

FX Matters

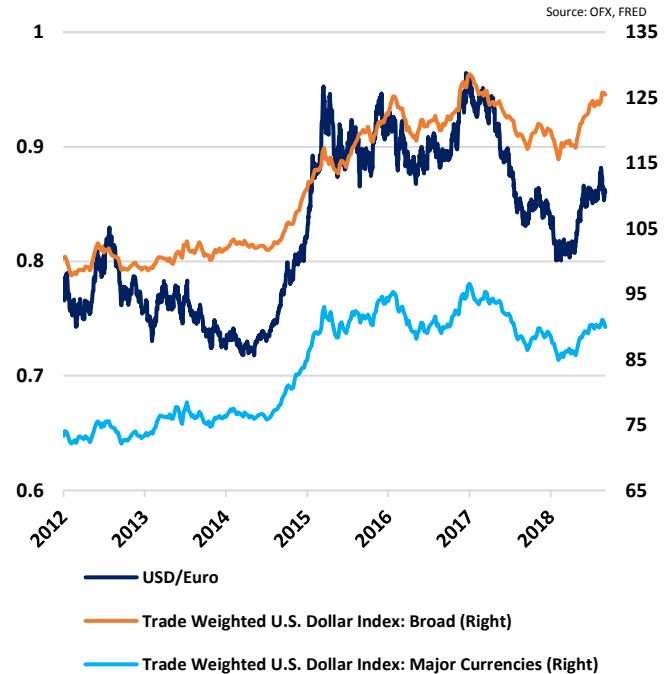
Market Viewpoint: September 28, 2018

The US dollar's strength this year has mattered greatly to capital markets and the world economy, notwithstanding its recent pause. The gains have been impressive: after declining more than 10% over the prior 13 months, the Buck has appreciated from its January 2018 low point by about 6% in terms of both the Fed's trade-weighted MAJOR currency index and the widely followed dollar euro pair; moreover, it has gained roughly 9% on a BROAD trade-weighted basis.

In spite of those moves, the MAJOR currency index and the Euro remain below their early 2015 highs, and even further below the dollar's post-election surge in late 2016. In other words, over the past three years the dollar, by these measures, has basically gone sideways. The BROAD dollar index has been stronger, but still is below its post-election surge as well. Nonetheless, its ups and downs have had significant repercussions. The earnings of global companies, the trend of interest rates, commodity prices, and many nations' economies – emerging markets in particular – have all been impacted.

DOLLAR GYRATIONS

USD/Euro Exchange Rate vs US Dollar Indices
Jan 2012- Sep 2018



INSTABILITY DRIVING FOREX FRAGILITY

	Δ% since each event
Argentine Peso (ARS)/USD Since Argentina Sought IMF Assistance (May 8, 2018)	- 81.4%
British Pound Sterling (GBP)/USD Since Brexit Vote to leave EU (Jun 24, 2016)	- 13.7%
Russian Ruble (RUB)/USD Since New US Sanctions Announced (April 5, 2018)	- 13.5%
Turkish Lira (TRY)/USD Since Steel Tariffs Doubled (Aug 9, 2018)	- 10.5%
Chinese Yuan (CNY)/USD Since US Tariffs Announced (May 30, 2018)	- 7.4%
Euro/USD since Dollar Began Regaining Strength in April (Apr 17, 2018)	- 6.6%
USD BROAD Currencies Index Since 2018 Trough (Jan 31, 2018)	+ 8.9%
USD MAJOR Currencies Index Since 2018 Trough (Jan 31, 2018)	+ 5.4%

This issue of MRP's Viewpoint first examines the forces driving the dollar's fluctuations, then looks at where the buck might go next and offers some thoughts on what it could mean for the capital markets.

To a certain extent, the dollar's 2018 strength was not reflecting the many favorable things happening in the U.S. economy, i.e. GDP growth over 4%, record-low unemployment, and a stock market at all-time highs. Indeed, much of the strength was just a mirror reflection of idiosyncratic risks in a number of emerging markets, as well as the U.K., resulting in a dramatic weakening of those currencies.



