Dollar Bears Mercifully Silent

"The old dollar, she's going down" – Bill Gates at Davos, January 2005
"In your dreams, Windows-boy" – Howard Simons

Was there anything more tedious than listening to all those dollar bears a year ago proclaiming why the greenback was not going to be worth the paper on which it was printed? Their arguments were repeated breathlessly, and could usually be summarized as saying Americans were going to get comeuppance for their wicked, wicked ways by seeing the dollar sink, interest rates rise, stocks get pounded and (shudder) their ability to keep on consuming curtailed.

They were wrong then and they would be wrong today if they were so foolish to keep their jaws flapping about our twin budgetary and trade deficits in the face of an upside breakout in the dollar. But this is not me duplicating Randy Moss' touchdown salute to Green Bay Packers fans, even though my November 2004 observations on stocks and the dollar and my February 2005 observations on stocks and the trade deficit, both of which contained admonitions to the dollar bears to do their homework, might justify such an end-zone dance. No, this is about questioning whether the dollar rally has room to run and which stock groups would be helped or hurt most thereby.

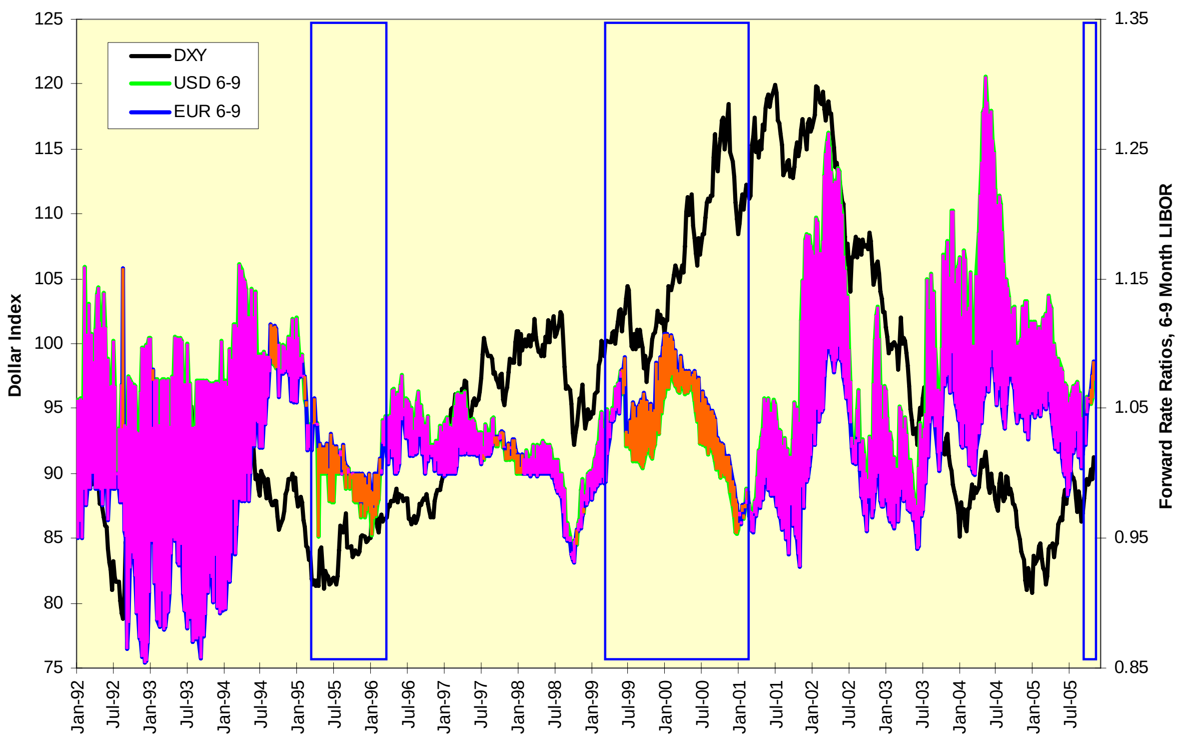
Money And Curves

Currency markets are not morality plays. The spot exchange rate reflects, amongst certain other factors, the relative returns between borrowing in one currency and lending in another. In the money market horizon, the most important for currency traders, these return differentials are determined first and foremost by expected changes in monetary policy between the two countries. We can summarize these expected changes by measuring the shape of the LIBOR curves between six and nine months; three months from now when the typical three-month forward transaction is unwound, today's six-nine month curve will reflect the then-prevailing three-six month conditions.

