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Strategies

The Dollar May Tumble, but It's O.K. to Shrug

By MARK HULBERT

INVESTORS have no shortage of economic and geopolitical issues to worry about. But a declining dollar may not deserve a high place on their list.

Concern about the stock market fallout from a possible sharp fall in the dollar may trace back to memories of the 1987 stock market crash. Many people attributed that plunge — the largest one-day percentage drop in United States stock market history — to the Reagan administration's apparent willingness, and even eagerness, to let the dollar's foreign exchange value decline.

Traumatic as that experience was — and even if investors were correct in blaming the Reagan administration's monetary policies for the crash — it is dangerous to draw any generalizations from a sample size of just one. And from a purely statistical point of view, there has been a very weak historical correlation between fluctuations in the dollar and the stock market's ups and downs.

Recent research explains, at least in part, why this correlation is so weak. It was conducted by Mahesh Pritamani, a senior research analyst at the Frank Russell Company, and two finance professors at the Pamplin College of Business at Virginia Tech: Dilip K. Shome and Vijay Singal. They presented their findings in an article in the summer 2005 issue of the Journal of Applied Corporate Finance.

According to the researchers, the domestic stock market has become increasingly dominated over the years by multinational companies whose costs of operations, as well as sales, are denominated in many currencies in addition to the dollar. That means these multinational companies are largely immune to the effects of currency fluctuations, the researchers say. When one part of such a company's operations is hurt by a change in the value of the dollar, other parts benefit, leaving relatively little net effect on the bottom line.

If the dollar fell in value against other major currencies, for example, the domestic sales of multinational companies based in the United States would probably suffer. That is because a declining currency is often associated with a weakening domestic economy, the researchers said. But these companies would make up for at least part of that domestic weakness by reaping higher sales overseas, because their goods and services would now be cheaper when priced in foreign currencies.

The greater immunity of multinationals to currency fluctuations helps to explain several curious features of the historical record. It turns out, for example, that the correlation between the dollar and the stock market has been declining over the years. Professor Singal says he believes that a big reason for this trend is the increase in international diversification among the largest companies.

In the 1970's, he said, fewer American companies enjoyed the immunity that international diversification confers. As a result, they were more vulnerable to dollar declines like the one that occurred in that decade. He suspects that the largest multinationals would be much less affected if a similar decline occurred today.

The increasing diversification of big companies also explains why small-capitalization stock indexes are more correlated with fluctuations in the dollar's value than are large-cap indexes. A greater proportion of smaller companies' operations and sales are conducted within the United States, according to the researchers. And

because a falling dollar is associated with a weakening domestic economy, it makes sense that those small caps are more vulnerable to a decline in the dollar.

Nevertheless, the researchers emphasize that the major stock market benchmarks will be relatively unaffected by what happens to these smaller companies. That is because those benchmarks give the greatest weight to the largest companies — the ones that tend to be most diversified internationally and therefore most immune to currency fluctuations. The 50 largest publicly traded companies in the United States, all with significant international diversification, account for 41 percent of the combined market value of the entire domestic stock market, according to the Frank Russell Company.

Professor Singal acknowledges that the largest multinationals may not be completely immune to a dollar decline. If a sharp slowdown in economic growth in the United States sets off a global recession, for example, those multinationals may not be able to make up in foreign sales what they lose domestically. But even then, it would not be clear to what extent the declining dollar caused the slowdown in the United States or instead was a result of it.

What, then, is the bottom line for investors? Those who try to anticipate the stock market's gyrations won't gain much insight by analyzing the dollar. And even if they know when and by how much the dollar will fall, it is unlikely that they will be significantly better at timing the stock market.

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