

Death of the Dollar?

by Dave Forest
October 16, 2009

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There were a lot of reports this week about the demise of the dollar. Is the end of the greenback truly at hand? Or are reports of the dollar's death greatly exaggerated? And what does this mean for commodities?

This week we cast a critical eye on some of the recent action in currency markets. One of the major "strikes" against the dollar recently was a report that oil market players may secretly be making plans to dump the buck. Many investors believe that a shift away from the dollar is already underway in some of the world's markets. Causing the recent slump in the dollar's value against many of the world's major currencies. We'll look at whether traders are really getting out of the dollar. And examine some interesting reports from the world's biggest banks that suggest an alternative explanation for the slump in the dollar. The recent fall in the greenback may not be as fundamental as some observers believe.

We'll also look at another controversial story in the natural resource sector: shale gas. At a major conference on the topic this week in Texas, attendees heard both sides of the coin. Some presenters suggested that shale plays like the recently-proven Marcellus of the northeastern U.S. will be the energy savior of America. Others told the conference that the potential for gas production from this formation has been blown out of proportion (no pun intended), with production rates and decline curves being overly-exaggerated to make the play appear more than it is.

Undeterred by the controversy, the *New York Times* took the opportunity recently to declare that development of shale gas will soon be underway around the world, unlocking trillions of cubic feet of new gas supply. But is a shale gas boom really likely? We'll look at some hard facts about the contested Marcellus play that reveal just how difficult it is to make shale work. Anyone who believes shale gas is simply a matter of drilling a well and watching the mcf's come flowing in should have a look at these numbers. But first, let's jump in with a look at what a dollar is worth these days.

The Dollar Sheds Weight

Everyone in the commodities sector has suddenly become a currency trader. This week, investors in gold, oil, base metals and a host of other hard goods were all talking about the value of the dollar.

Indeed, the recent action in the currency markets has been striking. Since the beginning of October, the dollar has been on a near-steady decline against most major currencies. This month, the dollar is down 2% against the euro, 5% against the Australian dollar, and 6% against the Canadian dollar.

These are big moves for a currency. And the dollar's fall isn't just benefiting other countries' money. Commodities also got a lift from dollar weakness. As we've discussed before, many of the world's major commodity exchanges price their goods in U.S. dollars. If the value of the dollar falls, it makes it cheaper for holders of other currencies to buy on dollar-priced exchanges. They can swap their euros, yen or Aussie dollars for U.S. dollars, and buy more gold or oil than they could spending the same amount of their own currency back home.

The dollar-related boost for commodity prices has been cause for celebration in a number of camps. Particularly amongst gold supporters. Many gold buyers have long believed that the dollar will eventually decline severely in value, a result of fast-paced expansion of the U.S. money supply. If more dollars are being created, they reason, the less a dollar should be worth.

This "death of the dollar" argument gained some traction last week, when Britain's The Independent reported that leaders in the Middle East, China, Russia, Japan and France have been holding secret meetings on buying and selling oil in currencies other than the dollar. This raised concerns that the demand for dollars globally will fall. Speeding devaluation. Upon the news, the dollar ticked lower against most currencies around the world.

Indeed, this month's dollar weakness seems to be confirming sentiment that the buck is headed for a "no-confidence vote" from trading nations worldwide. But is that what's really going on? Does the decline truly represent waning interest globally in using the greenback as the "weapon of choice" in settling international commerce?

Not necessarily. One interesting aspect of the recent decline in the dollar is its timing. The fall coincided (almost to the day) with the start of the fourth quarter. A time when investment funds typically shuffle their holdings.

Many funds take the opportunity at the outset of a quarter to sell some of their "in the money" positions in order to lock in these gains. This leaves these large investors with significant free cash. Which they then look to invest in new areas.

And it appears that one of the most recent areas of interest for investors is the currency markets. Since the financial crisis broke last fall, there has been rapid growth in investment products allowing investors to place bets on global currencies. Simply put, given last year's turmoil, currencies are seen as being safer than other types of investments. If you buy shares in company, the firm could go bankrupt. Yields on government bonds can be (and are) manipulated by central banks around the world. Even commodities trading involves counterparty risk. If you buy a bar of gold but the seller

goes bankrupt before it can deliver the goods, you lose even if you made the right investment call.

