FINANCIAL ARCHITECTS INC.

Capital Blueprints for the Future

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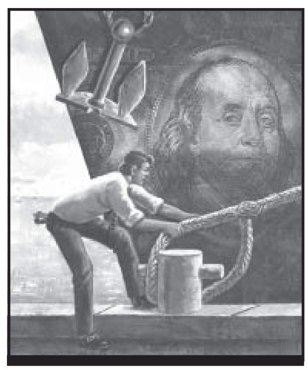
The Sinking Dollar

Will currency trends affect U.S. growth?

A SIZZLING ECONOMY and booming stock market attracted foreign investment to U.S. shores in the late 1990s. The influx of overseas capital drove the dollar higher. Now the dollar is trading near a record low vs. the euro and has fallen relative to other major currencies.[1]



With the economy rebounding, financial pundits have turned their focus to the declining dollar and its relation to the trade and budget deficits.[2] Many are worried that a further currency slide will disrupt the U.S. recovery and stall other major economies across the globe.

Don't let the alarm sidetrack you from understanding what's really at work in the currency markets. Here's a primer to help you keep a balanced perspective of the dollar's fate:

• **Markets, not governments, drive exchange rates.** In the short term, governments can manipulate the dollar's value relative to their currencies. But long term, the dollar, like all currencies, bows to market forces. Exchange rates essentially reflect the global forces of supply and demand.

For instance, the dollar rises against another currency when there's a net inflow of dollars into the U.S. This occurs when foreign demand for American products, investments, debt instruments and tangible assets is high. The dollar weakens when there's a net outflow of dollars from our shores. This results from U.S. businesses, consumers and investors sending a disproportionate share of dollars overseas while foreign demand for U.S. currency and assets is falling.

• **Currency trends are hard to forecast.** Currencies move in cycles, following economic performance and trade activity. But these trends are often unpredictable and lagging. And different monetary policies between nations can briefly distort exchange rates. Recent events in the U.S. and European exchange markets demonstrate this. The dollar remained strong well into the recession, then began sinking in 2002. And now, despite a rebounding economy, the dollar has continued its downward slide.

Some economists blame the dollar's weakness on the "twin deficits" of trade and federal spending, while others emphasize low interest rates and economic slowdown. In any case, the U.S. capital markets are not attracting a large enough flow of foreign money to support the dollar.[3]

In recent years, the U.S. has looked to a large, continuous flow of foreign capital to fund business investment and government spending.[4] This suggests that the U.S. financial system is vulnerable to the whims of foreign investors and governments. But the dependency is a two-way street. About 80% of our capital inflows come from countries that would experience major recessions without the U.S. as their primary export customer. A weak dollar works against their economic interests, so central banks buy dollars to support its value.[5]

• **Currency views are mixed.** Does a strong or weak dollar benefit Americans? Weak dollar proponents say that a falling currency makes U.S.

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(1) The dollar has fallen much more against the euro (down about 46% since October 2002) than against Japanese and other Asian currencies. The dollar has not changed relative to China's yuan since China pegs its value at 8.3 to the greenback. ("The Incredible Falling Dollar", BusinessWeek, 22 Dec. 2003, pp 36-38.)

(2) A trade deficit arises when the U.S. imports more goods than it exports. In 2003, the gap reached $550 billion—or about 5% of Gross Domestic Product (GDP). This, combined with a federal budget deficit in the $560 billion range, has placed downward pressure on the dollar. ("The Dollar in Distress", Fortune, 13 Oct. 2003, pp 39-40.)

To keep the dollar from falling, the U.S. financial markets must attract enough foreign capital to overcome the imbalance. Over time, this is accomplished by offering higher interest rates and higher expected returns on equities. During the 1990s boom, foreign money flows kept the dollar strong against other currencies. But the dollar began dropping midway through the recession in 2002.

(3) The U.S. needs to attract about $50 billion a month in net foreign purchases to cover its current account deficit. From January to August 2003, the average level of net foreign capital inflows was $65.5 billion. But this has dropped to $28.5 billion in late 2003. ("Worries About the Dollar Enter Stock Radar Screens", The Wall Street Journal, 22 Dec. 2003, C1.)

BALANCE & Purpose

To balance one's life is to bring all areas of life into a state of equilibrium or stability. Focusing on only one or two areas of life can work for awhile (and is sometimes necessary), but eventually life will begin to feel out of kilter and then start spinning out of control.

For example, individuals may have this experience when their careers have taken precedence at the expense of other areas of life such as relationships, leisure, or health. Hopefully this imbalance can be recognized and corrected before important relationships disintegrate, leisure becomes a forgotten art, and health is compromised. If not, these losses can multiply and greatly affect the success and fulfillment each stage of life can provide.

