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"Bon Voyage!" That is likely to be a common utterance across the country this travel season as the sharp rise in the dollar in recent months has suddenly made that dream vacation abroad far more affordable. The U.S. Dollar Index has appreciated by more than 20% since mid-2014 and is now trading near a twelve-year high. In addition to affecting summer vacation plans, this unusually rapid appreciation of the dollar is also weighing on the earnings of U.S. multinational companies and adding volatility to the stock market.

The surge in the dollar has been driven by both the relative strength of the U.S. economy as well as the diverging monetary policies between the U.S. Federal Reserve and other central banks around the world. Though the U.S. economy is not yet firing on all cylinders, it is outperforming most of the other developed economies. This has made the U.S. a more attractive destination for foreign capital, thereby generating demand for dollars. In addition, while the Fed has ended its bond buying program and appears set to raise short-term interest rates later this year, other central banks such as the Bank of Japan and the European Central Bank have continued to aggressively expand easy-money policies in an effort to stimulate their economies by keeping rates low. As a result, yields on U.S. government bonds, though still extremely low by historical standards, exceed those of most developed countries. This has attracted foreign investors in search of higher yields to U.S. Treasuries, which has also boosted the dollar.

The sharp rise in the dollar is likely to serve as a drag on U.S. corporate profits in the near term, particularly among companies that do a large amount of business overseas. All else being equal, a stronger dollar dampens demand for U.S. exports by making them more expensive for foreign buyers. The stronger dollar also hurts the earnings of U.S.-based multinational companies with operations in international markets as their overseas profits that are denominated in foreign currencies are reduced when translated back into dollars on their books. While some companies use currency hedging to at least partially protect themselves from foreign exchange exposures, the speed with which the dollar has climbed has made it much harder for them to accurately do so. In addition, as the economy has become more globalized, the earnings implications of currency swings have become more pronounced. With nearly half of the total sales of S&P 500 companies now coming from foreign markets, the spike in the dollar is a big reason for the expectation that total S&P 500 earnings declined for the first time since 2009 in the first quarter.

Given the issues that the run-up in the dollar poses for the earnings of U.S. multinationals, it is not surprising that the stocks of many of these companies have recently come under pressure. And though it is possible this weakness could persist for a while if the dollar continues its ascent, we believe that owning high-quality multinational companies continues to make sense even in the face of foreign exchange headwinds. It is important to note that many multinationals leave a good portion of their overseas profits abroad for tax purposes. As long as these profits are not actually converted into dollars and brought back stateside, the hit to the reported earnings of multinationals caused by the stronger dollar is purely of an accounting nature, with no actual economic impact on the companies. Additionally, currency moves are cyclical in nature and very difficult to time. The rising dollar that is now a headwind for the earnings of U.S. multinationals will at some point begin to weaken and become a tailwind for them. Therefore, we believe that long-term investors are best served by looking past these currency swings and instead basing their investment decisions on the underlying fundamentals and long-term earnings power of the companies at hand.

It is our view that a more important issue for the stock market than the headline-grabbing rise of the dollar is that stock valuations as a whole have become a bit stretched. The forward price-to-earnings ratio of the S&P 500 has steadily climbed from 11 in March 2009 to over 17 today, a level that is now above its historical average of about 15. The historically low interest rate environment, which has made stocks more attractive relative to interest bearing alternatives, has certainly played a big role in this higher valuation. Even with the Fed likely set to begin to tighten as some point this year, we do not expect that rates will rise dramatically any time soon. As such, we view the overall market valuation to still be at the upper end of reasonable. While the broad market appears to be about fully valued, we continue to find individual stocks that are attractively priced, including some quality multinationals that have weakened recently. We stand prepared to take advantage of any long-term investment opportunities created by the short-term effects of the strong dollar.

Sincerely,

Alison Gamble, President
Gamble Jones Investment Counsel