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INVESTMENT CONSULTING
UNDERSTANDING INVESTMENTS
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The Headwater Investment Consulting staff. *From left: Ginger Teller, CB Mason, Kevin Chambers, Tom Sherwood, and Scott Chambers.*

FIRM NEWS

- Kevin recently returned from a professional development trip to China with the Willamette University MBA program. Be watching our blog for an update from him.
- Tom is finishing up his Capstone Project for the University of Oregon Executive MBA program.
- The 2017 Form ADV will be available in February. Watch your inbox or visit the *Resources/Disclosures* page on our website to view our latest SEC filings.

Regular Office Hours

8am to 4:30pm Mon-Thu

8am to 4pm Fri

US Dollar:

The Impacts of a Strong Dollar

By Kevin Chambers

The US dollar rose through 2016. In the month after the election of Donald Trump, it increased sharply once again. It has risen against the Yen, the Pound, and many emerging market economies. What has caused the increase? How does that effect US business? What is the outlook for the future?

The Basics

To understand what has recently happened with dollar prices, it is helpful to recap the basic economic theory behind currency movements. Currencies are always valued against other currencies. This produces

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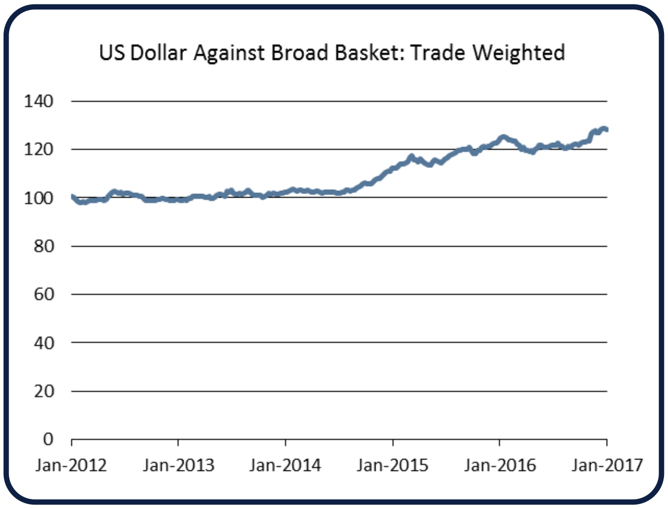
exchange rates. Exchange rates are an indicator of economic health, a country's foreign trade policy, and political or social issues. As a currency value increases, it makes a country's exports more expensive and makes imports cheaper. Higher currency prices tip the balance of trade (the ratio of imports to exports) toward importing more goods than are exported. A lot of factors can influence exchange rates. We will review a few of the most powerful reasons for exchange rate changes. Again, these are all relative between two countries, but usually can be generalized to the entire global economy.



1) Inflation Differentials:

If a country's relative inflation is constantly lower, it will tend to have a higher relative currency value. This is because the higher inflation decreases the purchasing power of a currency.

2) Interest Rate Differentials:

Since bonds are denominated in local currencies, the purchasing of bonds is a driver of exchange rate changes. As interest rates increase , more investors are likely to demand more of the local currency to buy those bonds to get the higher yield. Thus, pushing the exchange rate to increase.

3) Political and Economic Stability:

The relative health of an economy will lead investors to favor one country over another. When a country is relatively healthy, investment funds are drawn into that country, driving the price of the currency up. Political or economic troubles would make investors less likely to invest in a country (Van Bergen, 2014). If there are problems, less people demand this currency and the value will fall.

How Currency Effects the Economy

Currency changes, either up and down effects a countries international trade directly. It changes the value of imports versus exports. A strong dollar makes imports cheaper and exports more expensive. A weak dollar is the opposite. When the dollar is strong, a country with a weaker currency can make products less expensively. With a very strong currency, consumers will find foreign products cheaper than comparative domestic products. It is also harder for exporters to compete in foreign markets, because their products will be more expensive. For individual companies that rely on exporting out of the United States, having a strong currency hurts them.

In terms of overall economic health and growth, we need to review basic macroeconomic theory. GDP is the value of all goods and services created in an economy. It is the benchmark by which most people judge the economic health of an economy. The basic formula for GDP is the sum of consumer spending, government spending, capital investment, and the trade balance. The trade balance is all exports minus total imports. As we mentioned, when the dollar is strong it helps imports and hurts exports. Therefore, it pushes the trade balance negative and drags down GDP.

