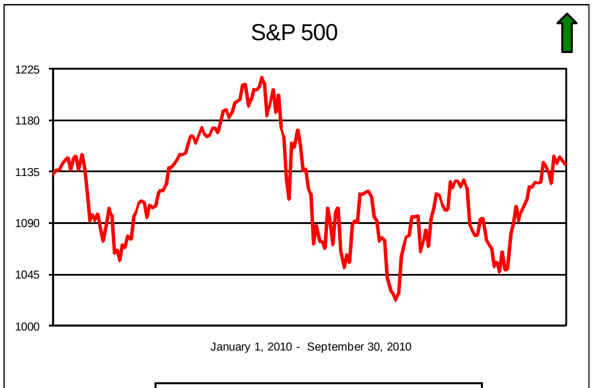
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

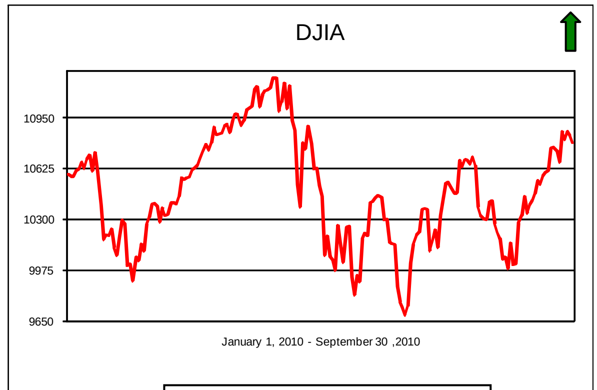
QUARTERLY REVIEW ***87th Edition*** ***2010: Third Quarter***

