SCS FINANCIAL
Strategic Capital Solutions

INVESTMENT PERSPECTIVES

APRIL 24, 2015

THE STRONG US DOLLAR

BY JEREMY L. RAGUS CFA, MANAGING DIRECTOR, GLOBAL ECONOMIC STRATEGIST

OVERVIEW: The US dollar has seen a rapid rise in its value on a trade weighted basis since the summer of last year. Changes in currency valuations are often difficult to explain, being driven by a variety of factors, the importance of which change over time. Economic theory suggests that a large number of factors influence relative currency valuations. First among these is the theory of short-term interest rate parity among nations. Under this theory, countries with high interest rates should see offsetting currency losses, so that short-term bond returns are equal to those of countries with low short-term rates but which then are likely to see rising currency valuations. However, over the very long-term, differences in levels of inflation may actually tend to dominate currency valuations, as high inflation currencies gradually lose their purchasing power, which leads to depreciation of their currencies.

MAIN POINTS

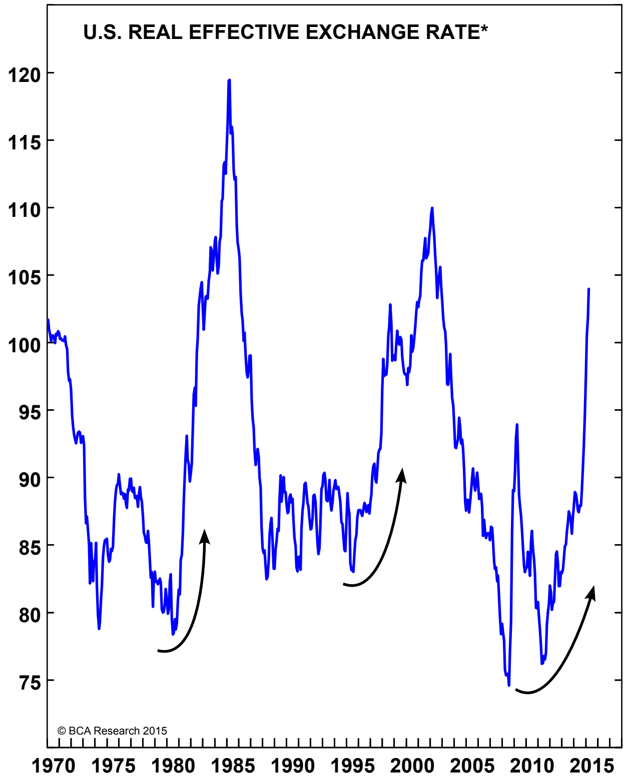
- The US dollar has strengthened owing to the country's stronger economic growth, better investment returns and prospects for higher interest rates when compared to other nations
- A shortage of US dollars as a result of lower oil imports has also contributed to dollar strength
- We may be entering a period of US dollar consolidation followed by more modest gains
- SCS has limited client exposure to non-US currencies where our managers believe opportunities for uncorrelated positive returns exist

The actual currency story, however, is much more complicated than theory predicts. Many other factors operate both independently and in unison to impact a currency's valuation. Among these are higher versus lower levels of productivity and real growth rates. All else being equal, low productivity growth will beget a weaker currency. Also of importance is expected return on capital invested in a country: capital tends to flee from low return countries to those with higher expected returns. Import and export cycles can also impact a currency. Over the past year we've seen dramatic declines in the currencies of countries that export commodities as the demand for these commodities has declined. All else being equal, countries running balance of trade surpluses (*i.e., those selling more goods than they buy*) will tend to have stronger currencies than countries running trade deficits (*as surplus countries sell the foreign currencies they earn, buying larger quantities of their own currencies*). Finally, financial flows are important: countries (*such as Japan*) that have large overseas investment portfolios see a constant flow of dividends and income that is typically converted back into yen, helping keep Japan's currency strong. Japan is a good example of a country whose currency was generally strong, from 1990 to 2011, due to extremely low inflation and merchandise trade surpluses, in spite of weak economic growth and sub-par equity market performance. Low inflation and financial flows trumped weak expected returns.

