

ROBERT PRECHTER
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NOTES ON THE STABLE CURRENCY BENCHMARK™ (SCB)

Here is what readers are saying:

“You may remember me as a long-time advocate of adjusting market prices for inflation.... The problem is that I’ve never found a reliable measure of inflation. The government’s figures are anything but reliable. *I think your approach using [this] basket of currencies is the best approach yet.*”

“Thanks for opening the door to new possibilities using the SCB.”

“I truly think you have found a great way to view the markets with EWI’s proprietary currency benchmark.”

A Useful Benchmark for Investors, Particularly Global Investors and Hedge Funds

The Stable Currency Benchmark™ (SCB) is a basket of four currencies, chosen for their unique potential to offer relative stability in expressing global purchasing value when combined as a single measure of value. For a full description of its makeup and the reasoning behind its formation, see the November 2004 issue.

The SCB is a better benchmark than any single currency for measuring the value of stocks, bonds, commodities, real estate and other investments for anyone with a global perspective. Treating the SCB as the “currency” by which one measures *every* investment and potential investment provides a convenient way to put them all on a level playing field. No longer does an investor have to spend time factoring out local currency fluctuations to get a true measure of relative value. With one benchmark, all comparisons are valid.

Why Gold Does Not Qualify as a Stable Benchmark for Pre-1990 Data

Gold — real money — would be the perfect benchmark by which to measure the true value of markets except for one thing: the U.S. government pegged the dollar price of gold for decades, causing a false undervaluation in gold, and then, when the pressure was too great to endure, it removed the peg. Gold soared, gathering such investment interest that it reached a tremendous overvaluation relative to dollars and goods. Following this overvaluation, it crashed. This history of relative value is so dramatic that it distorts the fluctuations of any market history measured in terms of gold at least through about 1990, when it settled down.

In contrast, we have reliable values for currencies going back to 1971, when they were allowed to “float.” Thus, *a basket of competing currencies* provides a relatively consistent benchmark against which to measure market values. It is also a more accessible investment than physical gold, an efficiency that has value as long as the chosen currencies stay managed well enough to avoid banknote (as opposed to credit) inflation.

Why the SCB is Not Mostly U.S. Dollars and Euros

The SCB is not designed to reflect global currency quantities. If it were, it would be weighted mostly in U.S. dollars and euros. Just because there is a lot of some currency in circulation does not mean that it belongs in the SCB. The SCB is designed to provide a stable benchmark of global purchasing power, and its components are selected to meet that criterion. For this purpose, the Swiss franc is clearly a better choice than the euro among European currencies. The euro is a currency managed by a group of trading partners

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who have been historically distinct if not involved in warring with each other. By contrast, Switzerland has been politically stable and neutral for a long time, and the fact that its financial institutions hold 40 percent of the world's privately held wealth contributes to its physical safety.

Why the U.S. Dollar Is Included in the SCB

The dollar is a necessary component of the SCB primarily because *it is the stabilizing factor relative to the other three components*. The U.S. dollar is (currently) the world's reserve currency, and when it rises, other currencies mostly fall, and when it falls, other currencies mostly rise. Without the dollar in the SCB, it would look almost the same as the Dollar Index but inverted. It would thus have nearly the same level of volatility. The point of the SCB is to form a *stable* benchmark. If anything, the dollar is *underrepresented* for achieving this balance. Other factors, however, override this one consideration.

There are additional reasons to include the dollar in the SCB. Geographical diversification is an important criterion for the composition of the benchmark, so it should certainly include at least one currency from the western hemisphere. The U.S. dollar historically has been the strongest currency in the Americas. The U.S. has central-bank transparency and is geographically protected by two oceans and friendly neighbors. The only other currency even remotely considerable is the Canadian dollar, primarily because of Canada's political neutrality. But the Canadian dollar has underperformed the U.S. dollar for most of its existence and since 1971 has lost half its value against the SCB, as you can see in the accompanying chart. Moreover, Canada is a benign socialist democracy, which is second to a constitutional republic in stability and inflationary pressures. Against our criteria, the U.S. does not score well in banking system liquidity and national savings rate, but neither does Canada. Some bulls on commodities have argued that the Canadian dollar be included because it comes from a heavily resource-based economy. Bears on commodities would obviously want to *exclude* that currency for the same reason. Such thinking is contrary to the spirit of the SCB, which is not designed to reflect any particular investment opinion or bias. As it happens, the SCB currently includes a representative of a resource-based economy (New Zealand, whose primary exports are agricultural, including timber), as



