

Should we fear a falling dollar?

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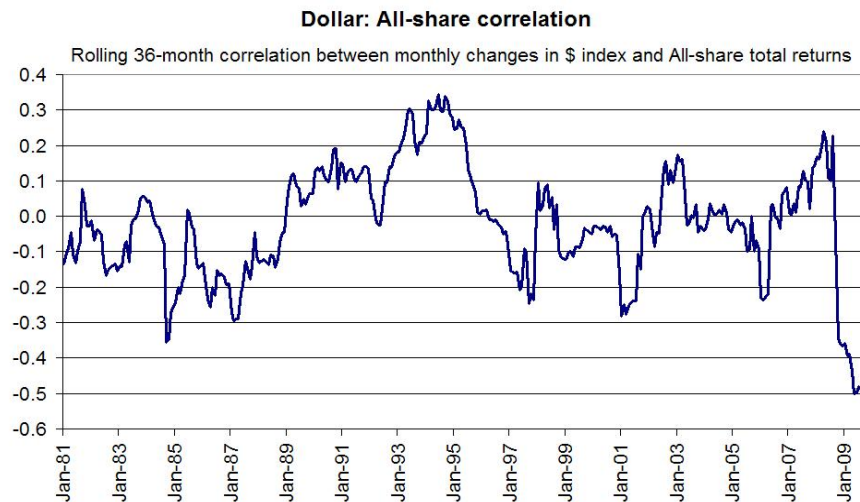
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The US dollar's weakness prompts the question: should equity investors be worried by the possibility that it could go even lower?

If we look at low-frequency moves, there does seem to be some cause for concern. Since 1978, the correlation between three-year moves in the US dollar's broad trade-weighted [index](#) and three-year returns on the All-Share has been 0.46. Generally, a weaker dollar has been accompanied by lower equity returns.

But this correlation is way short of unity, so there are times when a weak dollar sees the stock market do well. This happened, for example, between 2004 and 2007.

If we look at higher-frequency moves, the link between the dollar and All-Share is variable. My chart shows the correlation between monthly changes in the dollar's index and monthly total returns on the All-Share, measured over rolling three-year periods: the first point on the line shows the correlation in the three years to January 1981, the last the correlation in the three years to October 2009.



Most of the time, the correlation is around zero, which means the All-Share is roughly as likely to do well when the dollar falls as badly.

But there are exceptions. In the early 1980s, there was a negative correlation. Rises in the dollar fuelled fears (correctly, as it happens) that the greenback was in a speculative bubble, and stock markets worried how this would end.

Then in the mid-90s and again in 2005-08 there was a positive correlation. That reflects the fact that many risky assets - shares, junk bonds and suchlike - are priced in dollars, and so changes in global investors' appetite for risk cause the dollar and share prices to move together. If risk appetite increases, as it did in the mid-90s and in 2005-07, both go up. And if it falls, as it did in 2008, both go down.

However, at other times - such as 2003-06 and the past few months - there has been a negative correlation.

The likeliest cause of this lies in US monetary policy. If this is loose, as it was in 2003-04 and now, the dollar falls and shares rise; both are the natural effect of excess money.

Generally speaking, though, the forces for a positive correlation offset the forces for a negative one, and so the correlation is usually around zero.

This historical evidence leads us to a simple conclusion. Whether equity investors should worry about the dollar falling further depends upon why it would fall. If it does so because of the Fed's easy money policy, shares could gain; the same monetary growth that depresses the dollar pushes up share prices. If, however, the dollar falls because of a general increase in risk aversion, then it's probably bad for equities*.

But how likely is the latter? Ian Harwood at Evolution Securities points out that there has been occasional talk of panic selling of the US dollar since at least the early 1980s, and yet this has never actually happened on a significant scale.

Still, I suppose there might be a first time for anything.

**I say 'could' and 'probably' in these paragraphs because even when the correlation between the dollar and equities is positive or negative, it is not usually strongly so, which means there's still a chance of shares doing well if the dollar falls, or vice versa.*