Stop Worrying About The Dollar

Let's get off this,
And get on with it,
if you wanna change the world
shut yer mouth and start to spin it
Get off this
Get on with it
If you wanna change the world
shut your mouth and start this minute

- Cracker, “Get Off This”

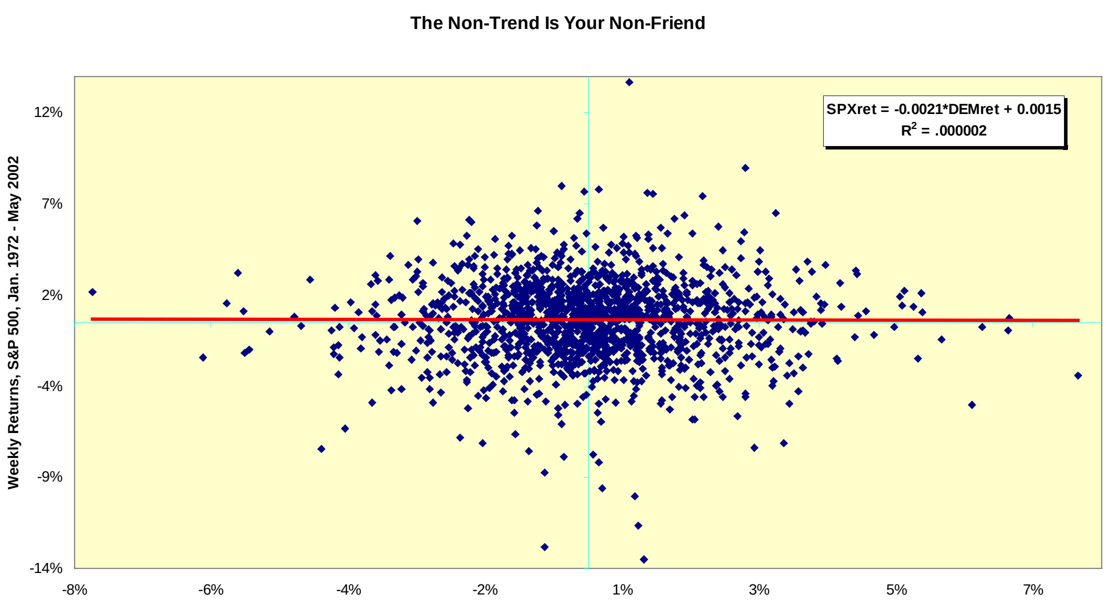
Good advice then, good advice now. Nothing pains an economist so much as hearing pundits of whatever stripe offer flippant conclusions unsupported by any actual data. This seems to be the common practice today with the tendency to associate a weakening dollar with a weakening stock market.

Let’s offer the conclusion up front: The stock market doesn’t give whatever part or product of the horse you choose to offer in sacrifice about any actual level or trend in the dollar. All it cares about is whether the dollar or any other currency is valued fairly and without interference from governments.

If the market senses that the dollar is being driven lower by a conscious political decision, foreign investors in particular will dump dollar-denominated assets. On the other side of the equation, if the market senses a “defend the dollar” policy that is being enforced through tight money and higher interest rates, it will conclude that slower growth is in store.