CAPITAL MARKETS SCOREBOARD

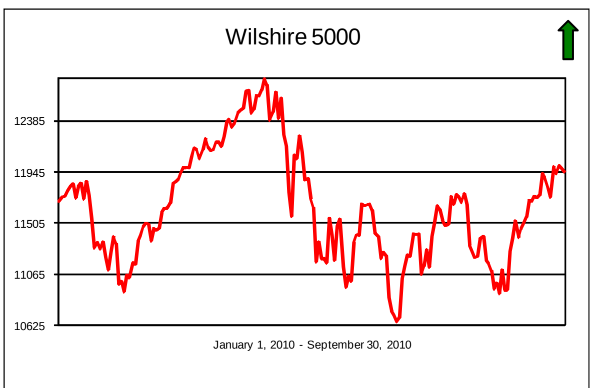
January 1, 2010 – September 30, 2010



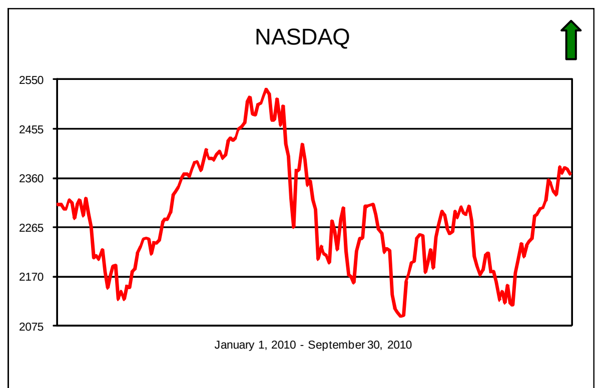
3rd Qtr 11.28% YTD 3.88%



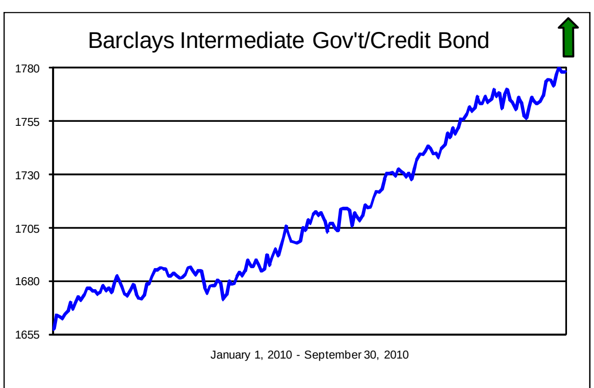
3rd Qtr 10.37% YTD 3.45%



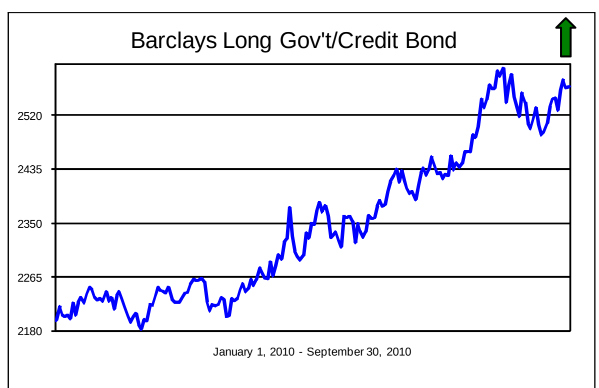
3rd Qtr 11.14% YTD 3.91%



3rd Qtr 12.30% YTD 4.38%



3rd Qtr 2.76% YTD 7.44%



3rd Qtr 5.85% YTD 16.69%

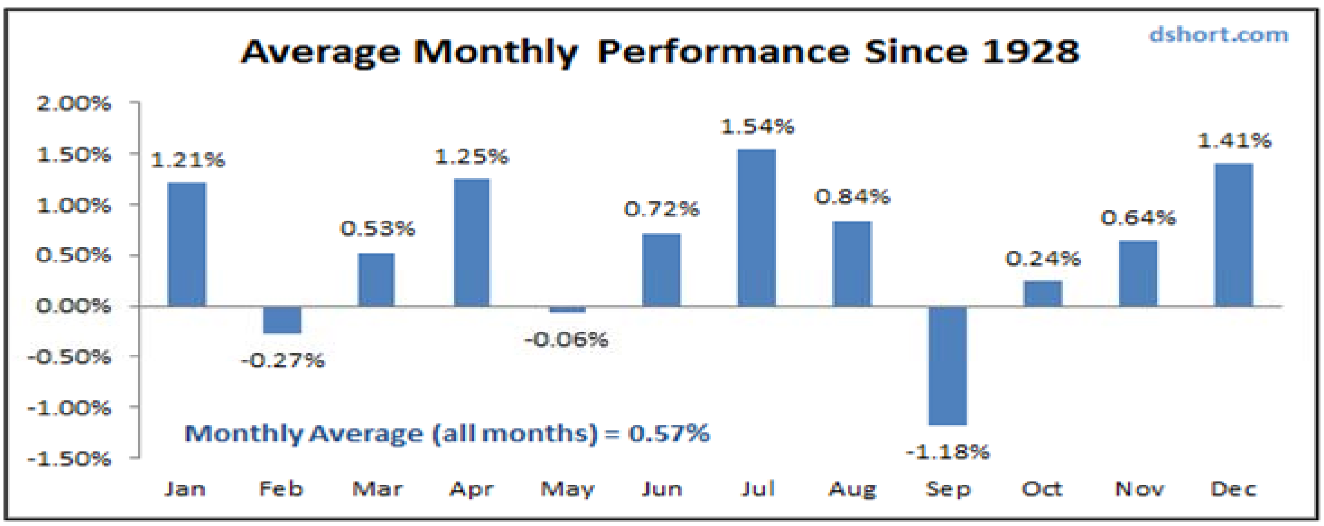
EQUITIES

Equity Market Performance

The Standard and Poor's 500 Equity Index (S&P 500) fell 4.7% in the month of August, which erased most of July's 6.9% gain leaving a net quarter-to-date return of 1.8% heading into the final month of the quarter. Market pundits worried that the weakness seen in August would carry through September based on what has come to be known as the "September effect". September has historically produced the lowest monthly returns for the stock market. Monthly data dating back to 1928 for the S&P 500 shows the index lost an average of 1.18% (see chart below) during the month of September versus an average gain of .73% for all other months. Equities bucked the trend this time around gaining 8.8% – the largest September gain since 1939! For the quarter, the S&P 500 rose 10.72% to 1,141.

S&P 500 by GICS Sector	Price Return (%)	
	3Q10	**YTD**
Utilities	11.10	0.87
Telecom Services	19.11	6.02
Consumer Staples	9.76	5.09
Consumer Discretionary	14.72	12.10
Health Care	8.21	-2.34
Information Technology	11.50	-0.77
Industrials	13.65	11.45
Energy	12.30	-2.48
Financials	4.06	-0.31
Materials	17.24	1.20
S&P 500 Index	**10.72**	**2.34**

Global equities outperformed the domestic markets, due largely in part to strong gains from emerging markets. The Morgan Stanley Capital International Europe, Australasia, and Far East (MSCI-EAFE) advanced 15.8% for the third quarter. Meanwhile, the MSCI Emerging Markets Index gained 17.2%. Southeast Asian markets were particularly strong during the quarter. European markets were pressured by worries surrounding the European bank stress tests and the ongoing sovereign debt issues, but still managed a gain for the quarter. The Stoxx Europe 600 Index rose 6.7% for the quarter. Greece, whose Athens Stock Exchange's benchmark index was down 33% on the year, saw a bit of a reprieve as the market rebounded 2.6% during the quarter.



Second Quarter Earnings Review and Third Quarter Preview

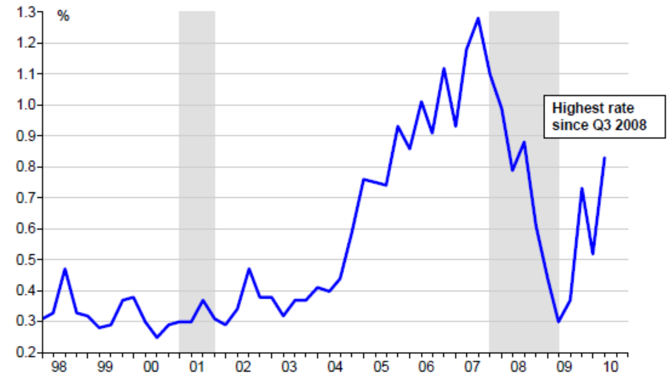
Second quarter earnings continued the trend of better-than-expected results. According to Credit Suisse, realized second quarter earnings per share for the S&P 500 grew 37% year-over-year to $21.30, and came in well ahead of initial expectations of $19.50. Positive earnings surprises were down slightly from the first quarter with 75% of companies within the S&P 500 reporting second quarter earnings ahead of consensus estimates. That figure compares to 78% in the first quarter of 2010 and 72% in the second quarter of 2009. In aggregate, earnings were 10.6% ahead of forecasts – a modest decline from the 14.4% beat posted in the first quarter. Similar to first quarter, Consumer Discretionary and Financial stocks were the strongest sectors with earnings surprises of 15% and 24% respectively. Negative surprises ticked up in the quarter with 16% of the S&P 500 companies falling short of forecasts versus 14% in the first quarter.

Third quarter earnings season begins in October when 80% of the companies within the S&P 500 will report. Third quarter earnings are expected to grow 24% year-over-year to $20.46. Financials are expected to produce the highest year-over-year growth at 69%. Year-over-year growth in Consumer Discretionary earnings is expected to fall to 16% versus the 64% seen in the second quarter. The deceleration is largely reflective of the improvement in the consumer during the second half of 2009. Despite the heightened fears of a double dip recession, analysts have held third quarter estimates essentially flat since March.

