Investment Fundamentals

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Currency

- Currency promotes economic activity by providing a medium for the efficient exchange of goods and services.
- Purchasing power varies across currencies, resulting in the need to set currency exchange rates for conversions.
- Exchange rates impact you both in terms of prices paid for foreign goods and on foreign investments.

Currency is a system of money put in place as a medium of exchange for goods and services. A major benefit of currency is that it facilitates commerce by eliminating the need to barter. When hiring a plumber, you may not be thrilled with paying $90 per hour for a house call, but imagine having to barter for that service. You could offer the plumber your services as a writer or your spouse's skills as a photographer; however, the plumber may not need either of those services. Perhaps you will be countered with a request to mow the plumber's yard for the next month. Currency significantly simplifies this transaction. With currency, you are now able to work a job that pays you dollars. You can use those dollars in a multitude of ways—hire a plumber, buy a car, eat at your favorite restaurant or invest in a mutual fund.

However, currency is not that simple. Most countries have their own currency—for example, dollars in the U.S., pounds in the U.K. and yen in Japan. Some countries even agree to form a currency union, such as the eurozone, where Germany, France, Spain, Italy and others all use a single currency. Separate currencies complicate matters. You may wish to travel to London for a vacation and take a taxi from the airport to your hotel. At the end of the ride, the taxi driver may inform you that the fare was £20. Since you are in the U.K., he is expecting to be paid in pounds and will not accept a payment of $20. This is not just because pounds are the standard currency in the U.K., but also because £20 are worth about $32 depending on current exchange rates.

When interpreting Exhibit 1 you should read the table as one currency unit listed in the left hand column will cost the specified total of the currency listed in the top row. For example, £1 costs $1.600. This is what is known as an indirect quote—how many dollars the one unit of the foreign currency costs. This is the typical quotation method for commonwealth currencies from countries such as the U.K., Australia, New Zealand or the euro currency bloc. Other currencies, such as the Japanese yen, are typically quoted using the direct method—how much of the foreign currency is purchased with $1. Note that the indirect and direct quotes are simply the inverse of each other.

Exhibit 1: Select Exchange Rates

	U.S. Dollar (USD)	Euro (EUR)	British Pound (GBP)	Japanese Yen (JPY)
USD	1.000	0.798	0.625	112.105
EUR	1.253	1.000	0.783	140.456
GBP	1.600	1.277	1.000	179.351
JPY	0.009	0.007	0.006	1.000

Source: Bloomberg, as of 10/31/14.

Interest Rates and Inflation Impact Exchange Rates

Exchange rates vary over time. They are influenced by demand for a currency as well as prevailing interest and inflation rates and other factors including international trade, government debt levels and political stability. Higher interest rates tend to increase demand for certain currencies. Conversely, higher rates of inflation tend to decrease demand. Export-oriented countries, China for example, often have in-demand currencies as foreign consumers purchase the exported goods. High levels of government debt are often viewed negatively, as they can potentially cause inflation and may be indicative of a future default on government bonds. Political instability can also undermine a currency's value.

Conclusion: What This Means to You

Currency exchange rates can impact you as both a consumer and investor. A strong domestic currency will increase buying power for consumers by making foreign imports less expensive due to the currency exchange rate. Conversely, a strong domestic currency detracts from investment returns for foreign holdings—when converting your foreign holdings back to dollars you will need more foreign currency per dollar (or in other words you will receive fewer dollars when converting back to your domestic currency). A weak domestic currency will yield the opposite result in each of these scenarios. This concept applies to mutual funds with an international focus as well. Even though a fund is priced in dollars, the underlying investments are often priced in local currencies and, therefore, must be converted to dollars.