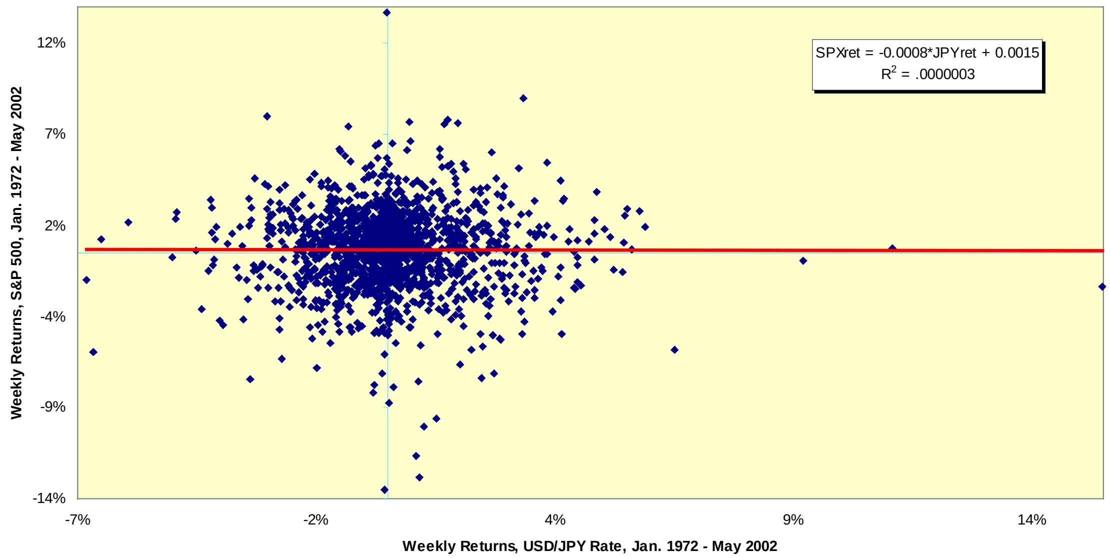
A Long-Term Non-Trend

The extent to which returns on the dollar and returns on stocks are uncorrelated over the long-term is astonishing. If we take the weekly returns on the S&P 500 and map them against the weekly returns on the Deutsche mark (DEM) – which is still quoted as a spread to the euro – we find an r-squared near zero. In other words, over thirty years of data shows that 0% of the variance in the S&P 500 can be explained by the DEM.



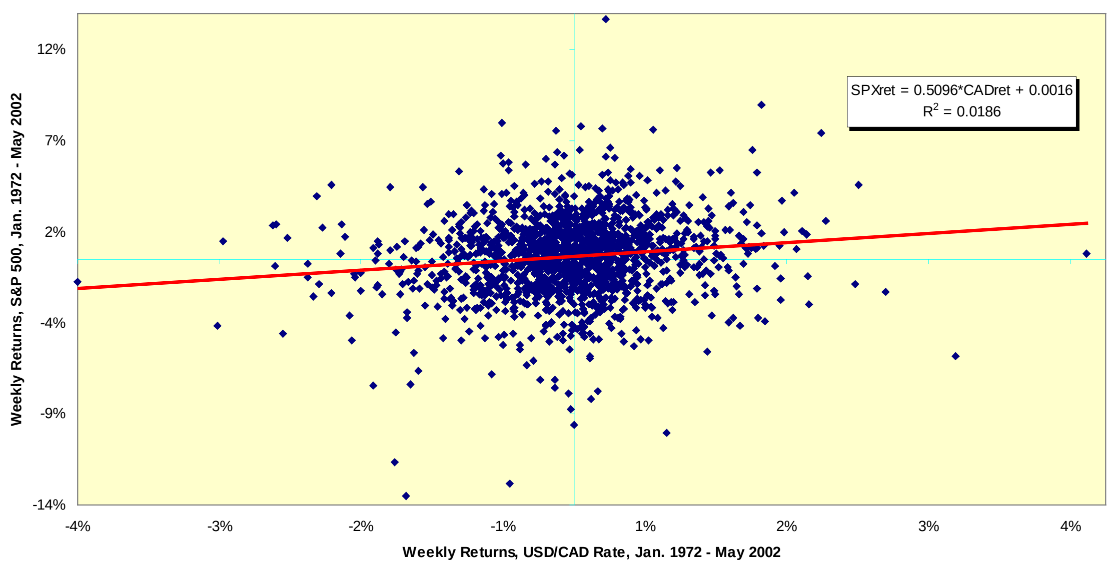
Ah, you say. What about the Japanese yen (JPY)? After all, aren’t we in hock up to our eyeballs to Japan? Yes, the relationship is different; it’s even more random than that seen for the DEM.