Equity Valuations

As indicated, emerging markets equities posted strong third quarter returns. Despite the strong performance, emerging markets equities continue to trade at a discount to developed markets. Based on 2010 consensus earnings forecasts, emerging markets trade at a price-to-earnings (P/E) multiple of 12.7X versus 13.8X for the S&P 500 and 12.8X for the MSCI-EAFE. Note that a wide range of valuations have been assigned to the various countries classified as emerging markets. For example, Indonesia trades at a P/E of 35.5X, India trades at 20.2X, and Russia trades at 8.5X. According to Alec Young, International Equity Strategist at Standard & Poor's, emerging markets equities have historically traded at a discount relative to their developed market peers due to greater liquidity and transparency risks. He suggests the valuation gap could narrow given the outlook for stronger relative emerging markets fundamentals and improving capital markets within these countries.

S&P 500 stock buybacks as a % of market capital



Shaded for U.S. recessions
NBFG Economy and Strategy Group (data via Standard and Poor's)

The International Monetary Fund estimates economies in emerging markets will grow 6.5% in 2011 versus 2.4% for developed nations and 2.6% for the U.S. From an earnings growth perspective, Bloomberg data shows earnings for the 915 companies in China's Shanghai Composite Index will climb 20% this year and profits for the 68 companies in Brazil's Bovespa Index will grow 29%. This compares to the 15% growth for the MSCI World Index of 24 developed countries and 14% growth for companies comprising the S&P 500. Mr. Young observes that the revision to earnings estimates has been stronger for emerging markets relative to the U.S. and developed overseas markets. Since the worldwide earnings trough in 2009, consensus 2010 emerging markets earnings forecasts have been upwardly revised by 35%. This compares to 15% and 13% respective increases for the S&P 500 and MSCI-EAFE. While earnings growth and momentum in emerging markets have been driving relative performance recently, many strategists caution about being too aggressive in this arena due to volatility and high level of risk associated with investing in emerging markets. To illustrate, consider the decline suffered by the MSCI Emerging Markets Index of over 54% in calendar year 2008.

Mergers & Acquisitions: Corporations Awash in Cash

Although consumers would welcome some extra cash in the bank, corporations certainly do not have that problem today. According to Bloomberg, the world's largest 1,000 companies held cash or its accounting equivalents of $2.87 *trillion* as of their latest regulatory filings. Companies have similar options as consumers – save it, repay debt and/or spend it on things that are needed or wanted. Based on the level of Mergers & Acquisition (M&A) activity in the third quarter, buying other companies appears to be the "go-to" option with share buybacks a close second. For instance, Intel agreed to purchase security-software maker McAfee, Inc. for $7.7 billion ($48/share) to better meet its customers' computer virus and data integrity concerns. Hewlett-Packard purchased 3Par, Inc. for $2.35 billion and ArcSight, Inc. for $1.5 billion during the quarter. Private equity firms are on the move, too, as evidenced by 3G Capital's $58.3 billion deal to take Burger King Holdings private (again). Of interest, Goldman Sachs, forecasted by some to lose a material amount of business due to its supposed conflicts of interest, has advised on $325.9 billion of M&A deals so far in 2010, a level higher than any other competitor in that space.

M&A Deals by Industry (YTD)

Industry Name	Base Equity Price ($mm)	% of Total	Total Deals
Computer Software, Supplies & Services	$30,582.8	12.77	65
Drugs, Medical Supplies & Equipment	$28,773.0	12.02	39
Energy Services	$16,527.2	6.90	9
Communications	$12,232.6	5.11	7
Broadcasting	$11,664.9	4.87	4
Brokerage, Investment & Mgmt. Consulting	$11,648.2	4.86	19
Retail	$9,121.4	3.81	11
Oil & Gas	$8,477.7	3.54	10
Electric, Gas Water & Sanitary Services	$7,997.9	3.34	9
Wholesale & Distribution	$7,618.3	3.18	13
Health Services	$7,448.1	3.11	21
Instruments & Photographic Equipment	$7,393.6	3.09	5
Leisure & Entertainment	$6,889.7	2.88	14
Insurance	$6,873.4	2.87	8
Chemicals, Paints & Coatings	$6,367.6	2.66	5
Banking & Finance	$6,144.5	2.57	15
Mining & Minerals	$4,796.0	2.00	7
Paper	$4,476.1	1.87	2
Office Equipment & Computer Hardware	$4,176.6	1.74	6
Electronics	$4,061.5	1.70	13
Transportation	$3,422.3	1.43	3
Construction Contractors & Eng. Svcs.	$3,297.0	1.38	13
Food Processing	$3,236.8	1.35	5
Industrial & Farm Equipment & Machinery	$1,695.4	0.71	5
Total	**$239,468.3**	**100**	**370**

Source: Strategas Research Partners

Share Buybacks: Corporations Awash in Cash

Corporate balance sheets are flush with cash, and according to data compiled by Bloomberg, free cash flow (earnings minus capital expenses) for companies in the S&P 500 has increased to $113 per share – the highest level since 1998. U.S. companies have announced their intent to repurchase over $270.5 billion in shares this year. According to data compiled by Birinyi Associates, this level is five times greater than the $52 billion announced for the first three quarters of 2009 and surpasses the $125 billion repurchased for all of 2009. In addition, Standard & Poor's announced in late September that preliminary data for S&P 500 shows that buybacks for the second quarter of 2010 increased 221% year-over-year to $78 billion, a seven-quarter high. As a share of market capitalization, buybacks have risen to 0.83% from 0.3% four quarters earlier.

