Weekly perspective on current market sentiment

August 19, 2020

Basic Dollar Concepts

Key takeaways

- Financial markets can often move in the short term based on perceived future potential moves in the dollar. Larger, longer-term moves can prompt changes in business strategies.

- Keep a few basic dollar concepts in mind when digesting financial news in coming months.

With all of the recent talk in the financial media surrounding the lower U.S. dollar (USD), we thought it might be a good time to review how the markets, from a very high level, think about movements in the world’s reserve currency. The effect of a falling or rising dollar for stocks, bonds, or commodities is not an exact science. Many times, a small move in the dollar may influence the underlying near-term movement in any of these markets just on a sentiment basis alone. On the other hand, a more meaningful long-term move one way or the other can have far-reaching impacts that cause businesses with dollar exposures to alter their strategies and operating models.

Think about stocks for a minute. A modestly weaker dollar, at least in the shorter term, is often perceived by investors to have a positive effect, especially given that nearly 40% of S&P 500 revenues come from outside the country. We currently favor large-cap U.S. equities. A lower USD means that it takes less of a given foreign currency (i.e., euros or yen) to buy a dollar’s worth of goods, all else being equal. That means American exports are cheaper for overseas customers to buy, which could very well lead to an increase in sales for domestic firms. It also means that when an American-based company earns profits in foreign currencies and then converts those profits back into USD, the company receives more dollars because the U.S. currency has weakened.

And what about commodities? We currently carry a favorable rating on this asset class that includes globally traded raw materials such as oil, wheat, and copper. An important factor to note is that, historically, most commodities are priced in dollars. So drawing on our earlier discussion, when the USD weakens, it takes less foreign currency to buy a dollar’s worth of any particular commodity. Cheaper input prices for non-U.S.-based producers and manufacturers can lead to increased demand for raw materials or finished goods. Emerging market (EM) economies have historically been tied to commodities. Higher commodity prices on world markets are often perceived as a benefit to these economies, and their stock markets typically respond positively. EMs also currently carry trillions of dollars in USD-denominated debt. If the dollar falls, it takes less of their home currency to pay debt holders their interest payments and principal.

Of course, the market is well aware that too much dollar weakness can be a negative. Since the U.S. is a big importer of many products, a weaker dollar makes those imports more expensive and can lead to higher inflation. As a result, the Federal Reserve may step in and raise interest rates to halt the decline in the dollar and/or slow inflation. Higher rates intended to slow an economy have frequently been market negative.

Keep these basic dollar concepts in mind as you digest the financial news of the day in coming months.
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