



# Rising Currency Risks for International Investing

By Dan Trosch, CFA\*

Some investors are asking if they should increase their international allocation because “people say the dollar is going to crash.” Currency movements are very important to U.S. investors because of the impact on non-U.S. investment performance. Since the end of the gold standard in 1971, a depreciating U.S. dollar has provided a roughly 2-percent annualized tailwind for U.S. investors invested in foreign stocks, as represented by the MSCI EAFE Index. The EAFE returned 10.1 percent in local terms and 12.2 percent in U.S. dollars from 1971–2007. However, the currency impact in specific years varied from a 28.3-percent positive impact (i.e., declining dollar) in 1985 to a 15.5-percent negative impact (i.e., strengthening dollar) in 2005. Figure 1 shows the history of EAFE (local and U.S. dollar) performance. Since 1971, appreciating currencies added to U.S.-dollar-based returns 76 percent of the time.

Investors witnessed dramatic currency trends due to macroeconomic fac-

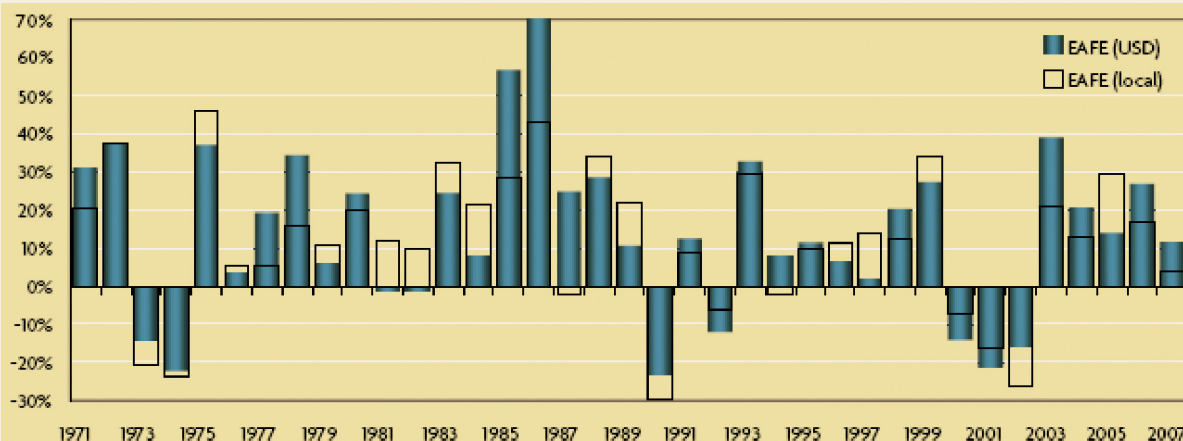
tors during several periods in particular. From 1981 to 1984, a strong dollar cut EAFE performance by almost two-thirds (from 18.8 percent to 7.2 percent, annualized). As a result of a large U.S. deficit with Japan (and, to a lesser extent, Europe) and the strong dollar, the G5 countries (France, Germany, Japan, the United Kingdom, and the United States) agreed to a dramatic devaluation of the dollar in the Plaza Accord of 1985. This coordinated devaluation led to continued dollar depreciation, as Japan and Europe continued their bull markets. From 1985–1987 EAFE (local) returned 34 percent annualized, while EAFE (U.S. dollar) returned 49.3 percent.

During the bull market of the late 1990s in the United States, the dollar was quite strong and currency detracted significantly from performance. From 1996–2001, the EAFE (local) returned 6.9 percent annualized, but currencies reduced this to only a 2-percent return in U.S. dollars. As the U.S. budget moved from the black into the red after 2001, large twin deficits (both budget

and trade) popularized the consensus for an impending structural weakening of the U.S. dollar. From 2002–2004, when EAFE (local) was flat (0.4-percent returns annualized), a weakening dollar resulted in a 12.3-percent return in EAFE (U.S. dollar).

Currencies, however, have a habit of surprising investors. At the end of 2004, after a two-year decline of the dollar against the euro of 25 percent, investors (and the media) were starting to call for a dollar “plunge.” In 2005, the dollar did not comply with consensus and rebounded 15 percent against the euro as the Federal Reserve raised rates from 2.50 percent to 4.25 percent through the year. The largest-ever negative currency impact to EAFE was in that year. However, the euro again regained strength through most of 2006 and 2007. Even including 2005, dollar depreciation from 2002–2007 had doubled EAFE (local) returns from 8.1 percent annualized to 14.8 percent for EAFE (U.S. dollar). Table 1 highlights certain periods with major currency impacts.

