

What a Rising U.S. Dollar Means for U.S. Competitiveness

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One of the most important themes impacting the global markets has been the strengthening U.S. dollar, a trend that WisdomTree expects to continue for some time. One consequence in terms of investor positioning has been a surge in flows and interest in currency-hedged international investment strategies. But this also has put pressure on the U.S. economy, revenue of American companies as well as corporate profits. The strong-dollar phenomenon has accelerated since May 2014—which coincides with the time European Central Bank (ECB) president Mario Draghi started discussing in his policy speeches how a “rising euro” was creating deflationary tendencies.¹ At that time the euro was at \$1.40 and started drifting downward in anticipation of the quantitative easing program Draghi finally initiated in early 2015. Looking back, the last decade-long dollar bear market actually ended in the middle of 2011, and we have entered a secular bull market of the U.S. dollar since then. What separates the recent strengthening of the U.S. dollar from prior periods is how fast the rise has been. On a year-over-year basis, the six-month has reached a record high of 18%, which caught both Wall Street and Main Street off guard and potentially led to higher volatility in both financial markets and corporate earnings.²

U.S. Dollar Real Effective Exchange Rate (REER) Year-over-Year Rate of Change Based on the Federal Reserve U.S. Trade Weighted Real Major Currencies Dollar Index



Sources: Federal Reserve, National Bureau of Economic Research, WisdomTree. Period is from 1/31/1974 to 8/31/2015, monthly data. Past performance is not indicative of future results.

Export Competitiveness Hurt by Rising Dollar A strong U.S. dollar, all else being equal, could erode the competitiveness of U.S. corporations, although it might take a considerable time for this effect to flow through the economic system. As illustrated below, the real U.S. dollar acted as a leading indicator for the competitiveness of the U.S. economy. We illustrate the declining competitiveness of the U.S. export machine by graphing a ratio of the exports of the U.S. economy over the imports, lagged by 36 months. The chart illustrates how as the U.S. dollar strengthened, the ratio of exports over imports weakened and the lines tracking each other move fairly well. **Real U.S. Dollar as a Leading Indicator of the Competitiveness of U.S. Economy**



Sources: Federal Reserve, U.S. Census Bureau, WisdomTree. Period is from 1/31/1990 to 8/31/2015, monthly data. Right vertical axis is inverted, meaning that an increase appears as a downward move and a decrease appears as an upward move. This is done to align the illustration with the intuition—that exports become less competitive if the dollar is strengthening and more competitive if the dollar is weakening. Past performance is not indicative of future results.

If history is any guide, we would expect the negative impact of a strengthening U.S. dollar on trade to materialize soon. In other words, given the lag we see in the ratio of exports/imports, we have yet to see the worst impact on the competitiveness of U.S. companies. WisdomTree provides some useful tools to position U.S. equity portfolios based on these trends. Exposure to this dollar factor is represented in the [WisdomTree Strong Dollar U.S. Equity Index \(WTUUSD\)](#). **Characteristics of stocks included in this Index:**

- **Local Economy Focus:** In a nutshell, **WTUUSD** selects eligible U.S. companies that derive more than 80% of their revenue from the U.S. The Energy and Materials sectors are entirely removed as part of the screening process³. Looking at WTUUSD, its weighted average revenue from the U.S. is over 96%, showing a very high sensitivity to the U.S. economy and a lack of global exports.
- **The constituent weighting** takes into account constituent market capitalization and the sensitivity of their stock prices' returns to those of the dollar. For those who believe, as we do, that U.S.-centric companies are a good place to focus on, given the trends of a stronger U.S. economy, we'd encourage them to think about this Index as a new benchmark for U.S. exposure.

¹Source: Mario Draghi, Monetary Policy Press Conference Transcript, 5/8/14. ²Source: Federal Reserve, as of 8/31/2015. ³Subsequent to Index screening it is possible that a current constituent may spin off a subsidiary company that may be classified as an Energy or Materials firm. Spin off firms that remain within the Index do not get removed between Index rebalances due to their sector classification.

Important Risks Related to this Article

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.