We can measure the shape of these curves by taking the forward rate between six and nine months, the rate at which you can lock in borrowing for three months starting six months from now, and dividing it by the nine-month rate. The more this ratio exceeds 1.00, the looser the monetary policy is expected to be. Critically, these forward-rate ratios are comparable across economies and across interest rate levels.

If we compare these forward rate ratios for the dollar and for the euro as reconstructed back to 1992, we see how U.S. monetary policy was significantly looser than Eurozone monetary policy over that period, as depicted in the pink shaded areas. This included the periods of 1992-1994 and 2001-2005, both of which saw a declining dollar. The periods wherein U.S. monetary policy was tighter, highlighted in orange and with blue rectangles, include late 1995, 1999-2000 and – you guessed it – today. All of these periods coincide with dollar strength. Given the Federal Reserve's rate-hiking stance and the unwillingness of *les poulets* at the European Central Bank to follow suit, we have every reason to expect dollar strength to continue.

Steepness of Money Market Curves Drives Dollar



Winners And Losers

Let's return to an analytic technique first introduced here in February and used several times since of measuring the relative impact of a market factor on industry groups. Negative numbers in the table below indicate groups benefiting from weakness in that currency against the dollar, while positive numbers indicate groups hurt by weakness in that currency against the dollar. The groups with statistically significant relationships (90% confidence interval) against the large-cap S&P 500, the mid-cap S&P 400 and the small-cap S&P 600 are displayed for the euro, the Japanese yen and the Canadian dollar.

For the euro, the list of victims is clear. Groups involved with oil and gas, the housing and housing-related financial groups and basic materials groups in steel, aluminum and chemicals all should be hurt by a weaker euro. These industries have the common thread of either being hurt directly by higher interest rates or by having their dividends rendered less attractive by higher interest rates.

Beneficiaries are concentrated in health care services, pharmaceuticals, specialty retailers and in diversified commercial services. These industries have the common thread of either being export-dependent or by having consumers relatively enriched by the stronger dollar. If higher energy costs crimp consumer spending, a stronger dollar restores it somewhat.

Relative Industry Group Betas To Euro

S&P 500		S&P 400		S&P 600	
Group	Beta	Group	Beta	Group	Beta
DRUG RETAIL	(0.297)	COMP&PERPH	(0.337)	LEISURE FACL	(0.723)
FOOD DISTR	(0.262)	COMP HRDWR	(0.307)	BIOTECH	(0.318)
COMP STG&PER	(0.260)	EMPL SERV	(0.243)	IT CONS	(0.266)
DEPT STORES	(0.189)	WIRELESS TL	(0.180)	DRUG RETL	(0.205)
ADVERTISING	(0.172)	COMM PRNT	(0.178)	RESTAURANTS	(0.187)
ENV SERV	(0.156)	MLTISECTOR	(0.178)	AUT PT & EQ	(0.173)
SPECIALT STR	(0.152)	HWARES&SP	(0.177)	TRDNG COMP	(0.154)
COMPUTER HW	(0.143)	PCKGD FOOD	(0.168)	SPEC STRS	(0.135)
FOOD RETAIL INDX	(0.142)	HLTHCR FAC	(0.166)	ELEC EQ MFG	(0.133)
PUBL&PRNTNG	(0.131)	HLTH CARE SRVC	(0.156)	HLTH CARE SRVCS	(0.132)
PHARM	(0.123)	SPCL STOR	(0.138)	HLTH CARE EQUIP	(0.129)
DATA PRCS & OTS	(0.101)	IND MACH	(0.085)	OFF SERV & SUPPL	(0.126)
				APPL SFW	(0.112)
				AEROSP & DEF	(0.108)
DIV BANKS	0.099	REITS	0.142	SPEC CHEM	0.130
ASST MNGMT & CST	0.100	DIV CHEM	0.201	PAPER PROD	0.159
SPECIALIZED FIN	0.133	OIL&G EXPL	0.282	OIL&GAS PROD	0.257
BUILDING PCT	0.162	OIL&G EQUI	0.292	OIL&GAS EXPL	0.333
OIL & GAS EQU	0.269	OIL&G DRIL	0.298	HOMEBUILDING	0.375
INTGR OIL&GS	0.302	INTGR O&G	0.359	STEEL	0.419
OIL&GAS EXPX	0.322	LEISR PROD	0.373	OIL&GAS	0.456
OIL&GAS DRIL	0.344	HOMEBLDNG	0.467	DIVSFD METL	0.524
FERT&AGR CHM	0.346			ALUMIN	0.610
ALUMINUM	0.358				
OIL&GAS REF	0.430				
STEEL	0.436				
HOMEBUILDING	0.475				
DIV MTLS&MIN	0.849				
GOLD	1.556				