The Current Situation

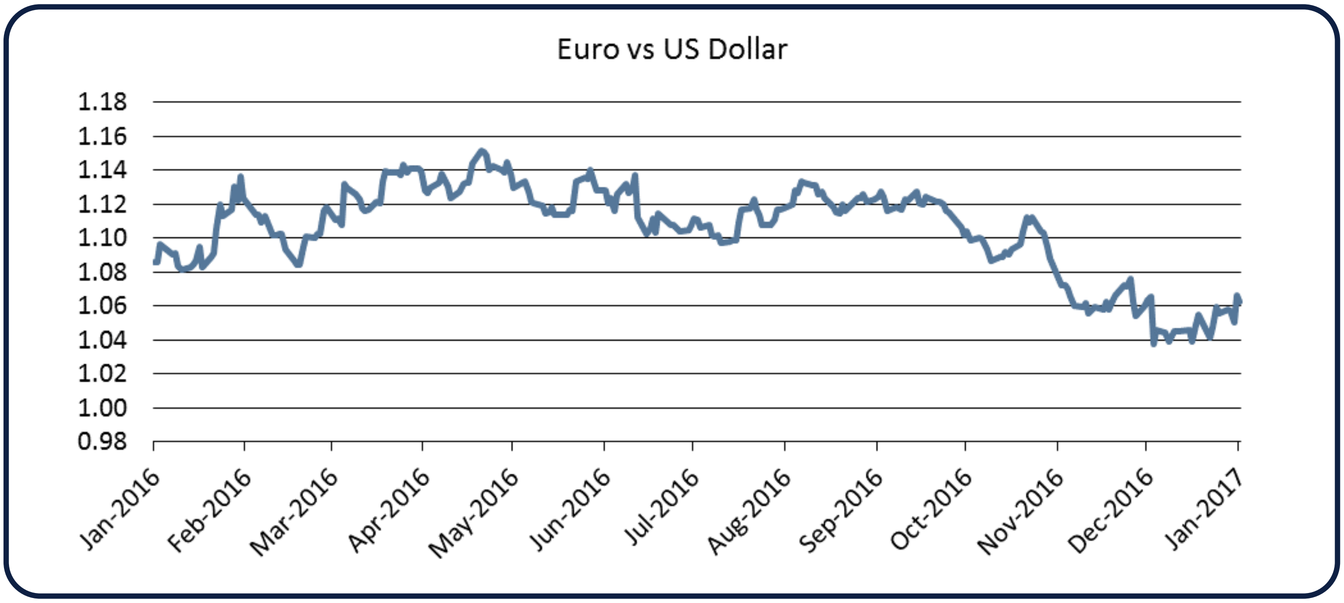
Since currency lows in 2011, the dollar has appreciated 40% and 3% since November 8th. This is against a basket of major currencies. We will break down the analysis by the three major influences of exchange rate changes.

Looking at our basic reasons for exchange rate changes, inflation has been a contributing factor. Inflation in the United States has been very low.

One of the main drivers of low inflation has been low oil prices that started in 2014. Gas prices have remained low and inflation has been almost nonexistent. Especially compared to many emerging markets, low inflation in the US has helped push the dollar higher.

Interest rates have also been a little higher in the US, especially when compared to Europe and Japan. Japan, Germany, and a few other countries have had negative interest rates, even out on the yield curve. For much of the last couple years, even German 10 year yields were in below zero territory. Through November and early December, yields in the US have been inching higher, which going forward would trend toward a continued strong dollar.

Looking at the final basic currency fluctuation factor: economic health. The US is the strongest economy in the world. Europe and Japan have been stagnant. China is going through a transition period and has slower growth. Emerging markets have struggled with low commodity prices. US companies have been growing and innovating. Overall, the economy in the US is pretty strong. The housing and labor markets have almost fully recovered from the 2008 collapse. Going forward, the new administration has more uncertainty in our political spectrum. It will be interesting to see how new policies will affect the national economy and the financial systems.



The Dollar in the World

Even with the strength of the dollar, the share of the world export market made up by the US has been shrinking. The number of countries for which the US is their largest export market has dropped from 44 to 32 over the last 25 years. The pure economic theory would indicate the dollar's value would have followed this trend and fallen. However, it has maintained its value and even gained (The Economist, 2016). This is because the US is still the world's reserve currency. Many major foreign transactions are conducted in US dollars. Most oil transaction, for example, are US dollar denominated.

Because of the ubiquity of the dollar, it effects the movement of other currencies as well. About 60% of the world's GDP is in a currency that is de facto tied to the US dollar movement. This means they are highly correlated and move as the dollar moves. That is a massive amount of power bestowed to one currency and one nation (The Economist, 2016).

There are some problems associated with the strong dollar. One problem, is that it has hurt debt-burdened emerging nations. As many emerging countries have looked to advance, they have financed their infrastructure and domestic industry through debt. Most of this debt is US dollar denominated. Financiers in the US and Europe, tired of low yields, have searched for higher yields in the developing world. To facilitate this transaction, it was easier for most of these bonds to be priced in dollars, as most of the investors are foreigners. However, the host country is required to pay the debt payments with local currency. As the dollar continues to strengthen, each debt payment has gotten more and more expensive. This exacerbates the original problem: as more of a nation's budget is required to make debt re-payments, the health of the government finances is weakened, and the value of the currency falls more (The Economist, 2016).

Looking Ahead

The dominance of the US dollar, therefore, is not helping the global growth problem. An expensive dollar makes it more difficult for international trade, investment, and economic coordination to occur. Because the US is the most stable economy, for now, there is not a good alternative for a second reserve currency. Although the Euro was discussed at length in the early 2000s, the current weakness projected by the EU has made it fall out of favor. After the news of the Brexit vote, the Pound lost significant value, indicating a lack of confidence in the UK by |investors. Finally, China's government is not trusted by most investors after their continued manipulation of their currency for domestic gain. It seems like the dollar dominance is here to stay, at least in the foreseeable future. If for some unexpected reason the US economy stumbles while the rest of the world is gaining strength, we could see a reverse in this trend. That being said, the US dollar as the reserve currency are probably here to stay.

Works Cited

The Economist. (2016, December 3). Why a strengthening dollar is bad for the world economy. The Economist.

Van Bergen, J. (2014). 6 Factors That Influence Exchange Rates. Alberta: Investopedia.

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