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Effects of a Strong Dollar

There have been many moves in the global economic environment over the last year, the two most significant being the fall in oil, and the corresponding rise in the dollar. US economic conditions are relatively favorable as conditions in Europe, China, and Japan all have displayed recent weakness, thereby influencing the dollar upward against the currencies of the aforementioned countries. The anticipation of the Federal Reserve raising rates has also increased demand for the dollar, and while US interest rates are historically low, they are still higher than many others in the global economy. US oil producers have been steadily more active over the past few years, which has decreased American reliance on foreign oil producers. While the strong dollar does have its advantages, it will likely have an adverse effect on many large US companies with a significant portion of their business rooted in foreign markets. As a result, the strong dollar has put small-cap, mid-cap, and foreign equities in a prime-position for growth as the global economy shifts in favor of these asset classes.

With the dollar significantly stronger versus currencies like the yen and euro, imports get cheaper for US companies, one of the most beneficial effects of a strong dollar. It comes as a double-edged sword, however, as exports are more expensive for foreign buyers, deterring demand from US goods to those in more affordable economies. Japan, emerging Asia, and Europe will undoubtedly see an increase in export demand as buyers shift their focus away from expensive US products. As a result, companies in certain international markets will reap the benefit of deferred demand, working to boost their economic standing as a whole; in Europe a quantitative easing program has been instituted by the ECB, another factor that will work in favor of countries with euro denominated currency. This combination will work to make European companies more profitable, resulting in economic growth, which has been relatively tepid in the region. This provides a unique opportunity for investors to shift capital into foreign markets while securities are relatively cheap based on currency disparities, but still capturing the potential growth which will use increased export demand, and/or QE, as a catalyst. While those invested in international securities experienced the devaluation of their holdings alongside its similarly denominated currency, now may be an opportune time to invest in international equities, as the dollar may not have much room to grow past its current level, except for a boost that an interest rate hike may bring. The dollar is not expected to concede much, if any, of its recent gains in the near future, meaning those who invest during this period could reap the benefits of increasing export demand without suffering the devaluation of foreign denominated currencies. This has already taken hold as the Eurozone is up an impressive 18% YTD, compared with 3.5% for the S&P 500 (as of 5/6/15).

Even though the strong dollar is relatively young, it is already having an influence on markets and the global economic dynamics. In 2014, the Russell 2000 index, which represents small-cap stocks, gained 4.91%. The Dow Jones Industrial Average and S&P 500 gained 8.80% and 12.78% respectively, showing that large-cap stocks significantly outperformed small-cap equities. In 2015, however, the story has changed. The Russell 2000 is up 4.09% Year-to-Date (as of 4/30), while the DJIA has gained just 1.35% and the S&P 500 is up 2.52%. During this period the euro began worth $1.21, and by the end 1 euro was equal to approximately $1.07. If the dollar remains strong, small-cap stocks should receive even further earnings boosts from the strong US economy, while enjoying isolation from struggling foreign economies. Large-cap stocks, however, should reap the benefits of robust domestic demand, but this will be countered by weak foreign revenue in addition to foreign exchange rates taking from those revenues. Of all the revenue collected by companies in the S&P 500, 47% came from abroad. The first quarter of 2015 has yielded some optimistic results, but the negative effects of the strong dollar taking effect on foreign profits. Half way through the Q1 2015 earnings season 73% of the companies in the S&P 500 have reported net income higher than the mean estimates. While this figure is on par with the 5-year average, blended earnings (I will explain here about BEG) have yielded a 2.8% decline, still above the forecast of -4.6%. If the quarter's earnings finish in the red, it would be the first time since Q3 of 2012 when profits declined by 1.0%, and the biggest decline since Q3 2009 when earnings fell 15.5%. Companies in the S&P 500 have beat their revenue expectations just 47% of the time in Q1, well below the 5-year average. The blended revenue decline for the quarter is 3.5%, surpassing the anticipated revenue decline of 2.6%. If the figure doesn't undergo any big changes, it will be the biggest quarterly revenue drop Since Q3 2009's fall of 11.5%.

While it is not absolutely certain that decreased foreign demand is the result of the lower-than-average earnings and revenue figures, it is supported by the fact that companies that derive over half of their sales domestically have produced superior profit and sales numbers in comparison to those who generate over half their revenue from abroad. While overall blended earnings growth is -2.8%, companies that have over half of their sales from US customers have blended earnings growth of 2.3%. Conversely, companies with over half of their sales from outside the US have blended earnings growth of -9.9%. The same trend holds true for blended revenue growth. US dependent companies have blended revenue growth of 0.0%, while foreign-dependent companies have blended revenue growth of -11.2%. With decreased foreign demand for US goods, and unfavorable foreign exchange rates, companies with a large dependency on their foreign business may have a harder time competing with domestically centered companies on a growth perspective as long as the dollar remains strong.

Looking forward, earnings are anticipated to continue their decline into Q2. Earnings declines for the period are forecast as -3.6%, while revenue growth is expected to drop 4.4%. 67% of the companies in the S&P 500 that have reported earnings decreased their EPS guidance for next quarter. Q3 is expected to decline by a smaller margin in both earnings and revenue, but record earnings growth of 5.4% is expected in Q4. This is due in part to improving profit margins, forecast to go from 10.0% in Q1 to 10.6% in Q4, all well above the 5-year average of 9.4%. As the dollar remains strong and foreign economies begin their recovery, small-cap, mid-cap, and international equities present the best opportunities for growth as the economic situation favors companies under these asset classes.

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