Groups hurt by a weaker yen also have a heavy representation in basic materials such as steel, aluminum, gold, specialty chemicals and metals and mining. Housing and housing-related issues are hurt as well; in all cases, the same comments made for the euro’s impact apply.

Groups benefiting from a weaker yen include motorcycle manufacturing, – that’s Harley-Davidson – pharmaceuticals, health care services, retail and distribution-oriented industries and both distillers and brewers. If you are planning to get drunk and rowdy and ride around on your Hog, now is the time to do it.

Relative Industry Group Betas To Japanese Yen

S&P 500 Group	Beta	S&P 400 Group	Beta	S&P 600 Group	Beta
MCYCL MANF	(0.297)	DIST&VINT	(0.277)	DVSFD CHEM	(0.398)
PHOTO PRDCTS	(0.277)	RESTRNTS	(0.241)	FOOD DIST	(0.299)
DRUG RETAIL	(0.267)	COAL & CONS FUEL	(0.239)	HSWR & SPEC PRDS	(0.270)
BIOTECH	(0.202)	HOME FURNISH	(0.213)	AIRFRT&LOG	(0.244)
PUBL&PRNTNG	(0.201)	EMPL SERV	(0.209)	GEN MRCH	(0.234)
WIRELESS SER	(0.201)	AUTO RETAIL	(0.192)	EMPL SRVCS	(0.188)
HYPR & SUPRCNTRS	(0.197)	PUBL&PRINT	(0.184)	INTRN TELPH	(0.171)
FOOD DISTR	(0.196)	IND PW PRD	(0.179)	OFF SERV & SUPPL	(0.156)
BREWERS	(0.157)	COMM PRNT	(0.171)	RESTAURANTS	(0.150)
DIST & VINT	(0.152)	HLTH CARE SRVC	(0.147)	HLTH CARE EQUIP	(0.138)
DIV COMM SER	(0.149)	BDCST&CBL	(0.145)	HLTH CARE SRVCS	(0.127)
PHARM	(0.134)	PCKGD FOOD	(0.128)	PROP & CASU	(0.099)
HOUSEHLD PRD	(0.134)				
HLTH CR EQIP	(0.130)				
DATA PRCS & OTS	(0.096)				
OFF SERV&SUP	(0.094)				
PACKG FOODS	(0.090)				
INDUST MACHN	0.098	SPCL CHEM	0.104	COMP & EQUIP	0.108
INVST BNK & BRKG	0.113	INVST BNK/BROKR	0.167	SPEC CHEM	0.139
OTHR DV FN SC	0.118	AS MNGMT/CST BK	0.174	COMMUNCTN EQUIP	0.156
SPECIALIZED FIN	0.159	GEN MERCH	0.225	CATLG RETL	0.260
ASST MNGMT & CST	0.176	CONS ELEC	0.374	HOMEBUILDING	0.302
BUILDING PCT	0.210	HOMEBLDNG	0.441	STEEL	0.378
HOUSHLD APPL	0.212			ALUMIN	0.447
COMP&ELECT	0.219			DIVSFD METL	0.580
ALUMINUM	0.325				
INTERNET RET	0.407				
STEEL	0.419				
HOMEBUILDING	0.470				
DIV MTLS&MIN	0.747				
GOLD	1.104				

Finally, let’s take a look at our largest trading partner, Canada, and the impact of its dollar on U.S. stocks. Groups hurt by a weaker Canadian dollar are largely the same as those noted for the euro and yen but include a strong representation in utilities as well.

