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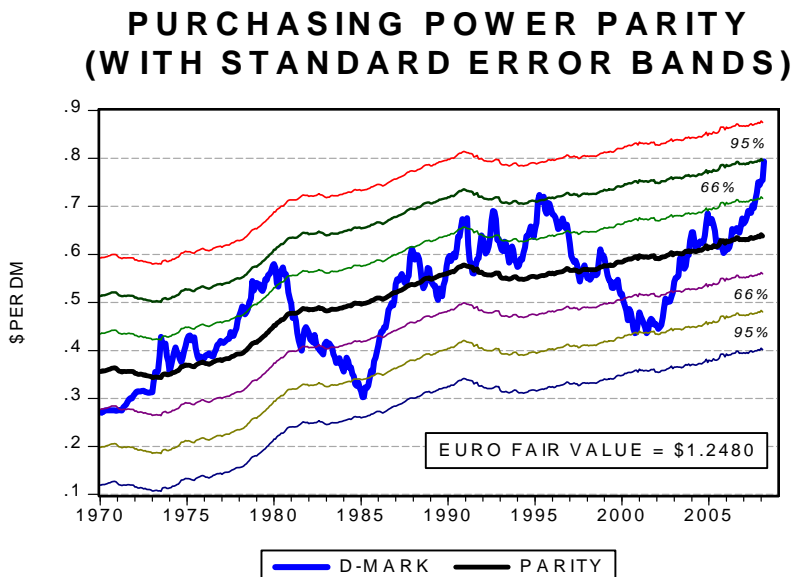
Bill O'Grady, Chief Investment Strategist

Will the G-7 rescue the dollar?

- The Group of Seven (G-7) nations includes France, Germany, the United States, the United Kingdom, Canada, Japan and Italy. This group represents about 62% of global GDP. The group meets quarterly to discuss global, geopolitical and economic issues. Russia often joins the group (thus making it the G-8) but mostly for geopolitical concerns.
- In this week's Chart of the Week, we show that the dollar is reaching a level where, in the past, the group has moved to change the trend. This is usually accomplished by concerted central bank intervention and changes to monetary policy. In the current situation, one would expect large dollar purchases by the G-7 central banks, promises by the European Central Bank to cut rates and indications the Federal Reserve is near the end of its easing cycle.
- Although intervention usually isn't enough to change the trend by itself, we believe it clearly signals to speculators that the trend is no longer a "one way bet." In addition, the concerted nature of the intervention indicates unity; traders tend to follow the path of least resistance and would likely cover short positions. Intervention without at least the promise of policy changes won't make a lasting change in trend, but it should make traders less confident in holding bearish positions in the greenback.
- If the dollar recovers, a number of trends in other markets will likely face counter-trend pressures. First, commodity prices could decline. Since most global commodities are priced in dollars, a stronger dollar tends to raise the price to non-dollar buyers. For example, the dollar price of oil since January 2001 is up 357%; a euro buyer has "only" seen an increase of 216%. On a relative basis, a stronger dollar would make commodities more expensive for foreign buyers and would likely depress demand. Second, over time, small cap stocks would likely start to gain on large cap stocks. *The prices of small company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.*
- In a weak dollar environment, larger companies usually have greater access to export markets. A weak dollar improves the competitiveness of these exports and gives large cap companies an edge. A stronger dollar would reverse those conditions. Finally, in terms of equity sectors, energy and basic materials have generally benefited by the rise in commodities and the soft dollar. A currency reversal would likely pressure these sectors.
- Although recent G-7 rhetoric does suggest concerted action may be under consideration, traders usually continue to press the trend until the intervention occurs. To some extent, currency markets tend to test the will of the central banks. Thus, we would not expect the dollar to anticipate concerted action by the G-7.

Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.

Chart of the Week:



*For illustrative purposes only. This does not reflect the performance of any specific investment.
Past performance is no guarantee of future results*

Sources: OECD, Federal Reserve, Wachovia Securities

This chart shows the results of a purchasing power parity model between the Duetsche mark and the U.S. dollar. Purchasing power parity is based on relative inflation rates; the premise is that a nation with relatively higher inflation will have a weaker exchange rate compared to a nation with lower inflation. If all goods were tradable and transportation costs were negligible, the nation with higher inflation would import goods from the low inflation country. In the process of increasing imports, the high inflation nation would bid up the value of the low inflation nation's exchange rate until there was no benefit to importing further. In other words, the exchange rate acts in such a way to equalize prices in both nations.

Purchasing power parity is the oldest theory of exchange rate valuation. Although deviations from parity are common, reversals often occur when deviations reach extremes. The midpoint line on the chart shows parity rate, based on the ratio of inflation between Germany and the United States. We use Germany rather than Europe to get a consistent data set on inflation; the current Duetsche mark rate is based on the euro conversion set in 1999. Surrounding the parity lines are sets of standard error bands, which are similar to standard deviation. Note the current exchange rate is approaching two standard errors from the parity rate. *Standard deviation measures the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation.*

The 1985 Plaza Accord, where the G-5 (the United States, United Kingdom, France, West Germany and Japan) agreed to reverse the dollar bull market, occurred when the deviation from parity exceeded two standard errors. The 1995 Halifax Accord to end the dollar bear market followed the same pattern. Recent comments from the G-7, coupled with the dollar's wide deviation from parity, would suggest that the odds of a concerted move to support the dollar are increasing.

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