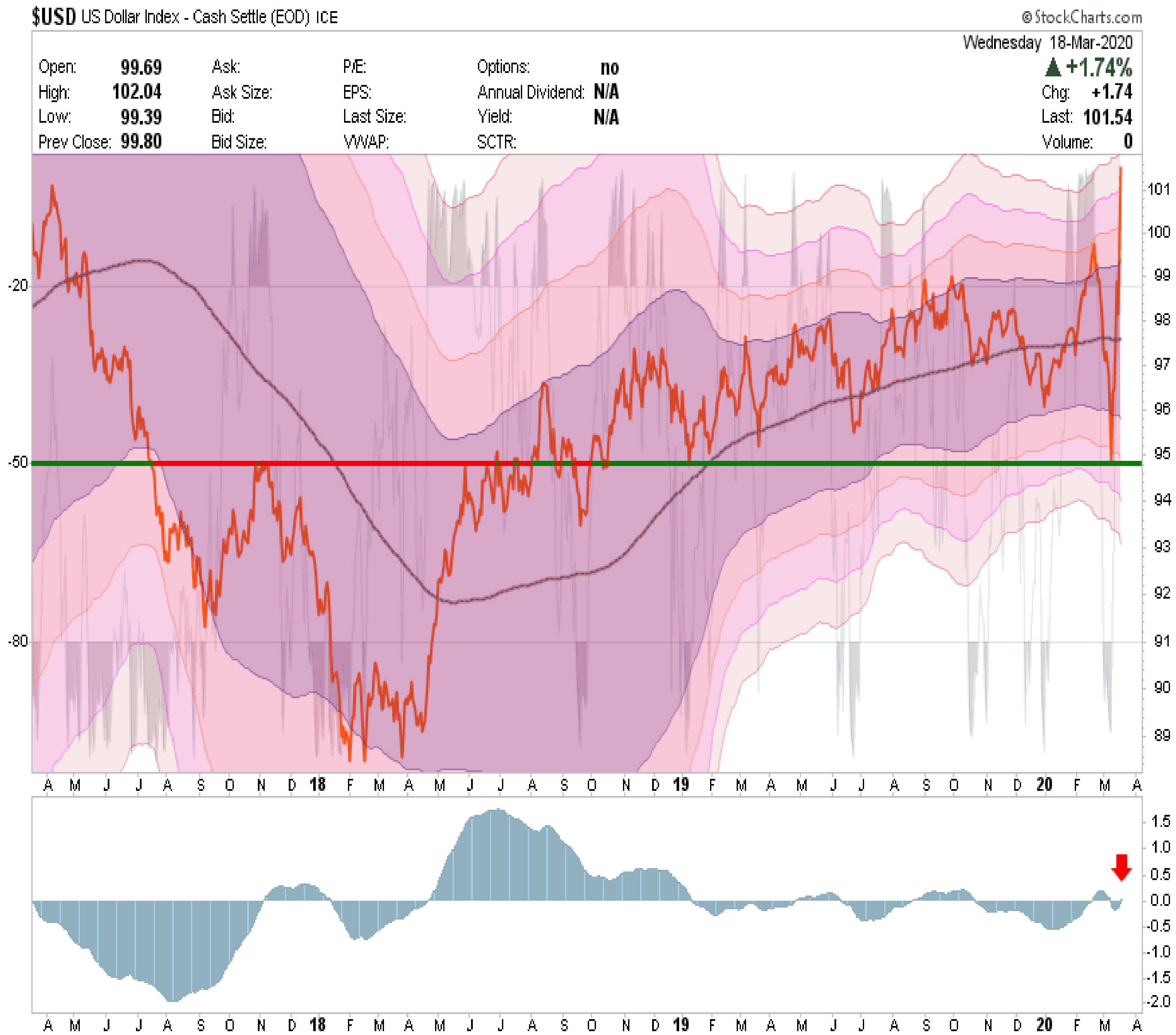
RIA Advice

Quick Take: The Dollar Problem

Over the last two weeks, the U.S. dollar index has risen by 6%. That may not seem like much to investors who are watching stocks rise and fall by that amount, and even more daily or bond yields falling in half and then doubling, but trust us; it is.



The dollar is unlike any other asset because it is the world?s reserve currency. When a Canadian tire company buys rubber from a Philippine rubber company, the payment occurs in U.S. dollars. Both countries have their own currencies, but neither currency has the liquidity, deep credit markets, and quite frankly, the world?s largest economy and military power backing it.

Because so many foreign countries and companies transact with dollars, they need to borrow in dollars, despite the fact their revenue is often not in dollars. This creates a mismatch between revenues and expenses as currency values fluctuate. If the mismatch is not hedged, as is frequently the case, foreign borrowers of U.S. dollars are subject to higher borrowing costs if the dollar rises versus their local currency. Simply the local currency depreciates versus the dollar; therefore, they need more of the local currency to make good on their debt. **Because of this construct, a stronger dollar is effectively a tightening of financial conditions on the rest of the world.**

This is what is occurring today as the virus is severely impacting the global economy. Revenues are deteriorating and the cost of dollar-denominated foreign debt is rising rapidly. As borrowers scramble to raise more dollars to meet their obligations, the situation worsens as the demand for dollars forces the dollar higher. In layman?s terms, there is a global run on the dollar and, in circular fashion, the run is pushing the dollar higher. Either the global economy will break or the dollar. Right now it seems that despite massive liquidity from the Fed the dollar does not want to back down. &#2013266080;

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