OBSERVATION
TD Economics

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STRONG DOLLAR A HEADWIND TO BUSINESSES, BUT A TAILWIND TO CONSUMERS

Highlights

- A strong dollar is a key factor for the economic outlook. The dollar has risen considerably over the past year especially relative to the currencies of other advanced economies. On a broad trade-weighted basis, the dollar is up over 12% relative to its level a year ago.
- A rising dollar makes exports more expensive for foreign purchasers and imports cheaper. Combined with relatively modest economic growth outside of the United States, this is expected to cause net-exports to subtract 0.7 percentage points from economic growth in 2015.
- The strong dollar and weak global growth will also take a bite out of corporate profits, with net profits earned abroad contracting by close to 10% in 2015, subtracting two percentage points from total profit growth.
- The dollar's rise is not all negative. The pass through of lower import prices reduces inflation and raises consumers' purchasing power. This will show up in greater consumer spending growth over the remainder of this year, offsetting some of the drag from international trade.

A strengthening U.S. dollar has been a theme of the economic outlook for the past year. The dollar's rise reflects the relative strength of the American economy against many of its trading partners and a divergent path for monetary policy. While the dollar has pulled back in recent weeks, it has had a terrific run over the past year. Between May of last year and its recent peak at the end of March, the broad trade-weighted dollar had risen around 15%. Against major currencies it was up over 20%. Even after its modest pullback, the broad trade-weighted index is up over 12% from the same time last year.

The dollar is likely to remain elevated and has scope to rise from its current level. While the U.S. economy disappointed in the first quarter of the year, job growth has continued and the unemployment rate has moved steadily downward. Inflation, while subdued, also appears to be on the upswing and with energy prices rebounding, is on track to approach the Fed's target sometime next year. As a result, the Federal Reserve is likely to begin a tightening cycle in September, even as other central banks are continuing to prime the pumps.

A strong dollar and weak global growth will be headwinds to economic growth. The first quarter is likely to be a low point for global growth, with a modest acceleration expected over the coming quarters. As a result, net-exports are expected to subtract 0.7 percentage points from real GDP growth in 2015. In 2016, the lofty dollar is expected to give up some of its gains, but with

CHART 1: BROAD TRADE-WEIGHTED DOLLAR

Source: Federal Reserve Board.

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U.S. domestic demand remaining stronger than many of its trading partners, net-trade will still subtract from top line growth, albeit by a smaller 0.2 percentage points.

In addition to the headwind to GDP growth, the higher dollar will have a noticeable effect on corporate profit growth. A higher dollar cuts into the market share of U.S. exporters and devalues the earnings that American companies generate abroad. Combined with the soft global growth environment, this is likely to reduce corporate profits earned abroad by close to 10% in 2015.

High dollar and weak global momentum a headwind, but it's not all bad news

A rising dollar hits international trade on both sides – making exports more expensive for foreign buyers and imports cheaper for Americans. One way of capturing the effect of the dollar's appreciation is to use a macro-economic model that allows for an estimation of both short and long-term effects of a rising exchange rate.

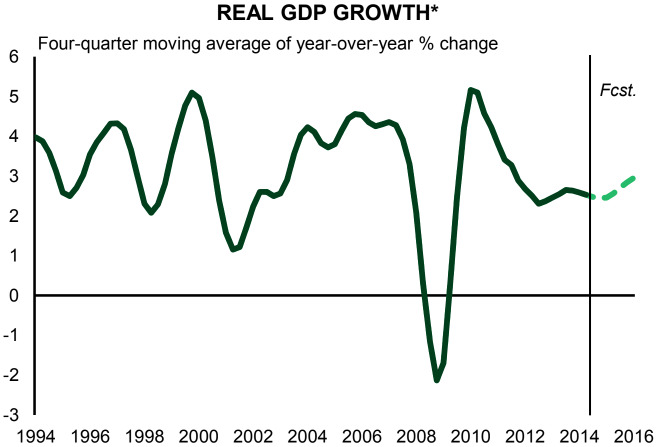
According to simulations run with macro the Macroeconomic Advisers model, in the period in which the change is registered, a 10% increase in the value of the trade-weighted dollar reduces exports by 3.0% and raises imports by 0.5%. Put together, the reduction in net exports subtracts 0.5 percentage points from economic growth. The impact becomes larger the longer the dollar remains elevated. If the increase is permanent, a 10% appreciation would also reduce GDP growth in the following year by 0.5 percentage points.

