July 1, 2015

THE STRONG DOLLAR — FRIEND OR FOE?

> "Central banks are no longer acting like central banks. I think it gets dangerous when they lose sight of the basic function of a central bank…to defend the value of the currency."
> *Former Fed Chairman, Paul Volcker*

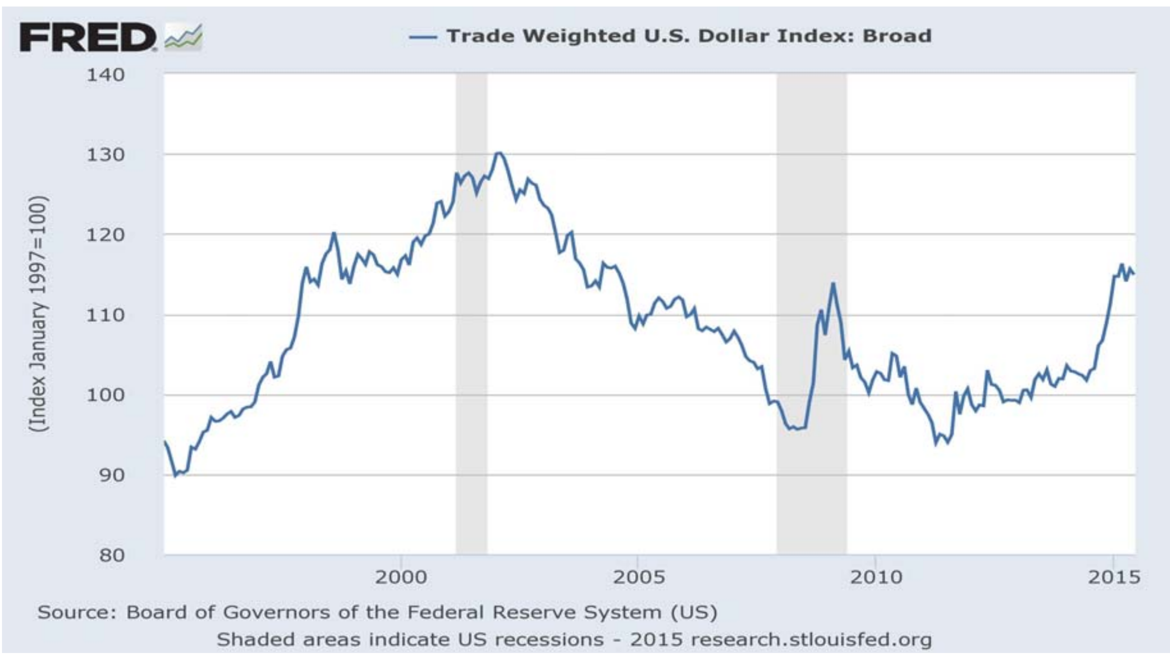
Two years ago we published an Investment Strategy Update titled *Currency War* where we forecasted "… a strengthening of the dollar that would be associated with a very positive environment for U.S. investments." Now that the dollar has, in fact, strengthened, and the stock and bond markets have continued their bull runs, we thought it wise to revisit the issue and assess whether a strong dollar is still a positive for U.S. investors. We believe so, for two key reasons. First, while a strong dollar makes exports more expensive, it makes imports cheaper, an undeniable positive for the U.S. which is an enormous net importer. Second, a currency's strength can be thought of as a scorecard encompassing the collective wisdom of the world's investment community, who send their wealth to markets with the best investment opportunities, and those markets tend to be places like the U.S. with strong and/or strengthening currencies.

Then and Now — Fundamentals of a Strong Dollar

The reasons for our optimistic stance when we wrote *Currency War* traced back to the U.S. policy response to the financial crisis of 2008. Along with the initial fiscal stimulus package and recapitalization of the banking sector, there was an aggressively accommodative monetary policy that consisted of near-zero interest rates and massive Federal Reserve balance sheet expansion: "quantitative easing" or "QE" for short. The result of this policy was that the U.S. experienced a more rapid correction of economic imbalances than was seen in other advanced economies. In turn, we thought this would allow the Fed to begin tightening monetary policy at a time when most other central banks would still be accommodating. We believed that as the U.S. economy continued to strengthen, and interest rate differentials between the U.S. and elsewhere widened further, the dollar would continue to strengthen.

As it turned out, the dollar's ascent was fairly limited between early 2011 and mid-2014, rising only 8% based on the broad based, trade-weighted U.S. dollar index. This muted rise was primarily due to sluggish U.S. economic growth that fell below expectations, causing the Fed to maintain near-zero interest rates and continue significant quantitative easing for longer than we had originally expected. However, beginning in the second quarter of 2014, several factors combined to provide the basis for the current upturn in the dollar. There was an acceleration in the strengthening of the U.S. economy, along with a signal from the Fed that interest rates would almost certainly begin to increase in 2015. During the same period, the European Central Bank began embarking on its own QE program, and the Bank of Japan significantly upped the ante on its quantitative easing program in an effort to break that country's two-decade deflationary mindset.

The result was that by March 2015, the dollar increased in value 25% versus the euro, 20% versus the yen, 15% versus the British pound, and 15% when measured against a broad basket of currencies. This percentage rise has only been matched three times in the past 30 years: in the early-to-mid 1980s when interest rates reached historically high levels, in 1997 due to the abandonment of fixed currencies in Asia, and during the financial crisis of 2008 when funds flowed to the U.S. in a general "flight to quality." The dollar's rise in recent years has been fairly broad-based, however it has been especially strong versus the currencies of countries aggressively engaged in QE programs (Europe and Japan) as well as against the currencies of commodity export-driven economies.



