COMPASS WATCH

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IMPLICATIONS OF A STRONG U.S. DOLLAR: IS A STRONG DOLLAR GOOD FOR THE STOCK MARKET & ECONOMY?

Since mid-2014, the U.S. trade-weighted broad dollar index[1] has appreciated nearly 20%[2], with the largest gains against the Japanese yen, Mexican peso, Canadian dollar and the Euro. Currency movements have always been complicated both in their causes and consequences. The rapid rise in the dollar, while not uncommon, is certainly significant. Factors behind the dollar's advance include: improving U.S. economic growth prospects relative to other major countries and diverging trends in monetary policy between the U.S. Federal Reserve (pending rate increases) and other global central banks (ongoing stimulus policies). Stronger growth also means that U.S. interest rates are higher than those of European countries and Japan[3]. These wide interest rate differentials make the dollar more attractive to hold. Not surprisingly, more than half of U.S. Treasuries outstanding are held by foreign investors, including major central banks[4].

While a stronger dollar makes exported goods and services more expensive, exports represent only 13% of U.S. GDP, compared with 68% for domestic consumer spending. Since many commodities, notably oil, are priced in U.S. dollars, a stronger dollar means lower commodity prices, which is good for consumption-orientated economies like the United States. Today, approximately 40% of earnings of the S&P 500 Index come from outside the U.S. A number of U.S. based companies (those manufacturing in the U.S. and selling outside the U.S.), have acknowledged that the rise of the dollar will negatively affect their bottom line. Positively, a rising dollar is cutting import prices, keeping a check on inflation. While the U.S. unemployment remains low, limiting capacity to absorb extra demand without generating some inflation, a higher dollar may effectively transfer demand from the U.S. economy to economies globally. As a result, other world economies (e.g. Europe) may see a boost in their exports from the strong dollar. In the long-run, this should lead to a healthier, more balanced global economy.

However, a surge in the dollar tends to hurt sales and profits of U.S. based multinationals, at least in the short-term. This is because foreign profits get translated back into U.S. dollars at less favorable exchange rates. For example, Proctor & Gamble maintains plants in Europe for which it derives revenues in euros, incurs costs in euros, receives payment and pays taxes in euros. In their latest earnings report (10/23/15), P&G saw core earnings per share decrease 1% versus the prior year. Excluding the impact of foreign exchange, currency-neutral core earnings per share increased 12% for the quarter! While many on Wall Street would look at P&G's quarter and view it as letdown, we feel that it was positive (growth of 12% in factors they can control seems great in the current environment). In our opinion, it is far more important to evaluate investment opportunities on a "constant currency" basis as currency is simply an accounting metric. This allows us to focus on uncovering opportunities in great businesses at bargain prices. In general, a stronger dollar is likely to be both a market and economic positive. Since 1980, the stock market has performed twice as well during dollar bull markets than dollar bear markets and has posted gains every year following years when the dollar appreciated by more than 10%[5].

If you are interested in learning more about how we manage our equity portfolio, give us a call. How may we help?

[1] Trade Weighted U.S. Dollar Index: an average of the exchange rates of a country's currency with the currencies of its most important partners, weighted to reflect each trading partners' importance to the country's trade, also known as its effective exchange rate. Currencies in the U.S. dollar index are the euro, yen, sterling, Canadian dollar, Swedish crown and the Swiss franc. It was launched in 1973 with a value of 100.
[2] Bloomberg, Dec 1, 2015.
[3] See previous *Compass Watch*, Investment Mistake #6: Allowing Public Perceptions To Drive Your Fixed Income Portfolio.
[4] Federal Reserve.
[5] Barron's & Bespoke Investment Group.

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