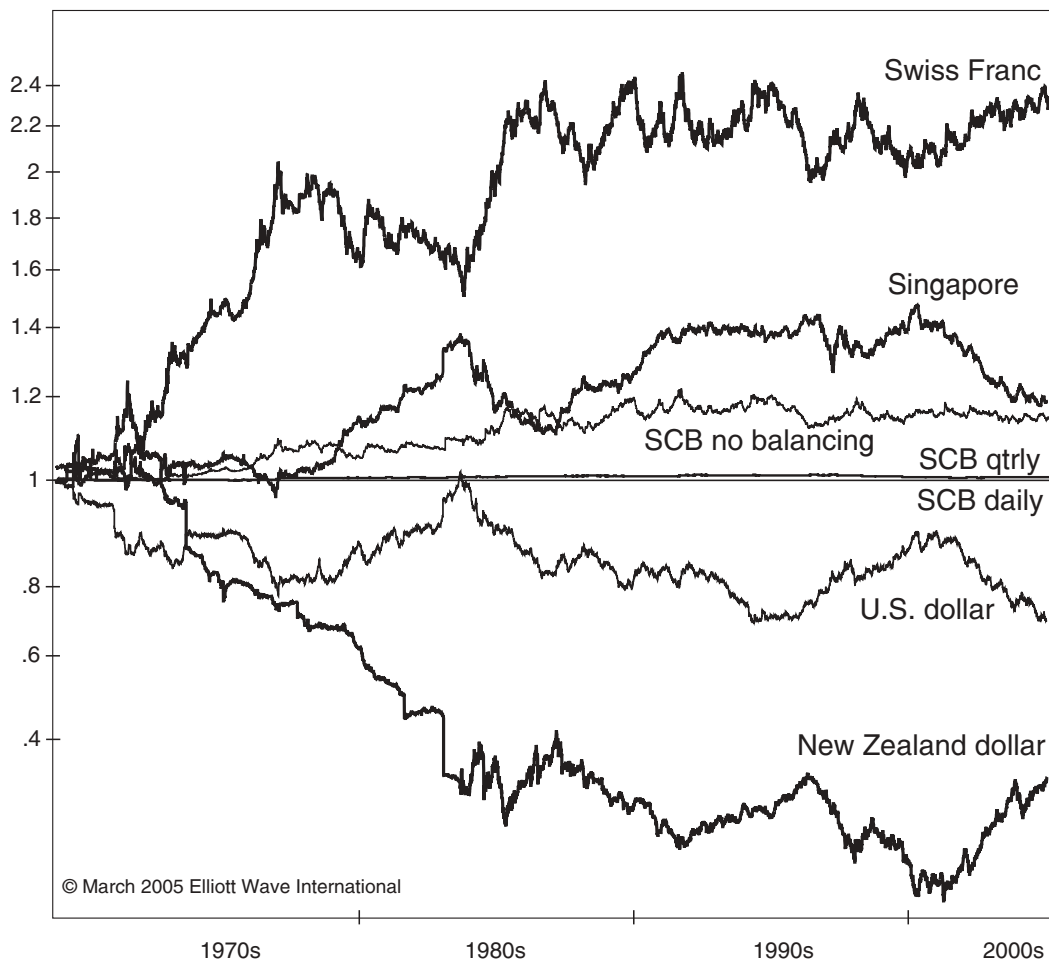
well as from a financial economy (Switzerland), an industrial and service economy (the U.S.) and a general business economy (Singapore). Typically, we have found that people who dislike one of the currencies in the SCB come from the country that issues it. They live there, so they see the local negatives and think their country, currency or central bank is being overrated. Hating the Fed and fearing inflation are acceptable reasons to create a *speculative fund* — for example one comprising commodities or non-U.S. currencies — but it is a poor basis upon which to design a stable currency benchmark.

We plan to watch the management of these currencies closely. Should any global quadrant produce a currency that is more attractive for the SCB's purposes than the one currently chosen from that quadrant, we will change the SCB's composition accordingly.

Is Re-Balancing Necessary?

Theoretically, one should re-balance the SCB index every day to keep the value of each of its components equal to 25 percent of the total. Practically speaking, however, we have found that the choice of re-balancing interval has a negligible effect on the value of the benchmark. Figure X shows the SCB against various currencies. The two lines in the center, almost indistinguishable from each other, are the SCB, one re-balanced daily, the other quarterly. As you can see, the lines are virtually identical.

In fact, even if you never re-balance, the equity is not greatly affected relative to the more dramatic fluctuations of individual currencies. The line just above the center is the result of holding the original mix from January 1971, and as you can see, it varies far less than individual currencies do. (The relative performance of this line will vary depending on the start and end dates, so it is not always better or worse than balancing.) Someday, if one or two of the currencies were to move dramatically in one direction or the other, re-balancing might be important. As keepers of the SCB, we plan to re-balance quarterly. In terms of investing, however, anyone who wishes to maintain liquid capital in terms of the SCB will be adequately served by allocating it equally among the SCB's four currencies at the outset and then leaving it alone.