Therefore, it is important to remember that money can act as a tool for achieving our goal. However, financial resources alone cannot produce the essential ingredients of a rich and rewarding life such as happiness, good health, loving relationships, and meaningful activities. When you have identified your values and clarified your priorities, then you can make your decisions purposefully in all areas of life.

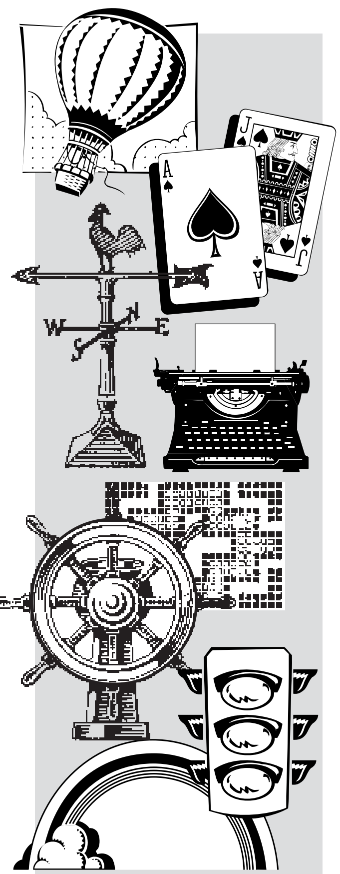
Undeniably, quality of life means different things to different people. Therefore, your own definition will be unique to you. In addition, it is important to focus on the premise that life is multifaceted and that each facet contributes to the life satisfaction you will experience.

Think of each facet as an integral part of your total "life portfolio." It is your investments of time, energy, and money that will make your portfolio grow. Once you have a clear definition of what "true wealth" means to you, then you can invest in each area of life in a purposeful way. Are you experiencing the "return" from your investment that you should expect? If not, it's time to re-evaluate and re-balance your life portfolio! ■

No Rules Retirement

New Perspectives for Midlife and Beyond

The concept of retirement is undergoing a metamorphosis. Demographic, societal, and workplace trends have all converged to offer a stage of life at mid-life and beyond that is much more fluid and flexible than what most of us had imagined.



When planning for retirement, the "old rules" have been thrown out, and individuals are discovering that "no rules" apply. "Retirement" has become a matter of personal definition.

No longer is retirement equated with not working, leisure, and being old. Instead, individuals are likely to experience multiple "retirements"—moving from one endeavor to another from age 40 to 90 or beyond! Others will choose career sabbaticals to pursue new learning, personal renewal, or volunteer service. Others will stay within their career paths, but find renewed enthusiasm by taking on a new assignment or by adopting a new work style such as part-time, free-agency, or telecommuting.

"No Rules Retirement" is a new way of thinking about your future. Instead of "not working," retirement has come to mean emancipation—freedom to do the kind of work (paid or unpaid) you find most meaningful and freedom to enjoy the lifestyle you find most fulfilling.

A recent AARP study, Baby Boomers Look Toward Retirement, indicated that more than 80 percent of this generation believe they will continue to work in their retirement years. This growing interest in post-retirement work is confirmed in other studies as well.

Dr. Phyllis Moen, director of the Cornell Retirement and Well-Being Study, believes that our society should respond to this trend by developing new perspectives on the nature of work. "This includes an appreciation for volunteer work and new opportunities for part-time, part-year, and paid employment." The results of her study indicate that retirees want to engage in meaningful, productive activities.

Whether paid or unpaid, it is especially important that your "work" in retirement enhance your self-worth and personal identity. In her book, *I Could Do Anything if I Only Knew What it Was*, Barbara Sher explains that the first step to finding work that "fits" you—matches your skills, interests, values, and preferences—is to understand the connection between doing what you love and doing something worth doing.

At that intersection you will find meaning. ■

Sinking Dollar
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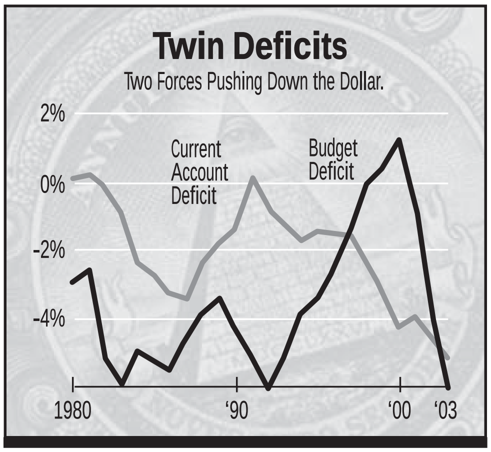
goods cheaper and imports more expensive. This pricing disparity helps boost economic growth by raising demand for domestic goods (at the expense of foreign goods) while slowing the migration of factories and jobs to foreign sites. A cheaper dollar gives U.S. companies more room to raise prices while staying competitive with imports. Domestic companies gain market share while their foreign subsidiaries experience improved profits when sales are converted from higher local currency to dollars.