But trading currencies avoids many of these risks. The market is big and liquid. Currencies seldom go bankrupt. And best of all, currencies are one of the few types of investment that have been largely uncorrelated to the rest of the financial world lately. During last fall's panic, stock markets, commodities and real estate all fell in value. But currencies like the U.S. dollar rose. Investors who believe there may be more problems ahead for the financial system can use currency trading to make bets with less fear of getting completely wiped out in the event of another crisis.

Recognizing this, banks around the world have been rolling out currency trading products, allowing more investors to get in on the action. As one Citibank vice-president recently told, *The Banker* magazine, "FX [foreign exchange] is now being seen as an investable asset class in its own right, beyond its historical use as a pure portfolio hedge." The head of FX products for BNP Paribas Europe agrees, saying recently that "Investors have increasingly been looking for instruments which will give them exposure to FX as an asset class." Clearly there is a trend toward more trading of currencies.

More trading means currency values globally will increasingly be affected by investor sentiment. And not surprisingly, prevailing sentiment is that the dollar is headed for a breakdown. Several banks have rushed to cash in on the current anti-dollar trend. RBS recently unveiled its "currency pyramid" product, which allows investors to easily short the dollar against a basket of global currencies.

All of which raises the question, is the recent fall in the dollar due to businesses around the world moving away from the buck? Or simply due to investors guessing that this will be the case? The former would mean that dollar weakness is fundamental. The latter suggests that the fall in the dollar is speculative. And we all know that speculative bets can reverse themselves quickly if and when sentiment changes.

More of Something Useless

Even if we assume that the dollar's recent weakness is due to fundamentals, the effect of a weak dollar on commodities may be somewhat different than many investors are expecting.

It is entirely possible that the world will move away from the dollar. The recent explosion in the U.S. monetary base doesn't inspire much confidence in the currency. Even the bond market showed signs of non-confidence in the dollar this week. Between October 7 and October 14, yields on the U.S. 30 year bond rose nearly 0.3%. The largest single-week increase since May. Rising yields mean that investors are selling off bonds. A vote of non-confidence in the U.S. government.

But a weak dollar may not be the boon for commodities that many investors are expecting. It was almost comical last week to see oil investors celebrating the news about

the petroleum market potentially moving away from dollars. Indeed, if oil was to be sold in other currencies, it would be a significant setback for the dollar. Demand for bucks would drop, likely depreciating the currency. And this would raise the dollar price of oil. So far, so good.

But here's the problem. If the oil market moves away from using dollars, *the U.S. dollar price of oil isn't going to matter anymore*. No oil company is going to be receiving dollars for its crude. The NYMEX price could go to \$1 billion per barrel, and it won't make one bit of difference to the bottom line of oil producers. Did anyone celebrate this week because oil hit \$28,000 Zimbabwean dollars per barrel? No, because no one sells oil in Zim. If the currency becomes obsolete, so do commodities prices based upon it.

Increasing commodities prices due to dollar weakness is a "paper game" only. Yes, anyone who owns a barrel of oil or a bar of gold will be able to get more dollars when they sell. But those dollars won't buy any more than they did a month, a year or a decade ago. Owning more of something that's worth less is a net wash out.

And this will be exactly the position that producing companies will find themselves in following a dollar devaluation. Suppose the dollar falls 50% tomorrow against the world's major currencies. Sure, the price of gold might double to \$2,000 per ounce. And gold producers' revenues will double in stride. But for mines in any country outside the U.S., costs will suddenly double too. An Australian mine pays its workers in Australian dollars. It will now take the company twice as many U.S. dollars to buy the Aussie dollars it needs to pay its staff. Likewise for any supplies purchased locally. Steel, fuel, even camp food will cost double.

This will ultimately ensure that margins (which are really the important metric for a business) improve little. Mines in the U.S. might fair somewhat better. They would still be able to pay employees in dollars. Except that any goods America imports from other countries would now be twice as expensive. That means fuel (made from imported oil), steel (made from imported iron ore) and a lot of mining equipment. Even labor would likely get more expensive as workers, facing now increased costs of living, would demand higher wages.

Admittedly, a dollar collapse would benefit commodities companies in the very short-term. If investors see oil suddenly jump to \$300 per barrel, the knee-jerk reaction will be to buy shares of oil producers. But the world will very quickly realize that a weaker dollar does not mean higher profits for producing companies. Life will go on, largely unchanged. Except that we will put a different symbol in front of our price quotes.

