MARKET SNAPSHOT

U.S. EUR	OPE AS	SIA					
NIKKEI	8,844.50	+59.17 0.67%					
TOPIX	762.66	+5.26 0.69%					
HANG SENG	20,110.40	+167.42 0.84%					
75.80 -0.26%	S&P 500	1,314.65 -0.10%	FTSE 100 5,751.90 -0.53%	STOXX 50 2,432.07 -0.38%	DAX 6,419.22 -0.27%	Oil (WTI) 99.16 +0.21%	U.S. 10-ye

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OP-EDS

Strong Dollar Advocates Make a Weak Case: Schnidman and Nadler



Illustration by Victor Kerlow

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By Evan A. Schnidman and Daniel J. Nadler | Jan 24, 2012 7:01 PM ET | 0 Comments



USD: SPX (US Dollar Index -Cash Settle (EOD)/S&P 500 Large Cap Index)

In almost every recent Republican presidential debate, some candidates have advocated for a "strong dollar."

Among the more extreme views are the push by Representative Ron Paul for a return to the gold standard and the statement by Texas Governor Rick Perry that Federal Reserve Chairman Ben Bernanke may have committed treason, a crime punishable by death.

What gets lost in this clamor is any discussion of winners and losers from a strong U.S. currency, and the recent correlation between the greenback's strength and declines in the stock market.

A study we recently conducted indicates that investors -- who constantly look for the most predictive correlations and lead indicators -- could have done little better over the past five years than by tracking the relationship between the dollar and the Standard &

Poor's 500 Index. We found that simply looking for an intermediate high in the dollar could have successfully predicted every intermediate S&P 500 market bottom over the past five years (see attached figures).

This comparison of USD (U.S. Dollar Index) and the SPX (S&P 500) shows that on each of the seven occasions since 2008 when the dollar index reached an intermediate high, the S&P 500 hit an intermediate low. Perhaps no other asset in recent years has traded as

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precisely in (inverse) tandem with the market as the U.S. dollar. A weaker dollar might be easy fodder for politicians seeking to score rhetorical points, but it also has provided fuel for every intermediate market rally since 2009.

Stock Prices

Beginning in late 2008, most major financial-news outlets conveyed some variation of a tight correlation between a weak dollar and rising stock prices. Our research finds that since 2008, the correlation has not only persisted but gotten tighter. In particular, since the European debt crisis worsened in the spring of 2010, the correlation has been almost perfect; the dollar drops and stock prices soar.

Various different rationales can be posited as the cause for this correlation but the most obvious is that a weak dollar means a strong euro, which, in turn, is an indication of elevated confidence that European leaders have come up with a solution to the crisis.

If this is true, then the correlation may disappear as the euro area stabilizes. That doesn't seem likely to happen any time soon and the relationship between a weak dollar and stockmarket gains is likely to persist.

Traditionally, American consumers buying cheap imported goods have benefited from the strong dollar. However, in many cases, this benefit is offset because these same consumers of cheap foreign goods also tend to be producers of American goods that are less marketable globally as a result of the strong dollar.

In recent years, however, it has become easier for U.S. companies to produce cheaper goods abroad that are then sold to American consumers. In many cases, the owners of these businesses have benefited from a strong dollar even if American workers haven't. Still, those workers also may directly benefit from a weak dollar because it reduces their personal debt load in real terms.

The U.S. government is perhaps the most obvious beneficiary because a weak dollar means budget deficits (and the larger national debt) are worth less in real terms, lowering the cost of servicing the debt and potentially making it easier to eventually bring the fiscal shortfall under control.

Yuan Appreciation

Moreover, some politicians (including several who profess a desire for a strong dollar) have, in effect, advocated for a weaker currency by pressing China to allow the yuan to appreciate.

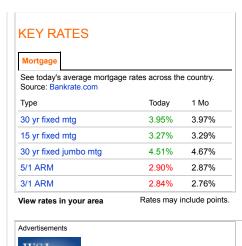
So who really wants a strong dollar? The Republican presidential candidates made this one of their themes of this election year by issuing threats to the supposedly independent Federal Reserve. Yet this position isn't wholly rational. While some American consumers might benefit, most producers wouldn't and almost all equity investors would be harmed.

If you have a stock portfolio, retirement account or pension plan, you might well benefit from a weak dollar. Alas, "weak" doesn't make for a good political sound bite.

(Evan A. Schnidman and Daniel J. Nadler, both Ph.D. candidates in the Harvard University Department of Government, are co-directors of the upcoming Harvard University Workshop on the Economic Crisis, organized through the Harvard Institute for Quantitative Social Sciences. The opinions expressed are their own.)

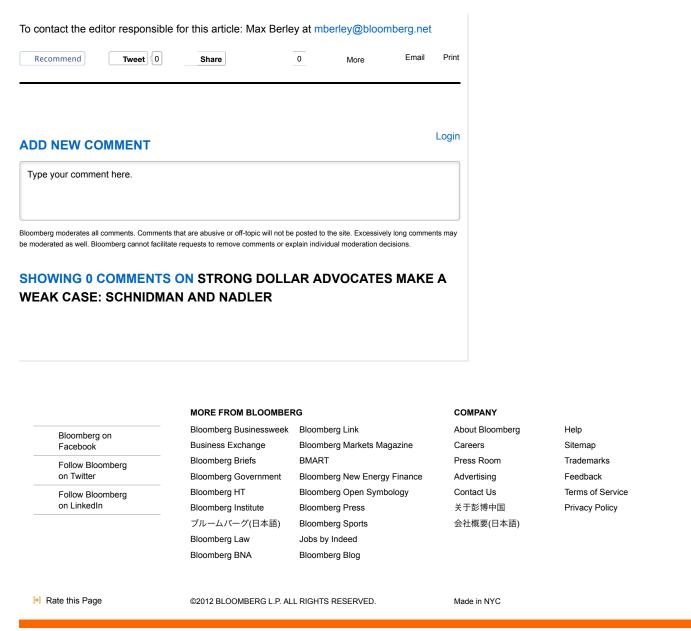
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