Ignore The Yen More Than Now And Then



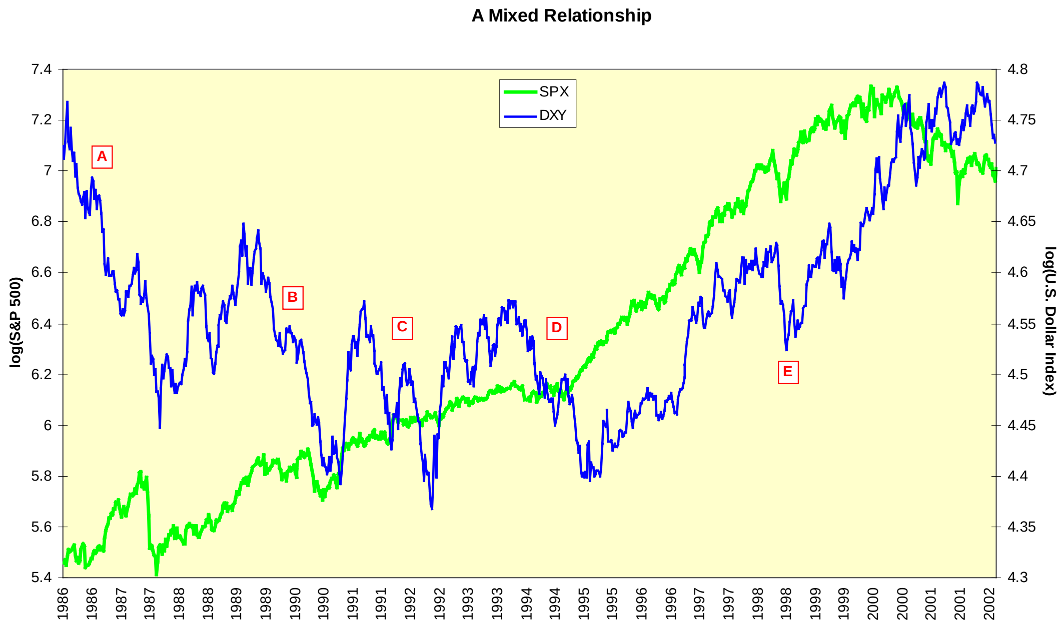
How about our largest trading partner and Neighbor To The North? The weak dollar / weak stocks argument is refuted weakly: A stronger Canadian dollar and a stronger U.S. stock market go hand in hand, and for good fundamental reasons. A strong U.S. economy helps the Canadian export sector, which in turn puts upward pressure on Canadian interest rates, thereby increasing its relative attractiveness.

Canada Gets It Backwards



Foreign Affairs

So, perfesser, is there any reliable consequence of a weakening dollar? Not really. Let's take a look at five weak dollar episodes, as measured by the trade-weighted dollar index, since 1986. The data are (admittedly confusingly) displayed in logarithm form to depict relative growth rates.



The five episodes are:

A. The 1985-1987 deliberate policy of dollar weakness produced by rapid interest rate reductions. This monetary largesse fueled the mid-1980s rally and culminated in the 1987 crash. The market at that point feared an interest rate reversal as part of a dollar defense policy.
B. The 1989-1991 weakness produced by a combination of rising European interest rates, the Japanese bubble, and the weak dollar preferences of the first Bush administration. Stocks experienced a period of slow growth.
C. The 1991-1992 weakness produced by the U.S. recession and a series of interest rate cuts in the U.S. combined with a tight monetary policy by the Bundesbank in the aftermath of German reunification. Stocks experienced a period of slow growth.
D. The 1993-1995 period of weakness produced by foreign investors lack of confidence in Clinton administration prior to the fiscal discipline imposed by the new Republican Congress. Stocks were flat in 1994 and then began the 1ate 1990s bull market.
E. The short-lived 1998drop associated with the Russian default and Long Term Capital Management debacle. Stocks fell sharply for a short period and then surged higher into early 2000.

The record, obviously, is mixed. Every market environment is different. The one combination missing conspicuously is the one feared at present, and that is a weak stock market produced by a weak dollar. And, while a strong dollar may be desirable for its inflation-dampening effects, it won't by itself produce a stronger stock market. After all, the pain and suffering of the last two years in stocks was accompanied by a persistently strong dollar that in itself defied interest rate differentials in favor of the euro.

Currency movements produce winners and losers in the economy. The reallocation of resources that accompany these fluctuations produce strong "frictional costs" and can be quite disruptive. Amongst other effects, a weakening dollar will reward exports and penalize importers. But unless it is the result of a deliberate policy of monetary inflation, it will not produce a weaker stock market by itself.