The Future is Shaley

The *New York Times* ran a big article this past week on the future of shale gas. In the piece, the paper discusses the potential for shale gas development around the globe. According to the writers, shale will help western Europe reduce its dependence on Russian gas imports. And eventually shale gas production will become a major source of

supply for energy-hungry developing markets like China and India. In short, shale will be an energy savior for much of the planet.

In terms of science, this makes sense. There are certainly extensive shale deposits in many countries around the world. And many of these are known to be gas-bearing. The NYT correctly points out that there are, or have been, investigations of shale gas potential in Germany, France and Poland. I've reviewed projects in Hungary and Romania that also show promise for large gas-in-place volumes.

And the push for shale gas outside of the established fields of North America is gaining strength. Italian oil major ENI recently paid \$280 million for a 27.5% stake in leases in Texas' Barnett shale, held by long-standing unconventional gas developer Quicksilver Resources. More than just gaining production upside, ENI is looking to up its shale gas knowledge here. After learning what works in the Barnett, the hope is that the company will be able to apply this expertise to shale plays in other parts of the world.

To be sure, this is a worthwhile pursuit for gas producers. The success that North American producers have had with shale plays like the Barnett, Haynesville, Horn River and perhaps now the Marcellus of the northeast U.S. (more on that in a moment) certainly suggests that shale gas can be a profitable and prolific enterprise. There is all the likelihood that some shales in other parts of the world will prove equally successful.

But this won't happen overnight. To suggest that shale gas is going to quickly become a solution to world energy demand is misleading. Yes, we know of a lot of shales around the globe that hold a lot of gas. But getting that gas out is another matter altogether.

First, there's the issue of developing proper completions. Shale gas wells are far from conventional. This isn't just "plug and play" technology, where you spot the shale, drill a hole, and then sit back and watch the gas come flowing up. Getting gas to flow from shale almost always requires "fracking". A more-complex method of completing a well, where fluid is pumped down the well and then put under pressure until it cracks the rock around the wellbore.

Fracking is common practice in North America. We know a lot about the science behind it, and there are a number of service companies that do it very well. But it takes time and effort to design a proper frac. The well operator must decide how much fluid they need to put down the well. And how much pressure to apply.

The chemistry of the frac fluid is also a science unto itself. Fracs can be performed with water, foam, or a host of proprietary chemicals. If the target shale contains clay, care has to be taken to choose a frac fluid that won't cause clays to swell and plug the cracks through which gas is supposed to flow.

Frac can be "energized" by adding nitrogen or carbon dioxide gas to the fluid. In some cases this increases the gas flow from the well. But in other types of shale, energized fracs damage the producing formation and result in less gas being recovered. In the

Marcellus shale, operators originally tried energized fracs that had worked on wells in Texas. The results were sub-par. The play didn't open up until some operators began trying non-energized "slickwater" fracs that had been successful in the Barnett shale.

A final consideration in frac design is "sanding". Sometimes cracking a gas-bearing rock is not enough to keep gas flowing. Some formations, especially deeper shales, have the annoying habit of "healing". The rock flows like Plasticine, sealing off the cracks created by fracking and choking off gas flows just a few weeks or months after completion.

To prevent this, operators often inject sand into their frac fluid. The sand grains are shot into the cracks in the producing formation and hold these fractures open. Done properly, sanding can greatly increase gas flow rates. But it's a fine balance. Putting too much sand into the well can plug up the cracks and actually reduce flow rates. But if not enough sand is included, there will not be enough force to prevent cracks from healing. Some well operators even use specialty products like tiny ceramic beads, rather than natural sand, for their fracs. A lot of variables to consider.

At What Cost?

There is a lot that goes into designing a proper frac. Making this a challenging task. But it is certainly not a show-stopper. The petroleum industry is getting better and quicker at assessing shales and designing fracs to match. During the pioneering work in the Barnett shale, it took a decade to get the frac right. But in the most recent wave of shale gas development across North America, it has taken much less time to optimize completions.

The technical challenges in getting shales to flow gas are manageable. Proper fracs can certainly be designed for shales around the planet. The bigger issue is making these procedures economic.

