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The Dollar Hedge – Should We Change Our Strategy?

Almost a year ago I sent a Client Bulletin indicating I wasn't too worried about the falling U.S. dollar, especially since I have been hedging client portfolios with foreign bonds. Well, now the dollar has risen to a two-year high against the euro, propelled by rising interest rates in the U.S. and rising pessimism about Europe. Does this mean we should modify our hedging strategy? My short answer is "no", and I'll explain why below.

Last year, traders and investors were fixated on the large and rising foreign indebtedness the U.S. has, also called the trade deficit. Now that has changed drastically, with all eyes focused instead on interest rates, which have been moving up while rates in Europe and elsewhere around the world have stayed relatively low. Moreover, the Federal Reserve, concerned about inflation and determined not to slip back into stagflation of the 1970's, has hinted that it will continue to raise short-term rates. Higher interest rates attract investors and tend to drive up a nation's currency.

My belief is that concern about higher interest rates is transitory, and that once the Fed raises rates another two or three times, that process will be completed and emphasis will again return to the trade and budget deficits. In fact, just this morning, Alan Greenspan, the Fed Chairman, commented that the huge trade deficits the U.S. has been running up each year "cannot persist indefinitely. At some point, investors will balk at further financing."

What Greenspan is referring to is that foreigners, chiefly China and Japan, have been financing our deficits through purchases of our government bonds.

The concern is that at some point, they will lose their appetite for holding dollar-denominated investments. That could cause them to unload investments in U.S. stocks and bonds, which would send prices down and interest rates up.

I believe that this may already be happening, since the dollar's share of foreign investment, tracked by the Bank for International Settlements, has dropped 4% in the last three years. However, that's a gradual drop, and I'm pretty convinced the trend will continue to occur in a slow and steady fashion with little impact to U.S. rates.

What this means is that the U.S. dollar may, at some point in the next six months, recommence its downward march, which will once again argue in favor of keeping foreign bonds as a hedge. The way it works is that whenever the U.S. dollar drops, the value of foreign bonds increases. In fact, our trade and budget deficits are so gargantuan and rising that I'm recommending that we increase the hedge by adding a new fund, the PIMCO Developing Local Markets Fund. This fund, as some of you have been hearing from me recently, provides access to local debt and money market instruments of emerging markets abroad. Such markets are maturing, as shown by improved credit ratings, higher foreign-currency reserves, sounder economic policies and a broader investor base. This fund will allow us to diversify our hedge against a falling U.S. dollar to many currencies beyond the yen, euro and pound sterling. We will be establishing a holding of this fund amounting to 2.5% of portfolio value, for all clients who agree with the recommendation.