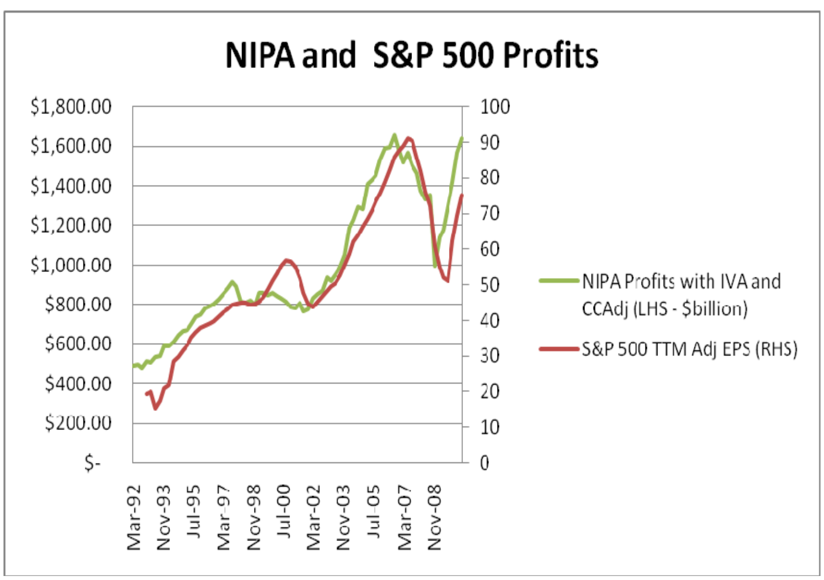
Smaller firms outside of the S&P 500 have also been actively repurchasing shares. TheStreet.com notes the biggest buybacks of 2010 (measured as a percentage of shares outstanding) have been made outside the S&P 500. Three companies outside of the S&P 500 have buyback programs representing at least 20% of outstanding shares. Fossil (FOSL), Herbalife (HLF) and URS Corp. (URS) have programs in place to repurchase 24.3%, 23.8% and 21.5% of their respective total shares outstanding. Texas Instruments (TXN) is the only company within the S&P 500 with a buyback in place for more than 20% of its shares outstanding.

In Spite of Cash Balances, Corporate Debt Levels Increase

Not only do companies have cash on their balance sheets to spend, they can readily boost their buying power by issuing debt at the lowest rates since the credit bubble. *Grant's Interest Rate Observer* pointed out that IBM managed to "bookend" a generation of interest rates - 9.5% for AAA rated seven year bonds in 1979 that quickly traded down to yield 10.7% when Volcker began fighting inflation and 1% per annum for A+ rated three year paper in August 2010. *Grant's* publishing deadline did not allow it to mention Microsoft's quarter-end debt issuance, wherein the company floated a three tranche deal, including $1 billion of three year notes with a coupon of just 0.875%. Despite the size of their respective deals, IBM and Microsoft represent a small portion of the corporate debt issued this year. For instance, new issuance in September exceeded $110 billion by companies from all over the world, including IBM, Microsoft, Royal Bank of Canada, BPLC Group (French mutual bank) and Johnson & Johnson (total global issuance year-to-date exceeds $4.6 trillion). The Federal Reserve (Fed), with its various efforts to maintain low rates, and robust investor demand have been a boon to investment grade and high-yield companies alike. High-yield issuers have taken advantage of the current easy-credit environment to refinance debt issued as the credit bubble expanded in order to forestall a possible liquidity crunch in the next 2-3 years (the so-called "Wall of Maturities"). The demand for fixed income is perhaps best illustrated by LyondellBasell (LBO'ed in 2007, bankrupted during the credit crisis and now trades post-bankruptcy on the pink sheets) which issued 10-year debt in April of this year with a coupon of 8% that now trades to yield 6%.

Corporate Profits

The second quarter GDP release showed the National Income and Product Accounts (NIPA) measure of corporate profits rebounded to match the prior peak of roughly $1.6 trillion established in September 2006. The NIPA figure represents profits from current production with a capital consumption and inventory valuation adjustment to convert depreciation of fixed assets and inventory withdrawals reported on a tax-return, historical cost basis to the current-cost measures used in the national income and product accounts.



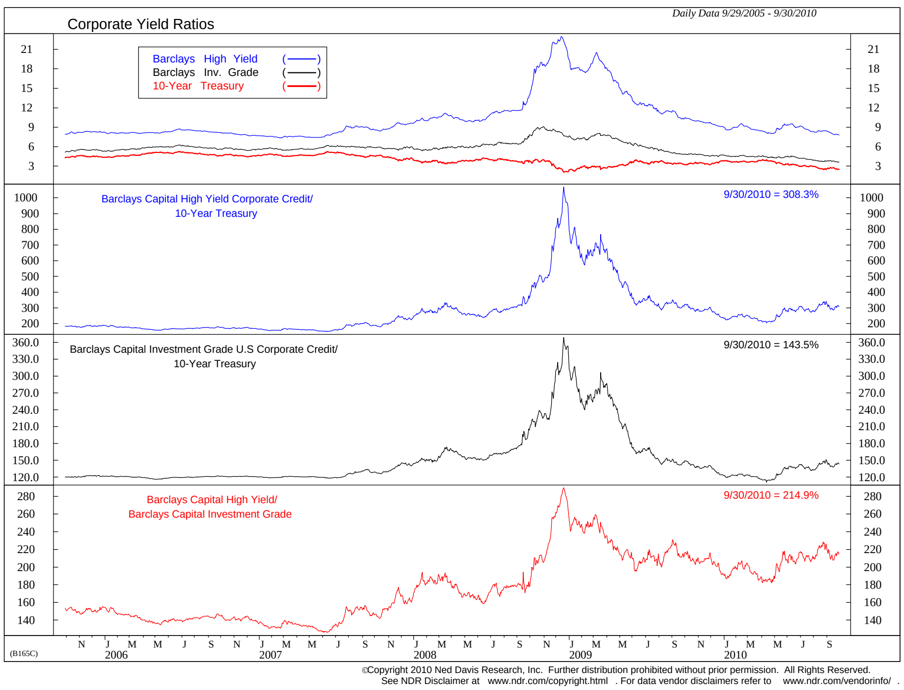
Meanwhile, S&P 500 Adjusted EPS (a proxy for operating profits) on a twelve trailing month basis remain approximately 20% off their highs set in June 2007. There are several differences between the two measures: NIPA profits cover all incorporated businesses – both publicly traded and privately held – and all industries. The S&P 500 profit measure, naturally, is tied to the earnings of the 500 large companies that comprise the S&P 500 Index. In addition, the composition of the S&P 500 is based on market values, so the strong market sectors will tend to have a higher weight in the S&P profits measure versus the NIPA profits measure. Finally, differences in tax and financial accounting can result in substantial short-term divergences between the two measures.