A Universal Benchmark of Value

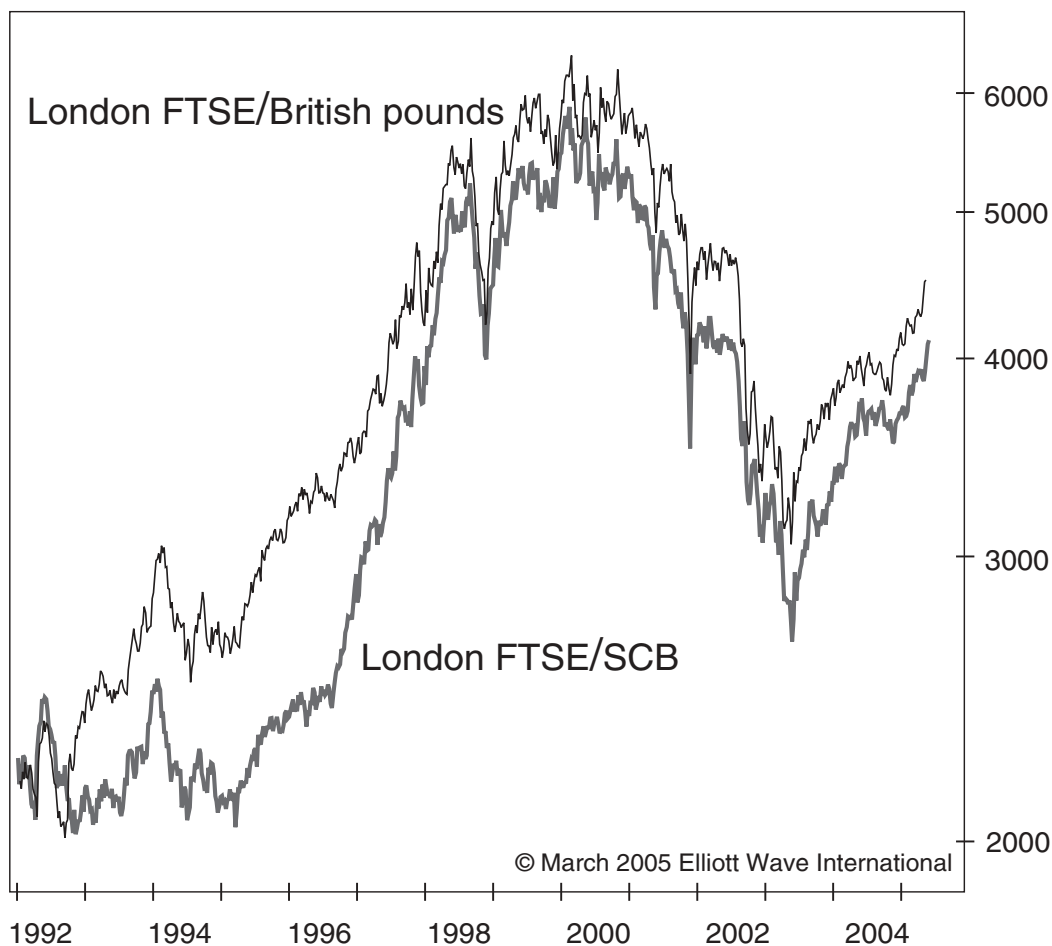
Did you really make money in the S&P 500 in 2004, or was it an illusion due to a weak dollar? Did you really make money in the Mexican Bolsa since 1993, or was the market rising only because of a crashing peso? Did you really make only one percent in Swiss money market claims in 2003, or did a strong Swiss franc hide the true relative yield? How about your U.S. T-bills? What about South African gold stocks? German bunds? What did the Nikkei *really* return in 2004 in terms of global purchasing power?

