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Dollar power: The economic and market implications of a strong dollar

Dan Morris, CFA
Global Investment Strategist

Executive Summary

- Fears of a strong dollar are unwarranted. The rising value of the U.S. currency reflects the relative strength of the U.S. economy.
- International equities are likely to outperform U.S. stocks despite the currency drag, thanks to valuation gaps and divergent monetary policy.
- Lower import costs dampening inflation plus foreign demand for Treasuries will keep U.S. yields lower for longer.

Cause or effect?

The recent swift rise in the dollar — more than 10% since May 2014 and twice that since 2011 — has raised worries about the impact on the U.S. economy and financial markets (see Figure 1). The concern is that a strong currency will reduce U.S. exports and lead to slower economic growth.

This fear is misplaced for several reasons. First, it confuses cause and effect. The value of the dollar reflects the strength of the U.S. economy relative to its trading partners. As long as the U.S. continues to grow at a faster pace than much of the rest of the developed world, the dollar is likely to continue gaining in value. It is true that U.S. net exports would be lower than if the dollar had not appreciated, but the U.S. economy is not very trade dependent. Goods and services exports account for only 13% of GDP, compared to nearly 50% for Germany. In fact, because the U.S. is a net importer, its economy benefits more from cheaper imports than it loses from more expensive exports. Companies gain as the cost of imported materials and machinery falls, while consumers see lower food and product prices in stores.

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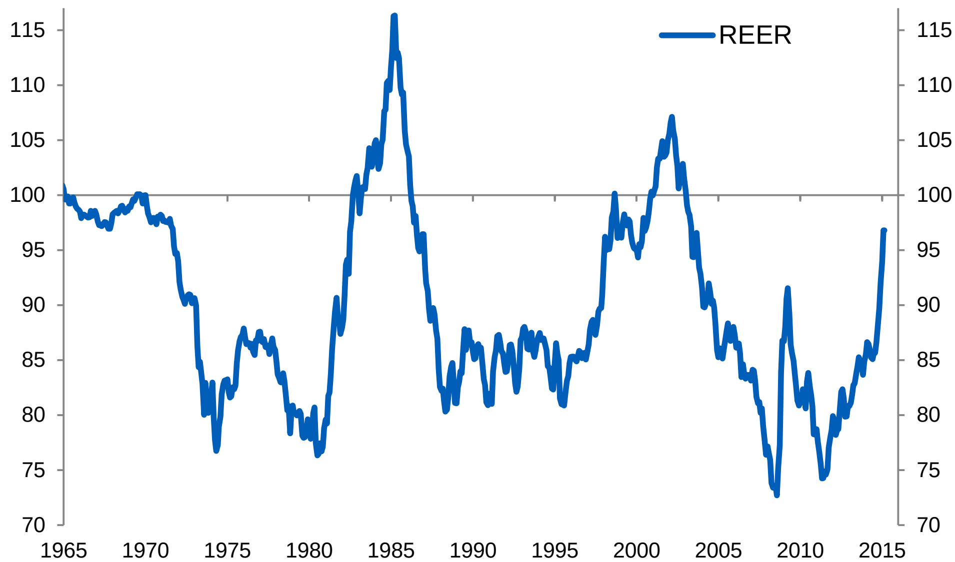
Figure 1: U.S. dollar real effective exchange rate (REER)



Last data 25 February 2015. Sources: J.P. Morgan, TIAA-CREF Asset Management.

There are, however, other forces driving the recent surge in the dollar. Not only is the U.S. economy growing more quickly than its international counterparts, but the steep drop in oil prices has led to sharp declines in currencies of energy-exporting countries. The Russian rouble may be an extreme case, falling by over 40% since last summer, but the currencies of other oil-exporting countries, such as Canada, Colombia, Venezuela, and Nigeria, have also declined significantly.

The U.S. economy benefits — in aggregate — from a strong dollar.

A more important factor in the dollar's rise is central bank action in Europe and Japan. The European Central Bank (ECB) will soon be printing €60 billion a month (equivalent to about $70 billion) in order to purchase the bonds of Eurozone governments, agencies, and European institutions. In Japan, the money supply is increasing by about ¥7 trillion a month ($58 billion), with predictable effects on the value of the respective currencies given such a dramatic increase in supply. Between the gap in growth rates between the U.S. and the rest of the developed world, lower oil prices, and quantitative easing, the dollar may be in store for a continued rally similar to that seen in 1980-1985.