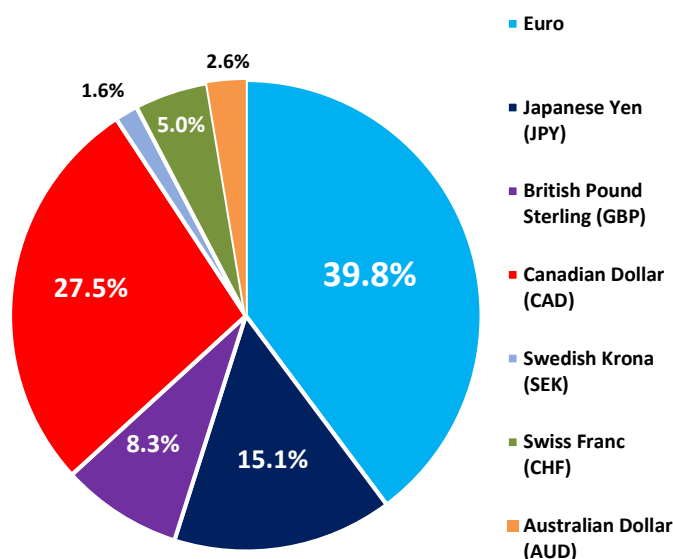
Joseph J. McAlinden, CFA, is the founder of [McAlinden Research Partners](#) (MRP) and its parent company, Catalpa Capital Advisors. He has 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10 year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than \$400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research.

This point is elucidated in the divergence between the BROAD index which has jumped 3.0% just since May, versus a gain of less than a percent in the MAJOR index over the same period. These international issues have pushed demand not only into the dollar, but into US Treasuries as well, helping to hold down the yields on government debt.

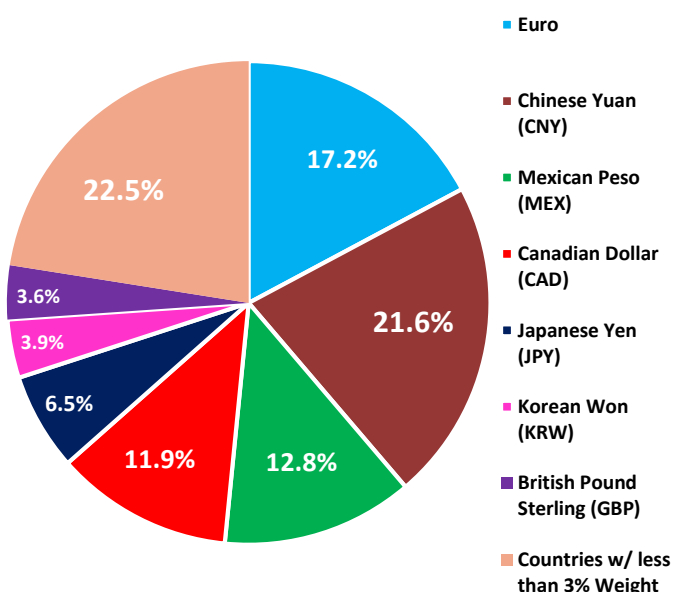
For instance, ongoing global trade disputes have hit China hard. The Trump administration's sanctions have pushed the exchange rate for the Chinese Yuan to US Dollars toward a rate of 7 Yuan to 1 USD; a level that strategists say is technically and psychologically important in the market and not seen since 2008.

Dollar Index Breakdowns

USD MAJOR Currencies Index Composition



USD BROAD Currencies Index Composition



Source: FederalReserve.gov

Meanwhile, financial turmoil, exacerbated by recently doubled US tariffs on Turkey's steel industry, have sent the Turkish Lira tumbling about 60% on the year. Other emerging markets and European countries with exposure to Turkish assets have also begun to lose ground due to contagion fears. Similarly, the ruble has weakened toward its lowest level in more than two years as traders priced in the risk of more U.S. sanctions and foreign currency purchases by the Russian central bank. Argentina's rapid inflation explosion has pushed their Peso down more than 80% against the greenback, just since May.