Strategas Research Partners notes that 146 of the 500 companies in the S&P 500 have achieved net income above their pre-2009 highs. Not surprisingly, Health Care and Consumer Staples, two of the more defensive sectors, have the greatest percentage of companies with net income exceeding pre-2009 levels at 60.8% and 43.9% respectively. Basic Materials and Energy, two commodity-sensitive sectors, are lagging with only 15.6% and 5.1% of companies posting net income above the pre-2009 highs. Assuming current consensus estimates hold true, S&P profits should match peak levels in late 2011.

ECONOMICS AND FIXED INCOME

Fixed Income Market Performance

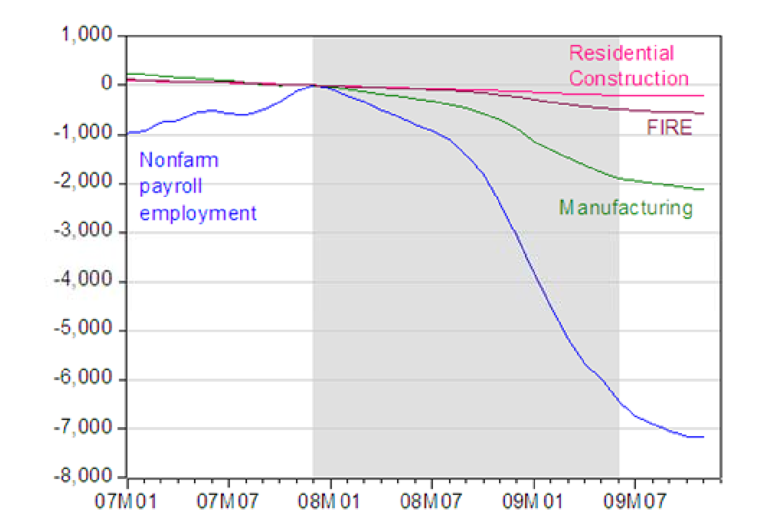
Fixed income investors of all stripes likely ended the quarter pleased with their returns based on data from Merrill Lynch's numerous fixed income indices. For instance, Treasury bond holders gained 2.74% on top of the 5.9% increase from the first half of 2010. Those who chose investment-grade corporate bonds fared better at 4.9%, while high-yield debt returned 6.7% in the third quarter. The municipal bond index rose 3.7%, reversing the downtrend we noted in last quarter's newsletter.



The intra-quarter returns for the various fixed asset classes reflect their broad risk classifications. For example, the Treasury return for the quarter was earned primarily in August (up 2%) as "double-dip" fears reached their zenith. On the other hand, high-yield bonds gained the most in July and September, with the lowest rated bonds (CCC and lower) losing 1.6% in August versus a small gain for BB and B rated bonds. However, the CCC bonds bounced back in September (up 3.8%) as compared to BB and B bonds rising 2.8%. September was the poorest month in the quarter for investment grade corporates and municipals, as evidenced by returns of 0.6% and -0.1%, respectively.

Economic Pulse – Unemployment: Structural v. Cyclical

When economists consider the unemployed, they sometimes divide them into three broad tranches instead of viewing them as one aggregate block. These tranches include the frictionally unemployed (normal and unavoidable), the cyclically unemployed (the size of which rises and falls inversely with the economic cycle) and the structurally unemployed (caused by a long-term mismatch between skills needed by employers and skills available in the workforce). Structural unemployment can be especially pernicious because it tends to leave people unemployed for extended lengths of time. As you might imagine, long-term unemployment can have deleterious effects on the individual's psyche as well as the economy. The construction industry, especially the residential construction industry, provides a prime example of cyclical unemployment given the downturn



Source: http://www.econbrowser.com/archives/2009/12/how_important_i_1.html, BLS 11/09 release, FRED II and NBER in residential construction. Workers categorized in the FIRE industries (Finance, Insurance and Real Estate) and manufacturing have fared much worse than those in residential construction.

On a related note, the debate about whether the U.S. has a problem with structural unemployment or cyclical unemployment has become quite heated. The reason: the policy prescription to address structural unemployment is materially different than the one to address cyclical unemployment. For instance, if the country's workforce is suffering from cyclical unemployment, another round of government sponsored aggregated demand stimulus is a legitimate option. On the other hand, another stimulus package will accomplish little more than increasing the U.S.' debt burden if the problem is structural in nature. The graph on the previous page, which breaks out employment associated with residential construction and manufacturing, appears to support the assertion that the U.S. currently has a cyclical unemployment problem.