U.S. equities

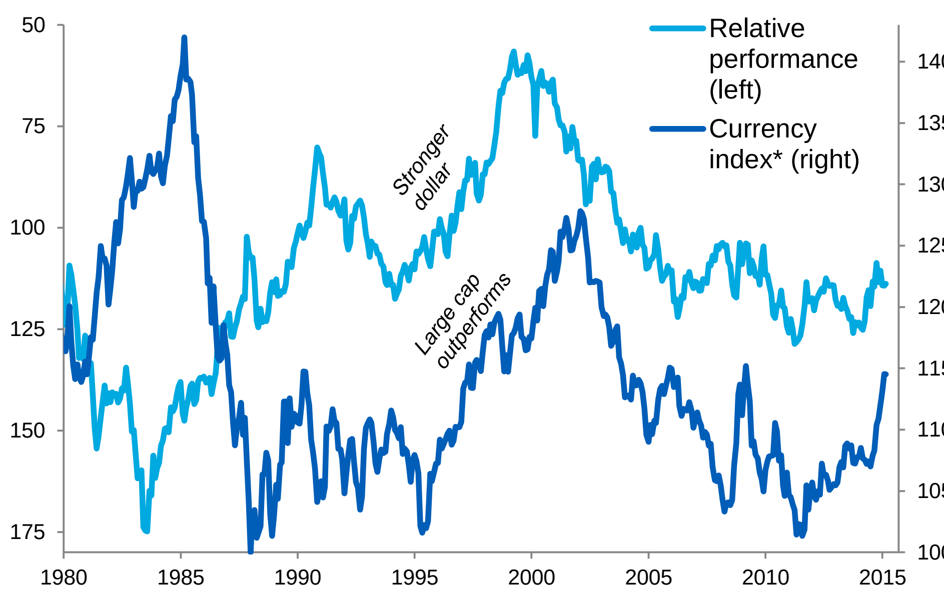
The U.S. economy benefits in aggregate from a strong dollar, but that does not mean that all companies benefit individually. The impact on any particular firm will depend on the import share of its inputs and the export share of its sales; looking just at the percentage of sales that are made abroad is not enough. Industries running a large trade deficit (imports greater than exports) will see the

Companies with a high share of imported inputs could see earnings gains.

biggest boost from a strong dollar. These include Automobiles & Components, Technology Hardware & Equipment, and Consumer Durables & Apparel. Those with the biggest surplus (hence those whose profits are most vulnerable to a strong dollar) are Household & Personal Products and Health Care Equipment & Services.

Though earnings from large multinationals will suffer from lower foreign sales, large-capitalization stocks generally benefit from a rising dollar thanks to lower input costs, while small-capitalization stocks are largely isolated from currency swings. Sharp spikes in the dollar often lead to short-term underperformance of large-cap equities, but over the longer term, large caps broadly outperform small caps stocks when the dollar has risen (though the correlation is only 24%; see Figure 2).

Figure 2: Dollar and relative performance of large vs small caps

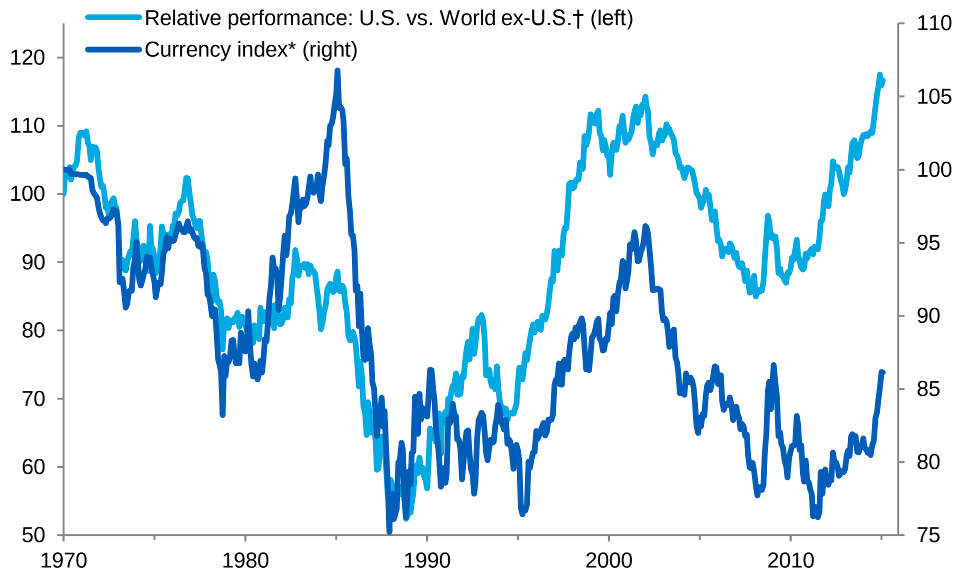


Last data: 25 February 2015. *Weighted by MSCI ACWI/World Index country membership. Sources: J.P. Morgan, TIAA-CREF Asset Management.

International equities

In spite of the drag on foreign sales for U.S. companies, a stronger dollar makes international investing marginally less attractive, because the non-U.S. market returns have to make up for the depreciation of the foreign market's currency. Historically, international equities have not been able to overcome the drag from a weaker currency (see Figure 3).However, it is possible — and we expect it to happen this year. We anticipate returns out of Europe in particular to be better in 2015 relative to those in the U.S., and great enough to compensate for what could be another 10% depreciation of the euro.

Figure 3: Dollar and relative performance of U.S. vs international equities



Last data 25 February 2015. †MSCI World Index till 1987, MSCI ACWI after. *Weighted by MSCI ACWI/World Index country membership. Sources: J.P. Morgan, TIAA-CREF Asset Management.

