

Broad Impact of a Strong Dollar



The strength of the U.S. dollar has economic effects on global trade and individual investors. Below we share insights from American Century Investments, one of our institutional investing partners. Here, we review the causes of U.S. dollar strength today, who is benefiting, who faces challenges, and how to invest. ¹

The Federal Reserve's aggressive post-pandemic rate-hiking and higher-for-longer rate strategy has helped underpin the U.S. dollar. This has significant consequences for global economies, currencies and inflation. Who are the winners and losers, and how long can this dollar strength last?

Factors Behind a Strong U.S. Dollar

The Fed's aggressive rate hike campaign to combat inflation affected both sides of the supply/demand equation. Higher interest rates effectively removed dollars from the supply by increasing the cost of borrowing. At the same time, rising rates created attractive yields for some dollar-denominated investments, which attracted foreign investors and increased demand for U.S. currency.

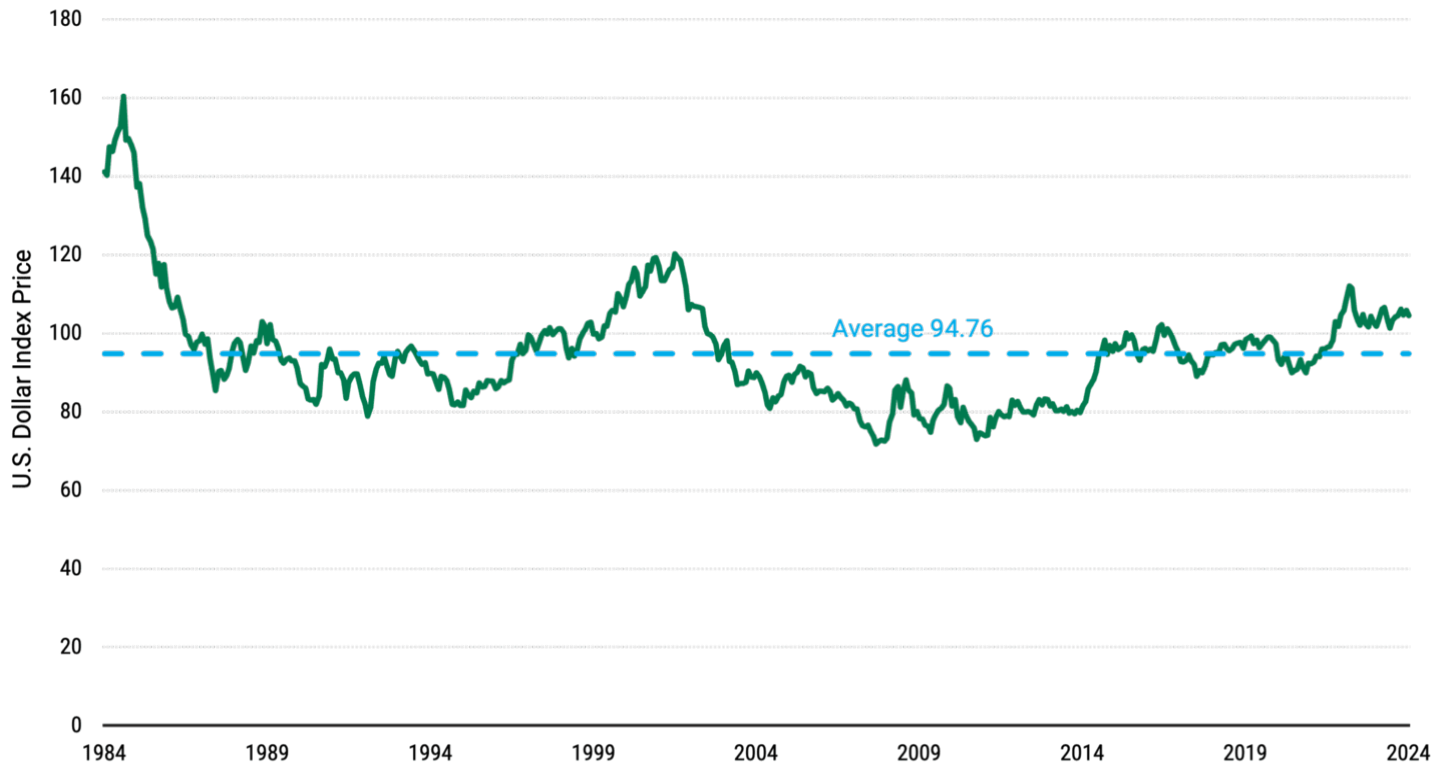
Slowing global economic growth and market uncertainty also affect demand for the dollar. The U.S. economy remains relatively strong compared to other markets, making it attractive to foreign investors who must purchase dollars to invest here. At the same time, the relative strength of the domestic economy and stock market may be keeping American investment dollars at home. Some U.S. investors may be less inclined to increase their overseas holdings, which would require selling dollars to buy foreign currencies.

