SHOULD INVESTORS FEAR A WEAKENING DOLLAR?

Global Financial Private Capital

SYNOPSIS

- The U.S. dollar (USD) plays an integral role in global economic activity, so its value relative to other major currencies is watched very closely.
- A weaker currency does not imply a weaker economy, and the two often march to the beat of their own drum.
- The USD is the most widely accepted, trusted, and stable currency in the world, and the odds of this changing anytime soon is extremely low.

DOLLAR FEARS

The U.S. dollar (USD) plays an integral role in global economic activity, so its value relative to other major currencies is watched very closely. Over the last several months, the "greenback" has fallen, and given its importance, investors are now starting to ask if an extended period of weakness will adversely affect their nest eggs.

To make matters worse, anytime the dollar weakens by more than a few percentage points, the fearmongering ramps up around two frightening outcomes:

1. **Imminent Crash**: A weaker currency will drive our economy into a deep depression.
2. **Reserve Status:** China or some other contender will take over as the world's reserve currency and cause the value of dollar-denominated assets to fall apart.

Don't believe me? Conduct a Google search on the subject, and you will be inundated with tall tales of an impending dollar collapse. Some have even filmed videos that look like fake talk shows in the same manner used by TV infomercials in the 1990s (until the government banned many of them).

The world does not end all that often, so before we discuss the implications of the recent dollar weakness, let's first deal with the doomsday rhetoric.

IMMINENT CRASH

Most Americans who have traveled overseas would agree that a stronger dollar makes for a more enjoyable vacation. For example, let's assume that a hotel in Paris is charging €300/night. Currently, one euro can buy approximately $1.15, so the hotel would cost $345/night (300 x 1.15 = $345).

A year later, the dollar strengthens relative to the euro, to where €1 can only buy $1.05. The hotel then becomes cheaper at $315/night (300 x 1.05 = $315). The stronger dollar makes an American more confident because his/her money can buy more stuff.

> *"...a weaker currency does not imply a weaker economy..."*

A weaker dollar does the exact opposite. If a dollar can buy fewer euros, then an American traveler will feel less confident because hotels and anything else priced in euros will be more expensive.

When it comes to investing, most forms of weakness tend to carry a negative connotation. Falling revenues, shrinking profit margins, and a softening market for goods and services usually leads to bad outcomes for investors.

However, currencies are very complex instruments that often test the limits of intuition. There are times when a weaker currency can help an economy, and governments will often intentionally drive the value of their currency lower for two reasons:

1. **Increased Demand for Exports:** If the USD has weakened relative to the EUR, then €1 can now buy more dollars. U.S. products become less expensive for buyers paying in euros, and the U.S. would expect to see increased demand for their exports.
2. **Reduced Demand for Imports:** If companies in the U.S. buy goods from Europe, these costs have now increased because $1 now buys fewer euros. Americans and U.S. companies may start buying less from Europe and shift to domestic producers.

Both advantages lead to stronger international competitiveness and economic growth, but that is not to say that a weaker currency is always a good outcome for an economy either. Rather, the point is that the strength of a currency, on its own, is not enough to inform us one way or another on the true health of the economy.

501 North Cattlemen Road, Suite 106 • Sarasota, FL 34232 • Tel: (866) 641-2186 • Fax: (941) 312-6512 • www.gf-pc.com

LOSING RESERVE STATUS

The International Monetary Fund (IMF) is an international organization created back in the 1940s to foster global monetary cooperation, secure financial stability, facilitate international trade, and assist in global economic growth.

The IMF executes its mandate through various services and levels of support for member nations. For example, the IMF is one of Greece's largest creditors, and they have given the country several billions of dollars over the years to help get their economy back on track.

Another function of the IMF is to set recommended guidelines on the use of "reserve currencies" by central banks across the world. A reserve currency is one that is held by governments and institutions in very large quantities to facilitate international transactions. Since the 1940s, the most widely accepted reserve currency has been the U.S. dollar (USD).

They currently recognize five currencies in a basket that is weighted based on their prominence and availability – U.S. dollar, Euro, Chinese renminbi, Japanese yen, and British pound sterling. Most central banks like the Fed and the European Central Bank hold several currencies, but the bulk of their assets are in some combination of these five.

A reserve currency must be both desirable and available, and here is where the doomsayers' prediction fails to hold water. According to the IMF, more than 85% of foreign exchange trading involves the dollar, and nearly all commodities are priced in dollars.

For example, if a company in Malaysia wants to buy a barrel of oil from Saudi Arabia, that transaction will need dollars to complete. Rewriting these contracts and redirecting so much international trade would take time and equal trust in a replacement currency.

Regarding availability, the USD currently represents 64% of all known central bank foreign exchange reserves. The next closest is the euro at 19%, so there is nowhere near enough euro in circulation, let alone any other currency, to replace the total value of dollars held.

China is even lower. The renminbi accounts for around 5% of international trade and less than 3% of central bank reserves. Given China's blatant manipulation and strict currency controls, it's virtually impossible to envision how they could gain any real traction, let alone supplant dollar anytime soon.

Simply put, it took the U.S. several decades to create the level of trust and availability needed to become the world's reserve currency, and there is little chance this will change anytime soon.

IMPLICATIONS FOR INVESTORS

Now that the fearmongering has been put to rest, let's address what has been driving the value of the dollar down this year.

The first culprit has been expectations from investors that the global economy is improving. Foreign investors desperate for returns had invested heavily in the U.S. since the end of the financial crisis, and it appears that many are now packing their bags and heading home.

As they sell their dollar-denominated investments, they must then convert those dollars into their home currency, and this increases the supply of dollars available on the open market. Rising supply leads to lower prices, so the value of the dollar falls.

The second is lower expectations around President Trump's ability to push his economic agenda through Congress. His policies are expected to stimulate the economy, so if they were to go away, this could weaken the demand for dollars.

While both make for good banter amongst the pundits on television, they are far too myopic for long-term investors to lose sleep over for three reasons:

1. **The Trend:** Trends matter far more than data points, and the trend for the past six years has been an indisputable bull market for the dollar, where it has strengthened nicely alongside our economic recovery.
2. **Home Bias:** Portfolios tend to have a "home bias," which means that the bulk of the investments are in the investor's home currency. Since most U.S. investors' expenses are paid in dollars, the need to manage foreign currency risk is lower.
3. **Natural Hedge:** A properly diversified portfolio should create a natural hedge, where the impact of currencies diminishes over time. For example, if the euro strengthened versus the yen, a portfolio's European allocation should offset a portion of its Japan exposure.

SHOULD INVESTORS FEAR A WEAKENING DOLLAR?

There is no question that currencies impact returns, but the degree of impact to U.S. investors only becomes problematic when a portfolio is imbalanced and/or improperly diversified. If this is the case, then an investor has much bigger problems than currency risk.

The bottom line is that the USD is the most widely accepted, trusted, and stable currency in the world. Traits like these take decades to reverse, so ignore the ups and downs that happen over the span of a few months because any impact to your portfolio will likely be minimal over the long run.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer,
Global Financial Private Capital
mikeonmarkets.com