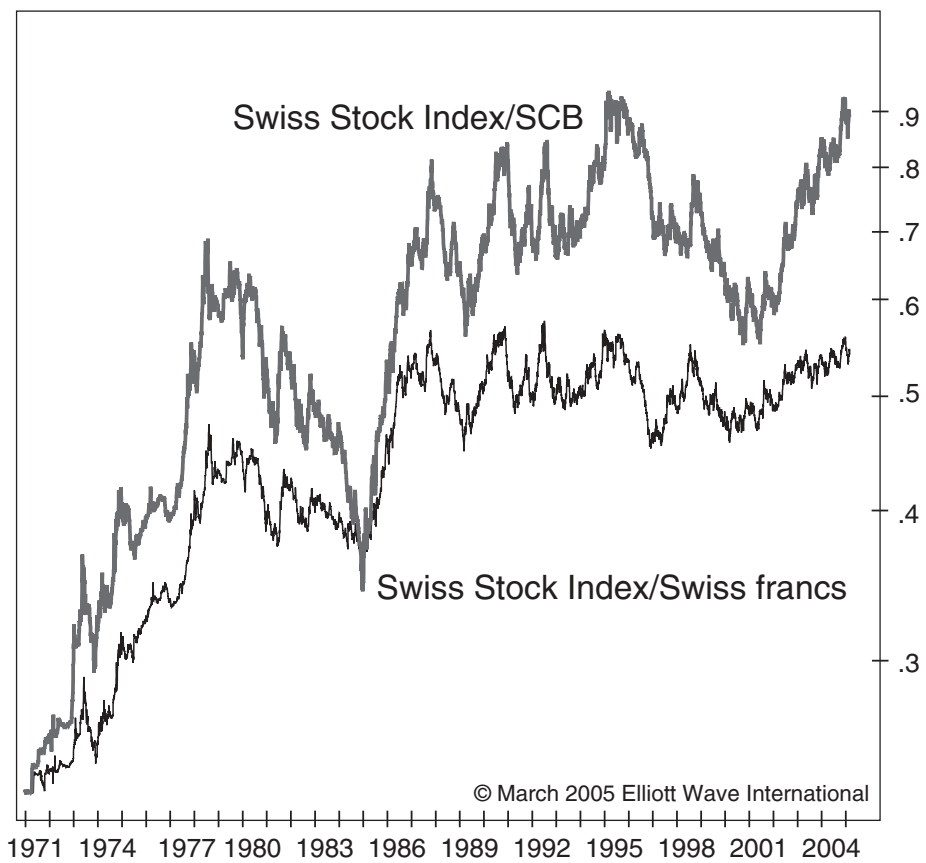
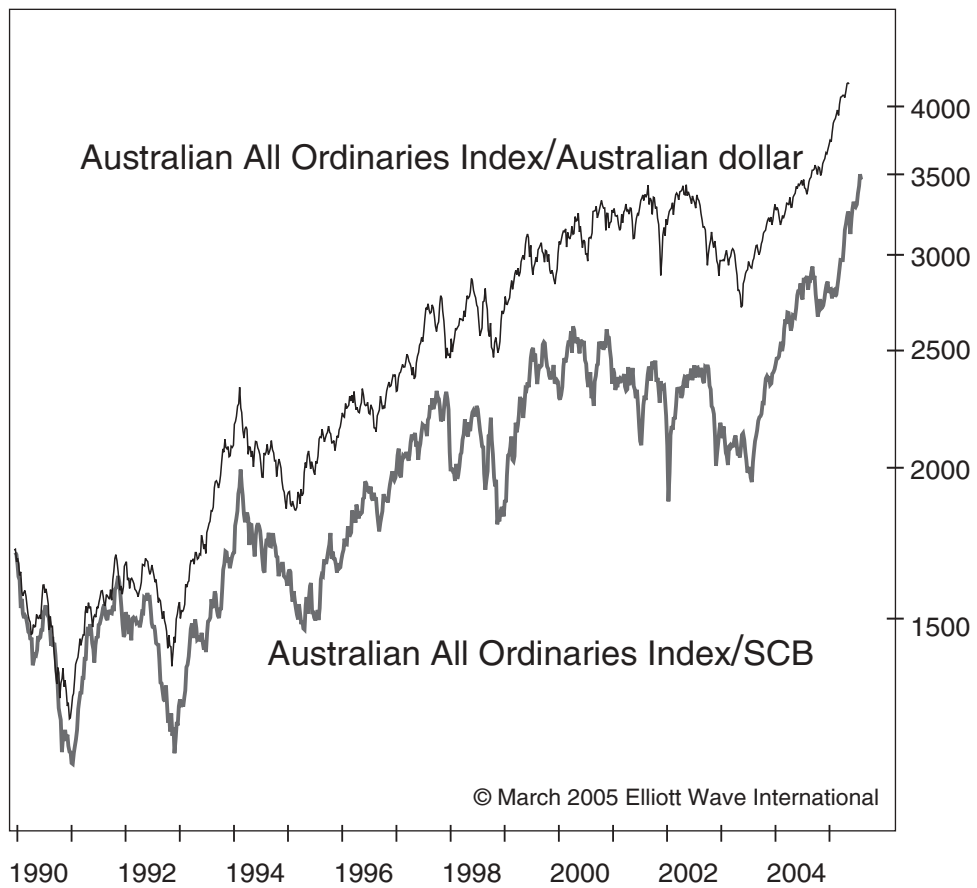
The following pages show various investment markets and indexes in terms of their *local* currency and in terms of the *SCB*. You will observe moderate differences in some of them and radical differences in others. If you get into the habit of graphing *all* the markets that interest you in SCB terms, you can *eliminate* the bogus charts and view all of them only in terms of a stable benchmark that pits each one against the other with a dispassionate equality of opportunity to provide real value.

