



Why the Falling Dollar is Good for the Market

Anyone who has visited another country recently has seen the effects of the weakened dollar. As it sinks to all-time lows against many major currencies, travelers have felt the financial pinch at Parisian cafés, English pubs and even Canadian hockey rinks. The panic may have reached its peak with reports (since debunked) that supermodel Gisele Bündchen was demanding payment in Euros instead of dollars. But what is troublesome for tourists – and perhaps supermodels – may be a boon for the U.S. economy.

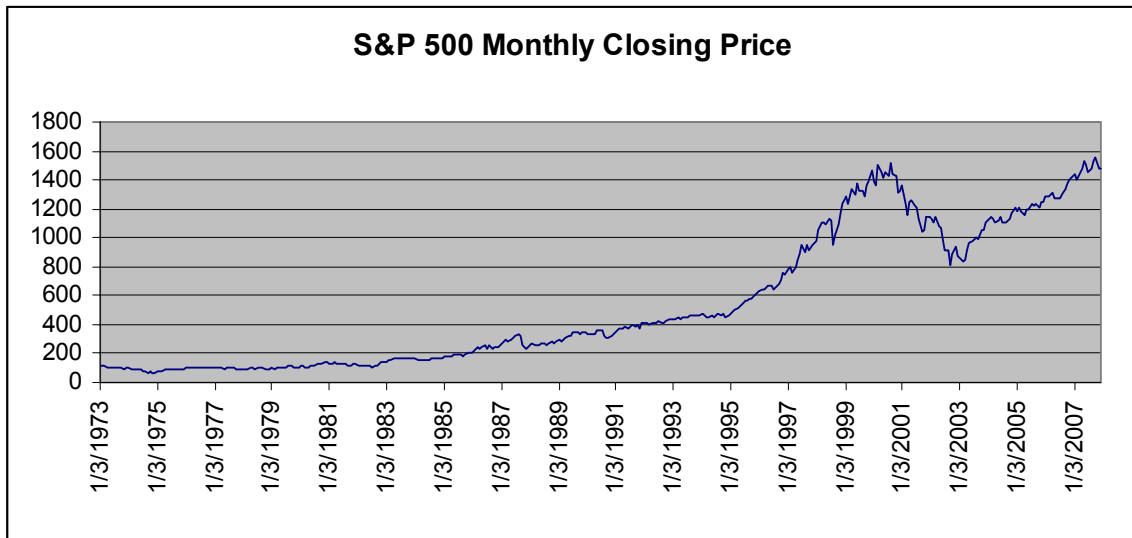
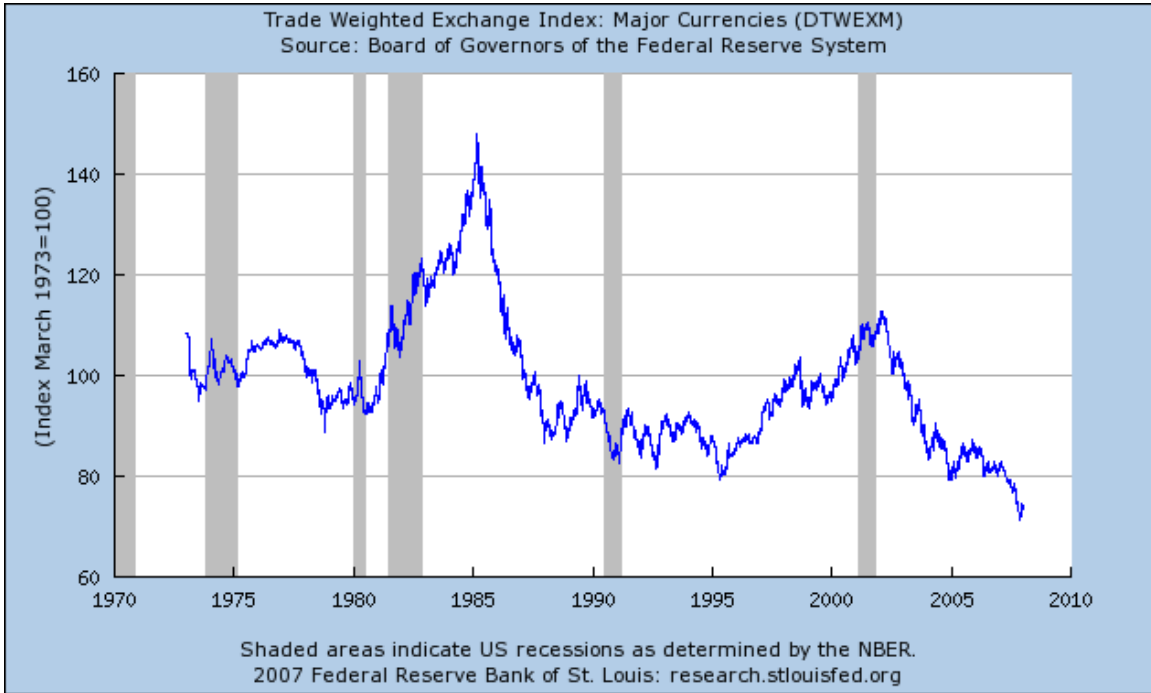
Look at what the dollar has done over the past year, and since the start of the current bull market (roughly Jan. 1, 2003) against some of our major trading partners:

