	5.4
Current account (% of GDP)	-4.8	-5.7	-6.4	-6.2
Fiscal balance (% of GDP)	-3.5	-3.5	-2.9	-3.4

tor confidence would probably engender an unprecedented re-trenchment in the other components of aggregate demand, result in a severe contraction in the US economy and lead to further weakness in the greenback. Interestingly, the "doom-and-gloom" scenario has continued to permeate the market despite the recent modest reaction to the trade, current account and long-term portfolio flow data releases in the US.

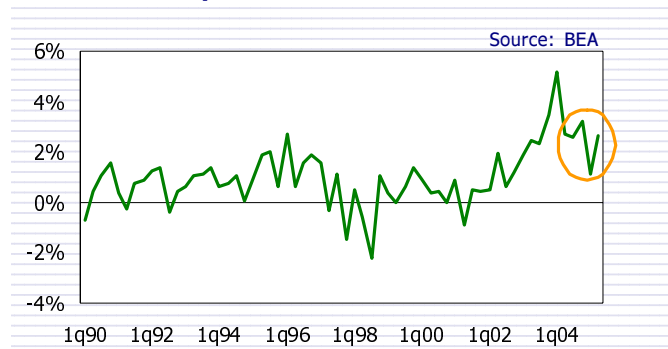
BOP: Net Foreign Direct Investment (% of GDP) Still Negative...



BOP: Net Private Flows (% of GDP) Eased in 2q 2005



BOP: Net Official Flows (% of GDP) Recovered in 2q 2005



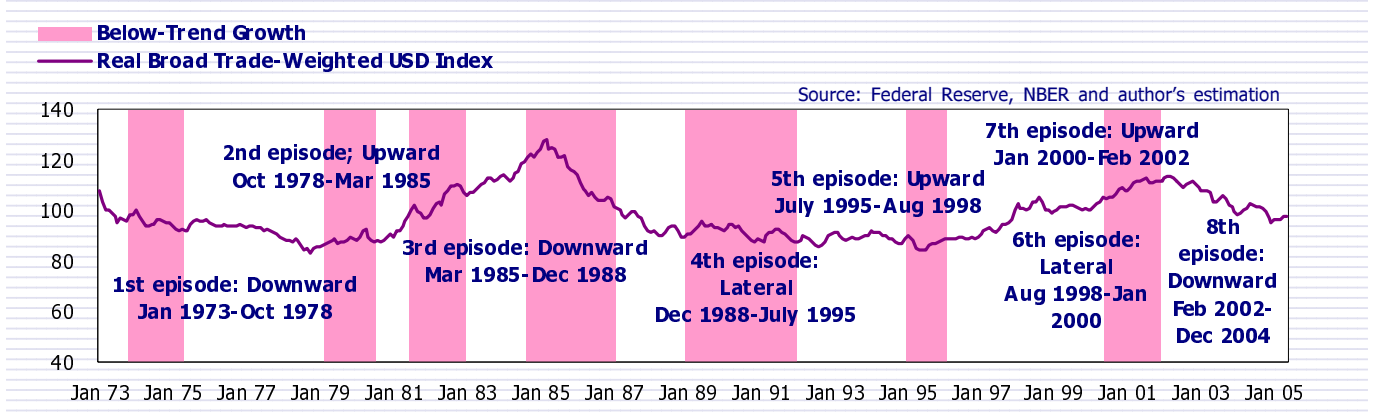
Ironic, Yet Compelling, USD-“Friendly” Forces

In our judgment, one reason for the apparent "insensitivity" of the USD to the external trade and capital account data releases is perhaps related to the willingness of foreign central banks (in particular Asia including Japan) to continue to accumulate USD reserves in order to mitigate the volatility and manage their foreign exchange rates, probably as a result of their continued dependence on export-led growth and their gradual approach to greater foreign exchange flexibility. Another reason is perhaps due to the lack of alternative sources of foreign currency investments that yield comparable risk-adjusted returns relative to USD investments. In addition, given the current large composition of USD reserves in Asian central bank portfolios, naturally it is against the interest of the respective central banks to promote a significant USD depreciation because of the magnitude of unrealized losses. Also relevant in the discussion is that the share of the US economy in the global economic backdrop is still fairly significant (roughly one-third, and far greater when adjusted for the degree of import absorption), and as a result, if US economic growth slows appreciably, it would undoubtedly impact the positive trade flows of the current account surplus countries (predominantly in emerging Asia). A growth slowdown in the current account surplus countries would probably lessen available investment opportunities in the respective countries and temper the USD weakness.

