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The Strong Dollar: A Rare Occurrence With Mixed Implications

For decades the U.S. dollar has been relatively weak as measured against other major world currencies. Yet recently the greenback has been on the rise, and a record number of investors expect its strength to intensify in the next 12 months.

The universal "why" behind the dollar's current rally is one of the fundamental truths of investing: The safest perceived haven in the global arena is still the U.S. dollar.

A monthly poll conducted by Bank of America/Merrill Lynch found that 83% of asset managers worldwide expect the dollar to appreciate in value over the next year. This is the highest percentage ever recorded in the history of the survey (dating back to 2001).[1] Indeed, the U.S. Dollar Index (DXY), the index that measures the value of the dollar relative to the majority of its most significant trading partners, has been rising since 2011 and is on track to reach multiyear highs sometime this year.[2]

What's Driving the Rally?

A number of interlocking factors have influenced the dollar's recent ascent: The slow but mostly steady recovery in the U.S. economy, particularly in the housing sector; the recent announcement by the U.S. Federal Reserve suggesting that, due to the strengthening economy, it might begin tapering its bond purchasing program later this year; the mere prospect of an end to the Federal Reserve's accommodative monetary policy has pushed up long-term interest rates, as evidenced by the increasing yields on 10-year U.S. Treasuries. As the yields on Treasuries rise, the dollar is perceived as being more valuable relative to other currencies.

The other, more universal "why" behind the dollar's current rally is one of the fundamental truths of investing: The safest perceived haven in the global arena is still the U.S. dollar. This is especially true amid ongoing economic woes in Europe, China, and many emerging market economies.

The Implications: A Mixed Bag

Generally, a strong dollar means that our native currency buys more of a foreign country's goods. This can be beneficial for consumers and travelers who will see their dollars go further when purchasing imported goods or when travelling abroad.

On the downside, U.S. companies that export goods to foreign countries may suffer, because, relative to a weaker currency, U.S.-produced goods and services cost more. This fact may put American producers at a disadvantage in the global marketplace.

For instance, the declining values of the Japanese yen and the Brazilian real -- which have, respectively, lost 15% and 8% of their value against the dollar since January -- are eating into the profits of many multinational companies, including

McDonald's Corp., United Technologies, and Lexmark International.[3]

If prolonged, this competitive disadvantage could lead some U.S. manufacturers to move plants to foreign countries with lower costs, which could result in jobs lost in the United States.

Yet, perhaps the most significant impact the strengthening dollar may have is against emerging market currencies. A few emerging market countries, including India and South Africa, which depend on foreign capital to finance their trade deficits have already seen their currencies fall by around 10% since the beginning of May, merely on the prospect that the Federal Reserve may begin winding down its U.S. bond buying program.[4] If and when the Fed does take action, it is assumed that U.S. investors who have been purchasing emerging market bonds would divert their investment dollars back home.

Takeaways for Investors

If the dollar continues to strengthen as many market analysts predict, U.S. investors may want to consider how a strong dollar may affect various asset classes in their portfolios. For example:

International bonds: When evaluating currency risk associated with international bonds, it is important to remember that bonds are loans tied to the value of the local currency. When the dollar strengthens against that currency, it will likely affect the total value of that investment. Given the current environment, this may be especially true for investors holding emerging markets bonds.

Equities: Because equity prices can be affected by a wide range of factors, from sector data to their own earnings reports, currency moves do not carry as much weight with equities as they do with bonds. That said, general investment wisdom states that holding a broad mix of domestic and international equities may help an investor to stay adequately diversified and to potentially gain from enhanced portfolio performance.

- Within a domestic equity allocation, companies that focus on importing -- not exporting -- goods may be at an advantage when the dollar is strong, as they can buy their goods at a discount.
- Conversely, within a foreign equity allocation, companies and countries that are heavily reliant on exporting to the United States may be attractive as U.S. importers buy more goods because of the strong dollar. Specific emerging markets with export exposure (e.g., Indonesia, South Korea) may be attractive as the dollar strengthens against those currencies.

As with any investment decision, it is important to discuss with a trusted financial professional the potential effect the strengthening dollar may have on your portfolio holdings. Together, you can consider your unique situation and, if warranted, deploy various hedging/risk management strategies to balance the risks/rewards of international currency exposure.

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[1]Source: Bloomberg.com, "Investors Buy U.S. Stocks Amid Dollar Strength, BofA Says," July 16, 2013.

[2]Source: *Barron's*, "The Strong Dollar: Who's Helped, Who's Hurt and Who Should Run for Cover," May 17, 2013.

[3]Source: *The Wall Street Journal*, "Strong Dollar Eats into DuPont Profits," July 23, 2013.

[4]Source: *The Economist*, "The rising dollar: Green and back," July 13, 2013.

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