Beneficiaries of a weaker Canadian dollar overlap those for both the euro and yen, but include a few eyebrow-raisers such as airlines and casinos & gambling as well.

Relative Industry Group Betas To Canadian Dollar

S&P 500		S&P 400		S&P 600	
Group	Beta	Group	Beta	Group	Beta
AIRLINES	(0.430)	AIRLINES	(0.694)	AIRLINES	(0.491)
HOME ENTRTMT SFW	(0.424)	RESTRNTS	(0.313)	INSUR BRKG	(0.340)
DRUG RETAIL	(0.268)	DIST&VINT	(0.272)	RESTAURANTS	(0.287)
CAS & GAMING	(0.207)	HOME FURNISH	(0.266)	HOME FRNSH	(0.284)
AIR FT&LOG	(0.202)	APPR RETL	(0.257)	SPEC STRS	(0.270)
PHARM	(0.201)	EMPL SERV	(0.240)	PUBL & PRTG	(0.266)
WIRELESS SER	(0.200)	FOOD RETL	(0.204)	IT CONS	(0.266)
FOOD DISTR	(0.200)	CAS & GAMB	(0.202)	BIOTECH	(0.250)
ADVERTISING	(0.187)	COMM PRNT	(0.201)	CATLG RETL	(0.220)
TOBACCO	(0.185)	RESTRNTS	(0.196)	CONSTR & FRM MACH	(0.152)
ENV SERV	(0.175)	INS BROKRS	(0.195)	ELEC EQ MFG	(0.131)
HOUSEHLD PRD	(0.171)	HLTH CARE SRVC	(0.195)	AEROSP & DEF	(0.129)
PUBL&PRNTNG	(0.166)	IND CONGLM	(0.193)	HLTH CARE SUPP	(0.126)
BREWERS	(0.162)	SPCL STOR	(0.170)	HLTH CARE SRVCS	(0.126)
DISTRIBUTORS	(0.152)	PUBL&PRINT	(0.157)	PROP & CASU	(0.119)
RESTAURANTS	(0.137)			HLTH CARE EQUIP	(0.105)
HLTH CR EQIP	(0.133)				
INTGR TELCM	(0.129)				
DATA PRCS & OTS	(0.101)				
AEROSP & DEF	0.088	SPCL CHEM	0.109	PAPER PROD	0.163
SPECIALT CHM	0.101	GAS UTIL	0.162	SPEC CHEM	0.219
ELEC COM&EQU	0.139	PAPER PCKNG	0.185	HOMEBUILDING	0.248
ELEC UTIL	0.150	CONST&FARM	0.200	CONSTR MATR	0.251
SPECIALIZED FIN	0.164	DIV CHEM	0.237	OIL&GAS REF	0.330
INDUST GASES	0.169	IND GASES	0.295	OIL&GAS PROD	0.558
PAPER PRDCTS	0.170	OIL&G EQUI	0.373	OIL&GAS EXPL	0.590
PAPER PACKNG	0.202	HOMEBLDNG	0.381	STEEL	0.614
MTL&GLASS CO	0.211	CMDTY CHEM	0.454	OIL&GAS	0.690
DIV CHEM	0.220	INTGR O&G	0.462	DIVSFD METL	0.707
BUILDING PCT	0.226	OIL&G DRIL	0.484	ALUMIN	0.719
CONST MATRLS	0.261	OIL&G RFNG	0.488		
OIL & GAS EQU	0.350	OIL&G EXPL	0.583		
INTGR OIL&GS	0.391				
ALUMINUM	0.506				
HOMEBUILDING	0.536				
OIL&GAS DRIL	0.591				
OIL&GAS EXPX	0.622				
STEEL	0.717				
OIL&GAS REF	0.739				
DIV MTLS&MIN	1.254				
GOLD	1.346				

If any of this can be summarized whilst holding a lit match, it would be "A stronger dollar produced by higher interest rates is going to shift market gains from tangible resource issues to consumer-dependent issues." And if there's any flame left on that match, use it to ignite the collected writings of last year's dollar bears. If that keeps your house warm cheaply for a few minutes this winter, their wrongheaded scribbling was not a total waste.