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How Might the U.S. Dollar Affect Markets in 2017?

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Those of us who haven't been living off the grid in Antarctica or dodging media headlines for two months have heard a lot about how the new administration of President Donald Trump plans to strengthen our economy. Repeatedly, the president has said he will use tax cuts, trade tariffs and deregulation to boost both the income of middle-class Americans and the bottom line of businesses. Various members of Trump's Cabinet have echoed his plans, and these techniques have gotten a lot of attention in the press. But there is one relevant topic that has been little mentioned: the prospect of a weaker U.S. dollar.

Throughout the Republican primaries and since then, Trump has touched on this subject only a handful of times, while hammering his intentions to build a wall along the border with Mexico, stem immigration and revise tax rates. Steve Mnuchin, Trump's pick for Treasury secretary, broached the possible implications of a weaker dollar only briefly during his nomination interviews on Capitol Hill in January. Yet in fact, a weaker U.S. dollar, all but ignored in the debate on how to improve the economy, may be the strongest card the new administration has up its sleeve.

Trump spent much of his campaign blaming China for America's economic woes (e.g., loss of manufacturing jobs, stagnant wages, sluggish economic growth). Statistically speaking, there is some truth to that, as the U.S. trade deficit in goods amounted to a stunning $314 billion in 2016. In the simplest terms, this means that Americans buy more stuff from the Chinese than they buy from us. One reason is because their currency, the yuan, is valued much lower than the U.S. dollar, making Chinese products cheaper for American consumers to purchase. China has accomplished this by synthetically purchasing U.S. dollars on the open market, thus driving down the value of its own currency and making it easier for other countries to purchase Chinese products.

Why does this matter?

Let's look at how this affects companies based in the United States. As this country began moving away from a manufacturing economy and toward a service-based economy (around 1940-1970), other countries with lower production costs (originally Taiwan and more recently China) filled more of the demand for manufactured goods. American CEOs took note and started outsourcing large percentages of their manufacturing to provider countries like those to take advantage of lower costs and improve profit margins. During periods when the U.S. dollar is strong, low-cost provider nations produce goods more competitively, enabling companies to sell more of their goods to U.S. consumers.

Most people tend to think a strong dollar is preferable to a weak dollar, but in reality, it depends on where you stand. An American factory worker would probably prefer a weaker dollar because that allows the factory to increase exports to other countries, increasing the worker's job security. As his company achieved higher revenues he could probably also expect to get a raise and better benefits. However, someone who wants to purchase a foreign product (say, a Samsung phone) or likes to travel abroad would likely prefer a strong dollar; foreign products would be relatively cheaper because dollars would be worth more relative to the yuan or Euro.

A weaker dollar relative to the yuan or Euro makes goods imported from other countries more expensive and may encourage American consumers to buy domestically, theoretically narrowing the trade deficit. At the same time, our exports would be cheaper for foreign consumers, and we might also see foreign producers deciding to build factories on U.S. soil. Finally, a weaker dollar boosts tourism to the United States, as people from other counties can visit more cheaply, and their domestic currencies enable them to buy more goods priced in U.S. dollars.

How can the Trump administration achieve a lower dollar?
The initial answer to that question may be debt. Many of the ideas that the Trump team has considered will eventually lead to greater borrowing (bond issuance) and capital spending, both locally and nationally. Another choice is to focus on protectionist policies that would lead to a weaker dollar as a natural, but intentional, consequence. Trump has vowed to renegotiate trade treaties and impose import tariffs on China and Mexico, moves that may undermine the dollar and generate a more favorable exchange rate for American exporters.

In the end, a weaker dollar would help Trump and his administration deliver on one of the largest promises to their constituency: to bring jobs back to America, specifically, manufacturing jobs. America has indeed lost millions of industrial jobs over the last few decades. Whether China truly is the source of the declining status of American factory workers is a discussion for another day. A weaker U.S. dollar, although not an exciting attention-grabber, may just be the answer our country needs.

How does this affect me?
The U.S. dollar is the 800-pound gorilla in the currency and exchange-rate world. A weakening U.S. dollar would likely cause inflationary pressure in many asset classes. Using history as a guide, we would expect to see price increases in commodities and precious metals, such as oil, corn and gold. We would also expect to see stronger demand for certain emerging market assets (e.g., Brazil, Indonesia, South Africa). Conversely, this would create a more difficult environment for most bond investments.

Beyond any inflationary impact, a weaker U.S. dollar could provide a nice tailwind to foreign markets in general, including those of Europe and Japan. As we have watched this trend develop, the investment team at FSA has started moving into some of these areas, specifically gold and foreign stocks. If the weakening of the dollar builds momentum, we will be adding more of these types of funds to your portfolios.

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