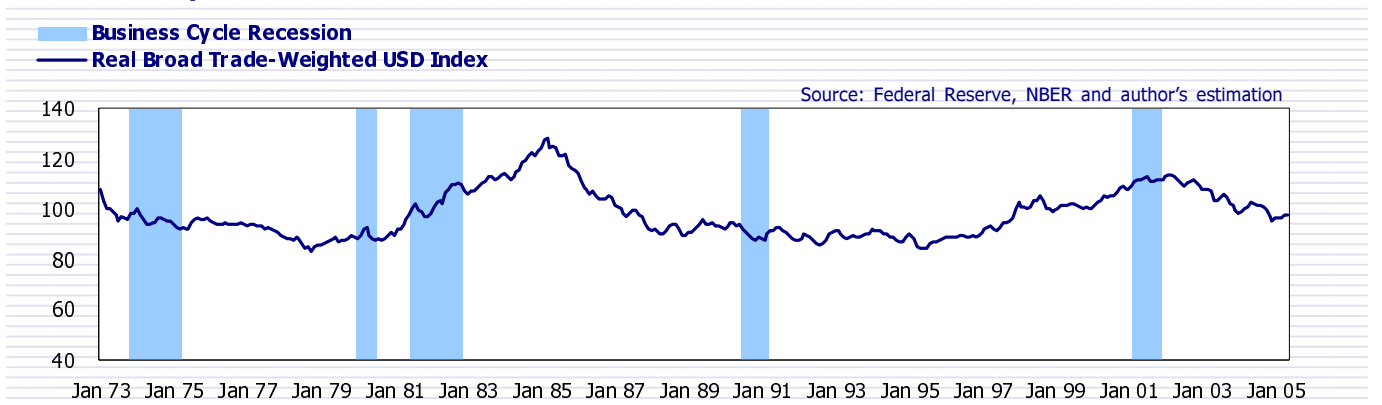
More Intricacies in the USD Equation

After taking the foregoing factors into consideration, although the structural bias is for a weaker USD over time, countervailing forces are at work to keep the USD from overshooting. However, if domestic-led economic growth in the rest of the world becomes more sustainable, US growth surprises on the downside considerably and perhaps Asian preoccupation with USD reserves diminishes gradually and so on, the USD would probably have more room to depreciate and assist partially in the external adjustment process. Nevertheless, the historical evidence shows that the relationship between the real trade-weighted USD index and episodes of sub-par growth in the US has been fairly mixed. This implies that a sub-par growth episode in the US alone would not necessarily lead to a weaker USD per se, presumably because of the negative spillover into the rest of the world, given the undue dependence on the US growth locomotive. This suggests that the greenback, at least for the time being, could be more resilient than conventional expectations. If anything, the aforementioned external factors appear to be more structural in nature, and hence require more time to evolve. Nonetheless, this does not suggest that the USD could not depreciate or appreciate temporarily over the next several months against the major and Asian regional currencies if near term factors instigate a shift in market sentiment and lead to temporary portfolio adjustments.

Sub-Par Growth & Real Broad USD Index



The Business Cycle & Real Broad USD Index



Note: Sept 1985: Plaza Accord and Feb 1987: Louvre Accord

More Volatility in the Pipeline

As best we can judge, some of the near-term factors (within the US and outside of the US) suggest a heightened degree of volatility in the USD in the coming months, as market participants remain unwilling to bet decisively in one direction or another. The on-going "Asian flavor" in the market, in particular actions/speculations related to the Chinese foreign exchange regime flexibility issue, implies a modest appreciation of the Asian regional currencies including the JPY relative to the USD in the coming months (the USD/JPY probably has more room to fall because of its greater liquidity conditions and relatively less inter-

ventions compared with the Asian regional currencies). On the other hand, the major currencies excluding the JPY would probably continue to fluctuate in a broad trading range against the greenback, as relative fundamental and technical factors remain fairly moot. Essentially, the extent of the fluctuations of the major currencies excluding the JPY over the next several months would probably be driven by on-going developments in the US (i.e., US economic backdrop following the Hurricanes, evolution of Federal Reserve policy, potential financial market reaction, etc) rather than by external developments in the respective countries.