What Does the Strengthening Dollar Mean to the Worldwide Economy?

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Few American consumers lament the return of a strong dollar. They see the rewards in their gas tank and whenever they buy foreign-produced products. But the rest of the world, particularly Europe, are not as sanguine.

For nearly ten years, the U.S. dollar took a back seat to the euro. Record-high federal deficits, soaring commodity prices, and a weak economy all extracted their toll. Three rounds of quantitative easing (QE) to stem the effects of the global fiscal crisis resulted in punitively low interest rates for savers.

In July 2014, economist David Malpass called for change, claiming that a stronger dollar and lower oil (and other commodity prices) would strengthen the U.S. economy and engender world peace.[1] As though on cue, the dollar has risen 18% against the euro since June 2014, and oil prices have fallen nearly 40% due to both lower global demand and increased U.S. supply. U.S. interest rates, by no means robust, are still higher than those in other countries, thereby attracting capital inflow. GDP is also improving, and the Federal Reserve is hinting at raising interest rates by summer. The federal deficit is shrinking, and the shale oil revolution is reducing the U.S. trade deficit.[2]

While the U.S. has terminated its quantitative easing program, the Bank of Japan and the European Central Bank (ECB) are expanding theirs. ECB Chairman Mario Draghi launched a massive bond buying program of €1.1 Trillion ($1.3 Trillion)[3] to spur Europe's stagnant economy and lure foreign investment.

Since the late 1970s, the U.S. stock market investor has seen the stock market perform twice as well during dollar bull markets than during dollar bear periods.[4] But, while Americans may be enjoying fatter portfolios and greater spending power, multinational U.S. corporations who depend on exports to Europe are dealing with the revenue fallout. Not only do they have to handle lower levels of exports thanks to U.S. goods being more expensive in Europe, their profits shrink even further

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[1] http://www.forbes.com/sites/currentevents/2014/07/02/peace-through-weakness-the-u-s-and-japan-sputter/

[1] http://online.barrons.com/articles/3-ways-a-strong-dollar-impacts-the-global-economy-1413236429

[2] http://online.barrons.com/articles/3-ways-a-strong-dollar-impacts-the-global-economy-1413236429

[3] http://www.bloombergview.com/quicktake/europes-qe-quandary

[4] http://www.marketwatch.com/story/heres-why-a-stronger-dollar-wont-suck-the-wind-out-of-stocks-2014-09-24

when those revenue dollars are repatriated, because income earned in euros is worth less when converted to dollars. Just a few months ago, American corporations anticipated double-digit earnings growth for 2014.[5] As the actual numbers are posted, expectations have been tempered downwards, and energy, materials, utilities, and consumer staples are slated to post negative growth rates for Q42014.[6] For example, McDonald's predicted that the higher dollar could cause a $.09 per share hit to fourth quarter earnings [7] and Procter & Gamble and Pfizer both predicted profit hits because of negative currency impact - $1.8 Billion and $2.8 Billion, respectively.[8]

But benefits also can accrue on both sides. For one, European imports cost less for U.S. consumers. Therefore, European manufacturers, capitalizing on subsequent increased demand in the U.S., will reap the rewards of greater revenue and stronger balance sheets. In addition, foreign investors seeking higher returns than what may be achievable in their own financial markets are again investing in the U.S., where the yield on 10-year U.S. Treasury bonds hovers slightly below 2% compared to just .46% for 10-year German bonds. This trend is expected to continue. In fact, in 2013 (the latest numbers available), seven of the top ten foreign investors in the U.S. were European.[9]

A stronger dollar also has direct, positive ramifications for U.S. mergers and acquisitions (M&A) activity in Europe, as long-term players who've had an eye on making European investments can now purchase them less expensively. The private equity market, known for its propensity to follow growth, rather than to lead the charge into unproven economic waters, is witnessing resurgence. Conversely, Euro Zone companies seeking U.S. investments may put those plans on hold, as the eroding euro means it will cost more to buy companies here.

Europe's tourism industry should also gain, as U.S. travelers bearing dollars flock to foreign hotels and restaurants. Similarly, Euro Zone companies with U.S. manufacturing subsidiaries should see an uptick to their bottom line.

Our European-based clients are optimistic about the strengthening dollar. Their U.S. subsidiaries purchase goods from the European parent, who in turn, invoices the U.S. companies in dollars, which then flow to the company's bottom line. The U.S. subsidiaries realize higher profits via lower costs, creating a win-win situation.

A word of caution: it takes more than currency manipulation to strengthen an economy, something to which Japan can attest. Countries must fix their underlying economic problems, which may require austerity, commitment to job creation, and other tough measures. Sudden currency moves can also create market instability,[10] or at the least, high volatility, as we have seen in the gyrations of the S&P 500 Index since the beginning of the year. Mohammed El-Erian, former CEO of PIMCO and now Chief Economic Advisor at Allianz, suggests that sharp currency shifts could be characterized as a currency war, prompting a retaliatory policy response,[11] if not a fiscal one.

In summary, Europe has seen Japan and the US derive benefits from a weakened currency that allowed them to grow their economies through exports. The U.S. economy has gained traction in an environment of greater global cooperation. A stronger dollar transfers demand to other economies, and once they are on firmer footing, they can again purchase U.S. goods. Healthy global economies ultimately are positive both for the US and for its trading partners.

[5] http://www.spokesman.com/stories/2015/jan/17/strengthening-dollar-hurts-us-corporations/

[6] S&P Capital IQ Consensus Report, January 30, 2015

[7] Buck up, Profits Down: High Dollar Dents US Company Earnings, WASHINGTON — Jan 16, 2015, By PAUL WISEMAN and STAN CHOE AP Business Writers, Associated Press

[8] http://www.wsj.com/article_email/stocks-get-a-dollar-hit-1422404608-lMyQjAxMTE1NTI4ODUyMDg3Wj
January 27, 2015

[9] Content First, LLC, Foreign Direct Investment in the United States, 2014 Report, www.contentfirst.com

[10] http://d21uq3hx4esec9.cloudfront.net/uploads/pdf/OTB_Nov_13_2014.pdf

[11] Ibid.

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