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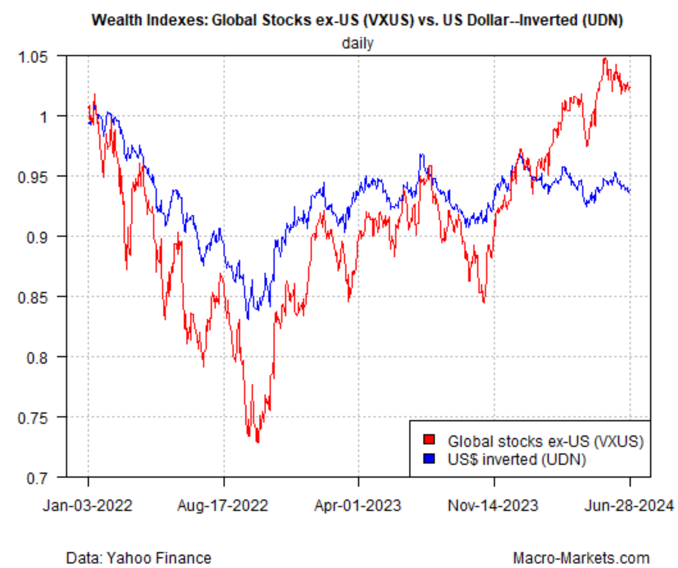
If the US dollar weakens, the trend change could be a boost for foreign stocks

Key Points:

- *The US Dollar Index's rally may be running out of steam*
- *A flat/weak US dollar is usually a bullish factor for global equities ex-US*
- *If the Fed starts cutting interest rates later this year, downside pressure may increase for the greenback*

There are multiple factors that drive equities outside the US, but the ebb and flow of the world's reserve currency tends to always be on the short list. The reasoning is straightforward and reflects basic economic logic. All else equal, a stronger dollar translates into fewer dollar-based earnings after translating foreign currencies into greenbacks. The opposite is also true, and so a weaker dollar boosts offshore earnings from a US perspective.



Markets tend to price in this relationship, which means that the dollar's trend is a key factor that determines the strength of headwinds and tailwinds for global shares outside the US. The chart at right highlights this relationship recently, using a pair of ETF proxies: Invesco DB US Dollar Index Bearish Fund (UDN), which falls (rises) when the dollar is weak (strong), and Vanguard Total International Stocks (VXUS). The two funds have a relatively high correlation in recent years but have been diverging this year. Foreign stocks have continued to rally while UDN has been in a trading range. That could be interpreted as a sign that that this year's dollar rally is set to weaken.

Another sign that America's currency may be set to soften relative to its foreign counterparts: moving averages. The 5-week average of the US dollar index has been above its 20-week counterpart since mid-February and remains so through last week's close (as of Friday, June 28). If and when the 5-week average consistently falls below the 20-week average, that may suggest the start of new period of dollar weakness.

An expected change in US monetary policy is could provide additional support for foreign stocks, perhaps to the point that offshore equities begin to outperform US shares. Fed funds futures are pricing in moderate odds that the central bank will start cutting interest rates in the months ahead, perhaps as early as the September 18 FOMC meeting. If and when rates are cut, the relative allure of dollar-denominated securities may ease, if only on the margins.

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