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THE DOLLAR FOR YOUR THOUGHTS
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Earnings, revenues, price-earnings ratios and many other corporate income and balance sheet metrics dominate investors’ considerations, while the value of the U.S. dollar often is overlooked. After an 8-month decline, however, the fate of the dollar has become a more integral part of many market narratives.

Commonly, investors try to assign a direct corollary between movement in the dollar and the stock market. However, as the chart on the left (courtesy of Stockcharts.com) illustrates, there is no long-term consistency between dollar and the S&P 500.

It may be counter-intuitive, but a falling dollar often is good for business.

With almost half of all revenue for companies in the S&P 500 coming from outside the United States, mainly Europe and Asia, the recent drop in the dollar helped revenues and earnings for U.S. multinational companies by making their goods and services more competitive overseas. Conversely, when the dollar rises, prices of American-made goods become more expensive. U.S. consumers, however, benefit from the lower prices of imported goods, which could be enough to offset the drag on corporate earnings.

The easy to remember cliché, money goes where it is treated best, helps to explain the dollar’s role in the debt and equity markets.

If interest rates in one nation are higher than they are elsewhere, money will flow to that nation’s markets. In order to execute purchases in the nation with higher yields securities, investors of the nation with lower yields must convert their own currency into the currency of the higher yielding nation. This process, which essentially is buying the currency of the higher yielding nation, will raise the value of the higher yielding nation’s currency. If this yield disparity persists, eventually it can impact exports from the nation that has higher yields. This is the primary reason the equity market has been concerned about the potential for the U.S. Federal Reserve raising short-term interest rates. The New York Federal Reserve office suggests that a 10 percent appreciation of the U.S. dollar would be associated with a 2.6 percent drop in real export values.

Also, remember that a currency can appear to have vastly different values when compared to specific countries that can have very little bearing on a nation’s overall trade posture. This is why we consistently refer to the Dollar Index, which is a measure of the value of the United States dollar relative to a basket of its key trading partners’ currencies.

The impact of a currency value is most obviously recognized in the effect it has on commodity prices. There are numerous factors underlying the price of crude oil, but there is a strong short-term one-to-one inverse corollary between the dollar’s value and the price of crude oil. Many industrial commodities have similar short-term relationships to the dollar.

A rising dollar does not assure that the negative impact it could have on corporate earnings will derail equity prices. The equity market is fine if the dollar strengthens because growth accelerates, but a strong dollar while foreign economies are weak could be a headwind for equity prices. The 1990s probably was the best example of a period when the dollar strengthened notably while U.S economic growth was robust.
An August 7 Janney Investment Strategy Group report titled “CORRECTIONS - CAUSE AND OPPORTUNITY” detailed eight general factors that could lead to a market correction. The value of the dollar was not specifically listed as a correction cause, but combined with other conditions, the dollar can tilt the market toward a pullback or full correction.

From its late-December 2016 high, the Dollar Index has fallen nearly 10.5%, which, as noted previously, has helped sales and earnings for U.S. multinational companies. At this time, however, the Index appears to be positioned for a rally. A rebound in the Dollar Index appears potentially to be relatively modest (approximately 2%), which would not meaningfully impact the equity market, but a more consequential move of nearly 5% is possible. Although a 5% change might appear to be inconsequential, the directional change could turn the dollar from being a tailwind for equities into a temporary headwind.

On its own, the value of the dollar typically would not be a catalyst for a significant move in the equity market, but it should be monitored nonetheless.

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