Country	1/1/2003	1/1/2007	12/27/2007	Cumulative Change From 2003-2007	Cumulative Change During 2007
Canada	1.5750	1.1647	0.9808	-26.1%	-15.8%
Mexico	10.354	10.779	10.867	4.1%	0.8%
Japan	119.86	118.83	114.00	-0.9%	-4.1%
China	8.2800	7.8051	7.3079	-5.7%	-6.4%
UK	0.625978	0.506688	0.502336	-19.1%	-0.9%
Euro	0.965158	0.752672	0.684885	-22.0%	-9.0%

Source: [Federal Reserve Data](#); Exchange rates are units of foreign currency per U.S. dollar

Over the longer term, though, the decline is not nearly as dramatic. As George Mason University Professor of Economics Tyler Cowen points out in a recent article, [The Dollar is Falling, and That's Good News](#), the dollar fell 19.8% from January 2001 through November 20 of this year, when adjusted for the value of goods exchanged with the United States' major trading partners. Cowen called this a "noticeable decline, but hardly a radical economic event," adding that tourists can still find bargains in Latin America and Asia.

We looked back to 1973 to see how the markets have reacted to changes in the value of the dollar, specifically how the trade-weighted foreign exchange index has tracked against the S&P 500:



The message from the historical data is a declining dollar does not correlate with market declines, either in the short or long term. In this decade, exchange rates and the S&P 500 have followed a close inverse correlation. The value of the dollar increased until roughly Jan. 1, 2003, when it began its decline. The S&P 500 has followed the opposite path, declining from mid-2000 until 2003, then beginning its current upward trend. As Cowen points out, the dollar has undergone one other significant decline, from 1985-88, yet this was a good time for the markets, as was the ensuing decade. There have been periods where the



inverse correlation was not apparent, such as from 1980-85, when both the markets and the value of the dollar increased, but this has not been the case in the more recent past.

The Effect on Imports and Exports

A falling dollar increases the cost of imported goods, but makes our exported goods more competitive. Imports currently represent 14% of the U.S. economy. The dollar has a strong influence on the prices of luxury goods, particularly those made in Europe, which have little effect on most Americans. Products manufactured in Asia, including everything from electronics to apparel, have experienced little or no price increase, and these are the goods that are purchased by larger numbers of American consumers.

Oil is our most closely watched import, though it accounts for only about 8% of U.S. imports. Oil is priced in dollars and has risen from \$54.57 to \$94.62 per barrel in 2007. Part of this rise is attributable to the fall of the dollar, but supply and demand exert a much greater influence.

Exports represent 8% of our economy, and approximately three-quarters of exports are capital goods. These are the sectors that are experiencing the greatest benefit from the weakened dollar. Exports have grown more than 10% in the past year. Much of that growth has come from China, our fourth-largest export market, which has grown 17% this year.