Additionally, the approach of the UK's exit from the EU and a lack of certainty about the probability of a hard or soft Brexit, as well as the economic implications that will follow, pushed the British pound to an 11-month low in early August. Sterling accounts for about 8% of the MAJOR index and 4% of the BROAD index.

A recent CNBC review of 143 global currencies showed that, so far this year, more than 80% have fallen in value.

Exchange rates typically fluctuate for many different reasons. Economists and journalists often cite current account deficits and surpluses, comparative GDP growth rates, and government deficits and surpluses... all of which do have a bearing on FX rates eventually.

Over the very long run, exchange rates are primarily determined by the relative changes in the cost of living between countries. That is what economists call Purchasing Power Parity (PPP); it is the central tendency to which exchange rates eventually mean-revert. In the case of the Euro, for example, a simple PPP would suggest an eventual rise to nearly \$1.50 USD per Euro.

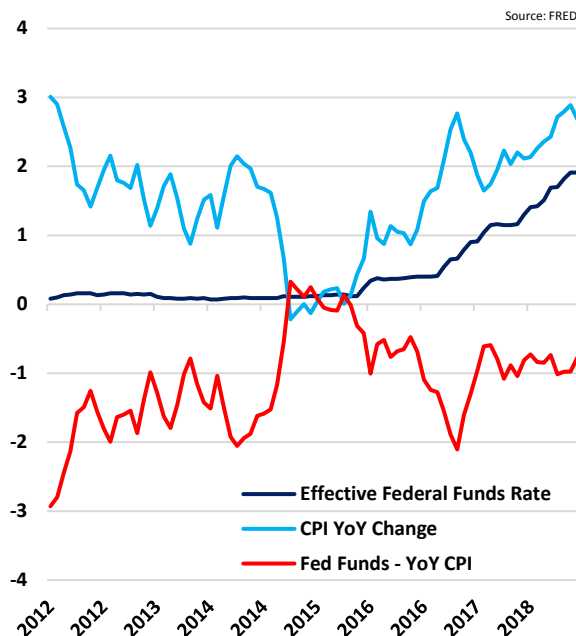
But in the short-to-intermediate term, FX fluctuations are all about the returns on the money ... or rather, where people park their money to protect it and earn some level of return. Trillions of dollars are traded every day as corporate treasurers, governments, hedge fund managers, and various other players move money around the globe.

The most obvious determinant of where the money goes is short-term interest rates and their differences from other currency regimes. Other things equal, it makes more sense to keep cash in a currency that has a higher rate of interest. Still, there is another key consideration: inflation-adjusted or “real rates”. However enticing a short-term yield may be, it doesn’t buy much if the purchasing power of the currency diminishes by more than the interest earned; or it can buy even more if purchasing power improves. This point is often forgotten in much of the FX narrative we see in the media every day. When overnight bank rates are adjusted for inflation, the swing in “real” rates is sometimes even more pronounced. International money flows usually chase “real” yield, however small the differentials may sometimes be.

Three years ago, at the beginning of the current U.S. rate hike cycle, higher rates were cited most commonly as the reason the dollar would rise further. But as it turned out, rates got hiked, [and the dollar stopped going up](#); it then had some wild fluctuations including a short-lived surge following the surprise Trump election victory. But to this day, the Dollar/Euro and the MAJOR index have wound up below their Nov. 30, 2015 highs. The Fed raised short-term rates, but U.S. inflation rose faster so that “real” rates fell.

