Dollar Cycles: What Do They Mean for You?

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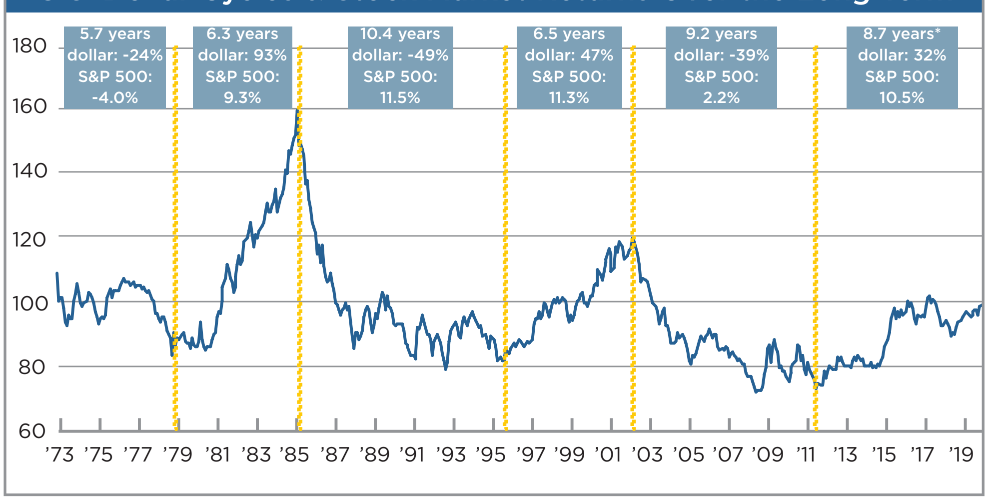
Currency exchange rates are relative prices, meaning their levels and direction usually depend on conditions in one country compared to the others. Relative economic growth, inflation and interest rates can all impact currency values.

What's a dollar actually worth?

As shown in the graph below, the U.S. dollar tends to move in multiyear cycles, with extended periods of strength followed by prolonged periods of weakness. Over the past nine years, the U.S. dollar has risen steadily against a basket of major currencies, driven by:

- **Faster U.S. economic growth –** As the world recovered from the global financial crisis, the rebound in U.S. economic growth and stocks was stronger than in most other developed countries. Despite periodic slowdowns in global growth, U.S. growth held up better because of the economy's smaller reliance on manufacturing and global trade.
- **Higher domestic interest rates –** The gap between U.S. and global interest rates started widening in 2016 as the Federal Reserve hiked interest rates, while central banks in Europe and Japan cut rates to support the fragile economic recovery. With U.S. rates higher than in most other developed countries, foreign demand for U.S. Treasuries and dollars increased.
- **The dollar's role as a "safe haven" –** Whenever uncertainty is high and investors become nervous, they tend to reallocate money into U.S. Treasuries, increasing the value of the dollar. This "fear trade" was prevalent in 2011 with the eurozone crisis, in 2015 with China worries and oil price declines, and in 2018 because of tariff fears.

U.S. Dollar Cycles & Stock Market Returns Over the Long Term



Source: *as of 12/31/2019, Bloomberg, Morningstar Direct. The U.S. Dollar Index indicates the general international value of the U.S. dollar and consists of the trade-weighted average of six major world currencies. S&P 500 returns are price returns, annualized.

MAKING SENSE OF INVESTING

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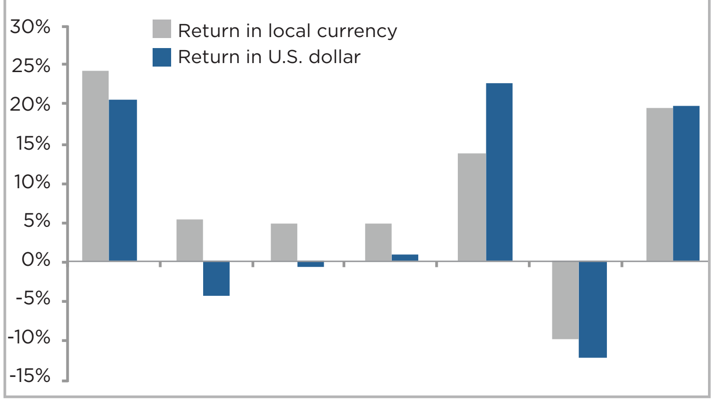
How does the dollar impact investments and the economy?

A rising dollar makes imports from other countries less expensive, pushing domestic prices lower and increasing consumers' purchasing power. However, it also makes U.S. exports more expensive and, therefore, less competitive. U.S.-based global companies can see their overall earnings growth reduced when they convert profits from a foreign currency into a strengthening dollar.

Higher U.S. stock returns have accompanied periods of dollar strength, likely reflecting a strengthening U.S. economy. However, the strong dollar can be a drag on international stock returns: In five of the past seven years, the rising dollar reduced returns for international developed stocks by an average of about 3% per year when compared to returns in local currencies.

Rising Dollar Reduced Returns to U.S. Investors
(MSCI EAFE total return %)



	2013	2014	2015	2016	2017	2018	2019
Local Currency	26.9%	5.9%	5.3%	5.3%	15.2%	-11.0%	21.7%
U.S. Dollar	22.8%	-4.9%	-0.8%	1.0%	25.0%	-13.8%	22.0%

Source: Morningstar, 12/31/2019.

What's ahead for the dollar?

Short-term changes in the dollar's value are hard to predict given all the factors that cause them. That said, based on our economic outlook, we expect the dollar to flatten or fall modestly over time for the following reasons:

- **Slowing domestic growth –** U.S. economic growth is expected to moderate while growth in other major economies is expected to bottom out. Growth has averaged 2.3% during the current U.S. economic expansion, the longest on record. While weaker than in past expansions, this pace of growth has been above the economy's potential, according to the Congressional Budget Office. As the expansion matures, growth will gradually slow. At the same time, global growth has been depressed and is poised to stabilize and potentially rebound.

- **A narrowing interest rate gap –** U.S. interest rates will probably continue to be higher than those of other developed countries, but the yield differentials are likely to narrow. The Fed will not be inclined to hike rates until inflation, which remains stubbornly below the bank's target, picks up materially. Interest rates are already negative in Europe and Japan, and in our view are not likely to fall much further. This dynamic will provide less support for the dollar than in the past.

- **Twin deficits a headwind –** Despite its recent strength, the value of the dollar has been trending lower for more than 30 years. We expect the rising U.S. federal budget and trade deficits to continue to exert downward pressure on the dollar.

Action for investors

Over longer periods of time, currency fluctuations tend to have less impact on investment performance, so we don't recommend making sizable changes to your portfolio based simply on the dollar. However, following several years when U.S. stocks have outperformed, you may need to add international equities to return them to their appropriate weight in your portfolio based on your comfort with risk, time horizon and long-term goals. International investments can be an important source of diversification and, based on compelling valuations and the potential for a weaker dollar, have the potential to provide better relative returns in the future.

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