

The U.S. Dollar's Decline: What's it all about?

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The headlines these days are full of pessimism about our currency, as the dollar hits its lowest level in years against major currencies like the Yen and the Euro. Is the decline in the dollar over the last decade a sign that the United States is in decline- is the sun setting on the USA? Are we destined to be remembered as just another once – great world power like Greece, Rome, Spain or the United Kingdom? Is the story really just a reflection of what is wrong with the United States (huge public budget deficits and skyrocketing national debt, moribund real estate markets, near-zero short term interest rates, and a weak banking sector), or is it more reflective of the tremendous growth of developing economies around the world?

Have you ever been hit repeatedly by a “BRIC”? The dollar has been hit regularly over the last several years by a certain kind of “BRIC,” also known as Brazil, Russia, India and China. The International Monetary Fund recently published its quarterly *World Economic Outlook*, and the numbers, while not new, never cease to amaze. After growing its economy in 2009 at 9.2% and 10.3% last year, **China** is expected to see 9.6% economic growth this year and 9.5% in 2012. **India** is expected to grow 8.2% in 2011 and 7.8% next year. **Brazil** and **Russia** are both expected to grow at a 4.5% rate this year; meanwhile the **U.S.** is forecasted to grow at 2.8%, the **EU** will grow at 1.6%, and **Japan** at 1.4%.¹ Capital flows into the leading emerging markets are already above pre-financial crisis levels.

Capital will head towards where it can get the best returns. As corporations and investors who hold dollars move to invest in these economies, dollars are sold and local currencies are bought. Populations in these countries are advancing – getting better educated, being employed in higher skilled jobs, earning higher incomes and spending more and more. Companies that sell goods and services in these markets (many of which are U.S. companies) have flourished. Capital markets in the emerging world have grown and matured and now represent about 14% of the total world equity market capitalization. This is all great for these populations and for the global economy. It is good for us too, but it also calls for adjustments.

By the way, in recognition of these long-term changes, our Investment Committee has, over time, adjusted upwards our recommended allocations to non-U.S. markets. We did so again this year, and the equity component of our *recommended* model portfolio allocation calls for a 40% allocation (up from 30%) outside the United States, with ¼ of that 40% allocation specifically invested in emerging markets like China, India and Brazil. We also allocate 15% of our fixed income portfolios to non-dollar bonds both in developed and emerging markets. You will be hearing more about this soon from your consultant, of course.

¹ Table 1.1. Overview of the World Economic Outlook Projections. The International Monetary Fund. (April 2011). World Economic Outlook: Tensions from the Two-Speed Recovery- Unemployment, Commodities, and Capital Flows. p. 2. Retrieved from <http://www.imf.org/external/pubs/ft/weo/2011/01/index.htm>

The decline in the dollar has been a tailwind for the dollar value of our non-U.S. holdings, which have proven to be a critical component of our well-diversified portfolios. While the S&P 500 has returned 3.3% a year for the last 10 years through March 31, 2011, the MSCI Emerging Markets Index has returned a whopping 17.12% a year over the same 10-year period. And foreign bonds have performed very well.

So what does all this mean for the United States? Will the dollar ever rebound and be strong again? Well, probably yes at some point. All economies are cyclical to some degree, even the faster growing ones. Asia and Latin America will at some point see a marked slowdown in growth, maybe a recession or a crisis. Meanwhile the U.S., with its already weak currency pricing in plenty of concerns, just may start to turn the corner in one aspect or another, whether it is a comprehensive deal on the federal budget or the eventual comeback of the housing and banking sectors. No one really knows, but it is not so crazy to think that in 2011 or 2012, the dollar finally bottoms out and starts to appreciate against other major currencies, slowly or otherwise. It would not be the first time we had a major surprise in currencies.

That being said, as the U.S. Federal Reserve keeps short-term interest rates close to zero, investors find the rates on short-term instruments in the U.S. very unappealing. The European Central Bank has already started to raise rates, and many natural resource economies like Canada and Australia offer much higher rates on cash equivalents than we do. This explains why even against the Euro, the dollar is having a tough time. People sell dollars and buy currencies like the Euro to obtain higher interest rates on their deposits. However, all things being equal (although they never are), once the Federal Reserve starts its interest rate hiking cycle, the dollar should start to get enough support to move higher.

That is not likely to be in the immediate future. Chairman Ben Bernanke held the Fed's first-ever press conference on Wednesday and pledged to keep rates low, with no change to current policy. The Fed confirmed its intention to end the \$600 billion Treasury bond buyback program in June but to maintain the 0-.25% fed funds rate for "an extended period."

Whether the dollar continues to slump or whether it starts to grind higher, we feel our approach to building portfolios that consist of a broad mix of countries, industry sectors, and companies both large and small, in both equity and debt, is the best approach. Trying to forecast currency movements and adjust portfolio allocations accordingly is foolish and speculative and would do nothing but enrich the securities brokers. While it promises to be very interesting in the coming years to see how things play out with the dollar, you can rest assured that we have all the bases well covered.

Sincerely,



John Bussel
Principal, Senior Vice President

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