MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

# US Dollar Strength is a Mixed Bag for Investors

In our last issue of *Consilium*, we noted the sharp rise in the US dollar (up 23% on a trade-weighted basis) against most other foreign currencies in the last year. As real (i.e., inflation-adjusted) interest rate differentials between countries explain most currency movements, this is not a terribly surprising outcome. When real interest rates are higher in the US than in the Euro area, for example – and they are – then funds will tend to flow into dollar-denominated investments, and rising demand will drive up the "price" of the dollar in foreign exchange markets. This process can continue as long as the US offers global investors an opportunity to earn a higher real rate of return.

Most US investors shake their heads in disbelief at the low level of interest rates in their home country. More than six years of extreme monetary stimulus against a backdrop of persistently low inflation and generally sluggish economic growth has produced the lowest rates in at least 65 years – beyond the experience of nearly every active market participant today[1]. And yet, the yield on the 10-year US Treasury note (1.92%) remains well above the comparable yields offered by most of our major trading partners:

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| Japan | 0.33% | Germany | 0.14% | UK | 1.57% |
| Canada | 1.26% | France | 0.46% | Netherlands | 0.25% |

Even more remarkably, the yield differential offered by US Treasuries has actually *widened* in the last year, suggesting that the dollar may be even more attractive to overseas investors today than it was last spring when it was more than 20% lower.

These interest rate differentials are the result of diverging economic conditions – the US has begun to grow more rapidly and predictably in the last year, as we have discussed on several occasions, while Europe and Japan remain mired in slumps. The US economy is now strong enough that the Federal Reserve has been able to end its bond-buying program, removing a source of downward pressure on interest rates. But central banks in Japan and Europe are doing the opposite, aggressively expanding quantitative easing and creating something of a bond "shortage" that has pushed yields below zero in several countries. If the Bank of Japan and the European Central Bank follow the same path that the Fed did from 2009-2014, their bond-buying programs could last for some time.

The resulting stronger dollar undoubtedly pleases Americans planning their European summer vacations, but it can be very disruptive to US-based businesses. Among other effects, foreign profits are worth less when translated back into dollars, and corporate profits – surely the brightest spot in the US economy over the last five years – face a significant headwind in 2015 as a result. Second, foreign cash balances and investments held by US corporations decline in value. This is no small matter, as a substantial portion of American companies' cash positions are held overseas. But company managements have been living with and adapting to these issues for decades; in some years the dollar rises, in other years it falls. Within reason, a degree of unpredictability is par for the course.

[1]For a timely discussion of why rates are so low, see former Federal Reserve Chairman Ben Bernanke's recent blog post: http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/30-why-interest-rates-so-low?wpmm=1&wpisrc=nl_wonk

Sources: Federal Reserve Board, Bloomberg, Wall Street Journal, Baseline

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Dollar strength also jumbles the Fed's decision-making. All else being equal, a strong dollar reduces the prices of imported goods, putting downward pressure on inflation; and it reduces demand for US exports, cutting into economic growth. While the Fed is counting on a stronger economy, the dollar now has the potential to limit its preferred course of action on interest rates. But again – dollar fluctuations, *within reason*, are always a factor in the performance of our economy and, in turn, Fed policy. This is nothing new.

What is different about the current dollar run-up is not only its suddenness – this has been the second-fastest six-month jump in 40 years – but also its potential to last longer and extend further than many market participants expect. If the Fed does indeed begin to raise short-term interest rates this year, and the Japanese and European economies remain sluggish, then the dollar could embark on another significant leg higher; after all, the dollar's previous peak against the euro (set in 2001) is still 26% above current levels. After many years of hard work to make American manufacturers competitive globally, company managements might again be faced with the prospect of having to cut prices and accept reduced profits, or lose market share, or shift operations overseas. The business outlook for globally-exposed US companies, which make up a large share of the S&P 500, could be significantly disrupted.

Finally, there are almost always significant unintended or unanticipated consequences from a large, sudden change in the dollar's value. Any country that "pegs" its currency to the dollar (including China and much of Latin America, the Caribbean, and the Middle East) will similarly find its exports to be less competitive and tourists staying away, and its government debt will be more costly to service. And any dollar-based investor or institution placing large, leveraged bets overseas could experience substantial losses and be forced to liquidate holdings. The Asian financial crisis of 1997, which led directly to the collapse of the Russian ruble and default of 1998, and in turn to a period of extreme volatility on all world stock markets, ultimately was the result of a dollar surge for which no one had planned. Market participants had spent the decade leading up to the crisis acclimating themselves to and counting on a weak dollar – an eerily similar pattern to what we experienced until a bit more than a year ago[2].

While it is certainly true that there is almost no lasting correlation between the direction of the dollar and the US equity market, over shorter periods of time a large, sudden rally can just as certainly complicate matters for investors. We will remain mindful of these risks – and potentially positive developments – as 2015 unfolds.

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The US equity market continued its remarkable run of positive returns in early 2015, with the S&P 500 Index rising for the ninth consecutive quarter and generating a 0.9% gain. This is the longest such string of positive quarterly returns since 1998. Other stock market indices were stronger, with the Nasdaq Composite rising 3.8% and the Russell 2000 small-stock index rising 4.0%. Stocks continue to benefit from rising valuations and falling interest rates, as earnings growth has slowed sharply, and profits are likely to remain under some pressure from the aforementioned strong dollar and falling oil prices in the near term. We have noted on several occasions that above-average stock market returns from current valuation levels likely require above-average earnings growth; we do not expect the valuation stimulus from low interest rates to last forever. Therefore, the extent and duration of any earnings slowdown will be critical in developing market expectations for the next year.

[2]A deep look into the Asian financial crisis can be found at http://www.wright.edu/~tdung/asiancrisis-hill.htm, and a useful timeline of events from that period can be found at http://www.pbs.org/wgbh/pages/frontline/shows/crash/etc/cron.html


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