Small Business Jobs Act

When President Obama signed the $42 billion Small Business Jobs Act on September 27th, he stated, “Government can't create jobs to replace the millions that we lost in the recession, but it can create the conditions for small businesses to hire more people through steps like tax breaks…” Key aspects of the bill are as follows:

1. Small Business Administration (SBA) Loan Size Changes – The SBA's maximum loan size is now $5 million ($5.5 million for some manufacturing related loans) versus $2 million previously. Entrepreneurial microloans are now capped at $50,000 instead of $35,000 and express loans (generally working capital loans) can now reach $1 million instead of $300,000;
2. Capital Expenditure Write-Offs – Small businesses are allowed to expense up to $2 million worth of capital expenditures in 2010 and 2011 ($500,000 can be completely deducted, while the remaining amounts are subject to a scaled phase-out provision). Companies can also write off $250,000 of qualified improvements on leased property, restaurant property and retail-business property;
3. Health Care – Self-employed individuals can write off the cost of health insurance for themselves and their families;
4. Capital Gains Elimination – About 1 million companies are expected to benefit from a capital gains exemption applied to holdings in companies with less than $50 million in gross assets that have been owned more than five years;
5. Small Business Lending Fund – The legislation also established a $30 billion fund to provide capital via preferred stock to financially sound small banks (less than $10 billion in assets) to encourage small business lending. The terms of the program require banks to pay the government a dividend on a sliding scale that begins at 5% per annum and declines to 1% as more of the funds are loaned out.

Critics of the new legislation promptly pointed out a number of flaws in the bill, such as:

1. Small Business Loan Definition – The Act's definition of a “small business loan” seems to leave the door open for mischief – “The term ‘small business lending’ means small business lending, as defined by and reported in an eligible institution's quarterly call report…” Note the conflict of interest introduced by allowing banks to define a “small business loan” while providing capital at a lower cost based on the amount of loans extended;
2. 1099s and Health Care Reform – The new law includes a provision increasing the penalty for failure to file 1099s to the IRS. This could be a particularly onerous provision because the recent healthcare reform bill stipulates that businesses must file 1099s for every merchant, vendor, contractor or supplier that receives more than $600 per year. Compliance was obviously going to be an administrative and financial burden for small businesses, but now it will also be grounds for IRS penalties. Note that small businesses are already well known for violating some provision of the U.S. Tax Code (who can blame them – the 2010 Tax Code runs to 71,684 pages, up 325% from 2006's 16,845 pages);
3. Loan Supply & Demand – It’s possible that neither the small business owners nor the banks want to participate in the loan program. Here's why: according to the National Federation of Independent Business, small business owners are concerned about slow or declining sales (51%), followed by uncertainty (22%), access to credit (8%) and falling real estate values (8%). These data highlight two problems. First, small business owners apparently want and need customers more than additional debt. Second, small businesses often use real estate (personal homes and/or commercial properties) as collateral for their business loans. Given the state of the real estate markets, banks may not want to accept the collateral small businesses have to offer.

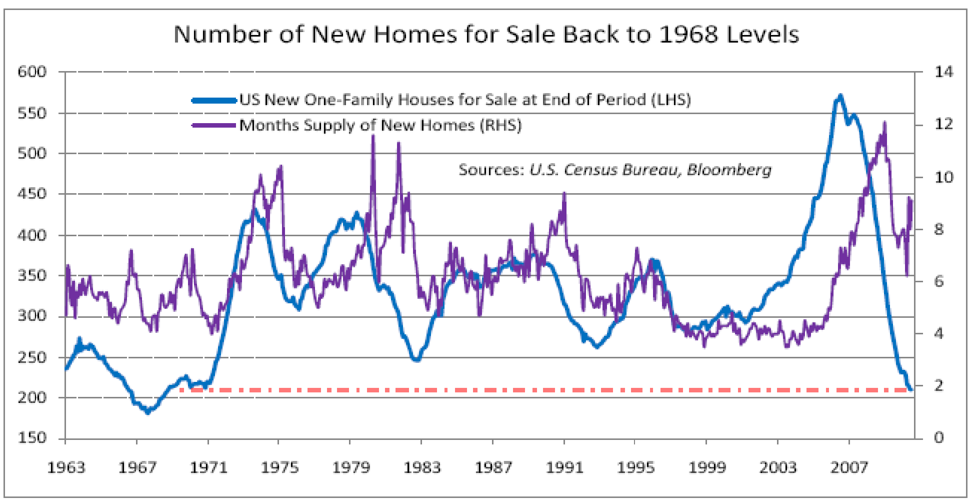
Financial Reform – The Dodd-Frank Act

President Obama pledged “no more tax-funded bailouts” as he signed the financial-overhaul legislation titled The Dodd-Frank Wall Street Reform and Consumer Protection Act into law in late July. While the bill does explicitly prohibit the use of taxpayer funds to rescue failing financial institutions, some critics charge that the bill doesn’t go far enough to address the “too

big to fail" issue. The industry will continue to be dominated by six banks with a combined $9.4 trillion in assets whose size and scope would make any one of them difficult to wind down in the event of another crisis.
Another oft-cited criticism of the bill is its sheer size (2,300 pages when it passed through the Senate for the final vote) and complexity in light of the numerous exceptions and exemptions scattered throughout many of the provisions. The Chamber of Commerce performed an analysis which revealed that the bill requires agencies to write more than 500 rules, conduct 81 studies, and submit 93 reports in the coming years. In turn, the ultimate effects of the legislation won't be understood for several years as new regulations are drafted and implemented over time. The burden is already being felt by the agencies assigned with shaping the bill. Just this week the Federal Deposit Insurance Corp. (FDIC) delayed a vote on its first major rulemaking, while last week the Commodity Futures Trading Commission (CFTC) warned they may not meet statute-imposed deadlines.