Inflation, the Dollar, and Monetary Policy

A falling dollar is tied to inflation. The rise in the cost of imported goods has a direct and immediate impact on consumers, and many economists consider a falling dollar by definition to be inflationary. While the Federal Reserve does not seem to be particularly concerned with the plight of the dollar, it is acting to offset inflation and the possibility of a recession. By lowering interest rates, the Fed is hoping to stimulate borrowing and spending which, if successful, will help U.S. companies continue on their five-year path of growing profitability.

The federal funds rate is now 4.25%; it stood at 1% in 2003, when the Fed was struggling to bring an end to the last recession. There is still significant room to lower rates, if the Fed deems such cuts necessary, and our current situation (even if we are already in a recession, as some argue) cannot be likened to 2003. Investors can expect the Fed to continue to use monetary policy to fight recession and inflation, rather than to counteract the falling dollar. As Harvard Professor of Economics Gregory Mankiw points out in [How to Avoid a Recession](#), "Treasury secretaries often repeat the mantra of favoring a strong



dollar, but these pronouncements are based more on public relations than hard-headed analysis.”

The Bond Market

Lower interest rates, whether a result of monetary policy or other reasons, make the bond market less attractive for new investors (although existing investors benefit). Furthermore, foreigners investing in dollar-paying bonds earn a lower rate of return when the dollar falls, because the value of their fixed rate payments in foreign currencies declines. These two factors combine to drive money from the bond market, and that money is likely to end up in the stock market. Foreign investors may see opportunities in other asset classes, particularly in distressed real estate, but low single-digit interest rates are likely to result in inflows into the equity markets, driving up the prices of stocks.

A flight out of the U.S. bond market – particularly government bonds – will further depress the dollar. China holds a significant portion (approximately \$1 trillion) of U.S. government debt. It is unlikely the Chinese will forego the credit worthiness of this U.S. debt to chase incrementally higher returns in other markets, so the biggest single bondholder will not become a seller. In his article, Cowen adds that China has no interest in precipitating a run on the dollar, because it is a poorer country with underdeveloped capital markets, and is dependent on a successful and thriving U.S. economy.

Psychological Effects

Cowen argues that instability and continued volatility in the dollar will decrease confidence and potentially discourage investment. The biggest danger of a weakened dollar is a loss of confidence among investors, resulting from the increased stress that accompanies a dramatic shift from a paradigm -- a strong U.S. dollar -- we all took for granted. Falling currencies have caused capital flight in other countries, notably in Mexico in 1994 and in some Asian countries in 1997. Mankiw suggests this scenario is unlikely for the fundamentally strong U.S. economy, but it is “one reason Treasury secretaries maintain public fealty to the strong dollar.”

The doomsday scenario for the U.S. equity markets is a free-fall in the value of the dollar, accompanied by a shift of assets out of the bond and equity markets and into foreign markets or non-financial asset classes such as real estate. Such a scenario is far-fetched and unprecedented in the U.S. economy, and is highly unlikely for a number of reasons. First, as noted above, the Fed would act aggressively to prevent this. Second, a precipitous decline in the dollar would stimulate investment by American manufacturing firms serving export markets. Last, foreign capital markets and non-financial asset classes do not present



sufficient investment opportunities to absorb a massive outflow from the U.S. markets.

Summary

While some sectors of the economy, such as luxury imports, will suffer from a weak dollar, the overall effect on equity markets will be positive. This has been the case historically, particularly over the last decade, and for good reason. American manufacturers and exporters are increasingly reliant on foreign markets, with 45% of the revenue from the companies in the S&P 500 coming from outside the U.S. Our goods and services in these markets are more competitive, and this more than offsets the increased cost of imported goods. The main concern is psychological because, as Cowen notes, "A low dollar simply looks bad." The direction of the equity markets will be driven by the possibility of recession, the debt crisis, and geopolitical instability, not by a falling dollar.

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