Countries with large trade surplus vis-à-vis the U.S. include Mexico, Canada, and Japan.

Foreign exporters benefit from a depreciated currency, which generates stronger revenue growth. The biggest gains will be seen in those countries whose **net** exports to the U.S. are large. As with evaluating the dollar's impact on U.S. companies, both imports and exports must be taken into account. A country's exports gain if its currency depreciates, but the cost of its imports rises commensurately. Those countries with the largest trade surplus with the U.S. are China, Mexico, Canada, Japan, Germany, Italy, and South Korea. While the Chinese yuan has depreciated by only 1% against the dollar, as its value is managed by the Bank of China, the currencies of the other countries have fallen by amounts ranging from 9% (Korea) to 17% (euro).

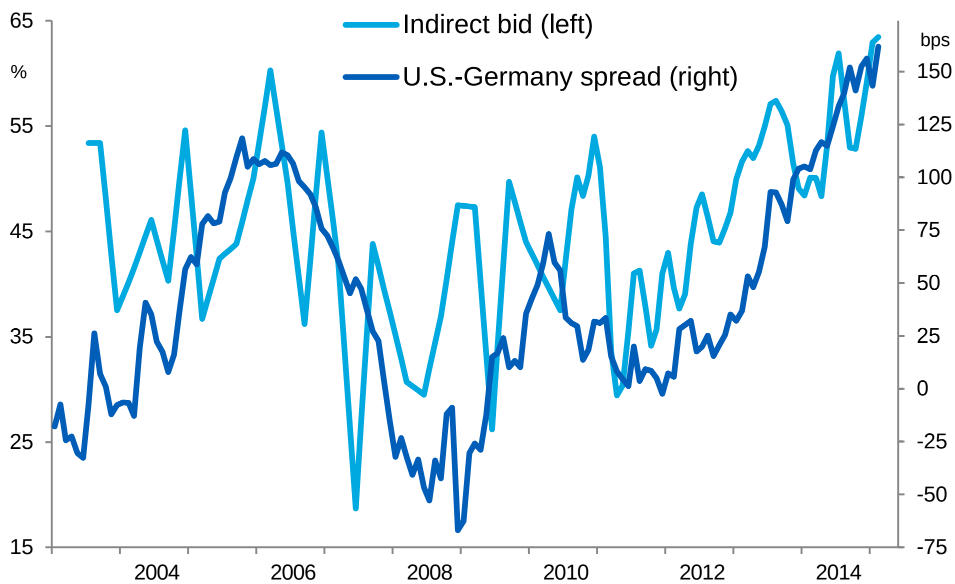
U.S. fixed income

Government and corporate bond returns are largely immune to currency swings, though high-yield debt has a modest negative correlation. In the same way that equity earnings might suffer from lower export revenues, the cash flow needed by high-yield issuers to make interest payments may fall as well.

The strong dollar is helping keep U.S. Treasury yields low.

U.S. Treasury yields have been moving inversely with the value of the dollar more recently, however, as the launch of quantitative easing in the Eurozone nears. Between stronger U.S. growth and the expectation that the Federal Reserve will raise interest rates this year, the gap between the yield on (10-year) U.S. Treasuries and German bunds is at Eurozone-era highs. This alone would attract foreign investors seeking what is a comparatively generous yield. The expected depreciation of the euro, however, adds a further incentive, as the coupons and principal will be worth even more in euro terms over time. Consequently, foreign demand at Treasury auctions has been rising (see Figure 4). Given that foreigners own nearly 50% of outstanding U.S. Treasuries, this demand is a significant factor keeping yields lower than would be expected in light of inflation and growth rates in the U.S.

Figure 4: Foreign participation in 10-year Treasury bond auctions and spreads



Last data 25 February 2015. Note: Bids are three-month moving average.
Sources: U.S. Treasury, TIAA-CREF Asset Management.

Lower yields driven by foreign demand are compounded by the falling cost of imports, adding to disinflationary pressures. Lower yields and lower inflation bolster the argument that the Fed will see no need to raise interest rates until September.

Conclusion

Fears of a strong dollar are unwarranted.

Fears of a strong dollar are unwarranted. The rising value of the U.S. currency is a reflection of the strength of the U.S. economy compared to the rest of the world. While U.S. net exports are likely to fall, consumer demand and investment — both from households and business — will more than make up the shortfall. Many parts of the economy benefit from cheaper imports, and the stronger dollar is an implicit tightening of monetary policy, meaning the Fed can wait yet longer before it needs to begin normalizing U.S. interest rates.

U.S. equities would be expected to outperform international equities in a rising dollar environment, but given the difference in valuations, looser monetary policy in Europe and Japan, and accelerating cyclical recoveries abroad, we expect the recent outperformance of non-U.S. equity markets to continue throughout the year. Large-cap stocks with a high export revenue share but a low import cost share will likely lag the market, but those companies with the opposite mix should outperform.