GLOBAL INVESTING

Bottom Dollar. Economic turmoil in the U.S. has the rest of the world increasingly rattled—for good reason

BY JIM FREDERICK

EVEN A MONTH AGO, THE GLOBAL ECONomy seemed poised to weather the U.S. sub-prime crisis with relative aplomb. But, suddenly, something approaching panic has gripped the world's financial community. The headlines are grim. The U.S. housing slump is worsening. Banking giants such as Merrill Lynch and Citigroup are posting record losses. The U.S. dollar is getting pounded by the British pound—and virtually every other currency. Oil has run up as high as $98 per bbl., and gold—the traditional doomsday investment—has topped $800, its highest level since the early 1980s.

But despite the fear, the end is not, in fact, nigh. After an orgy of excesses in the credit and housing markets, a measure of sobriety and restraint may have a useful cleansing effect. That said, tremendous risks remain—not least a mounting threat of a U.S. recession. Surveying this treacherous landscape, Paul Donovan, a global economist at UBS, predicts: "It's going to be very unpleasant but it's not a disaster."

Of course, the "core problem" is the U.S. property market, says Han de Jong, chief economist for ABN Amro in Amsterdam. "In hindsight, the housing market in the U.S. was a bubble." The cause? Superlow interest rates that encouraged lenders to offer loans to virtually anyone, even those with bad credit. Those loans were then bundled together into exotic derivatives and sold off to financial institutions worldwide; when borrowers began to default on their mortgages, money managers from São Paulo to Seoul suffered huge losses.

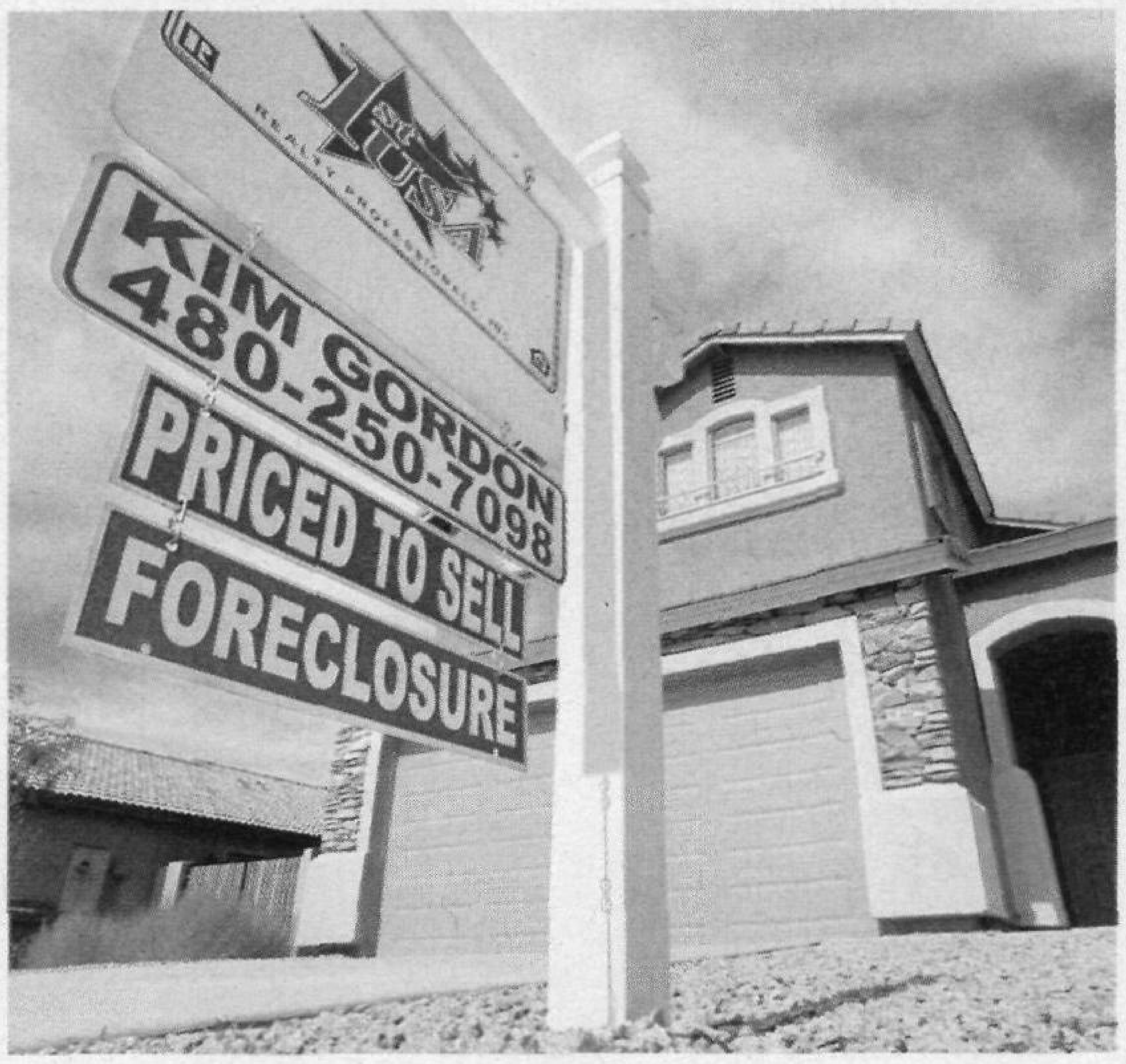
The ramifications of this housing and credit debacle now look far worse than previously expected. Housing sales and starts are down sharply, while shares in everything from homebuilders to banks to mortgage insurers have been massacred. Moreover, there's a deepening fear that U.S. consumers—a key driver of global economic growth—might dramatically pare back their spending in the wake of this assault upon their wealth and confidence. In a recent letter to shareholders, legendary U.S. money manager Bill Miller warned: "The difference between what is unfolding now and the Crash of '87, or the problems with Long-Term Capital Management in 1998, is that they were confined to Wall Street, whereas this issue extends to Main Street and to the value of the biggest asset of most consumers, their house." With lenders tightening the reins, home prices falling and repossessions on the rise, consumer confidence and consumption are already weakening. This will put tremendous pressure on GDP, leading analysts at UBS to estimate the probability of a U.S. recession in the next 12 months at 40%.