THE CURRENT RALLY: The problem with explaining the current dollar rally is that it has happened despite higher expected inflation rates in the US than in Europe or Japan as well as higher interest rates. This rally is also unusual because of how rapid it has been (*see chart on next page*) and because it has preceded actual rate increases by the Fed. The last two major dollar rallies came after rate hikes (*early 1980's and mid to late 1990's*), although there were other factors involved in those dollar rallies, including sharply falling US inflation rates in the 1980's and an economic boom in the 1990's. Part of the explanation for today's dollar rally appears to be a combination of factors, including higher expected growth rates, better productivity and higher expected investment returns since 2009 compared to most of our competitors.

However, the recent pace of the dollar's appreciation also appears to be due to the relative differences in policy stances between the Fed and the rest of the developed world's central banks. While the Fed has not yet actually raised rates, it has stopped buying securities, ending its quant easing program – which is effectively a form of tightening. Over the same period the ECB, BOJ and PBOC have adopted easier monetary policy stances. In a world of zero to negative interest rates, these small relative differences may tend to produce larger net impacts on currencies than they would have in the past. It has been this net differential between US and non-US central bank policies that we believe has made the difference in recent relative currency valuations. Continued weakness in major non-US economic blocks suggests that these policy differentials are likely to persist over the next year or two and, while not conclusive, this continuance should be supportive of dollar strength.

The Ascent Has Been Swift, Steep...



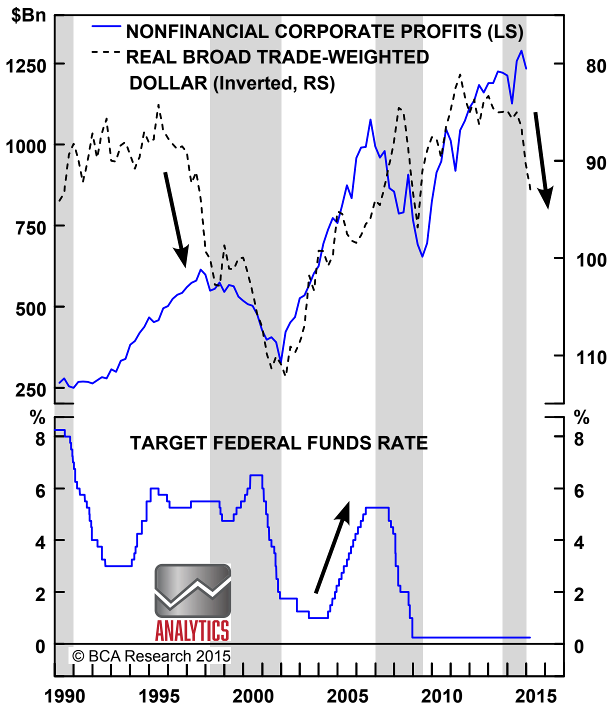
**Source: BCA Research, April 2015*

Finally, one additional factor that appears to be important in the current dollar rally is the relative shortage of dollars available in the world. There is an estimated $9 trillion of outstanding dollar denominated debt issued by non-US sovereign nations and corporations. None of these issuers has the ability to print dollars and, therefore, needs to acquire the dollars in the open markets (*to pay debt service*), either from trade (*exports*) or from market purchases. However, there are fewer dollars in circulation due to reduced US oil imports outright (*because of increased US production*) as well as to a lower dollar value of those imports (*due to falling oil prices*). Fewer dollars in circulation has produced a period of tighter dollar liquidity and has had a number of impacts which include an increased bid for the dollar itself, as well as a relative weakening of the economies of these countries as they are forced to spend resources on buying dollars instead of generating economic growth.

