Exchange Rate Effects on Earnings are Often Overblown

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Last Week’s S&P 500 Index: -0.5%

Key takeaways

» Most U.S. corporations with international operations are in the business of selling “widgets” and are not trying to speculate in the global currency markets.

» S&P 500 companies often hedge most of their foreign exchange exposure. Concerns as to earnings implications of currency moves are typically overblown.

As the equity market moves through the last handful of companies that have not yet reported second-quarter earnings, one of the topics being discussed has been the dollar and its effect on corporate results. Coming into 2019, most of the “Street” were calling for the dollar to weaken as the Federal Reserve ended its slow march toward “normalizing” (whatever that means) interest rates. We expected to see a softer dollar as well. But, the dollar has not weakened and remains trapped at the top end of its 14-month range in terms of the U.S. Dollar Index (DXY). In the nearer term, it does not appear the greenback is likely to exhibit the weakness many expected.

But all-in-all, and looking at history, the DXY has not been even remotely volatile this year. And although the U.S. dollar has been trapped in a relatively narrow range for more than a year, some pundits and CFOs (Chief Financial Officers) have been quick to try and tie movements in the dollar to domestic corporate earnings performance. While expected currency movements might make the top 10 in terms of factors we watch while trying to predict the movement of the S&P 500, those potential movements wouldn’t normally make the top 5 unless they were expected to be extreme (i.e., 10% to 15% or greater). While there is no doubt that a weaker dollar can translate into a domestic corporate tailwind (each unit of foreign currency profit equates to more dollars) and a stronger dollar can translate into a domestic corporate headwind (each unit of foreign currency profit equates to fewer dollars), in real life it just isn’t that easy.

The problem, at least in our opinion, is that the stock market often reacts as though corporate treasurers have never heard of the concept of hedging their currency exposures. Then many financial pundits pile on. The dollar weakens, and some investors think profits immediately go up by a similar magnitude. The dollar strengthens, and profits are negatively affected by a similar magnitude. The two are intricately linked—right? Not quite.

Keep in mind that most U.S. corporations are in the business of selling “widgets,” not speculating in the global currency markets. With nearly 40% of revenues for companies in the S&P 500 coming from foreign lands, many have a team of employees whose sole job is to make sure currency effects are dampened or entirely negated so the company can focus on selling “widgets.” When bidding on potential business outside the U.S. where revenue will be received, the company takes into account the price at which those future anticipated proceeds can be exchanged back into dollars. Companies can sell foreign currency for a future date at a known exchange rate today (the “forward” rate) and make delivery when those funds are eventually in hand. If the company will need to deliver foreign currency in the future to make payment on goods or services received, it can buy that currency now and take delivery later.

Because companies doing business internationally tend to hedge much of their foreign exchange exposure, the impact on earnings from currency movements is usually reduced. In most cases, the anticipated effects are overblown by analysts and financial pundits.
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Definitions

U.S. Dollar Index (DXY) measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies. An index is unmanaged and not available for direct investment.

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