Economic Impact

Gross Domestic Product (GDP) is simply the sum of consumption, investment, government spending, and net exports. A strengthening dollar tends to reduce GDP growth by depressing the net export of goods and services. Foreign buyers are negatively impacted by an effective price increase when purchasing U.S. goods, while domestic consumers enjoy the benefits of cheaper foreign goods which results in stronger import demand. Given the U.S. has long been a net importer, with exports representing only 13.5% of U.S. GDP (a much smaller percentage than many other countries), the impact of a stronger dollar to the overall economy is not that great. Federal Reserve Board projections suggest that a 15% rise in the trade-weighted dollar will cause GDP to decrease approximately 0.5% in the first year following the dollar's rise and 0.8% in the second year.

A stronger dollar also limits U.S. inflation since domestic producers are forced to hold the line on pricing in the face of flat or declining import prices. Here again, this impact tends to be fairly small, knocking perhaps one or two tenths of a percent off the CPI, based on the Fed's model. This modest effect derives from the relatively small contribution of goods as compared to services in the calculation of CPI (25% and 75%, respectively). Since the expectation for the U.S. unemployment rate is for continual improvement over the next several years, we expect rising services prices will offset the positive impact on inflation from the strengthening dollar.

In recent months, the upward march of the dollar against certain currencies has leveled off and in some cases actually given back some of its gains. This flattening is likely in reaction to the weak first quarter U.S. GDP report, and more importantly the Fed's decision to postpone its initial rate hike until later this year, along with the growing expectation that once rate hikes do commence they will proceed at a slower pace than in past tightening cycles.

Our bottom line is that growth in the U.S. economy should continue to ramp up after a first quarter that was artificially weakened by dreadful weather and a dockworkers' slowdown, and as businesses and consumers reap the benefits of the drop in energy prices. Also, with less pressure on the Fed to tighten aggressively, housing-related spending should pick up. Finally, to the extent dollar strength does dampen inflation, it effectively boosts real wages and thus promotes consumer demand, which is by far the largest component of GDP. In other words, what the U.S. may lose in terms of net exports may be more than made up for by the other larger components of the economy.

Investment Implications

Historically, a stronger dollar has increased foreign money flows into U.S. investments, for the simple reason that such flows are seeking to benefit from what is causing the stronger dollar: to wit, more robust growth and/or higher yields. Foreign investors also get the benefit of the "currency kicker" if the dollar continues to appreciate versus their weaker home currencies.

Price-to-earnings multiples have historically been positively correlated with dollar strength. While a higher dollar can be negative for U.S. corporate earnings, the impact has typically been offset by commensurate P/E multiple expansions, suggesting that most investors tend to "look through" any adverse foreign currency impact on the theory that quality companies will be able to adjust and manage to grow earnings going forward. In other words, since the strengthening currency is a sign of better growth prospects in the economy generally, investors decide that growth trumps currency effects.

According to Deutsche Bank research, a 15% rise in the dollar versus major currencies, which we have experienced since last summer, should subtract 3 ½ % to 4 ½ % from S&P earnings, or roughly a $4-5 reduction in earnings from the consensus estimate of $120 for 2015. Their expectations see 2015 "foreign exchange headwinds" by sector as: 5% for technology, 4-5% for industrials, 4% for consumer staples and materials, 3 ½ % for health care, and 3% for consumer discretionary. The energy sector has a very low direct foreign exchange sensitivity, since most oil is priced in dollars, and therefore earnings remain mostly sensitive to commodity price changes.

Turning to the bond market, record spreads between U.S. Treasury notes and German bunds are driving capital out of the eurozone and into the U.S., which is bullish for the bond market and has contributed to talk of “bond scarcity” in certain fixed-income sectors. One of the more unusual aspects of recent central bank monetary policy has been the occurrence of negative interest rates in several parts of Europe. The European Central Bank got the ball rolling last June when it began paying -0.1% on deposits, which was lowered to -0.2% in September. Denmark, Switzerland, and Sweden have since seen negative interest rates as well. Investors would only be willing to pay a bank to hold their money if they thought the currency of that deposit would appreciate more than the negative interest rate. In our opinion, this just makes U.S. returns look even more attractive, which should continue to draw capital into U.S. investments.

Market Outlook

The stock market was little changed this quarter – primarily a function of lackluster earnings growth and global economic headwinds. However, the U.S economy seems to have regained its footing following a modest contraction in the first quarter. New and existing home sales are tracking higher while auto sales remain robust. Consumer confidence and spending are picking up, driven by steady employment growth and modest wage gains. We believe corporate earnings and therefore share prices can continue their trend higher, despite somewhat elevated valuations and probable interest rate increases. However, we would not be surprised to experience a correction along the way.

At its recent meeting, the Federal Reserve reiterated their guidance for a rate hike later in 2015 – the first such increase in nine years. While inflation remains benign and any rate hikes will be modest, we believe bond returns will lag behind equities.

As we go to press, Greece has once again entered the news, temporarily closing their banks and stock market, and putting to a public referendum the latest offer to restructure its debt. What happens to Greece, and the EU for that matter, could certainly jolt our markets in the short term. However, we doubt these events will have a lasting effect on the global economy. And in the end, our stock market progress will be a reflection of U.S. companies’ ability to continue to grow their earnings.