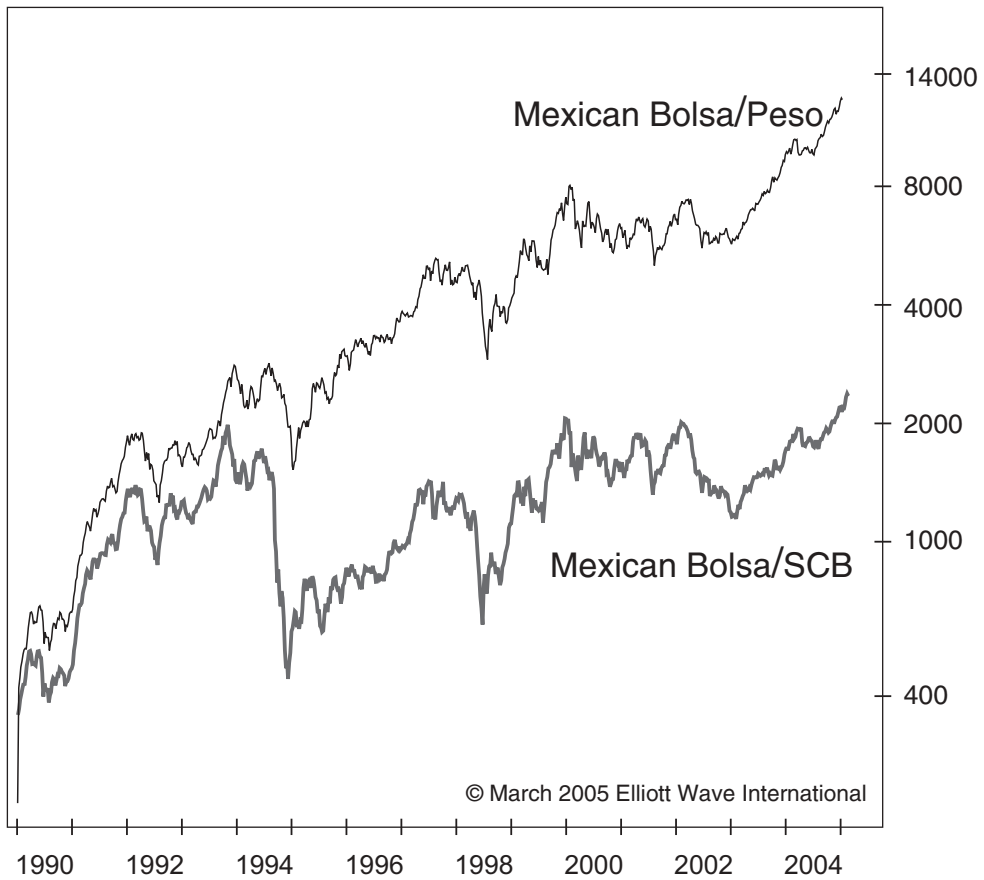
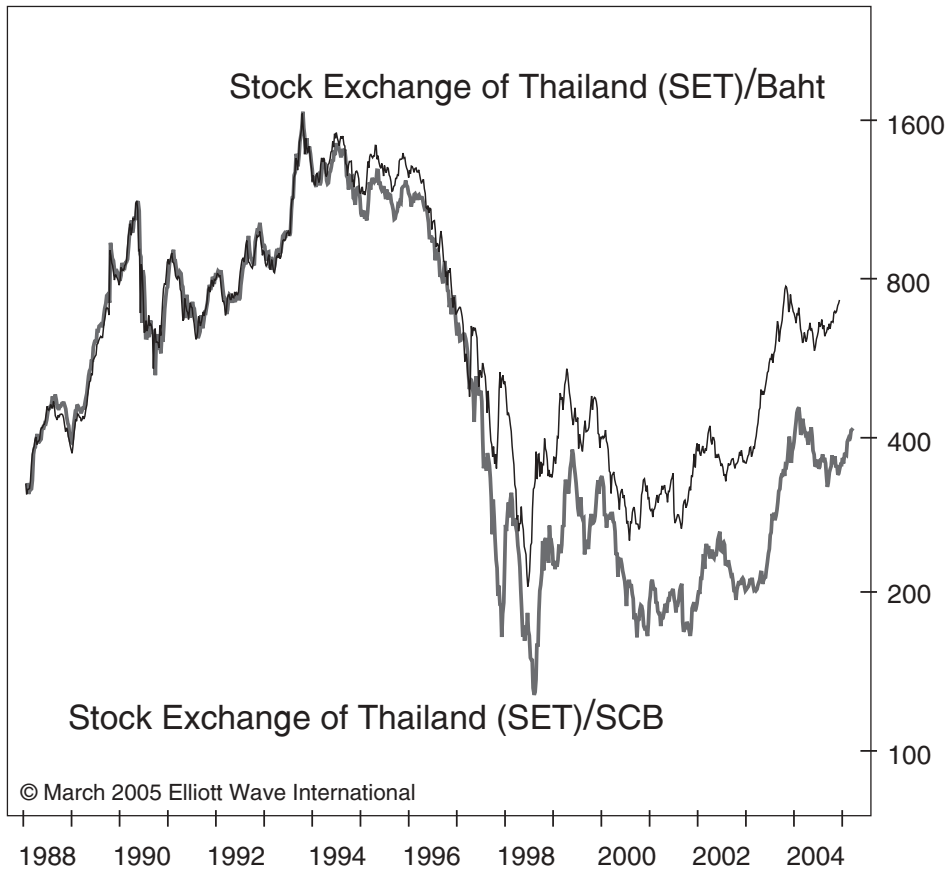
It should be clear how useful it would be for any globally minded investor or fund manager to keep all markets in SCB terms and forget what they look like in terms of local currency values. With one glance, you will be able to identify pockets of relative strength and weakness.

