EMERGING MARKETS DEBT | EQUITIES

US dollar weakness furthers case for international equities

By: Christopher M. Dyer, CFA | September 8, 2020

London - The US dollar (USD) dropped to a two-year low on September 2, down 10% from its March highs, and many analysts expect further weakness going forward. While detrimental to US equity markets, a weaker USD could potentially boost portfolio results for international equity investors, where currency conversion works in their favor.

We have previously flagged the dramatic increase in US government debt resulting from COVID-19 as one of the drivers of the case for international equities. The International Monetary Fund projects that US government debt will be 43 percentage points higher than eurozone government debt coming out of the crisis. This level of US debt not only increases the probability of higher future US tax rates to address the debt, but also increases pressure on the USD. The announcement by the Federal Reserve last week that the central bank will tolerate inflation above the 2% target is significant — a weaker dollar is part of the equation to achieve higher levels of inflation in the US.

Implications of a weaker USD

So what does a weaker dollar mean for investors? For those investing in an international equity portfolio of non-US dollar-denominated assets, it could potentially bolster returns. Why? Because the earnings from those international companies will be worth more in a portfolio whose base currency is US dollars. In a portfolio that does not hedge currencies, which is the case for the international equity portfolios we manage, the benefits of a weaker US dollar flow through to investors in the portfolio.

Overall, we continue to have strong conviction in the case for international equities, predicated on several important drivers mentioned in previous blogs:

- Greater cohesion in Europe, as reflected in the European Recovery Fund
- Expected outperformance of cyclical and value-oriented markets like Europe and Japan that are in the early stages of economic recovery
- Volatility around the US election and the prospect of higher US taxes
- Likelihood of market rotation following more than a decade of outperformance by US equity
- Prospect of further USD weakness

In our view, now is a particularly opportune time for investors to consider the benefits of portfolio diversification and rebalancing with international equities, which offer an attractive counterpoint to US equity markets.

Bottom line: The weakening USD is another significant reason international equities appear attractive relative to US equity markets. Greater European cohesion and lower eurozone government debt compared to the US are other strong, long-term factors favoring investment in international equities.

Investments in equity securities are sensitive to stock market volatility. Equity investing involves risk, including possible loss of principal. Investments in non-US instruments or currencies can involve greater risk and volatility because of adverse market, economic, political, regulatory, geopolitical or other conditions. In emerging countries, these risks may be more significant.

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"The high level of US government debt, resulting in part from COVID-19, increases both the probability of higher future US tax rates and pressure on the USD."