Strong dollar proponents claim that a weakened currency hurts the business environment, raises prices for consumers and drains capital from the stock and bond markets. When foreign investors leave the U.S. markets, the Federal Reserve must eventually raise interest rates to attract more capital. This, combined with higher prices, ignites an inflationary trend. These events curtail consumer spending, business investment and economic growth.

A weakening dollar may point to deeper business problems—such as low productivity, runaway costs and inferior products—that are making U.S. companies uncompetitive in the world markets. Strong dollar advocates also question many of the assumed benefits of currency debasement. Exporters and retailers, who cannot immediately change their arrangements with foreign suppliers, must pay higher production costs, which are passed along to consumers.[6] Also, some economists believe that America's trade gap results more from its economic growth rate than from the dollar's value. A vibrant economy raises domestic demand. If U.S. factories are running at full capacity and cannot meet this demand, buyers look to foreign producers to close the gap.[7]

• The dollar affects fortunes and economies. The dollar is the world's business currency. It is broadly accepted as the preferred medium of exchange in most international transactions. Most countries outside Europe use the dollar as their primary intervention currency. Asia, the Middle East and Latin America hold 90% of the world's international reserves—most of which are dollar denominated. These three regions also are the largest holders of U.S. debt. China and Japan also run the largest account surplus with the U.S. and are inclined to unofficially peg their currencies to the dollar.[8]

Large, export-driven economies cannot afford for the dollar to slip and American buying activity to stall. This is why Japan, China and other Asian economies regularly intervene in the markets to keep the dollar high against their own currencies.[9] Europe is the largest foreign holder of U.S. equities. A massive sell-off would further drive down the dollar, raise the price of European goods and threaten the Continent's current export-driven recovery.[10]

Most countries have a continuing stake in the dollar's strength. During times of uncertainty, countries hold the dollar because it reflects the stabilizing influence of U.S. economic power, military strength and political balance. And during good economic times, the highly liquid dollar (along with dollar-denominated assets) serve as fuel for continuing expansion. This gives the U.S. a continual line of credit and gives other regions the stability of dollar-denominated assets and a reliable export market.

• The dollar has fallen at the right time. A strong dollar helped the U.S. during the mid 1990s. It made imports cheaper, which held down inflation and satisfied consumer demand, which was growing beyond what U.S. companies could supply at full utilization. The situation reversed midway into the last recession. Today, early into the recovery, U.S. factories are running at only 73% of capacity, which is a 40-year low. Inflation has been minimal, with consumer prices growing at only 1.3% in 2002. In fact, the Fed has signalled its concern over the threat of falling prices and has committed to keeping interest rates low to maintain economic expansion.

So, the dollar's decline has come at an opportune time—and with the federal government's support. In a quest to make the dollar cheaper, fight deflation and fuel the economy, the Fed has maintained an easy money policy. A weakened dollar has given manufacturers a break from low-price Asian goods and consumers have been

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(4) "Why A Falling Dollar Makes Sense…Won't Help", BusinessWeek, 6 Oct. 2003, pp 126-28.

(5) "The Strong Dollar Charade", Forbes, 3 Feb. 2003, p 122.

(6) There also is evidence that a currency change has less impact on import and export volume than traditionally assumed. When the dollar declines, foreign producers adjust prices downward to stay competitive. Also, U.S. manufacturers raise their prices to improve profits. Both actions close the pricing gap between foreign and domestic goods. Here's proof: Since 1990, import and export prices have moved only 25% as much as the dollar's relative movement to other currencies. ("Strong Dollar Ahead", Forbes, 21 July 2003, p 138.)

(7) According to one statistical model, imports have risen 2.9% for each 1% increase in real GDP, but only 0.2% for each 1% rise in the dollar. ("Strong Dollar Ahead", Forbes, 21 July 2003, p 138.)

(8) "A Strong Case for Keeping the Dollar Weak", Investment News, 9 June 2003, p 11.

(9) Almost 50% of all U.S. Treasury bonds are held in reserve by foreign central banks and governments. Aggressive selling of their dollars would undermine the competitiveness of their own currencies. ("In the Dollar We Trust", BusinessWeek, 28 Oct. 2002, p 26.)