Aside for the dollar, net trade is highly dependent on economic activity at home and abroad. In particular, exports are sensitive to foreign economic activity, while imports depend on domestic demand within America. The good news on the export front is that after a fairly dismal first quarter, economic growth in the rest of the world is expected to pick up over the remainder of the year. In Canada – the biggest purchaser of U.S. exports – the economy contracted by 0.6% (annualized) in the first quarter. Going forward, the Canadian economy will benefit from the rebound in energy prices, lower interest rates, and a stronger U.S. economy. We expect Canadian growth to average 2.1% over the remainder of 2015. In Europe, which pleasantly surprised in the first quarter with its best growth in four years, there is growing evidence that improved credit growth will help fuel a stronger economic expansion. We expect the Eurozone economies to grow by a bit over 2.0% over the remainder of the year (see EZ Credit). Similarly, after very weak growth in the first quarter, a concerted policy response in China is likely to lead to a modest acceleration in growth over the remainder of the year to around the 7.0% target rate.

Weighted by their share in U.S. exports, growth in America's trading partners through 2015 is expected to be 2.4% on an annual average basis, down from 2.6% in 2014. However, given growth in the first quarter was shy of 1.8%, this implies an improvement over the remainder of the year to around 2.8% (annualized). Supported by a continued recovery in Europe and elsewhere, we expect growth to improve to 3.0% in 2016 (see global outlook).

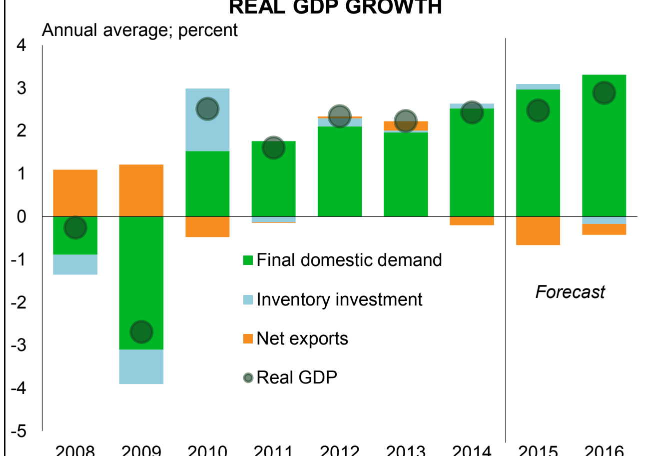
As a result, despite the high flying dollar, export growth is likely to improve over the remainder of the year. In fact, an improvement won't be difficult considering exports declined by an estimated 6.3% (annualized) in the first quarter. Some of the decline in the first quarter was due to a labor dispute

CHART 2: FOREIGN TRADE-WEIGHTED REAL GDP GROWTH*



*Federal Reserve export trade weights as of October 2014.
Source: Haver Analytics. Forecast by TD Economics.

CHART 3: CONTRIBUTION TO REAL GDP GROWTH



Source: Bureau of Economic Analysis. Forecast by TD Economics.

at West Coast ports and will be met with stronger growth in the second quarter. Following that, export growth is anticipated to rise over 5.0% in the second half of the year. It should improve further to around 5.5% in 2016.

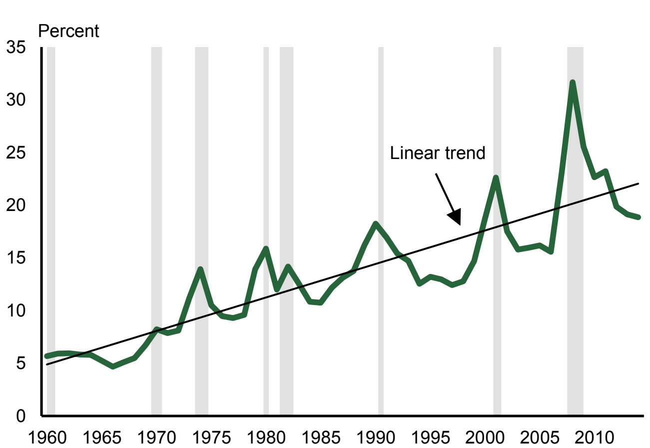
On the import side of the equation, the higher dollar will augment the strength in imports resulting from rising domestic demand. Following three straight quarters above 3.3%, domestic spending by consumers, businesses and governments fell to 1.3% (annualized) in the first quarter of this year. Growth will be more robust over the remainder of the year. Supported by strong income gains and low energy prices, we expect it to rebound to around 3.5%. Given the strength in the dollar, this is consistent with import growth north of 6.0% for the rest of 2015.

With imports outpacing exports, net-exports are expected to subtract 0.7 percentage points from economic growth in 2015, falling to 0.2 percentage points in 2016 as global growth picks up and the dollar pulls back.