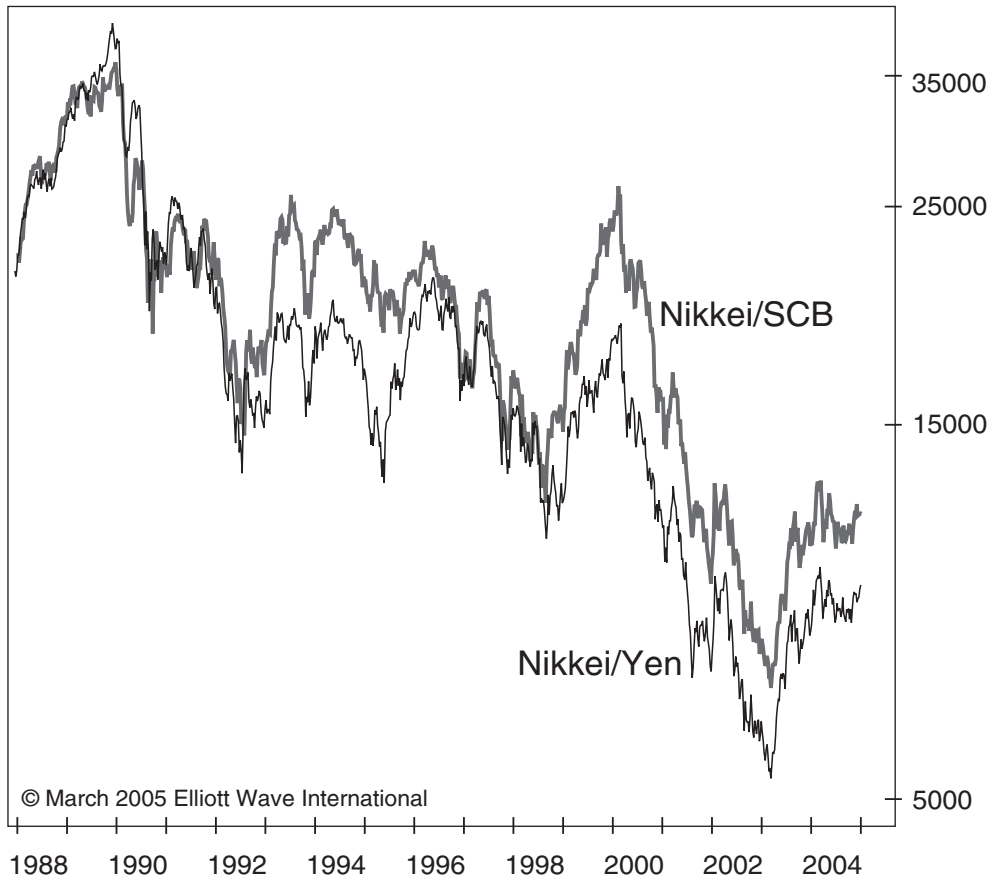
Holding savings in the form of the Stable Currency Benchmark is an excellent way to “park” capital, particularly for global players such as banks and hedge funds. An SCB mix is like a money market account but without the individual currency exposure. After you make your profits in SCB terms instead of local currencies, you can spend your money in whatever country is providing the best purchasing-power values due to a weak local currency. Using the SCB to hold capital thus offers a dual advantage.

