



The Declining Dollar

In recent months, the dollar has hit an all time low as compared to a broad index of six major world currencies. What could this mean for the US economy, the global economy, and your portfolio?

A declining dollar has both positive and negative economic effects. On the positive side, when the dollar weakens, goods priced in dollars become cheaper for overseas consumers, which increases demand for US goods. According to Liz Ann Sonders, Schwab's Chief Investment Officer, the recent weakness in the dollar has had the positive effect of boosting US exports, in turn boosting US GDP (Gross Domestic Product); this positive effect of the dollar's decline has played a large role in keeping our economy in decent shape despite the housing slump.

Since Standard and Poor's estimates that about 44% of the revenues generated by the companies in the S&P 500 (a broad index of US large company stocks) are derived from international sources, the increase in demand from abroad bodes well for the bottom line for many US corporations. Corporate profits are the ultimate driver of stock prices, so the increase in overseas demand for US goods can have a positive impact on your portfolio.

Another positive impact comes in the form of higher returns generated by foreign stocks you may hold. Here's a good example of how, from the Wall Street Journal: "Suppose a U.S. fund buys a stock priced at 10 euros when the euro is worth \$1.30. That means the stock is worth \$13 to the U.S. fund. If the euro strengthens (and the dollar weakens) to \$1.40 without the stock price's moving, that share is now worth \$14 to the U.S. investor." The declining dollar is a large part of the reason why international stocks have performed so strongly in recent years. The currency exposure works both ways, of course; when the dollar strengthens, returns will be hurt. The fluctuation in the value of the dollar is one of the unique risks associated with foreign investing.

One of the biggest risks the falling dollar carries is the risk of inflation -- namely, import inflation, according to Schwab's Sonders. We are huge consumers of imported goods as indicated by our country's record trade deficit; when the dollar weakens, imported goods become more expensive here, and carry the risk of sparking inflation. Inflation is bad for stock prices, bond prices, and the ability of retirement portfolios to keep up with purchasing power; the risk of inflation also limits the Federal Reserve's ability to stimulate economic growth. So far, import inflation has not been a problem; according to Schwab's research, import prices have been rising at about the same pace as core consumer inflation for the past several years. Year to date, inflation is running at about 3.14%.

Another unpalatable result of the dollar's decline cited by Ms. Sonders is rising oil prices; as the dollar weakens, oil-producing nations charge more to compensate for the fact that their oil dollars (US dollar-denominated) translate into fewer goods and services

around the world. Rising oil prices, of course, have a negative impact on consumer spending, which is a big driver of our economy, and reduce corporate profits. And finally, a falling dollar creates the risk of rising interest rates. The income from US debt held by foreigners is worth less as their currency strengthens; to remain attractive, US debt has to pay higher interest rates. Higher interest rates cut into corporate profits (hurting stock prices) and cause bond prices to fall.

I sat in on a presentation on the dollar at the recent Financial Planning Association conference. It was given by Andrew Rose, an economist and professor at UC Berkeley with a long list of impressive credentials and editorships to his name. His assessment, echoed widely in the financial press, is that there is strong consensus among economists that the dollar must continue to fall given the unprecedented size of the trade deficit, but that there is very little consensus on by how much it might fall, or for how long. That's the million dollar question. An orderly decline is seen by economists as fairly benign, but a sudden decline would be very problematic for the financial markets.

The value of the dollar is one item on a long and complex list of drivers and results of economic activity around the world. All the portfolios we manage that include equity exposure include an allocation to foreign stocks -- not in the expectation of the dollar's continuing decline, but in the expectation that foreign markets and US markets over the long run will react somewhat differently to economic events such as global trade imbalances and currency movements, providing the risk-reducing benefits of diversification.

-- Therese Govern. Posted 11/15/07.