How Smart Traders are Playing the Dollar

The U.S. dollar has been on an unstoppable run since the start of the second quarter.

In fact, it just rallied to a five-month high after the U.S. and China called a truce over trade tariffs, prompting investors to cut back on their short positions on the dollar, and on news that an improving U.S. economy could bolster the Federal Reserve's tightening stance.

As a matter of fact, many analysts believe the dollar will continue to rally with the central bank expected to raise interest rates two more times this year, and another three times in 2019.

And while that's great news for dollar bulls, it's not welcomed news for corporate America.

It wasn't long ago that Nike, Costco and FedEx were crediting a weaker dollar for boosting their earnings because it made their products less expensive in foreign markets. Companies can report higher revenue from overseas numbers whey they translate international sales back into dollars.

Unfortunately, a stronger dollar could now toss cold water on those profits.

For example, Apple recently noted that a stronger dollar could hurt its profits.

> "Because about two-thirds of our company is outside the United States, a weak dollar is a positive for our gross margins," said Apple chief financial officer Luca Maestri, as quoted by CNN. "A strong dollar, as it's been during the last four years, has been a bit of a headwind."

Royal Caribbean announced that the dollar's rebound ate into its most recent profits, too.

In short, there's now growing concern that a stronger dollar could derail earnings growth.

But while a stronger dollar can be negative for larger cap stocks, like Apple, a stronger dollar is also forcing investors back into small cap stocks for safety.   We have to consider that small-caps are more levered to the domestic economy than larger companies are.

Small companies are more likely to sell products domestically, insulating them from the loss of competitiveness and currency translation impact of a stronger dollar, as noted by Perritt Capital Management. When the dollar is strong, multi-national corporations lose a competitive advantage, as foreign buyers see U.S. goods as more expensive than non-U.S. goods.

Perritt Capital Management also noted that:

> During periods of dollar increases of 15% or more, Small-Caps, as represented by the Russell 2000 Index, has achieved an annual total return of 13.2% versus 10.3% for the S&P 500, which represents Large-Cap stocks. On the flip side, when the dollar was weak, Small-Cap stocks compounded at 9.5% compared to the S&P 500's return of 11.1%.

So while there are negatives with a strong dollar, there are plenty of positives, especially for small cap stocks that have staged quite a rally in the last few months. There are two ways we can trade the strength of the USD.

One is to buy the Power Shares DB US Dollar Index Bullish (UUP). We can hedge this with a position in the Power Shares DB Dollar Index Bearish (UDN) to be safe, too. Another way is to hedge the iShares Russell 2000 ETF (IWM) with put options, including the IWM July 20, 2018 163 calls and the IWM July 20, 2018 162 puts.

What we'd like to do is profit from both sides of the hedges. We want to capture remaining momentum in small caps, and then potentially make money on the short side, as small caps begin to show signs of exhaustion at the top.