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Peck Financial Advisors

Valerie L. Peck, MBA, CFP® Presents:

Can Stocks Advance Further Without a Weak Dollar?

Are we seeing the early signs of a dollar bull run?

What happened to the weak buck? In recent years, stock market gains have been associated with a weak dollar (among other factors). This latest rally on Wall Street seems to be an exception: years of dollar weakness may be giving way to renewed foreign investment in U.S. currency, spurred by global belief that things are getting better in America.

If the trend keeps up, it threatens to toss a wet blanket on a sizzling market. As the Dow and S&P 500 have logged gains, so has the U.S. Dollar Index. The USDX is up since the start of February, and it reached a six-month peak against a basket of foreign currencies on March 13. On that day, the euro sank to a three-month low against the dollar while the yen approached a four-and-a-half-year low against the buck.[1,2]

If a rising dollar does pressure stocks, the pressure may subside. High unemployment and slow growth may signal that the country is still in an economic recovery. In response, the Federal Reserve is keeping interest rates at historic lows and creating dollars to buy bonds. So even if stocks pull back a bit in the coming weeks, you could still see central bank policy encouraging a soft dollar.

While printing money can promote inflation, the Fed faces little pressure to stop easing – at last look, yearly gains in consumer and producer prices were well within its annualized target. For Fed policy to change, inflation would have to pose a real macro threat. It doesn't today and it probably won't until GDP and wage growth approach historical norms. That may not happen until 2014 or 2015. 7

What if this show of strength isn't fleeting? If the U.S. is leading the way in a global recovery –as it has in many past economic cycles – we could see a bull market in the dollar in the distant future, and it could coincide with a bull market in equities.

For a dollar rally to happen, you need three conditions in place. The dollar has to be cheaply valued; the U.S. economy has to be on the upswing, especially relative to the rest of the world; and, interest rates need to rise.

At the moment, defense spending isn't on the rise and the NASDAQ is a long way from 5,000. While times have certainly changed, other conditions might function as catalysts for a sustained strong dollar anyway: a very weak euro, a yen slipping into a bear market, and America's decreasing reliance on foreign oil. All of these conditions may persist for some time.

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Some statistics worth noting: here in March, the yield on the 10-year Treasury has risen to its highest premium in 19 months versus the yield on Japan's 10-year note. The yield on our 2-year note is nearly 0.20% higher than that of Germany's, the biggest gap in yield since early January. As for the USDX, it is currently more than 30% below its 2001 peak.[3]

It is also worth noting that the dollar bull markets of the 1980s and 1990s did not obstruct the concurrent bull markets in U.S. stocks. A dollar rally can be rough for emerging markets, however – witness the debt crises that hit Latin America in the 1980s and Southeast Asia in 1997.

Maybe the relationship is changing. It could be that the recent correlation between a weak dollar and a bull market is fading, and that the course of the dollar is in sync with the course of the market – that is, leading the way for the rest of the world. As CEF Holdings CEO Warren Gilman told CNBC, "The dollar is the best currency among a sad group [of currencies] and that will continue as anticipation of strength in the economy grows." Relatively speaking, the dollar looks good – and perhaps U.S. stocks will look even better as the year continues.[4]

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Citations

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