

CURRENCY MARKETS 101

Currency Markets – out of sight, out of mind. Until recently, this little discussed area of finance has worked behind the scenes to grease the wheels of global commerce. Besides exchange rates quoted in the financial news, little ink is devoted to the subject. However, the global economic slump, a falling dollar and politics have thrust currencies into the news. So, what is going on? What is the foreign exchange market? And why should U.S. investors take note?

First, the foreign exchange (currency) market is a decentralized network of traders, i.e. there is no central location such as the New York Stock Exchange (NYSE). Participants include banks, brokerages, foreign exchange dealers and corporations around the world. Volume is approximately \$2 trillion per day, over twice the daily dollar volume of the NYSE. Like the stock markets, supply and demand determines value, influenced by economic & political events, market expectations and market manipulation.

Foreign exchange has gained attention because the U.S. dollar has hit multi-year lows against many currencies around the world. A gradually weakening dollar, as we've seen over the past 18 months, is a natural occurrence given the United State's enormous trade deficit, fiscal deficit and low interest rates. A weaker dollar, though, has upset Japan and the Euro-zone because their goods are now less competitive in the U.S. Both economic blocks are struggling to revive their own economies and, to some extent, want to export their way out of trouble via the United States.

Meanwhile, there is China. While the dollar should also be falling versus the Yuan, it has not. China manipulates the currency markets to maintain a near constant exchange rate of approximately 9 Yuan to 1 dollar. So, China's economy is booming, but their currency has not budged. U.S. manufacturers have complained for years about cheap imports, however, presidential candidates have now rallied to the cause ...thus the headlines. Unfortunately, the issue with China is complicated. China's banking system is a mess and their government holds \$10's of billions of U.S. Treasury Bonds (due to manipulating the currency market). A de-valuation of the Yuan, handled poorly, would cause problems on both sides of the Pacific. This newsletter is an inadequate vehicle for addressing the whole issue. Instead, let us shift gears and look at the effects of foreign exchange on investors.

During the 1990's, our government's strong dollar policy created a formidable headwind to investors with assets overseas. A rise in the value of the dollar versus the yen meant the value of a person's Japanese stocks decreased in dollar terms. Now a falling dollar is producing the opposite effect. Most foreign stocks are up for the year, but the depreciation of the dollar means those foreign investments are even more valuable than if the dollar exchange rates had stayed the same. We have a tailwind rather than a headwind.

Looking forward, a continued decline in the dollar would boost the value of foreign investments. This may or may not come to pass. Nonetheless, there are many excellent reasons to own international investments. A currency regime where the dollar is NOT steadily rising increases the appeal of foreign stocks and bonds.

Best regards,

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