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Strength of the Dollar: Are You Ready for an Overseas Vacation?

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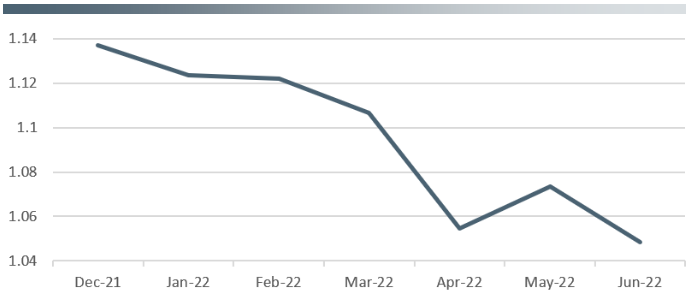
Is now the right time for an overseas vacation?

While economic weakness has penetrated nearly every facet of the market, one asset has managed to top 20-year levels and provide some opportunities for investors: U.S. currency exchange rates. While the U.S. dollar has generally been strong since the start of COVID, appreciation against other currencies has accelerated since the start of 2022. Currency moves are usually viewed as a zero-sum game with winners and losers; in this note we explore who the winners and losers are, why the U.S. dollar is strong, why other currencies may be weak, as well as the potential impact of these moves on economic growth, international trade, and where you should go on your vacation!

Euro/Dollar Exchange Rate: 1999-2021

Euro/Dollar Exchange Rate: January-June 2022



Why is the U.S. dollar so strong?

The U.S. dollar has long been the world's reserve currency. While both the Euro and Chinese Yuan have aspired to replace or supplement the U.S. dollar in recent years, both have been hampered by political and economic issues. Europe's economy is more directly impacted by Russia's invasion of Ukraine given trade and a heavy reliance on Russian energy. Meanwhile, China continues to suffer from its zero-COVID policy with continued lockdowns impacting economic growth. Such concerns lead investors to favor holding the U.S. dollar over both the Euro and Yuan. And while some investors may have dreamt about Bitcoin becoming a reserve global currency, recent price action has dispelled such hopes; Bitcoin has effectively suffered a 60% depreciation against the U.S. dollar over the past year. Consequently, when a deteriorating global macroeconomic environment leads to a flight to safety, investors continue to seek out the U.S. dollar.

Moreover, as global investors consider where to park their cash, the interest rate paid on government bonds is a major attraction. In its fight against inflation, the Federal Reserve has already raised interest rates from 0% to 2.25%; it is expected that rates may rise to 3.50%-3.75% by the end of this year. By contrast, the European Central Bank recently raised rates from -0.50% to 0.00%. With a more fragile economy (due to Russia), it is unlikely that European rates will be raised as much as U.S. rates. High U.S. interest rates encourage global investors to invest in Treasury bonds for their superior income yields – and to buy Treasuries investors first need to buy U.S. dollars, both sustaining and increasing the demand for U.S. dollars relative to other currencies.

What are the economic impacts of a strong U.S. dollar?

A strong dollar decreases the cost of imports to the United States, from avocados to luxury automobiles. Unfortunately, the U.S. consumer does not benefit unless retailers pass on the savings, something that is less likely to happen in the current environment of strong retail pricing-power. On the flip side, other countries must pay more for their imports from the U.S., and this can contribute to their own inflationary pressures. While somewhat marginal, Citibank estimates that a 10% currency depreciation adds around 1% to a country's inflation rate. Put simply, the U.S. is currently importing deflation while exporting inflationary pressures to the rest of the world.

Commodity costs are particularly impacted by exchange rate fluctuations as most commodities are traded in U.S. dollars (given history as well as the dollar's reserve status). When a currency depreciates against the U.S. dollar, the cost of buying commodities increases. Thus, a strong U.S. dollar increases anything commodity related, from the price of petrol for consumers in the U.K. to the price Indonesian palm oil producers can sell their product at.

As time goes on, demand by U.S. consumers for relatively cheap imports coupled with a reduction in demand for relatively expensive U.S. exports, could lead to a deterioration in the U.S. trade deficit. The U.S. trade deficit in 2021 was a massive $860 billion, having imported $3.4 trillion in goods and services but only exported $2.5 trillion in goods and services to other nations. In the first 6 months of 2022 the U.S. has already notched up trade deficits of $540 billion and is on course to breach $1 trillion this year. Ultimately, trade deficits can lead to political pressure for protective measures to be implemented, often resulting in an escalation of retaliatory measures by other countries.

The strong dollar also impacts both corporate earnings and stock market returns. For U.S. corporations with business overseas a strong dollar is a double negative; it makes U.S. goods/services more expensive overseas (reduces demand) and negatively influences international earnings when they are translated back into U.S. dollars. The impact is particularly acute in the technology sector as many of the companies are multinationals that earn a substantial amount of their profits from overseas. While the U.S. dollar's strength may have a deleterious effect on multinational company earnings this year, over time the currency impact is relatively benign and tends to be outweighed by other strategic factors. Perhaps one of the greatest contrasts caused by exchange rates can be seen in translating international bond and equity returns into U.S. dollars. During the first six months of the year, European stock markets returned -12.3% in local currency terms. However, for U.S. investors this translates into a -19.2% return – a significantly worse outcome due to the strength of the U.S. dollar.

Finally, the impact is also felt in the international dollar-denominated debt markets. Many developing countries borrow by issuing dollar denominated debt. When the U.S. dollar is appreciating, these countries must give up more of their domestic currency to make dollar denominated interest payments and to eventually repay the dollar denominated principal. In some circumstances this can cause considerable economic pain, with Sri Lanka providing a recent example. In addition to the soaring cost of commodity imports, Sri Lanka's economic future was weighed down by the increasing cost of servicing over $51 billion in dollar denominated debt, debt that it is now likely to default on.

What should you be doing?

As the dollar strengthened investors would have benefited from an underweight allocation to international assets. At Market Street we have cut client exposure to international equities by around one-third over the past 18 months; a representative 'Growth" account saw its international equity allocation cut from around 22% to 14%. Likewise, within high yield we eliminated exposure to dollar-denominated emerging market debt. While currency moves are notoriously difficult to predict, given the current macro-economic backdrop we believe that portfolios should continue to overweight U.S. equities and bonds for the foreseeable future.

Notwithstanding this view, currency moves tend to reverse over time, and this will likely prove to have been an advantageous time to buy foreign currencies or assets; that Mediterranean holiday home or St. Martin investment property is now almost 20% cheaper in dollar terms than at this time last year! Furthermore, if you know you have international expenses over the next year, now could be a good time to move money into a foreign currency account. And obviously, now is a wonderful time for that vacation to the Greek Islands or pretty much any other international destination that is on your bucket list.

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