Soaring Dollar and Your Portfolio: Seven Things to Know

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Over the past year the Dollar has appreciated nearly 22% versus the world's currencies. With forecasts for continuing Dollar strength, what's the next move for investors?

Bottom Line

US currency strength is providing a tail wind for our financial markets. Investors worldwide are rushing to invest in our country.

Just look at the last 12 months: Overseas investors got as much as 36% from the S&P 500, adding together both index and currency movement. Short term oriented investors may increase their bets on US financial assets and domestically oriented companies as a result.

However, the strong Dollar is adversely affecting US multinationals' earnings. Their exports denominated in Dollars are less competitive, while earnings generated overseas are worth less. So, in the near term be cautious on the earnings power and hence stock appreciation potential of these companies.

Longer term investors might want to bet against the recent Dollar strength and investment beneficiaries; to the extent that investors have overlooked fundamentals to chase currency movements, there may be opportunities.

Future currency movements are extremely difficult to predict. Currencies move in response to economic conditions, geopolitical events, governmental policies, and investors preferences, none of which are easy to fathom.

1. Strong Dollar Depresses Value of Multinationals' Overseas Operations

40% of the S&P 500 revenues come in from overseas. Dollar strength makes exports pricier and reduces the value of foreign earnings. That's one of the reasons to expect an earnings recession in 2015's first half, two quarters in a row of down year over year profits.

The exact effect on any one company may vary. Some companies hedge currency exposure. Others manufacture overseas, reducing exposure to Dollar appreciation.

In the short term investors may seek to avoid sectors, like technology, with large international operations, and gravitate to more domestic sectors, like utilities and retailers.

Longer term, examine companies and sectors punished due to the strong Dollar; look for opportunity when there's some reversion to the mean in the Dollar's value.

2. Mighty Dollar Reduces the Value of Overseas Investments

Overseas investments have struggled to remain competitive for US investors. Obviously their stock, and perhaps much of their profits and operations are in denominated in depreciating currencies.

However, opportunities may exist where overseas companies actually do more of their business in America. For example, Euro based pharmas **Sanofi (SNY)** and **GlaxoSmithKline (GSK)** do more business in the US than in Europe. Any sell off due to their overseas headquarters may be unwarranted. The opportunity may be even greater if the manufacturing is being done abroad, before exporting to the US.

3. US Currency Strength Reduces Commodities' Attractiveness

Most commodities, like oil, trade globally. Dollar appreciation versus other currencies tends to reduce the value of commodities as measured in Dollar, even though there's been no change in their value in non-Dollar currencies. Note the symmetry between the decline in the Dow Jones commodity index (-24.9%) over the last 12 months versus the Dollar's rise (+22%).

Commodity weakness as measured in Dollars can be exacerbated if production is concentrated in regions where local currencies are weakening. The reduced value of the commodity may promote less production, but if production costs are dropping due to a weakened local currency production may continue full bore.

Consider South Africa. While the soft gold price (-7.3% over the last year) should discourage production, the very weakened Rand, now at a 13 year low versus the Dollar, holds down production costs. That incents more production, weighing on gold prices.

4. Robust Dollar Helps Keeps a Lid on Inflation

The flip side of Dollar strength is weakness in the prices of everything else. That's particularly the case for imports, 15% of the US economy.

The surging Dollar also reduces foreign demand for US goods and services. As an example, hotels in New York City are experiencing soft demand, undoubtedly affected by the strong Dollar; revenue, room rates, and occupancy fell sharply in January.

During the last year, US inflation has disappeared; prices were flat. That's below our Federal Reserve's target of 2%. It's no coincidence that low inflation coincides with Dollar strength.

5. American Money Strength Increases Appeal of US Financial Assets

If you are living in Germany, American investments no brainers! Take the 10 year sovereign bond. The German version yields just 0.16%, while the American one yields over 10 times as much, at 1.96%. That alone makes European investors gravitate Stateside.

Add to that a near 20% profit from the appreciation of the Dollar versus the Euro and you've got an investment home run. What's more, you didn't even take stock market risk, and came out better than US investors did investing in their own stock market (+13.6% on the S&P).

Next time you wonder why US interest rates aren't rising and a mildly overvalued stock market keeps chugging, thank overseas investors for snapping up US financial assets to take advantage of our surging currency.

6. Currency Forecasts Notoriously Tricky

The old saw is that there are only two economists who genuinely understand how currencies move, but that they disagree on the future direction.

Currency movements are partly a product of economic fundamentals: Economic strength and lower inflation makes a currency attractive.

Currency strength or weakness is also influenced by governments. Today, many governments want a weaker currency, to stimulate demand for their exports. Meanwhile, central banks will try to manipulate currency rates to target better their traditional objectives of high employment and low inflation.

At the end of the day currency prices are simply balancing out good old fashioned supply and demand. Markets in the short run are simply voting machines, the product of preference not necessarily tethered to underlying fundamentals. In the longer run they weigh the competing fundamentals.

The upshot is that making investments based on your predictions of currency movements is, well, a crapshoot. Your opportunity is to take advantage of bargains created by those who think they can predict.

7. Strong Dollar May Keep the Fed on Hold

Our Federal Reserve has twin mandates: Keep inflation low and employment high. Its primary tool is manipulating interest rates: Low rates stimulate the economy and employment but potentially exacerbate inflation; high rates do the opposite.

A strengthening currency is similar to higher interest rates. To the extent the US Dollar strengthens, it must make the Federal Reserve more cautious about raising rates.

When you consider when interest rates might rise and how that might impact your portfolio, realize that our currency's strength may delay that rise.

Strategy for Longer Term Investors

With the prevailing wisdom that the recent Dollar strength can only continue, relative bargains abound in sectors harmed by that assumption. Think big exporters like technology, commodity/energy based firms, plus groups that might benefit from higher rates, like financials.

Conversely, be skeptical of sectors that have attracted lots of interest as being "domestic plays," like utilities, retailers, and restaurants.

Names to play these trends? Consider longer term investments in energy behemoth **Exxon (XOM)**, tech **IBM (IBM)**, and financial **Bank of America (BAC)**.

Stocks that may be due for a rest given recent adoration as "dollar plays" include retailer **CVS Health (CVS)** and domestic restaurant chain **Chipotle Mexican Grill (CMG)**.