The Fluctuating Dollar

The value of the dollar has always fluctuated, and probably always will, as investors try to gauge the course of the complex global economy. Recent actions by the Federal Reserve and other central banks have increased awareness of currency movements. However, changes in currency values are largely unpredictable, so we think you should avoid making investment decisions based on currency fluctuations. Instead, prepare for the value of the dollar to vary over time by owning a diversified portfolio that includes international as well as domestic investments, as appropriate for your situation.

What Changes the Value of the Dollar?

Currency exchange rates are relative prices, meaning that their levels and direction usually depend on conditions in one country compared to others. The value of the U.S. dollar compared to other currencies (such as the euro, the British pound, the Japanese yen or the Chinese yuan) rises and falls over time depending on conditions here relative to those in other parts of the world. The main factors in determining exchange rates are:

- Relative short-term and long-term interest rates
- Relative inflation rates and expected inflation
- Relative economic growth

For example, recent Japanese policies have been designed to reduce the value of the yen compared to that of the dollar. In another situation, a foreign currency could strengthen relative to the dollar because of strong economic growth in that country's economy. However, currency markets are very complex, and these are just a few of the many moving parts in the global economy that cause movements in the dollar.

Many people think the market’s performance is related to the dollar, but that’s not usually the case. Sometimes when the dollar is strong, the stock market performs well. However, the market has also performed favorably when the dollar has been weak. And most importantly, when stocks retreat, the dollar is perceived as a “safe haven” and has historically risen whenever investors become nervous.¹ We don’t think that relationship is likely to change anytime soon. But overall, there’s no long-term systematic relationship between the two.

Reasons cited for why the dollar may decline over the long term have included the U.S. federal budget and trade deficits and weak U.S. economic growth. However, other developed countries have similar problems, and emerging economies have their own challenges. Since even experts are frequently wrong about short-term currency moves – and currencies tend to be more volatile than stock prices – we don’t recommend speculating on changes in the value of the dollar or other currencies.

The Main Reserve Currency

The dollar is one of seven currencies the International Monetary Fund (IMF) identifies separately as reserve currencies. In addition to the U.S. dollar, which accounts for about 64% of global reserves, the other traditional reserve currencies are the euro (about 20%), British pound sterling, Japanese yen and Swiss franc. In 2013, the Canadian dollar and Australian dollar were added to the list. We expect more currencies could be added, as international trade expands and those currencies become easier to trade, but we expect the dollar will still continue to play a major role.

International trade requires international payments, and the dollar is one of the most convenient ways to make those payments. That’s because the U.S. has the second largest share of world trade (China has the largest share). The large U.S. role in world trade isn’t surprising, since it’s the largest economy in the world.² And many products and services are also priced in dollars, making it more convenient for other countries to use dollars when trading among themselves as well as with the U.S.
Today, the largest percentage of international reserves are in U.S. dollars, followed by euros – but the main international reserve currency has varied over time. Before World War II, the British pound was the main reserve currency. Since the pound lost that status, London has remained one of the world’s largest financial centers, and the British economy and stock market have continued to rise over time. Although some have predicted dire consequences for the U.S. if the dollar loses its primary reserve currency status, we believe that’s not likely to happen anytime soon. Moreover, the British experience suggests that the consequences might be minimal.

### What Does the Dollar’s Value Mean to You?

Changes in the value of the dollar may affect your investments in several ways, including the value of your international investments and the earnings growth of U.S.-based global companies. Keep in mind those are considered domestic equity investments.

The dollar’s fluctuation can have a major impact on the performance of international investments. When the dollar declines relative to other currencies, U.S. investors experience higher returns from their international investments. When the dollar strengthens, the reverse is true.

A weaker dollar generally increases foreign earnings of U.S.-based global companies, boosting earnings growth. In contrast, a stronger dollar lowers the growth of foreign earnings, reducing overall earnings growth. The table above shows other advantages and disadvantages from a fluctuating dollar.

### Don’t Let the Dollar’s Swings Keep Your Portfolio at Home

Whether the dollar rises or falls, we believe international investments can be an important source of diversification within your portfolio. We recommend allocating up to 35% of a balanced portfolio internationally – primarily in broad-based international equity investments – to provide exposure to different economies and markets.*

Because of so many conditions that affect the dollar, we believe it’s nearly impossible to predict short-term changes in its value. But instead of worrying about the dollar’s possible moves, make sure your portfolio has quality investments – including international investments, if appropriate for your goals and risk tolerance.

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Sources:

1. Bloomberg, U.S. Dollar Index and Edward Jones calculations. The U.S. Dollar Index indicates the general international value of the U.S. dollar. The index consists of the trade-weighted average of six major world currencies.

Diversification does not guarantee a profit or protect against loss.

*Special risks are inherent to international investing, including currency fluctuations and foreign political and economic events. Investing in equities involves risks. The value of your shares will fluctuate and you may lose principal.