US dollar: double whammy worry

The pattern of late is familiar to the point of contempt: stocks go down, the US dollar goes up. Asset manager Factor Advisors notes that the 90-day correlation between the dollar and large-cap US stocks is negative 0.85 – the most extreme in a decade. Conversely, the correlation between the S&P 500 and the euro was positive 0.84.

This is anything but surprising, given financial markets' fixation on the ups and downs of the eurozone's efforts to save its currency. However, underlying this short-term effect is a fundamental but under-appreciated factor – the impact of currency moves on reported corporate profits. With the euro hitting an 11-month low this week, dipping below the $1.30 level, American companies are set for their second successive year of drag from currency translation gains. These gains may be noticed more this year than last, when they were offset by beneficial currency impacts from developing countries.

The EU accounts for 14 per cent of sales for S&P 500 companies, according to Standard & Poor's. Companies with high exposure include McDonald's, Mylan and Kraft Foods with 40 per cent, 36 per cent and 32 per cent respectively. Back in 2002 and 2003, when the euro rallied from $0.895 to $1.05 and then $1.25, McDonald's booked hefty reporting gains. In 2003 these contributed 7 cents to its total earnings per share of $1.15. Over the two years the revenue impact was nearly $1.9bn.

Translation gains and losses may be fleeting but they are more than an accounting identity. They can result in lost market share for manufacturers. US investors fretting about the impact of slowing growth abroad must also consider the double whammy caused by the dollar's haven status at a time of weaker US earnings growth. Watch the Big Mac Index, not just the number of Big Macs foreigners are buying.