The bill does deliver on its objective to enhance the government's ability to regulate the financial industry. Namely, it creates a new consumer-protection bureau, within the Federal Reserve, with powers to write rules for – and ban – financial products. The government now has the power to break up any failing financial firm, not just banks, with the cost borne by the financial industry in the form of fees. Firms who securitize assets will be required to retain a 5% stake in the debt they package and sell. Banks will face limits on their proprietary trading and investment in hedge funds and private equity fund and will be forced to push some of their swaps trading into subsidiaries. Dick Bove of Rochdale Securities believes that, ultimately, the brunt of the regulations will fall on the American public through higher fees and fewer services offered by financial institutions. The Obama administration counters that any costs will be modest in nature when compared to the costs of another financial crisis.

New Home Sales Retreat
The June 30th expiration of the homebuyers tax credit led to a dearth of summer buyers as home sales retreated in the third quarter. July and August new home sales averaged a seasonally adjusted rate of 288,000 – just above record lows for the series dating back to January 1963. Buyers appear to be much more responsive to fiscal incentives as opposed to lower borrowing costs in the form of record low mortgage rates. This is largely a function of both a risk averse home buying public and tight lending standards.



Builders are responding by keeping inventories low. The September release for new homes for sale at the end of August 2010 (seasonally adjusted) totaled 206,000 – absolute levels not seen since 1968 (see chart). In a further sign of restraint, builders are starting fewer homes. Seasonally adjusted annual housing starts rebounded to 598,000 in August from the June/July average of 540,000.

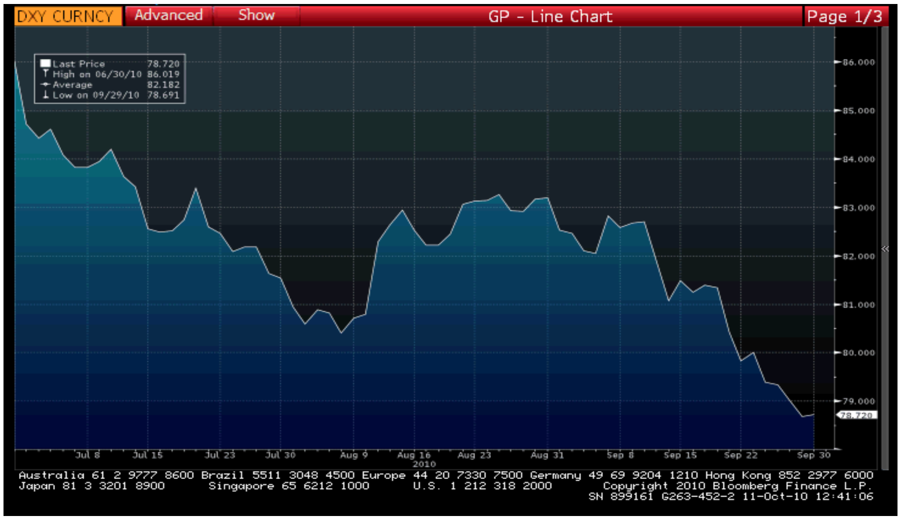
To put that number in perspective, the Census Bureau states the entire U.S. housing stock consists of 131 million units. Long-term household formation growth has averaged 1.6%, but according to Deutsche Bank it is currently 1%. Builders are only starting enough homes to meet roughly half of the demand generated by new household formations. JP Morgan argues that the number of excess homes built during the boom peaked at 2.7 million in 2008 and currently stands around 2 million. Given an average of 1.5 million household formations per year, they assume the surplus of homes will become a deficit by late 2011.

The End of the Great Recession

In late September, the National Bureau of Economic Research (NBER) announced the Great Recession ended in *June 2009*. Most reports of the NBER's announcement noted the "average" American would probably disagree with the NBER based on his or her personal situation. The NBER chose June 2009 as the end of the longest post-WWII recession after considering two measures of monthly gross domestic product (GDP), one measure of gross domestic income (GDI), real personal income excluding government transfer payments, the payroll and household measures of total employment and aggregate hours of work in the total economy.

DXY Down - The Recent Decline in the Value of the U.S. Dollar

DXY is the market symbol for a trade-weighted index comparing the U.S. dollar to the currencies of six other countries in the following proportions: the euro (57.6%), the yen (13.6%), the British pound (11.9%), the Canadian dollar (9.1%), the Swedish krona (4.2%) and the Swiss franc (3.6%). As the accompanying graph illustrates, the U.S.dollar lost 8.5% during the third quarter of 2010. The particularly steep decline evident near the end of the quarter occurred as market participants began incorporating the view that the Federal Reserve may start another round of quantitative easing (dubbed QE2).



COMMENTARY: Currency Conundrum

The financial and economic systems of the world are all interconnected, and the glue holding them together is currency. The international currency markets are the largest markets in the world with *daily* trading of more than $3 trillion. Those who do business outside their country (importers, exporters and tourists) must deal in the foreign exchange (forex) markets. The U.S. dollar has a special role in the foreign exchange markets as the most widely held currency and the main reserve currency of central banks. Many other currencies of the world are pegged to the U.S. dollar and most commodities are quoted and traded in U.S. dollars.