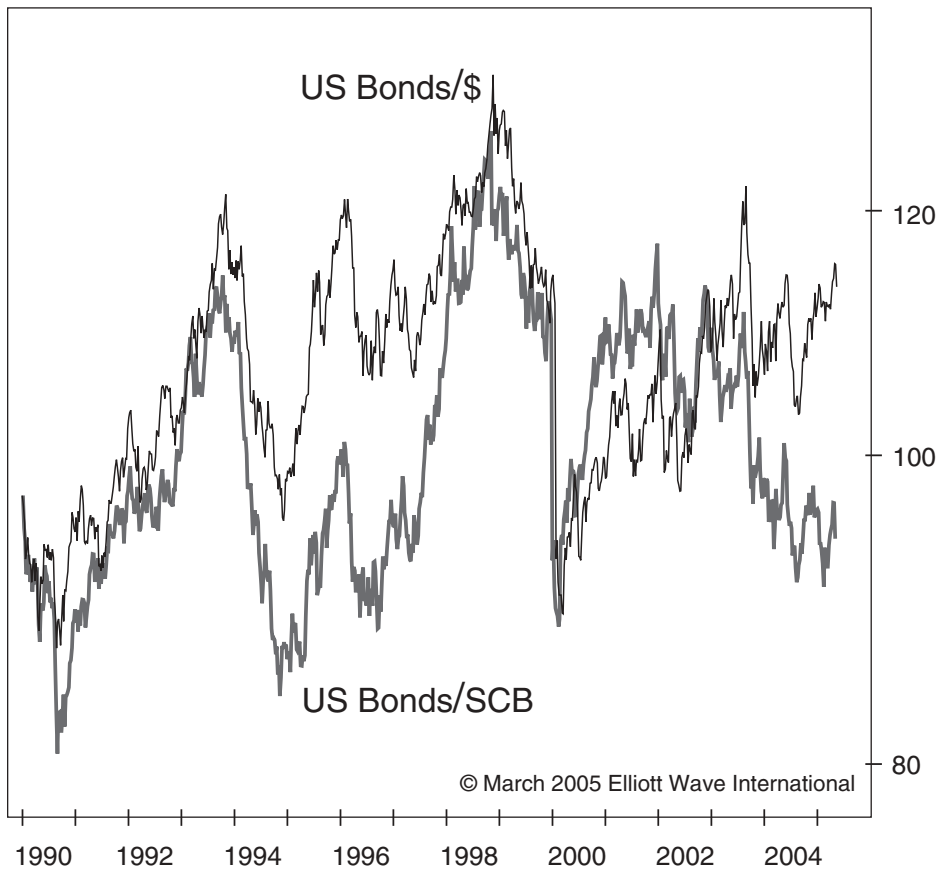
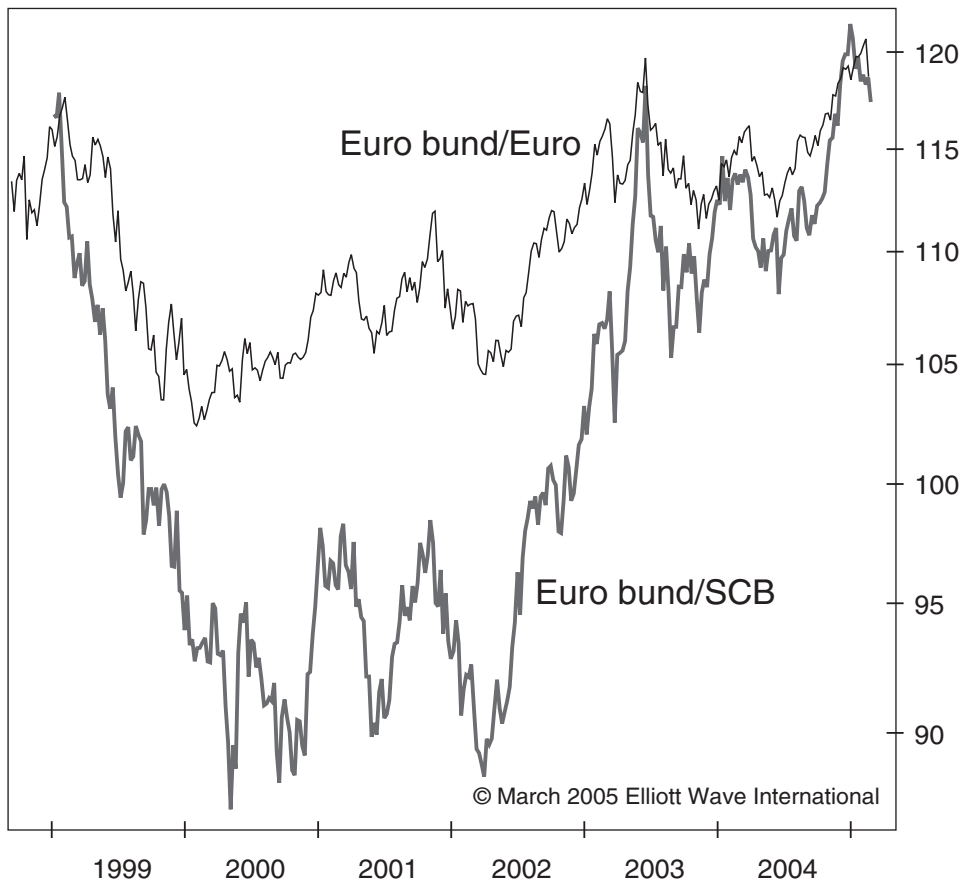
By the way, Hillier Capital Management has switched its method of holding funds for investors in SCB terms. Instead of a mutual fund, it is using an individually managed account structure, which requires higher minimums. Hillier may be reached at 616.796.6659 (ext. 10) or at www.hilliercapital.com. We continue to encourage all kinds of firms — hedge funds, mutual funds and account managers — to offer an SCB option to their clients.

