



US Large-Cap Multinationals Mull Faltering Euro

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A DOW JONES NEWSWIRES COLUMN

NEW YORK -- The recent surge in the long-battered dollar relative to the euro may begin to erode the export revenues of large-cap U.S. multinationals.

For several years, as the dollar became about as popular as a Yankee fan in Fenway Park, big American companies made huge profits by selling their wares to cash-flush Europeans.

Now, the dollar seems to have turned the corner, rebounding amid the apparent end of Federal Reserve easing, shrinking economic growth in Europe, and widespread expectation that the European central banks will not cut rates.

Indeed, fears of a possible recession in the U.K. recently pushed the pound sterling to a 22-month low against the dollar, while increasingly bad economic data and the military conflict in Georgia recently drove the euro below the \$1.50 mark for the first time since February.

Rafael Resendes, portfolio manager of the Treador Large Cap Core Equity Fund, believes the dollar rally is sustainable because the euro zone economy is likely to deteriorate further.

"Even if our economic house in the U.S. is a mess, the American economy is more dynamic and resilient," he said. "We've already absorbed a lot of the pain with the credit crunch and plunging house prices. But these issues have yet to spill over into Europe. And as these woes spread into U.K. and European markets, it will be a long and drawn-out affair. They are facing a long-term economic malaise, exacerbated by their aging demographics."

The Europeans are also worried about inflation, or at least their bank bosses are.

Mark Coffelt, president and chief investment officer of Empiric Funds, who also believes the dollar will continue to appreciate against the euro, said that the European Central Bank is reluctant to reduce interest rates because it wants to stem inflation.

"The ECB has held interest rates too high for too long," he said. "So now their economies are starting to roll over."

Wayne Titche, chief investment officer of AMBS Investment Counsel LLC and co-manager of the AHA Diversified Equity Fund (AHADX, AHDEX), concurs. "In the U.S., the Fed has lowered interest rates to help the banks work (their) way through the credit crisis," he noted. "In Europe, they have a different mandate; they want to fight inflation to sustain the economy. They have chosen not to cut rates. The implication is that potentially the slowdown in Europe could be more severe than ours."

Titche also said the dollar is probably 20% to 30% undervalued relative to the euro, suggesting this rally will have legs.

While some observers concur that the dollar could enjoy further gains against the once kingly euro, how this development will impact U.S. exporters is a more complicated issue.

Resendes does not think a falling euro will hurt large-cap U.S. exporters too much because the beneficial effects of a stronger dollar would probably offset a weaker European currency. "In a climate

of a strengthening dollar, the overall cost of business declines, making U.S. firms more competitive and able to aggressively execute their strategies," he said.

As an illustration, Resendes noted that as large U.S. companies have significantly increased their sales to Europeans (and other foreigners) over the past decade, large-cap stocks turned in a tepid performance, partially due to the weak dollar.

Thus, selling a lot of DVD players, soap and tissue paper to foreigners doesn't help the bottom line back home that much since your local currency is so fragile.

Specifically, in 1998, the average large U.S. company in the Russell 1000 Index generated 66% of its sales from domestic customers. By 2008, that figure was down to 59%, as the foreign business increased by 7%.

"Over that time, the U.S. dollar depreciated about 25% against the euro, a huge figure," Resendes said. "What has been the effect of that? How has it impacted the wealth of U.S. companies? The (Standard & Poor's 500) has been essentially flat."

In the big picture, a declining dollar is bad for the U.S. stock market. "When the dollar is weak, it costs more to do business, and that spreads to the whole operation," Resendes said. "But now, assuming the dollar gets stronger, it becomes cheaper for U.S. companies to do business, the cost of capital goes down, cost of input prices declines, cost of labor goes down."

Alec Young, international equity strategist at S&P, believes the slowdown in Europe (and elsewhere) will definitely hurt overseas sales of most companies in the S&P 500 index. Foreign sales have served as a major growth driver for these companies for the past several years.

"Unless the dollar quickly resumes its decline, U.S. multinationals will enjoy a much smaller positive currency translation in the fourth quarter of 2008 than they did in the first half of 2008," he said. "This will erode the value of their foreign sales as the latter will be converted into fewer U.S. dollars when the funds are repatriated."

Further complicating this analysis is the complex and intertwined nature of globalization. Consequently, it has become very difficult to make generalizations now about the relationship between currency fluctuations and company performance.

"The large-cap U.S. multinationals now have a lot of production overseas so they have 'natural hedges' in place," Titcher said. "If you have a company that has the majority of its production in the U.S., then they obviously benefit from a weak dollar. But if that U.S. company has plants in Europe and Asia (locally sourced), then the impact of dollar trends is not clear."

Still, Europe remains a very important customer for U.S. companies, even if one takes into account the phenomenal growth of the emerging markets.

According to data from S&P, about 28.8% of foreign sales by companies in the S&P 500 were recorded in the U.K. and Europe in 2007, with Asia a rather distant second at 16.8%.

Weak, strong or middling, the fortunes of the euro cannot be ignored by large U.S. exporters.