The dollar has played this role since the Bretton Woods Agreement in 1944, whereby all other currencies in the world were pegged to the dollar. At that time, foreign central banks could exchange their U.S. dollars for gold at a fixed price of $35 per ounce. All currencies were thus anchored by gold and had a fixed exchange rate against other currencies. Countries could devalue their currency, but this was a political or central bank decision and not a market-driven decision. This system worked until 1971, when foreign governments started to lose confidence in the U.S. dollar and the demand to convert to gold increased. Since there were more U.S. dollars outside our borders than gold in our vaults, President Nixon closed the “gold window”, barring countries from converting paper dollars into gold. Without the gold anchor, all currencies became fiat currencies dependent upon the reputation of governments and central banks. Most currency exchange rates became market based unless a country purposely pegged its currency to the U.S. dollar. The U.S. dollar remains the world’s primary currency, however, followed by the euro, the Japanese yen, and the British pound sterling. The Chinese yuan is controlled and not freely traded, which causes concern for the U.S. and many other trading partners.

The value of a currency can be determined relative to purchasing power or more typically against other currencies. For instance, the euro and British pound are quoted in the number of U.S. dollars needed to purchase one euro or pound, which, as of September 30, 2010, was $1.36 and $1.57 respectively. Inversely, it would take 0.74 euros or 0.64 pounds to buy one U.S. dollar. When the dollar is strong, it requires fewer dollars to buy one unit of foreign currency. For example, when the U.S. dollar was strong, as it was in June of this year, it took approximately $1.20 to buy one euro. Conversely, when the dollar was weak, as it was in November of last year, it took approximately $1.51 to buy one euro. In reality, there are many factors that determine the value of a currency relative to others, but the primary ones are economic growth, inflation, interest rates and international trade – exports vs. imports. Speculation can also play a role, much to the dismay of many politicians and central bankers, even though there have been many cases when speculators’ assessment of a currency’s value is correct.

The value of a currency is important since its strength or its weakness has conflicting implications for that country’s economy. To illustrate, a product that is priced at €100 (100 euros) in Europe would cost an American approximately $90 if the euro were trading at $0.90 and $150 if the euro were trading at $1.50. At $0.90, the dollar is strong and would place downward pressure on U.S. prices since domestic manufacturers of comparable products would need to lower their prices to remain competitive. As a result, a strong dollar can help contain inflation. The U.S. exporter, however, would prefer to have a weak dollar. A product that is priced at $100 in the U.S. would cost approximately €111 in Europe when the dollar was strong ($0.90 per euro) but only €67 when the dollar was weak ($1.50 per euro). For U.S. exporters, a weak dollar gives exported items a competitive advantage overseas which can help stimulate domestic corporate profits and, in turn, economic growth.

A strong currency also helps a country attract financial investments. For example, an investment of €1,000, with the euro trading at $0.90 (a strong dollar), would require $900. If the euro were to strengthen to $1.50 (a weak dollar), the investment could be repatriated (converted back to U.S. dollars) for $1,500 – a gain of over 67% just from currency fluctuation. Even though this is an exaggerated and simplified example, assuming a viable investment, it is beneficial to be invested in currencies that are strengthening. This is one reason why many economists believe the U.S. should pursue a path of defending the dollar – to make certain foreign central banks and others will want to continue investing in U.S. dollar denominated investments.

In the past, countries were proud of a strong currency, but recently many favor a weaker currency to help exports. For example, even though the Chinese yuan has strengthened over the last three years, many think China purposely maintains a weaker yuan to help exports. Since 2005, China has had a trade imbalance with the U.S. of $202 – $268 billion per year and is on pace to be in that range for 2010. The extra dollars from the net exports to the U.S. are bought by the Chinese central bank, strengthening the dollar. To fund this purchase they must sell the yuan, causing it to weaken. The Chinese central bank then takes these dollars and uses them to buy foreign securities. China's accumulated trade imbalance with the U.S. equals $2.5 trillion, which the Chinese have invested in U.S. Treasurys ($800 billion) and various other dollar-denominated securities ($1.7 trillion). In a sense, China has been financing our fiscal deficits by recycling its extra U.S. dollars into U.S. government securities. Japan, Taiwan, South Korea, Singapore and other Asian countries have also accumulated large foreign exchange balances since they, too, export more than they import. However, since worldwide exports must equal imports, not every country can maintain a positive trade balance to help drive economic growth. Currently, eurozone exports have become more competitive since the euro has weakened from its record high of nearly $1.60 per euro in July of 2008 to approximately $1.36 today.

The U.S. dollar is also a safe haven in times of distress, such as the financial meltdown in 2008 and recently with the problems in the eurozone. Many believe the dollar has to weaken over the long term because of our substantial fiscal and trade deficits. If inflation is not a problem the economy could benefit unless, of course, the dollar crashes because foreigners lose confidence in the U.S. government and central bank. There would then be dramatic adjustments in interest rates and capital flows. If all currencies weaken, not on a relative basis but on an absolute basis, there would be a flight out of dollars into real assets such as commodities. Perhaps that is why gold is selling at more than $1,300 per ounce today.

Investors worldwide appear skeptical of fiat money and remain concerned about the possibility of inflation, longer-term, given all of the deficit spending in the world. They may ultimately be proven correct. However, the power of currency devaluation via central bankers' actions across the globe to offset the deleterious effects of deflation remains to be seen. Should central bankers not be able to reignite inflation, the recent performance of gold and other commodities could prove to be in what some prognosticators suggest as the late stages of bubble formation.

*Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around and guard it. It has no utility. Anyone watching from Mars would be scratching their head. – **Warren Buffett***

*The budget should be balanced, the treasury should be refilled and the public debt should be reduced. The arrogance of public officialdom should be tempered and controlled. And the assistance to foreign lands should be curtailed, lest we become bankrupt. – **Cicero**, 63 B.C.*

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