



## **The Falling Dollar: Should We Worry?**

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Over the past several months, it has become increasingly fashionable to refer to the decline of the U.S. dollar as another financial “crisis.” Yet, given the current state of the global markets, declaring that the dollar’s recent losses amount to a “crisis” is an overstatement.

To the contrary, current conditions surrounding the dollar are arguably supportive of – if not integral to – economic recovery.

### **The fall of the dollar**

In 2002, the dollar began a sustained, steady descent relative to many of the world’s major currencies. By the first half of 2008, it had fallen nearly 50% against the euro and 30% against the British pound. It had fallen approximately 15% against the Japanese yen.

The dollar’s multi-year, downward trend continued unabated until 2008, when the subprime crisis began to unfold and unprecedented volatility struck the financial markets. Given the widespread panic that ensued, investors from around the world abandoned other currencies in favor of the perceived safety of the dollar, the world’s reserve currency. As a result, the dollar achieved significant gains during this period of maximum uncertainty, as people around the world showed a newfound respect for its underlying, long-term strength. The Dollar Index, which measures the value of the dollar compared to a trade-weighted basket of currencies, gained approximately 25% between April 22, 2008 and March 5, 2009.

On March 9, 2009, however, the equity markets hit their bottom, and as investors became less fearful, the dollar again began to decline. From that date until the present, while the stock and bond markets produced consistent gains, the dollar steadily surrendered most (but not all) of its newfound gains. Since its March high, the Dollar Index has fallen approximately 16%, due, in all likelihood, to loose



monetary policy (including abnormally low interest rates), dollar shorting, and an increased appetite for risk.

### **The implications of a weaker dollar**

A substantially weaker dollar over the longer term would make imports more expensive and would likely lead to inflation. Commodities and oil prices, in particular, tend to rise as the dollar declines, and higher energy prices generally serve as an impediment to economic growth.

In today's *deflationary* environment, however, the inflationary effects of a lower dollar have been offset by declining prices elsewhere in the economy. The housing sector, for example, is the largest component of the Consumer Price Index and it has been profoundly deflationary, thereby counteracting rising import prices. Indeed, with high unemployment rates, declining housing prices, and an oversupply of goods, the Consumer Price Index still remains *down* 0.2% from a year ago.

With the threat of inflation presently in check, the dollar's decline has, in all likelihood, contributed to the recovery of the U.S. economy. A lower dollar means that U.S. exports are generally more affordable to foreign buyers. U.S. goods have become increasingly competitive in the global marketplace, and the U.S. trade deficit has been reduced.

The importance of U.S. exports becoming more competitive should not be understated. Over 30% of the earnings of all S&P 500 companies are derived from abroad, and accordingly, more competitive exports translate directly to higher earnings for corporate America. Higher earnings typically translate to higher employment, and higher employment typically leads to a stronger housing sector. Thus, the dollar's decline has not been a "crisis," but more likely a key driver in sustaining the current recovery.

Indeed, as is the case with any economic phenomenon, the dollar's recent decline of approximately 16% must be considered in an appropriate historical context. The dollar has suffered far greater falls in the past without damaging the economy or otherwise creating any "crisis." During the latter part of the 1980s, for example, the dollar declined by almost 40% relative to other major currencies, but it did not wreak havoc on the economy. In fact, on a trade-weighted basis, adjusted for inflation, the dollar was below its present levels twice in the 1970s, once in the 1990s, and once as recently as the beginning of 2008.

### **The future of the dollar**

While a gradually declining dollar probably has served to bolster U.S. economic



growth, it is nevertheless prudent to remain cautious about the rate and duration of the decline. If the dollar were to suffer a *cataclysmic* fall, then the economy would likely contract. Large deficits and unprecedented injections of money into the economy are bearish for the dollar, and, accordingly, it is necessary to be watchful of how the dollar reacts to these conditions. Nevertheless, there are several factors that potentially are favorable for the dollar in the future.

First, currency values are determined based on the *relative* economic conditions of the issuing governments. While the U.S. economy may not currently be at its peak, it remains well ahead of most other developed economies. Therefore, the dollar is not likely to fall *precipitously* relative to foreign currencies. In fact, foreign central banks continue to purchase dollars, and no major country has any rational incentive to allow the dollar to collapse, as the negative implications would be global.

Second, the dollar may be oversold at its present levels. Despite the fact that the dollar is stronger than it was at the beginning of the subprime crisis, fewer investors are now bullish about the dollar. To the extent that history is any guide, when sentiment becomes so imbalanced, a period of value restabilization usually follows.

Third, monetary policy eventually will be tightened, interest rates will be raised, and the supply of money will be reduced. While the Federal Reserve has indicated in recent FOMC statements that it does not intend to raise interest rates until it believes that the economic recovery is self-sustaining, monetary tightening ultimately should support the dollar.

Fourth, some of the dollar's decline can be attributed to investors "shorting" the dollar. By shorting the dollar, an investor effectively borrows the currency, sells it, and reinvests the proceeds in other assets, in what is often called a "carry trade." Eventually, these short positions must be unwound by repurchasing dollars to pay back the lender. Consequently, when conditions change and investors seek to cover or close out their short positions, increased purchases of the dollar should support its value.

Finally, despite renewed calls for a multi-currency reserve system, the dollar is not in any immediate jeopardy of losing its status as the world's reserve currency, if only because there currently are no legitimate substitutes. Moreover, even if such a shift occurred, it would likely occur over a period of many years, as was the case when the dollar replaced the British pound following World War II. Approximately two-thirds of the world's official foreign exchange reserves are in dollar-denominated assets. Unwinding that level of concentration would take a great deal of time.



## **Conclusion**

Given the unprecedented nature of the recent global financial crisis, investors should remain vigilant as they watch for any changes in global policies or circumstances that may adversely impact the financial markets. Yet, even in these times of uncertainty, the decline of the dollar to date does not necessarily amount to a "crisis." A gradual and orderly decline actually could bolster the economic recovery, reduce the trade deficit, and increase productivity.

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