FIGURE 1: MSCI EAFE ANNUAL RETURNS



Source: Factset



The euro, introduced in January 1999, now is nine years old. From its low in June 2001, it has risen 73 percent against the dollar, from \$0.85 to \$1.46 by the end of 2007. This was great news for U.S. investors, who took notice and reallocated their investments—as evidenced by the flow of dollars out of domestic equity funds and into international funds over the past few years. Figure 2 shows the long-term history of the dollar against major currencies.

In 2007, the dollar declined against 14 of the 16 major currencies, as the Federal Reserve aggressively lowered interest rates during the unfolding subprime crisis. The United Kingdom (which is part of the European Union but does not participate in the euro) has seen domestic weakness somewhat similar to that in the United States. The recent divergence between the pound sterling and the euro, however, is a bit surprising. Over the last four months of 2007, the pound declined 9 percent against the euro. Indeed, 2007 had the largest annual decline of the pound (against a trade-weighted basket of currencies) in more than 10 years. The Bank of England is expected to continue to cut interest rates as the booming U.K. housing market has started to soften, showing some trends similar to the United States, while inflation

**TABLE 1: MSCI EAFE PERFORMANCE\***

	EAFE (local)	EAFE (U.S. dollar)	Currency Impact
<b>Negative currency impact</b>			
1981–1984	18.8%	7.2%	(-11.6%)
1996–2001	6.9%	2.0%	(-4.9%)
<b>Positive currency impact</b>			
1985–1987	34.0%	49.3%	15.2%
2002–2007	8.1%	14.8%	6.7%

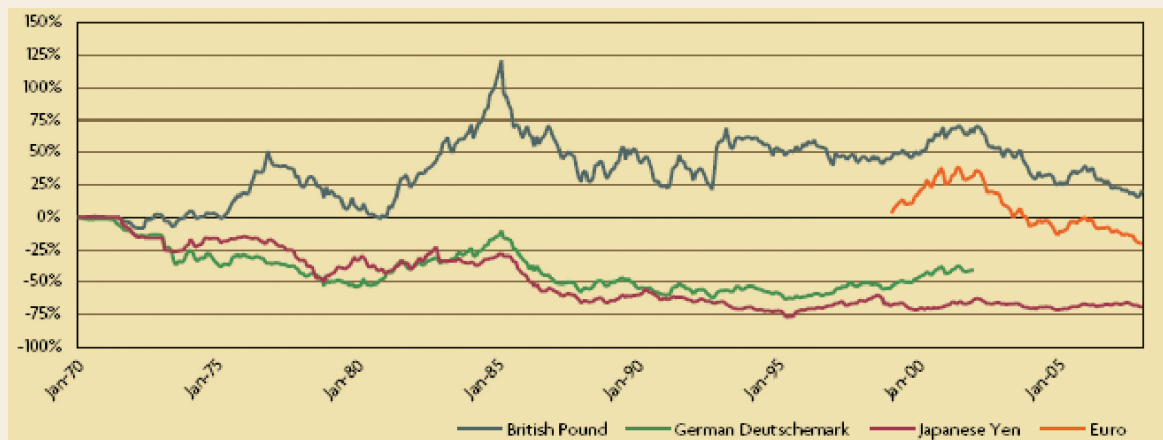
\*Returns are annualized  
Source: Factset

is slowing. On the other hand, the European Central Bank (ECB), which has kept interest rates unchanged, has a more pressing concern about inflation, which recently has accelerated for the Eurozone to more than 3 percent, the fastest rate since 2001.

Americans recently traveling to Europe have experienced sticker shock at hotels, restaurants, and local attractions. The recent decline in the pound is a bit of a relief, but from a purchasing-power parity standpoint, Europe as a whole still is expensive. *The Economist* magazine tracks the “Big Mac Index,” which is a simplistic way to see how over- or undervalued currencies are against the dollar. The index uses the purchasing power parity (PPP) method, based on the assumption

that currencies should adjust over time so that goods and services in different countries have a similar price. The last Big Mac Index calculation (July 5, 2007) showed that the Big Mac in the United States was \$3.41 compared to \$4.01 in the United Kingdom, meaning that the “fair value” of the British pound was \$1.71 (18 percent overvalued at the time). While in the long run currency disparities will pressure currencies to trend toward PPP, short-term movements often can reflect interest rate differentials and investment flows (e.g., institutional investors, hedge funds, and technical traders). In the meantime, frustrated U.S. tourists in London have been quoted on TV as having to eat at McDonald’s—even the local fish and chips no longer are a bargain.

