The Dollar Also Rises
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NEW YORK -- Don't look now, but the long-beleaguered U.S. dollar has made some sizable gains on its U.K. and European counterparts.

Better yet, the dollar remains relatively undervalued compared to its more glamorous cousins across the Atlantic, suggesting some nice near-term advances for many U.S. stocks.

The dollar index, which measures the dollar against a trade-weighted basket of six major currencies, reached a new cycle high on Oct. 20, likely boosted by a new round of efforts by the government to stabilize the financial system and talk from Federal Reserve Chief Ben Bernanke of more economic stimuli.

Since dropping to a trough in April, the dollar index is up more than 10%, in tandem with plunging commodity prices.

Year-to-date through Oct. 20, the pound sterling has declined 13.6% versus the dollar, while the euro has sunk 8.7%.

Walter Gerasimowicz, chief executive officer of Meditron Asset Management, estimates that despite the ongoing rally, the greenback probably remains about 15%-20% undervalued.

"A year ago, the euro and the pound sterling were very much over-valued relative to the dollar," he said.

Gerasimowicz expects the dollar will continue to strengthen over the next six months to one year.

"The dollar remains the world's currency of choice and one of the most attractive safe havens," he noted. "Both the Bank of England and the European Central Bank must cut interest rates, placing additional pressures on their respective currencies."

In a sense, the dollar has rallied as forecasts for global growth have been slashed.

The dollar, as well as the Japanese Yen, have flourished amidst the global volatility in stocks. Currency traders have been unloading higher-yielding -- i.e, riskier -- currencies like the euro in favor of dollars and yen, traditionally viewed as safe haven assets during periods of economic distress.

Some observers believe that U.S. stocks will directly benefit from the dollar's gathering resurgence.

"Our equity market leads the world, whether it's in a declining or advancing mode," Gerasimowicz said. "Once our stocks bottom out, they will climb ahead of the rest of the world in anticipation of the global economy's gradual emergence from this recession."

This, in turn, could lead to more European/British investors pouring more money into U.S. stock markets.

If an investor in Paris or Madrid buys dollar-denominated assets, as the dollar climbs in value and the Euro continues to decline, he will receive more of his currency back just from the foreign exchange gains.

"If the Europeans perceive that the dollar is likely to strengthen, it is to their advantage to be invested somewhat in the U.S. equity markets, particularly at this stage of the economic cycle," Gerasimowicz said.

As far as U.S. investors are concerned, Gerasimowicz suggests U.S.-based companies with extensive overseas operations will be particularly attractive, if they are hedged properly.

Rafael Resendes, portfolio manager of the Toreador Large Cap Fund, explains that a strong dollar has historically supported gains in U.S. stocks.

"Some people think that a weak dollar helps the profits of U.S. multi-nationals; but, contrary to popular opinion, that has never translated back into stellar returns for U.S. investors," he said. "This is partially because input prices for many U.S. firms rise amidst a soft dollar, thereby leading to higher wages, higher manufacturing costs, and eroding domestic profitability."

Moreover, even U.S. firms with significant export business to Europe should benefit from the healthier dollar, since our currency remains significantly undervalued to the pound and euro. Even though buying U.S. goods will cost a little bit more for foreign buyers, they will still likely be seen as an attractive bargain -- that is, less expensive than similar products available from other countries.

"We still have a competitive price advantage, particularly with respect to products related to infrastructure," Gerasimowicz said. "The ongoing global recession will definitely hurt our exports overall, but foreigners will find it more advantageous to buy from us, rather than from other sources."

Research from Merrill Lynch indicates that U.S. pharmaceuticals stocks perform the best when the dollar appreciates, followed by industrial conglomerates, food products, insurance, and other industries mostly in consumer staples and health care.

The worst performers during periods of dollar strength were all in relatively cyclical sectors, including machinery, chemicals, semiconductor and metals & mining.

Still, there are some formidable risks to any further dollar upside.

For one thing, next month's presidential election may play a crucial role in the dollar's near-term prospects, said Resendes.

"Under an Obama administration we are likely to see more spending, which might hurt any further advances in the dollar," he said. "In contrast, McCain apparently wants to freeze government budget spending and focus more on fiscal restraint. He has even explicitly said he wants to strengthen the dollar."

Government policy can indeed influence the dollar's fortunes looking into next year; however, it would be nice to think that this rising tide will overwhelm other factors and lead to a sustained robust U.S. currency.

(Palash R. Ghosh has been writing about U.S. and international equity and bond markets for the past 17 years.)