(10) Divergent monetary policies in the U.S. and Europe (rather than economic dominance) explains the euro's recent strength relative to the dollar. The Federal Reserve has lowered interest rates to battle the economic slowdown, while Europe has maintained higher interest rates to fight inflation. As a result, yield-hungry investors have migrated to European capital markets. ("The Euro Also Rises", The Wall Street Journal", 15 May 2003, A 16.)

(11) "Good News! The Dollar Is Down", BusinessWeek, 26 May 2003, pp 36-39.

(12) "Current Account Deficit Narrows in Third Quarter", WSJ-Online, 16 Dec. 2003.

(13) "The Dollar in Distress", Fortune, 13 Oct. 2003, pp 39-40.

Sinking Dollar
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shielded from price hikes. The biggest winners from a declining dollar have been suppliers of consumer goods, energy, materials and technology—all of which are driving forces in the economy.[11]

• **The dollar will rebound.** The U.S. is now importing 1.5 times more than it exports—and analysts expect imports to increase substantially in 2004 as U.S. manufacturers replenish inventories and move operations overseas in response to rising global competition.[12] So, the dollar may drop further in the short term. The larger question is how the capital markets will respond.

Of course, pessimistic scenarios abound. Many fear that foreign investors, who now hold over $9 trillion of U.S. assets, will lose confidence in the dollar and start a massive sell-off, which could spark a currency crash. Interest rates would have to rise to attract more capital, which could smother the U.S. recovery. Falling U.S. imports would stall regional economies across the globe.[13]

This is unlikely for many reasons. The Fed and U.S. Treasury are committed to economic recovery. Inflation isn't an immediate threat. America's trading partners need a stable U.S. buyer. And as long as the inflation rate stays low, an outflow of capital from U.S. financial markets will be offset by foreign central banks buying up dollars to preserve market share.

In the long run, America's commanding lead in new technology, combined with a pro-growth, low-regulation environment, suggests that the dollar will remain the currency of choice. High productivity, robust economic growth and attractive investment returns are magnets for global capital. The stage is being set for another round of prosperity. The dollar should rise again. ■

In My Opinion. . .

Robert J. Cole, Jr., CLU, ChFC, CFP™

Here Today…

My wife and I were dining out recently when we witnessed a sad event. We were seated at a table near a window that gave us an excellent view of the sidewalk in front of the restaurant. While we were waiting for our dinner to arrive, a gentleman in his mid-thirties walked by with his dog on a leash.

Suddenly, the dog stumbled and collapsed on the ground. The owner quickly knelt by the dog's side and tried to get him back up. It was obvious from the rapid panting of the dog that something was seriously wrong. We called our waiter's attention to the drama going on, but several people had already gathered from the open-air café next door. In a matter of three or four minutes the dog quit breathing; leaving his owner in tears. Several people helped load the dog into an SUV that was parked nearby and owned by a woman who had also witnessed the event. As they drove off, the whole scene had an eerie feeling about it.

Yet, almost immediately, a van full of hungry people (delighted at finding a parking spot) stopped right in front of the restaurant where the SUV had been. They parked the van and were all smiles as they walked in; totally unaware of what had just happened in the past ten minutes.

I lay on the hospital bed listening to the clock "tick tick" the seconds by. I was waiting for the nurse to come and get me for my colonoscopy. I had just had my annual physical (everything was great!) and my doctor wanted me to have this screening. I had avoided it for two years, but now I was resolved to get it done. You can't help but wonder how much of your future might be spent in such a surrounding. Although I was healthy and taking a proactive approach to my healthcare, most people who are in the hospital are fighting some illness. For many people (like my father) this place will be the last stop on their lifelong journey.

What do these events have in common? Nothing more than to remind us just how fragile our lives actually are. We never know when our time is up. Just like our pooch friend, we can be taking our favorite walk one minute and the next minute we are gone. Each of us is given a certain amount of time on this earth. It is up to us to determine how to spend it. Someone once said that no one ever declared on their death bed, "I wish I had spent more time at the office." Over the years, I have encouraged our clients to keep the big perspective and to treat their financial wealth as a tool for living a fulfilling life.

Starting with the next issue of our newsletter, you will see more articles on this theme. I hope that you take a few minutes of your time to read these articles and reflect on how you are managing your life. It is only through the daily practice of conscious effort to live an "on purpose life" that you can be prepared when your number comes up.

Until next time, that's my opinion.

Robert J. Cole, Jr., CLU, ChFC, CFPTM
President