**FIGURE 2: CUMULATIVE APPRECIATION/DEPRECIATION OF U.S. DOLLAR VS. MAJOR FOREIGN CURRENCIES**



Source: Factset



Many economists and well-respected currency strategists are bearish on the dollar, and we agree that the long-term case for a declining dollar has merit. A primary reason is that the United States continues to consume more than it produces, as imported goods from China and emerging Asia remain robust. The current account deficit is estimated to be 5.5 percent of U.S. GDP for 2007. A weakening interest rate differential and slow growth in the United States certainly are a recipe for a weakening currency.

Two other potential pressures on the dollar are gaining more attention from the market. The first concern is that foreign governments are diversifying their reserves and investments. While the U.S. dollar's "share" of the \$3.8 trillion in global foreign exchange reserves has declined slightly over the past 12 months (66 percent to 64 percent), total dollars have risen 17 percent over the same period. Note these figures exclude China and the Middle East, where governments have established massive "sovereign wealth funds" that serve as conduits specifically for investments. The ECB estimates that sovereign wealth funds have \$2.2 trillion in assets and are growing at 20 percent per annum. Interestingly, the financial sector (especially in the United States and Europe) has been a prime destination, especially as the subprime crisis has hurt many of these stocks. The Abu Dhabi Investment Authority plans to invest \$7.5 billion for nearly a 5-percent stake in Citigroup; Singapore's Temasek Holdings plans to invest up to \$5 billion to gain a nearly 10-percent stake in Merrill Lynch; and the Government of Singapore Investment Corp. plans to invest \$9.8 billion for a 9-percent stake in UBS.

The second concern is that the Gulf Cooperation Council (GCC) countries have been considering an end to their currency pegs to the U.S. dollar. Kuwait already has shifted to a currency-basket approach. With record inflows of oil money these economies are grow-

ing rapidly, with strong increases in employment and immigration. Rising housing and food prices have resulted in rising inflation—especially in the United Arab Emirates and Qatar, at 8 percent and 12 percent, respectively—a major risk to any economy. This inflation pressures the dollar peg in GCC countries.

On the other hand, one also can argue that the euro may be overvalued due to PPP differences and that the dollar could rebound, as it did in 2005. If it does, it easily could drag down EAFE performance, because Europe (including United Kingdom) now represents a 70-percent weight in EAFE. Most international managers do not hedge currencies, so currency risk is alive and well, especially within portfolios that overweight Europe.

That said, many international managers are underweight Europe in favor of Asian markets (either developed or emerging), and sometimes Latin America. Various currencies in the hottest emerging markets rose against the dollar in 2007. Brazil's real appreciated 20 percent (the fifth year of increases), helping to boost the MSCI Brazil Index 83 percent in dollar terms (along with strength in energy and materials stocks). India's rupee appreciated 12 percent against the dollar, its largest gain since 1974. The MSCI India Index gained 72 percent in dollar terms, with record inflows to stocks by foreign investors. Infrastructure-related stocks (e.g., construction and utilities) led the market. The strengthening currency has slowed exports and hurt profit margins, especially in technology software and service companies, whose stocks recently have lagged the overall strong market in India. These currencies may continue to strengthen, though rapid appreciation puts emerging markets-based exporters at risk.

The Chinese yuan was up 7 percent against the dollar in 2007 through government-controlled appreciation, and inflation pressures are appearing. The

MSCI China Index (an index of mostly H shares traded in Hong Kong) rose 64 percent in 2007. According to the Big Mac Index, the Chinese yuan is more than 50-percent undervalued against the dollar. While the currency is likely to continue to rise on a controlled basis, a rapid revaluation is unlikely.

With all these factors coming into play, investors should not increase their international allocations solely on currency expectations (as any investor who bet against the dollar just at the end of 2004 knows well). Many Asian currencies might revalue substantially due to higher GDP growth rates and strong surpluses. The euro and pound easily could decline against most world currencies in the foreseeable future (at least until the end of the global slowdown). Due to Europe's weight in EAFE, these currencies will have the most impact on EAFE returns in the future. Regardless of one's allocation, the decision to diversify international exposure across Europe, Asia, and various emerging markets is the most important one. The historical 2-percent currency tailwind easily could become a headwind for U.S. investors with managers benchmarking to EAFE, so we suggest a vigilant watch on currency risk. 

*Dan Trosch, CFA, is director of equity investments at Fortigent, LLC, in Rockville, MD. He earned a B.B.A. with a focus in finance, investments, and banking from the University of Wisconsin at Madison and an M.B.A. from Georgetown University. Contact him at dan.trosch@fortigent.com.*

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