The dollar also benefits from its status as the world's reserve currency. Central banks hold dollars in their foreign exchange reserves for deals with other countries. Commodities like gold and oil are priced in dollars, and many international transactions and cross-border loans are executed in dollars.

Historical Perspective on Dollar Strength

Despite its rise, the dollar is not as strong as it was during the mid-1980s. See the chart on the following page. Paul Volcker, chair of the Fed from 1979 – 1987, helped reduce inflation and strengthen the dollar's value worldwide.

The Dollar Is Strong But Not at Historical Levels ²



Data from 7/1/1984 – 7/1/2024. Source: FactSet.

Who Benefits from a Strong Dollar?

U.S. importers benefit from the strong dollar because goods produced outside the country cost less in dollar terms when the value of the manufacturer’s currency declines. As a result, their profit margins may improve as the cost of acquiring goods from countries with weaker currencies declines. In turn, U.S. consumers could see lower prices if importers pass the lower costs to their customers.

Foreign companies generating significant sales in the U.S. also benefit because the revenue reported on their financial statements will reflect the higher value of U.S. currency.

Other beneficiaries include companies with the pricing power to withstand the inflationary environment that a strong dollar supports. Companies with firm-specific growth drivers can often pass higher materials and wage costs to their customers. Such companies tend to rely less on a robust economic environment. They are often innovators serving niche markets or offering best-in-class goods or services with few viable alternatives.

Challenges of a Strong Dollar

A strong dollar tends to be a headwind for U.S. exporters and U.S.-based multinational companies generating significant revenue overseas. When the dollar's value rises, U.S.-made goods are more expensive for local buyers.

Emerging markets (EM) suffer as investment capital flows to the U.S. and its stronger currency. The strong dollar puts pressure on countries that have issued dollar-denominated debt, which they must repay in a stronger currency rather than their own. EM economies that are net commodity importers will also feel the pressure of higher costs for energy, raw materials and grain.

Interestingly, the strong dollar creates winners and losers in the travel industry. For U.S. travelers, the strong dollar can reduce the cost of vacationing overseas. On the other hand, the exchange rate results in higher costs for foreign travelers visiting the U.S.

Investing Through Dollar Fluctuations

The dollar's value fluctuates depending on market demand. And, with Fed policy and economic conditions evolving, the pendulum could swing from its currently strong position. Rather than making investment decisions based on currency expectations, we believe staying broadly diversified with exposure to U.S. and non-U.S. stocks and bonds remains a prudent strategy.

Conclusion

As our partners at American Century highlight above, a strong U.S. dollar is neither completely good nor all bad. It is just a factor of the macroeconomic environment where some benefit and some are challenged. At times when the dollar is weak, there are different winners and losers. This is true for all factors of the macroeconomic environment. We agree that currency fluctuations are yet another reason for smart diversification, especially since currency movement is notoriously difficult to predict. If you have questions about the current allocation of your portfolio and our use of dollar hedging, please contact your advisor.

Notes and Acknowledgements:

1. American Century Investments, "The Broad Impact of a Strong U.S. Dollar," July 26, 2024
2. American Century Investments, FactSet Data from July 1, 1984 – July 1, 2024