Foreign profits hit by dollar and weak global growth

In addition to its impact on domestic production, the dollar's rise also has implications for corporate profit growth. While GDP – gross domestic product – is measured in terms of goods and services produced in the United States, corporate profits include profits earned domestically as well those earned abroad. Profits are highly cyclical, but the share of profits from abroad has been on a general upward trend over the past fifty years (Chart 4). In 1964, profits from the rest of the world represented just 5.7% of total profits. By 1994 this had risen to 12.5%, and by 2014, profits from the rest of the world represented 19% of total corporate profits. The rising share of profits from abroad reflects increased

CHART 4: CORPORATE PROFITS FROM THE REST OF WORLD AS A SHARE OF TOTAL



Source: Bureau of Economic Analysis

CHART 5: CORPORATE PROFITS - ROW* RECEIPTS & THE DOLLAR

*Rest of world. Source: Federal Reserve, Bureau of Economic Analysis

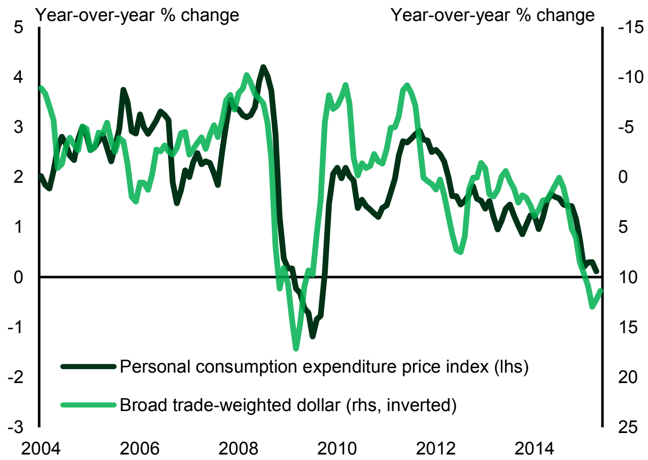
globalization and the rise of American multinationals. It also means an increased vulnerability to American profits when there is a negative shock to global growth or a sudden swing in the dollar that can lower the value of profits earned abroad.

Like exports, foreign profits depend not only on the dollar, but also on the rate of economic growth in the rest of the world. In fact, regression analysis shows that global growth is the more important determinant. Based on our expectation for the dollar and foreign economic growth, we expect profits earned abroad to decline substantially in the first half of the year, but then rebound over the second half along alongside foreign GDP growth. Nonetheless, with the dollar remaining lofty, the rebound is unlikely to be as strong as the declines, and on an annual average basis, we expect profits earned abroad to decline by 10% in 2015. The decline in foreign related profits will reduce total corporate profits by nearly 2.0 percentage points, all else equal.

Domestically-driven profits also face some headwinds, namely a slowdown in productivity growth and rising wages that have led to increases in unit labor costs. However, these are offset in part by reduced import prices, which will weigh on non-labor intermediate costs. As productivity growth rebounds in the second half of the year, the profit outlook is better, but with the drag from the foreign component, total profits are likely to decline modestly this year.

The weak profit outlook will have implications for the broader economy, implying less internal funds available for investment and a reduced wealth effect for consumers. However, these impacts are likely to be relatively modest and, as with other elements of the outlook, must be weighed against the other implications of the higher dollar – namely

CHART 6: CONSUMER PRICES & THE DOLLAR



Source: Federal Reserve, Bureau of Economic Analysis

lower import prices and interest rates. We take this up in our next section.

A strong dollar is a benefit to American consumers

The dollar's rise is not all negative. The pass through of lower import prices reduces inflation and raises consumers' purchasing power. The magnitude of the impact on prices depends on how much of the fall in imports is passed on. Empirical studies of exchange rate pass-through have found less than a one-to-one pass through to import prices and even less pass through to consumer prices. Based on the macro model we employ, the 10% rise in the dollar should lower consumer price inflation by around half a percentage point.

All else constant, this raises real disposable income by the same amount. This is one more reason to expect consumer spending to see more robust growth over the remainder of this year. Real disposable income is supported by both the fall in energy prices and the rise in the dollar. These are the main drivers of our expectation for real consumer spending to rebound to 3.3% over the remainder of the year, propelling the acceleration in economic growth.

Finally, the dollar's rise must also be taken in the context of its global monetary policy drivers. In addition to its exchange rate impact, quantitative easing by the European Central Bank puts downward pressure on U.S. interest rates. What is more, while we don't expect the higher dollar to stall the Federal Reserve from moving rates higher later this year, it will impact the pace at which they tighten. In effect the dollar is doing some of the work for them, allowing them to remain more accommodative and domestic demand to pick up the slack from the external environment.

Bottom line

The strength of the dollar reflects the relative outperformance of the American economy and the very real prospect that its monetary policy will diverge with the main trading partners. However, the magnitude of the rise over the past year has been a headwind to near-term economic growth. This has already showed up in the fourth quarter of last year and the first quarter of this year. Over these two quarters, net-exports subtracted an average of 1.5 percentage points from real GDP growth. Net exports should perform better over the remainder of the year. While the dollar will remain a headwind, stronger global growth will support exports.

The dollar will also present a headwind to corporate profits. We estimate that profits earned abroad will decline around 10% in 2015, subtracting just less than 2.0 percentage points from total profit growth and leading overall profits to see little growth on an annual average basis.

The offset to the higher dollar is the reduction in import prices and interest rates. This should contribute to domestic demand, which will be the main factor driving the acceleration in U.S. economic growth.