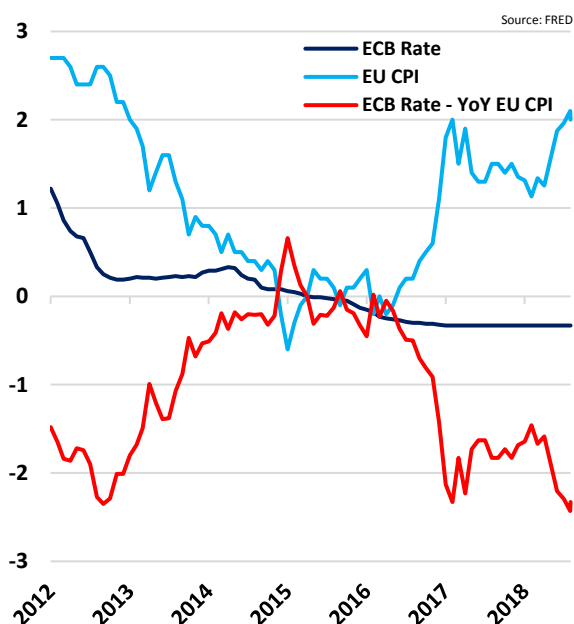
US Real Rate (Fed Funds - CPI YoY Δ%)

Jan 2012 - Aug 2018



EU Real rate (ECB Rate - EU CPI YoY Δ%)

Jan 2012 - Aug 2018



In this report we focus on the euro/dollar exchange rate, although similar outcomes can be seen for other major currencies. The Euro accounts for about 40% of the Fed’s MAJOR Currencies Index. Over the past three years, US short term interest-rates have risen 200 basis points because of the Fed’s eight rate hikes since 2015. The European Central Bank, on the other hand, has kept short term rates unchanged at around zero. Thus, the widening difference in nominal rates would argue for considerable strength in the dollar to the euro. But even though the Fed Funds Rate has risen, the U.S. headline inflation has soared from below zero to 2.7% over that same period, pushing the real short-term rate down around a full percentage point. Before year end, the Fed is expected to raise rates another 25bps, but if the inflation rate continues to rise, [as we believe it will](#), “real” short-term rates will stay negative. Indeed, if the inflation rate rises faster than the Fed Funds, real rates will dip even further into negative territory.

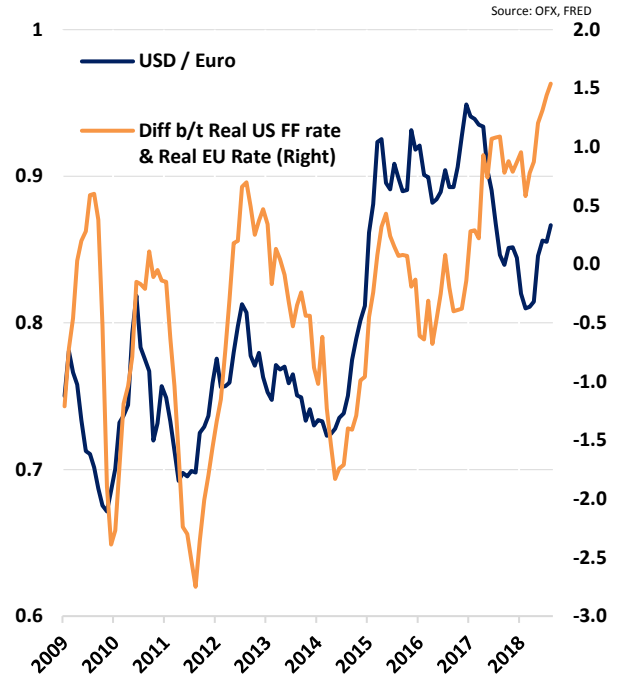
Meanwhile, nominal ECB rates are assumed to remain unchanged until at least 2019. The European Central Bank does expect to continue tapering its €30 billion (\$35 billion) a month bond-buying program, which is planned to conclude by December. Further, while July Eurozone inflation managed to reach 2.1% for the first time since 2013, economists expect Eurozone inflation to fall to an average of only 1.7% for the year. In effect, inflation in Europe should stall around that level, or fall a bit lower, as it did in August, slowing to 2% for the month. The lower the Eurozone inflation rate, the less negative the real ECB rate would be. Notably, core Eurozone inflation has not been as strong, having yet to break above its recent high of 1.2% in April 2017.

MRP expects the dollar's recent strength, relative to the Euro, to continue in the short-term, but begin to reverse course next year in the face of easing Eurozone consumer prices and the oncoming prospect of ECB rate hikes. Prior to the volatility in emerging markets and talk of trade wars, the Euro had seen huge gains against the dollar. MRP believes we will see this resiliency again, but not until next year.

