Market *Alert*

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STANDARD & POOR'S

Currency Volatility and Investment Returns: What's the Connection?

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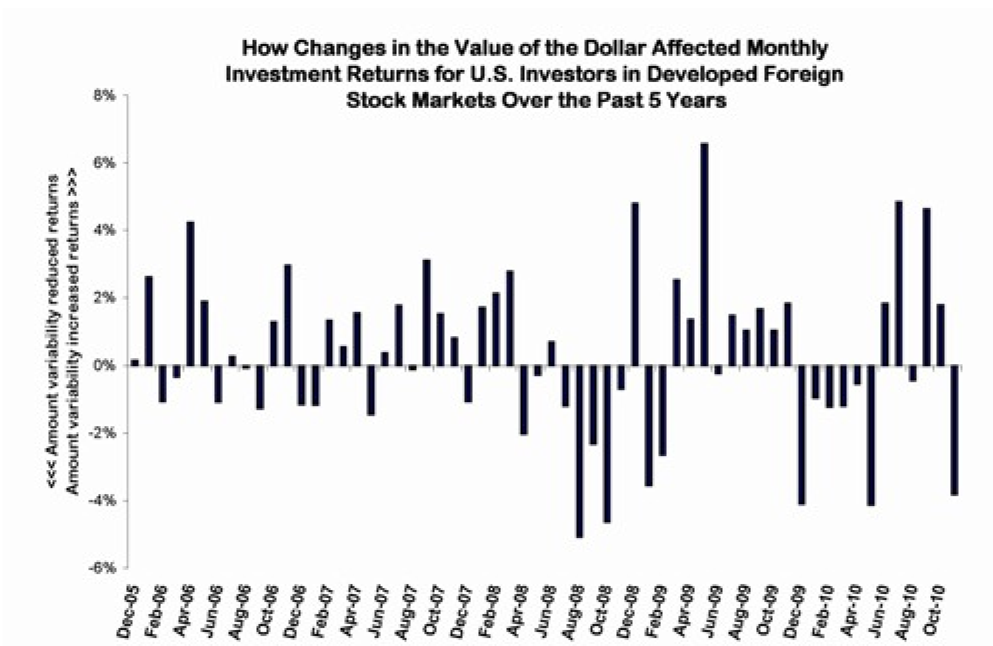
The value of the dollar on world currency markets fell more than 8% from its high for the year at the beginning of June to its low at the beginning of November, as measured by the Federal Reserve's Broad Trade-Weighted Foreign Exchange Index.[1] Volatility in the currency market reached a peak around the same time the dollar peaked, with abnormally large swings in value during the summer, and a gradual calming trend accompanying the value decline in the early autumn.

Since hitting its November trough, the dollar rebounded somewhat during the run-up to the Thanksgiving holiday. Again, along with the increase in value came an increase in volatility. To some analysts this may indicate a real reversal of the market's trend. But to others, it is seen as the kind of mid-slide rebound traders call a "dead cat bounce," meaning anything that falls fast enough could sometimes show the appearance of life even when it has none. Standard & Poor's long-term economic model suggests that the dollar could be lower in two years than it is now. But the model also indicates that, along the way, there could be periods when it rises higher.

Currency Volatility and Investment Returns

These currency changes have an immediate impact on the returns that U.S. investors might earn on investments in foreign markets. From month to month, the returns of foreign investments valued in their local currency vary when compared with the value of the same investments valued in U.S. dollars at then-current exchange rates.



One way to measure the effect is by comparing the U.S. dollar returns and the local currency returns on the same investment as benchmarked by the MSCI EAFE® Index. As shown in the chart, there are months when currency market variability adds to investment returns and months where it reduces returns.[2]

Generally speaking, the market value of a foreign investment increases as the value of the dollar declines. The reverse is true when the value of the dollar rises compared with the currency of the investment. This phenomenon is a major contributor to the portfolio diversification benefit of foreign investments.

What Is Driving the Currency Markets Today?

In terms of today's conditions, the factors tending to drive down the value of the dollar are the large federal budget deficit and the increasing imbalance between imports and exports. Both of these require growing volumes of foreign currency in order to be sustained. As a result, the markets must offer higher unit prices in dollars for a particular foreign currency in order to attract the necessary volume. The big question for the future is how much more change will be necessary before currency supply and demand reach a new balance.

On the other side, there are forces that could potentially push the value of the dollar higher in the months ahead, or at least hold it relatively steady. For instance, if economic conditions improve for America's foreign trading partners that could spark an increase in demand for U.S. products and services, which would increase the supply of foreign currencies and help to drive down their prices relative to the dollar.

Another factor could be an increase in political or economic uncertainty outside the United States. In many foreign countries, the United States is seen as the most secure place to store assets under siege. The global "flight to quality" during the worldwide financial crisis at the end of 2008 pushed the value of the dollar to a peak nearly 20% higher than it was at the beginning of this December.

Investment Implications

As of December 1, 2010, the Standard & Poor's Investment Policy Committee suggested that investors generally place approximately 20% of their portfolios in foreign equities. Those who had allocated a portion of their holdings consistently to diversified foreign equity portfolios were positioned to reap a potential benefit from the dollar decline in the second half of the year.

Continued currency volatility, however, offers the potential to reduce as well as enhance future foreign investment returns. As a result, the relatively steadiest long-term performance is likely to come from portfolios that are diversified across as many borders as practicable.

Foreign bonds face the same currency market effects as equities. As a result, a bond portfolio diversified with appropriate-quality foreign bonds would have similar benefits as an equity portfolio.

[1]Past performance is no guarantee of future results. It is not possible to invest directly in an index.

[2]Source: Morgan Stanley Capital International. Past performance is no guarantee of future resuls. It is not possible to invest directly in an index.