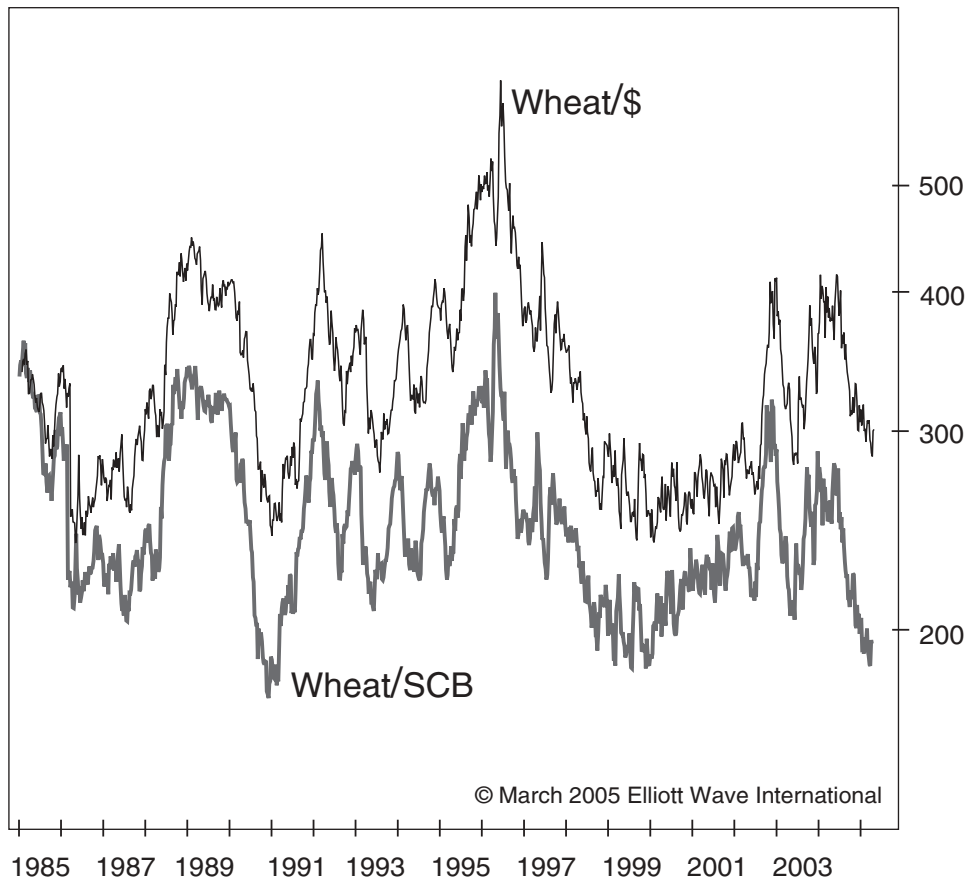


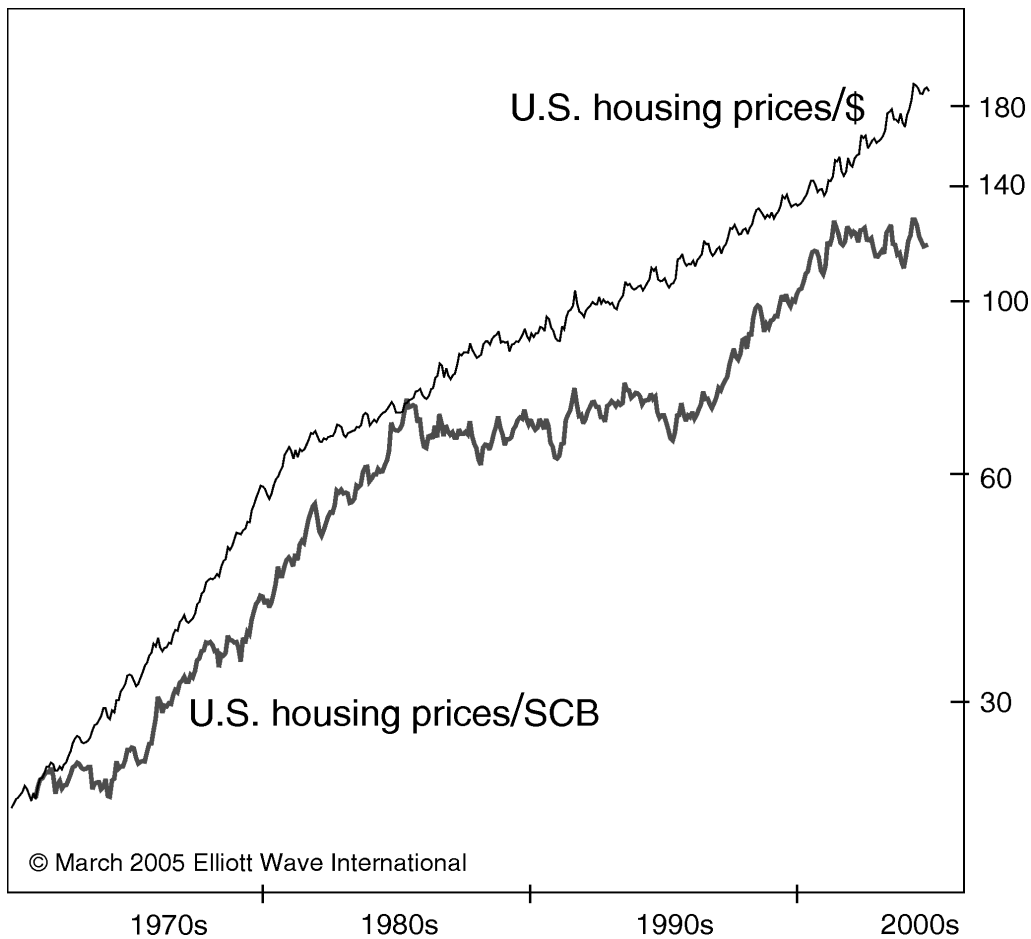












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