The trend of the dollar has had important implications for both stocks and bonds. The most recent surge in U.S. equity prices to all-time highs has been largely due to exceptionally strong reported earnings. Those record earnings are partly the result of a strong economy and the impact of historic tax cuts being compared with year ago numbers when a tax cut was only a glimmer in Trump's eyes and the economy had not yet begun to accelerate from its long malaise.

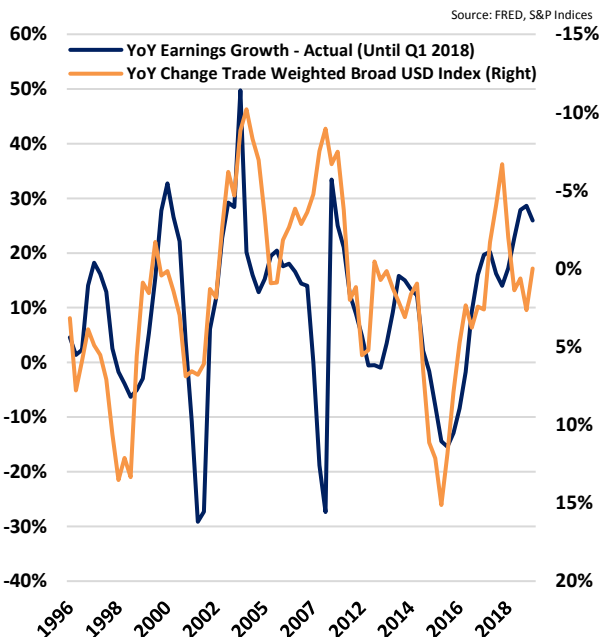
US/EUR vs Real Diff

Jan 2009 - Aug 2018



LOST (+ GAINED) IN TRANSLATION

YoY Change in Earnings Growth vs Inverted YoY Change in USD Index (Outliers Excluded) Q1 1996 - Q1 2019



In addition, a previously weak dollar vs the prior year has boosted those earnings comparisons as a result of the currency translation effect. Essentially, due to other major currencies' weaker exchange rates with the dollar, US companies that did significant business overseas saw inflated earnings growth when other currencies were translated into dollars. It is estimated that companies in the S&P 500 generated 44% of sales from non-U.S. operations in 2017.

Now, going forward, comparisons will be more difficult as the base effect begins to include the strong 2018 numbers and the recent reversal of the dollar's downtrend will soon be subtracting rather than adding to earnings growth. For example, when the dollar appreciated by more than 5% against major trading partners' currencies in the second quarter, HSBC reported that nearly two thirds of 200 finance chiefs in a July survey said their earnings got hit by unprotected exposure to foreign currencies. Bank of America Merrill Lynch has estimated that a sustained 10% appreciation in the dollar against the euro would result in a 3-4% reduction in the S&P 500's EPS.

MRP does not believe that the negative translation effect from the dollar's rise is factored in to consensus earnings expectations! Investors are likely to hear a lot about it in October on earnings conference calls.

Strength in the dollar may continue temporarily, but just temporarily. Just like all other facets of the market, the dollar is subject to fundamentals in the long term and less favorable "real" rate trends should begin weakening the dollar in 2019.

The huge earnings growth experienced in the first and second quarter of 2018 should be tempered by the rising dollar for the next couple of quarters. Eventually, however, it is likely we see earnings figures bolstered again next year if weakness in the dollar emerges - as we expect. A more favorable currency translation environment will help to offset difficult comparisons with super-strong 2018 earnings.

Finally, previous weakness in the dollar, followed by its subsequent rise, made dollar denominated debt look more attractive in the second and third quarter, continuing a suppression of US treasury yields. However, as U.S. inflation continues to accelerate, both the dollar and treasuries will not remain such attractive assets for international investors and the trend will reverse in 2019.

A handwritten signature in black ink that reads "Joe Mac". The signature is written in a cursive, flowing style.

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