KEEL POINT

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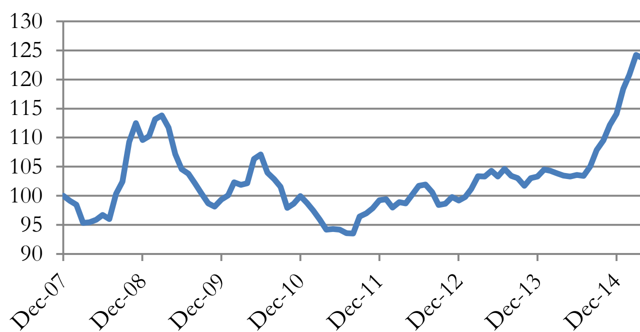
Strong Dollar Implications

As summer quickly approaches hopefully your mind is turning to a well-deserved vacation. Summer vacation 2015 may be a bargain as well – the price of gas is way down and the dollar buys more than it has in a long time overseas (specifically since 2003 as measured by the US Dollar Trade Weighted Index). All else equal, a trip to Europe costs 19% less today than it did on June 30th last year thanks to the weak euro.

Exchange rates do not often move so quickly (see Figure 1). As with any market shock, some benefit immensely while others find their interests materially worse. In the case of the strong dollar, the winners are US importers (your vacation counts as an import) and the foreign companies selling here. Losers are US exporters and consumers in the weaker currency countries.

Figure 1: Dollar Returns
US Dollar Trade Weighted Index, Dec 2007 = 100
Source: Bloomberg



Portfolios are impacted by the shift in international terms of trade too. We divide this discussion into two parts. The first deals with the surging dollar's impact on foreign assets. Second, we discuss business fundamentals for US companies, which face an ongoing headwind from the dollar.

Foreign Assets

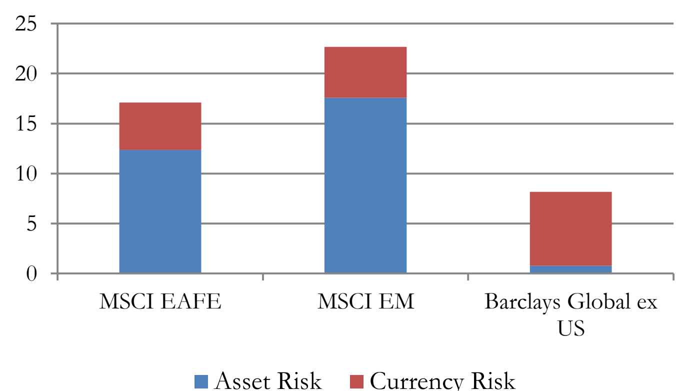
In the first quarter of the year, the MSCI EAFE Index (large companies in the UK, Europe, Australasia, and Japan) was up 10.8% when measured in the local currencies of the constituent companies. When translated to dollars, however, the result was a bit less than half: 4.9%. The dividends and capital gains earned by these companies in pounds, euros, and yen could be exchanged for fewer dollars at the end of the quarter than they could have been at the beginning of the quarter. Perhaps one implication of the strong dollar is that foreign assets should be hedged to significantly reduce the risk of currency losses eating away at dividends and capital gains.

There are good arguments both for and against currency hedging. Figure 2 suggests that hedging is the optimal approach. The bars illustrate the total risk of the MSCI EAFE Index, the MSCI EM Index (emerging market companies in Latin America, Eastern Europe, and Asia), and the Barclays Global Aggregate ex US Bond Index (government and corporate bonds issued by non-US entities in local currencies). Risk is measured as the annualized standard deviation of monthly returns. The blue vertical shows the contribution to the overall risk of the index from the actual assets (stocks or bonds); the red vertical shows the contribution from the currency component.

Foreign stock risk (EAFE and EM) is 70 to 80% derived from the constituent companies in the index. That leaves the remaining 20 to 30% attributable to currency fluctuations. Portfolio theory pushes investors to only assume risks for which they think they will be paid. We think there is compensation for the company risk, but probably not for taking passive, long-term foreign currency risk. The unhedged foreign stock investment, with its tag-along currency risk, therefore looks to be suboptimal.

With respect to bonds, the evidence in favor of hedging is even more straightforward. Most of the risk (90%) in the Barclays Global Aggregate ex US Bond Index is currency related. To truly get exposure to non-dollar foreign bonds an investor needs to hedge back to the dollar. Further, as a practical matter, it is easier to hedge bonds because the exact coupon and principal payments that need to be converted to dollars are known in advance.

