Key Questions

The U.S. Dollar Has Been Sinking. Should Investors Worry?

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What the strength of the U.S. dollar means for your investments.

Investors often do not think about the dollar as they consider their investment strategy, but exchange rates can have a major impact on the returns from overseas investments and on U.S. companies leveraged to overseas sales.

U.S. investors generally benefit from higher international exposure when overseas earnings grow faster than domestic earnings. If the U.S. dollar also falls against overseas currencies, translation gains amplify both earnings growth and the value of overseas investments. But when the dollar rises, translation reduces overseas investment returns. Last year, after rising for several years, a falling dollar helped drive stronger overseas gains.

What affects the value of the dollar? Inflation is critical. Over time, currencies tend to trade for what they can buy net of inflation. Fears of rising U.S. inflation, therefore, put downward pressure on the dollar.

Fears of inflation also come into play when investors expect rising government deficits. With projections of a sharply rising deficit as a result of the tax act passed last year and proposed increases of government spending, deficit fears have also put pressure on the dollar this year.

Trade and investment flows drive the dollar's value as well. When trade and investment flows into the United States are strong, the dollar tends to rise. If those flows are weak, so is the dollar. In 2014, strong U.S. growth and weak overseas growth helped push the dollar higher. Last year, as growth overseas increased relative to growth in the United States, the dollar weakened. The current outlook for solid overseas growth should keep the dollar from rising sharply.

Rising U.S. interest rates relative to overseas rates push the dollar higher, as rising rates encourage investment flows into the country. If U.S. interest rates rise sharply at some point this year, that could help lift the dollar.

Having fallen almost 10% last year, the dollar index has dropped another 2.6% in 2018. While that drop seems overstated in the short term, sharp currency declines can disrupt trade and help fuel inflation through rising import prices. Although dollar weakness can indicate slowing in the domestic economy, recent weakness resulted more from improving growth overseas, which argues for a sustained outlook for U.S. growth. Notably, during global recessions, the dollar often rises as investors flee riskier areas of the world.

On balance, many of the important pressures argue the dollar will weaken somewhat this year, but probably at a slower pace. That should be particularly good for international investments, where the potential for growth has also improved and valuations seem attractive relative to the U.S.

For questions, please contact your Key Private Bank Portfolio Manager.

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