

Fourth Quarter 2007 Knowledge College

The Fall of the Dollar

The value of the dollar relative to the euro fell about 8% during 2007. The dollar has depreciated by approximately 20% in real terms since 2002. What are the forces that drive the dollar and other currencies and how can that potentially impact your investments?

Factors That Impact the Dollar's Value

- **Growth Rates** – Demand for the dollar decreases when investors believe growth prospects are greater in the rest of the world vs. the U.S. Conversely, when U.S. growth prospects are improving, the demand for the dollar increases.
- **Trade Imbalances** – the dollar can weaken when the U.S. runs a large trade deficit. Stronger demand for foreign goods vs. U.S. goods decreases the demand for dollars in the world markets.
- **Interest Rate Environment** – If interest rates are higher in non-U.S. markets, the dollar can suffer because U.S. bonds become less attractive and demand for the dollar falls.
- **Political Climate** – When foreign countries become politically unstable, the increase in uncertainty often causes U.S. securities (particularly bonds) to be more desirable as a “safe haven” investment.

At the end of the 1990's bull market when demand for the dollar was strong, **one dollar was worth 1.18 euros** (as of October 2000). Since then, dollar demand has declined and the **dollar was worth only 0.68 euros as of the end of 2007.**

How does a weak dollar impact us?

Negative Implications

- **Foreign investment in the U.S. can decline** – this creates selling pressure in government bonds which drives up bond yields. This **can force up interest rates** because higher rates would be needed to attract investors.

Inflation – imported goods become more expensive (electronics, clothing, etc.). If demand for foreign goods stays strong in the face of inflation, this can worsen the trade deficit and put further pressure on the dollar. Also, **U.S. companies that purchase raw materials and parts from foreign markets would feel the cost increases**. If these companies are not able to pass along the costs in the form of higher prices, profit margins and employment levels could suffer.

- **Higher cost of overseas travel** – the cost of virtually everything would increase for U.S. citizens traveling to foreign countries.

Potentially Positive Implications

- **U.S investors holding foreign investments** – the weak dollar can **increase the investment return of foreign investments** (see table below).
- **U.S. goods become cheaper overseas** – a falling dollar **makes U.S. products more competitively priced in foreign markets**. U.S. companies that have global reach can benefit through higher overseas sales
- **U.S. tourism** – a weak dollar means **foreign tourists are more likely to visit the U.S. and spend their money** because their currency buys more.

↓ **European companies with revenues in dollars and costs in euros have been hurt by the dollar's decline.**

↑ **U.S. companies with global operations having revenues in euros and costs in dollars have benefited from the dollar's decline.**



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Summary

The currency markets are unpredictable. Seemingly overvalued or undervalued currencies often don't move in the direction that data might suggest. For long-term investors, the **impact of currency fluctuations tends to even out over the long haul.** A well diversified portfolio containing both foreign and domestic investments that provide exposure to a variety of different currencies is the most prudent approach. **Currency diversification can help your portfolio weather the ups and downs** associated with fluctuations in the value of the dollar.

For more information, please contact any of the professionals at DiMeo Schneider & Associates L.L.C.