Figure 2: Risk Contribution - Foreign Assets
Sources: Bloomberg, KP calculations
Note: Data for MSCI EAFE starts Dec '72, MSCI EM starts Jan '01, and Barclays Global ex-US starts Feb '90



In a white paper released earlier this month GMO laid out a convincing rebuttal to this sort of analysis. First, they believe currency hedging is futile for investors in most types of companies. At least

three quarters of the investable universe is comprised of natural resource companies, multi-nationals, or exporters by their calculations. Profits for these types of companies are not generally related to the currency of the country they call home. For instance, in the case of exporters, GMO would value the long-term boost to profits due to a weak currency much more than the coincident share price translation loss.

Second, per their research currency hedging does not actually reduce volatility of long run outcomes (in contrast to the volatility in monthly results discussed above). They analyzed the MSCI EAFE Index and found that, on average, after two years there is no reduction in return volatility due to currency hedging.

Third, the currency risk component of foreign assets is a major contributor to their lower correlation to US assets. Per our calculations, since 1973, the S&P 500 has a 0.15 correlation to the inverse of the US Dollar Index. In other words, the short dollar exposure implied by owning a foreign asset in a foreign currency is a diversifier. GMO found that the long run correlation of the local currency MSCI EAFE was about 0.2 lower than the hedged index.

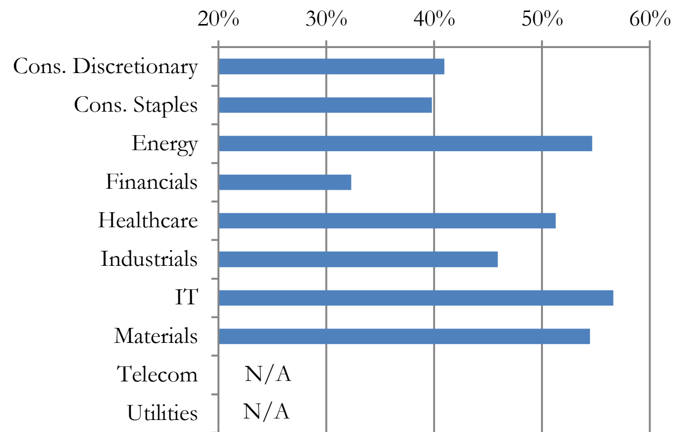
Our own view fits somewhere in between these two arguments. In some cases we have created positions in foreign assets in such a way to intentionally remove currency risk. This has recently been the approach with some positions in euro-domiciled companies. In other cases we have been willing to accept currency risk. On the fixed income side, our managers generally avoid foreign bonds. For most portfolios there is just one intermediate core bond manager that takes on some bond risk in currencies other than the dollar.

Finally, we use hedge fund strategies that take direct positions in currencies based on fundamental or technical views. This reflects our view that managers with the right expertise and ability to go long or short foreign currencies can provide positive, uncorrelated returns streams to portfolios (in contrast to the suggestion above that there is no risk premium associated with a passive long-term position in currencies).

Domestic Assets

US companies compete on the global stage for revenues. Per Standard & Poor's the companies in their flagship index made 46% of their sales somewhere other than the US in 2013. These sales are made in foreign currencies that now buy fewer dollars which in turn filter down to a smaller bottom line. Deutsche Bank estimates the relationship as follows: a 10% increase in the dollar index translates into a $2 (2%) decline in S&P earnings. The dollar index is up 20% since last summer suggesting a 4% earnings headwind.

Figure 3: Foreign Sales, Share of Total, by Sector
Source: Standard & Poor's



We are starting to see this headwind materialize in the reported results. As of May 1st, Factset reports that Q1 earnings are down 0.4% on the year prior. Current expectations suggest that both Q2 and Q3 will be lower than the same quarter last year as well.

Information technology and health care are two sectors more at risk than others (see Figure 3). Oracle, for example, reported a 6% headwind due to the strong dollar in their last earnings announcement and Johnson & Johnson blamed every bit of their earnings decline on currency movements. A chart of earnings beats and misses for Q1 would track very closely to Figure 3. Of those companies that have reported within the telecom sector, 100% have beaten estimates, whereas nearly 40% of industrial, materials, and IT companies have missed.

We believe the strong dollar is a significant impediment to continued earnings growth at the pace we have grown accustomed to during the economic recovery. We also believe valuations are at least at fair value. The implication is a reduced chance of higher than normal US equity returns. The higher probability of surprise is to the downside. □

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