Market Impacts: The currency decision has recently become of particular importance in driving investment returns. This is because stock market gains are resulting from declining local currencies that have a positive impact on corporate earnings, but for foreign investors, these gains may be offset by the declining currency itself, leaving investors only to benefit if they have hedged out the local currency risk[1]. Stated differently, declining currencies often result in corporate profit gains, but these can then be offset by the decline in the currency that helped produce those gains. European stocks fared worst in this game last year because of a sharply falling euro currency, while non-Japan Asian equities did best (*China, India, Taiwan, Thailand, Hong Kong, Philippines, Korea, Indonesia, Malaysia and Singapore*)[2]. The same dynamic has played out in the relative returns of global bond markets, but since the volatility in the currency tends to outweigh the moves in bonds, the exchange rate moves have tended to dominate the returns for global fixed income investments. So, getting the currency right has become of particular importance in driving investment returns. In fact, it is possible that we could be entering a period of declining corporate profits – similar to the period between 1995 when the dollar began a strong bull run and 1998 when profits then began to fall. The BCA chart[3], on the next page, illustrates this point, showing the real trade-weighted dollar (*inverted*) against non-financial corporate profits since 1990.

Impact On Fed: Will current dollar strength prove to be self-limiting? This may occur because the rising dollar is doing a lot of the Fed's work for it, suppressing inflation, and tightening economic conditions by reducing the competitiveness of US exports, which lowers the profitability of US corporations with substantial overseas revenues. Part of the slowdown that we saw at the end of 2014 was the result of net exports shaving an estimated 1% from real GDP in the fourth quarter alone[4]. Slowing export growth and lower corporate profits for multinational companies reduces the risk that the economy will begin to grow above capacity and generate inflationary pressures. The strong dollar also implies that the Fed can wait until the 2nd half of 2015 or even later before first raising rates and that it will be subsequently increasing rates at a slower pace than would otherwise have been the case. In effect, if the dollar continues rising and the Fed raises rates on its current projected path, it is possible that US monetary conditions would effectively become "restrictive" (*because of the effects of such dollar strength*) by early 2016[5], which would be an unusually short period for the Fed to go from an easing/neutral to a tight stance. If this scenario does take place, we would look for the strength of the dollar to begin to abate. This self-limiting feedback loop occurs because the rallying dollar reduces inflation expectations, which reduces the need for tightening, which limits the rise in US rates potentially pushing the dollar lower. Less dollar strength since March suggests that we could be transitioning into this negative feedback cycle.

Profit Contraction Can Be Driven By Dollar Or Rates



Source: BCA Research, March 2015 & Federal Reserve
Note: Shaded for periods of deteriorating corporate health

INVESTMENT CONSEQUENCES:

All of this begs the question – what are the investment consequences at this point in the cycle and how does SCS view our investment allocations relative to client dollar and non-dollar currency exposures? Our view is that the sharp dollar rally we've witnessed, particularly against the yen and euro, will continue, but in a much more modest and choppy fashion, simply due to the self-regulating forces outlined above. A stronger dollar is a headwind for US exports and corporate profits, and will slow down demand for US goods and services and ultimately, dollars. Likewise, weaker euro and yen currencies have created higher demand for European and Japanese goods, helping their GDP prospects, which is a tailwind for stabilization of their currencies. We believe the dollar's strength will abate over the near term and will then stabilize around a band for the next several years, particularly if trade flows continue to be liberalized in Asia and other parts of the world.

SCS generally sets a long-term, strategic target allocation to various asset classes which then impacts client currency exposures. Our goal is to have a majority of assets dollar based, with a relatively small allocation to attractive non-dollar investments and currency exposures. Given that our client base is overwhelmingly US based, dollar investments will predominate. In the fixed income and hedge fund programs, exposures are almost exclusively dollar based with a small allocation to non-dollar international securities. In our global equity program, we do have a more significant allocation to non-US investments that bring with it non-dollar exposure, mostly spread across Japan, Asia and Europe. We view this as appropriate, given many attractive equity investment opportunities in non-dollar based assets. This modest currency diversification should be of benefit, since various currencies are already below their "fair" purchasing power values. This creates higher demand for non-dollar products and helps return currency values to more normal long-term relative values. Understanding the dollar and the reasons for its changing value helps inform our overall investment decision making process and should add to returns.

REFERENCES

[1] *Bridgewater Daily Observations, Getting The Currency Right, April 2, 2015*
[2] *Ibid*
[3] *BCA Research, U.S. Bond Strategy, Weekly Report, The Dollar is Our Currency and Our Problem, March 17, 2015*
[4] *Ibid*
[5] *Ibid*

IMPORTANT DISCLOSURES