Such doubts are fueling a broader loss of faith in U.S. assets. Nowhere is this more pronounced than in the dollar's stunning decline. Since the start of 2006, it has plunged 24% against the euro and 18% against the British pound. But how big a problem is a weak dollar, and for whom? It might pain U.S. tourists shopping in cities like London or Paris. And it's a mounting worry for European and Asian manufacturers doing battle with U.S. exporters, whose products are made cheaper on the global market by a dwindling dollar. But for these U.S. manufacturers, the weak dollar is a spark of good news in an otherwise gloomy outlook. "If I were a policymaker in the U.S., I'd be happy to see the dollar slide," says ABN Amro's de Jong.

Yet there are deeper reasons to fear a persistently weak dollar. For decades, various emerging markets in Asia and the Middle East have either officially or unofficially matched their currency rates to the dollar to limit their own currency fluctuations and thus stimulate trade. Since these countries tend to be exporters, they have also historically generated buckets of surplus dollars, which they funneled into U.S. Treasury bills, attracted by the dollar's long-term stability. This arrangement benefited the U.S., providing it with a bountiful source of buyers willing to fund its debts, despite the relatively low interest rates on offer. But with the U.S. currency in a tailspin, dollar-denominated assets are less alluring than they once were.

China, Japan and others welcome the chance to scale back their U.S. holdings, but even the hint of a sale could send the dollar tumbling—as happened earlier this month when a Chinese official suggested China might shift some of its currency reserves to offset the "weak" dollar. The notion that the days of the dollar's dominance are numbered is, in fact, increasingly popular. In September, Alan Greenspan, former chief of the U.S. Federal Reserve, said it's "absolutely conceivable that the euro will replace the dollar as [the] reserve currency, or will be traded as an equally important reserve currency." If that ever happens, says HSBC chief economist Stephen King, "the dollar goes into free fall." ABN Amro's de Jong agrees that this would trigger a crisis, but doesn't think it will happen anytime soon: "Ultimately, the U.S. will lose its unique reserve-currency status, but it may take 20, 30 years." At the moment, he says, "the world simply doesn't have an alternative."

Declining faith in the dollar also helps to explain the surge in prices of a host of commodities—a classic hedge against currency instability. This includes the spike in oil, which has been further boosted by soaring demand, political turmoil in the Middle East and rampant speculation by trend-following investors. "Four times in the last 40 years we've had major disruptions in global oil supplies coming from geopolitical events in the Middle East," says Lewis Alexander, chief economist at Citi. "If you were to see one of those scenarios play out, that would be a big additional shock. The consequences could be quite dire." True enough. But for now, the greater threat to the global economy remains more prosaic: the real and present danger that battered U.S. consumers will renounce their profligate ways and put away their wallets. —WITH REPORTING BY ALEX ALTMAN AND LAURA BLUE/LONDON ■



Haunted house *Property and credit woes will crimp U.S. consumer spending, a key prop of the global economy*

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