DOLLAR SUPREMACY: FRIEND OR FOE?

Should we be happy that the US dollar is strong today? Since the dollar is considered the world's reserve currency, this means sovereign nations hold their foreign money reserves primarily in US dollars rather than say, the Mexican peso. The dollar has reached this position over time as a result of our economic success and military strength relative to other nations. The trust that the rest of the world has in our currency (its solvency, liquidity and banking system support) has meant that about 80% of world trade is done in dollars and near 90% of foreign exchange markets. Our dominant position in world trade has also impacted the currency in which many commodities trade. Oil, which is priced in dollars, is a prominent example.

For Americans, a strong dollar compared to the currencies of our trading partners can mean less inflation, since we can import the same amount of goods for fewer dollars. Foreigners support our dollar when they invest in our stock market or buy our US Treasury securities. American companies that repatriate cash held abroad in local currencies buy dollars to bring that money home. Americans also benefit when the US government borrows because we borrow in the world's reserve currency. As a consequence, we do not face currency risk in the repayment of that debt. For other nations, currency risk appears when their local currency has weakened compared to the dollar, thereby raising the cost of repaying dollar denominated debt. In this way, the recent strength of the dollar has raised costs and inflation for some trading partners. This contributes to tightening financial conditions globally.

There is another side to the strong dollar that is not so beneficial for Americans; it makes our exports more expensive. This is more important to the stock market than to the economy as whole given US exports run about 12% of GDP, but US corporate international sales are over 50% of S&P 500 revenues. To be sure, a strong dollar benefits some US companies importing items for their supply chain, unless there is a tariff applied by the US. **Charts #1** and **#2** portray recent and historical dollar trends.

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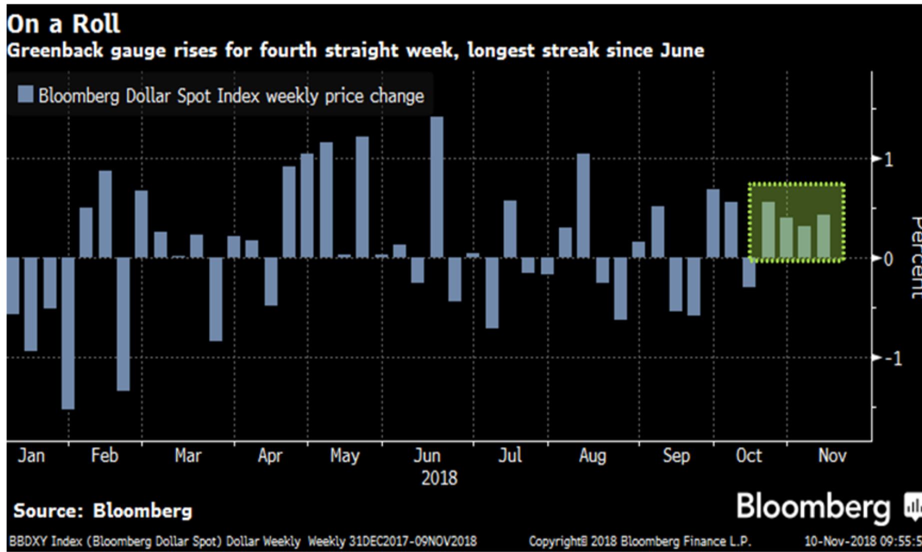
Chart #1



The U.S. Dollar Index is based on six currencies.
The currencies and their weights are:

Euro	57.6%
Yen	13.6
Pound	11.9
Canadian Dollar	9.1
Krona	4.2
Swiss Franc	3.6

Chart #2

There is also a geopolitical aspect to the dollar today as the US applies trade tariffs and economic sanctions. Tariffs target trade, but both tariffs and economic sanctions imposed by the US get much of their clout because the US can restrict a country's dollar-based trade. The sanctions on Russia, Iran and Venezuela demonstrate the vulnerability of their trade from a freeze-out from the dollar based global banking system and raise the prospect of further conflict. In some sense, the tariffs and sanctions of the US foreign policy are sowing the seeds of weaker future dollar status in global trade. China is not Cuba and can fight back by means of settling trade in Yuan with its trade partners. It can also weaken its currency against the dollar to offset tariffs. Russia is moving to establish an alternative to SWIFT (the current worldwide interbank financial messaging system). Even the Europeans are calling for a banking system independent of the US currency. The dollar supremacy may not last if its position as the world's reserve currency is diminished. For now there is no other substitute as central banks need its scale and liquidity. Looking ahead, there are other reasons that the dollar does not stay on a long-term path of relative strength. A primary example will be the relative growth rate in the US vs. the rest of the world. Our rising debt and aging demographics can lead to slower growth.

Investment Implications:

There is a growing awareness that the strong financial condition of the US is increasingly vulnerable to budget deficits and this is more worrisome with threats of a trade war slowing US growth. Present growth certainly reflects tax policy and may be challenged in the post-election environment. Central banks in Russia, China, Japan and Europe are buying fewer US Treasury securities at a time when our treasury needs to issue record amounts to cover deficits. Our own central bank, the Federal Reserve, is not buying, but is in fact slowly selling US Treasury securities as it ends its accommodative monetary policy. These are a few impulses that point ultimately to a weaker dollar. This suggests that dollar pressure on emerging markets from Fed tightening will fade next year and offer opportunity. The Federal Reserve may also need to be less restrictive in 2019 due to slowing trade and this could set up a topping of US interest rates, allowing bonds to rally.

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