The technology that goes into pulling off a successful shale frac doesn't come cheap. These completions require a lot of specialized equipment. Let's look at the aforementioned Marcellus shale for a moment. In prime acreage in Pennsylvania and West Virginia, the Marcellus is found at depths up to nine thousand feet (about three thousand meters). Putting enough pressure down a deep well like this to crack the shale requires upwards of 12,000 horsepower. That's one-eighth the power of a jet-engine! The operator needs to bring a serious motor on site.

Another problem with complex fracs is they have to be completed smoothly. Any stops and starts in the procedure can cause major problems. In the worst case, delays can completely compromise the well, wasting the millions spent drilling the hole in the first place. This means that when the frac is begun, all necessary supplies must be on site and ready to go.

This is an issue because of the sheer volume of materials required. In the Marcellus, a vertical well requires thousands of barrels of water to complete the frac job. A horizontal well needs *tens of thousands* of barrels. All of this water must be on hand. It can't be

trucked in as needed. If a delivery is late, the whole well might be ruined. Same goes for the two hundred tons of frac sand required for typical well.

The solution is to build on-site storage for these supplies. For water, this usually involves digging a large pit near the wellsite. At considerable cost. The sand doesn't need a pit, but it does require significant expense not only to purchase the sand but also to have it delivered by truck to site. A process that can take a few days, given the large volumes involved.

Once all of this is assembled, the operator needs to make sure they have all of the equipment (and equipment personnel) needed to smoothly move water and sand from storage to the well bore. This can require 20 different pumps. All of which have to be connected and managed. Far from a simple operation.

The kicker is that all of this expensive equipment needs to be backed up. We discussed above that any delays during the frac procedure can compromise the whole well. With millions in drilling costs at stake, most shale gas operators choose to have back-up engines and pumps on site. If something breaks, you just can't afford to wait for another to be delivered. And all of this back-up equipment costs yet more money.

The bottom line is that drilling a shale gas well is an exercise in project management. Operators need to get a lot of equipment and supplies on site. Often from several different contractors. They then need to manage all of these pieces through the drilling process. And do it all at as low a cost as possible. If your well ends up cash flowing \$15 million worth of gas, it's great if your original drilling costs were only \$10 million. But not so good if you spent \$20 million to drill.

Given all of these cost-control considerations, operators have a hard time managing things economically even in many of the most popular U.S. shale gas plays. And these are areas where drill rigs, supplies and trained labor are plentiful. The challenge becomes greater trying to pull this off in a completely new shale play. Especially if the play is in a country with little oil and gas activity. Trying to pull together all of the necessary pieces to drill and complete a well can get expensive fast.

Cost control is what makes the difference between an industry and a science project. Shale gas around the planet won't be developed on a large scale until people can make money doing it (and preferably a lot of money). And that will take time as local professionals get acquainted with the technology involved.

Colombia, Tokyo and the Wildcats

The rainy season has descended on Vancouver this week. With the mist socked in, I've been fortunate to be offered a number of "escapes" in the coming weeks. It looks as if my partners and I will be returning once again to Colombia in mid-November. The trip will involve a few days of project work in Medellin, but will end on a fun note with a golf

tournament in Bogota, hosted by my friends at EFG Bank. From what I've heard some of the courses in the city are quite stunning. I look forward to some "investigative ironing".

I'm also looking at itineraries to make it back to Hong Kong in mid-December, likely with a side jaunt into southeast Asia. Then it will be back home to settle a few things, collect the kids, and head to Tokyo, where I plan to spend most of the month of January. Japan tends to get less press these days than America or even Europe. But it is still the world's second-largest economy. What happens here makes a difference to the world financial order. The last time I was there (October 2008), there was panic in the streets about the high and rising yen, as the world's financial markets collapsed. It will be interesting to see what has changed (and what has not) over the past year.

With all of this traveling, time has been flying by. It's hard to believe it's nearly November. Although the approach of that month is especially exciting this year given that the college basketball season will kick off with my beloved Kentucky Wildcats looking like true contenders. The Cats have snagged two serious freshmen in John Wall and DeMarcus Cousins. I can't wait to see these gentlemen in action.

In the meantime, I'll be watching the markets like all of you. Trying to decipher whether we're headed for yet-higher heights, or whether the much-anticipated correction/crash is upon us. One thing is for certain, the next few months will not be boring! Happy investing to all of you, and have a great weekend.

Here's to sound business, whatever currency it's settled in,

Dave Forest
dforest@piercepoints.com

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