New Albany
Investment Management

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Market Insight: Strong Dollar, Turbulent Markets

It has been a choppy market environment so far this year as many economies around the globe continue to struggle with high debt levels, weak growth and deflationary pressures. In the developed countries, such as the EU, Japan, and Switzerland, Central Banks have taken extraordinary measures to prop up growth which has resulted in negative interest rates in some countries, and rapidly declining currencies across the board. Unfortunately, when one currency goes down, another must go up. Put another way, as each central bank allows its currency to decline, growth improves temporarily at the expense of another country's growth. Thus, the action or inaction by the Central Banks becomes a zero sum game. Though some may call this a currency war between Central Banks, it is really a war on deflation.

One of the biggest effects of this currency war is a stronger US dollar. What is the impact of a strong dollar and how does it impact the financial markets? Let's take a look.

Going in Opposite Directions: These days, the only currency that is going up is the U.S. dollar, because the United States is one of the few countries where the Central Bank is moving toward tighter monetary policy. This is indeed good news (for the US) that the economy is actually strong enough to warrant raising rates. Labor and housing markets continue to strengthen. Consumer and business confidence is high and balance sheets are strong. This strength is in stark contrast to the economies in Europe and Asia, and has resulted in conflicting monetary policies and significant turmoil in the financial markets.

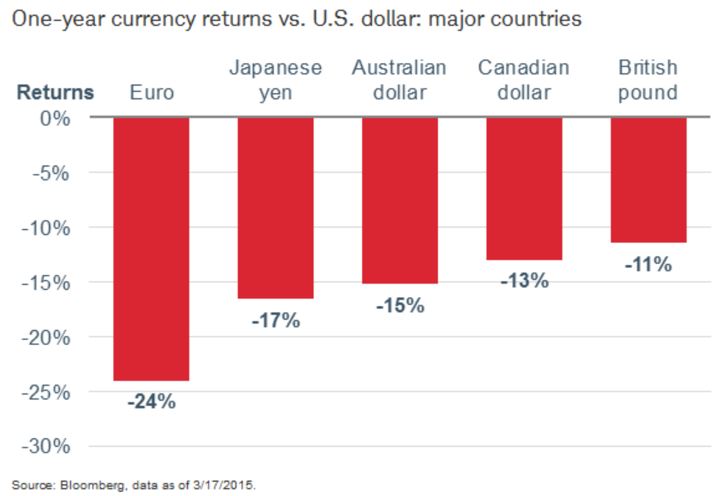
What's good for one part of the global economy is bad for the other. In the case of Europe and Asia, a weakening home currency can have benefits, namely:

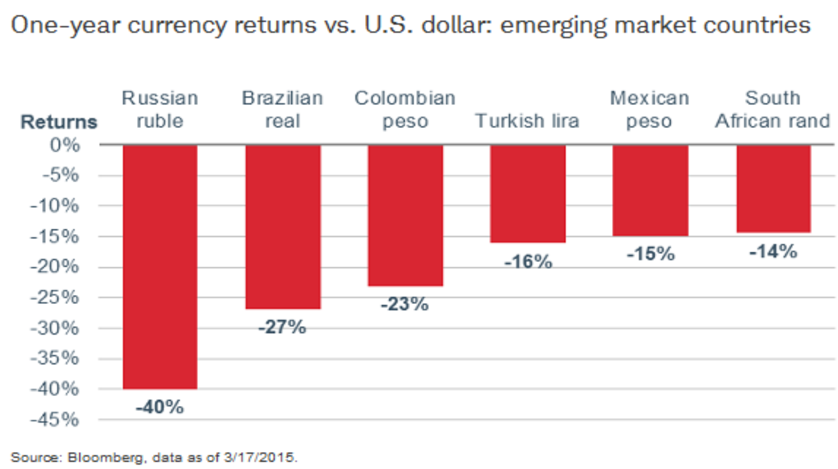
- Boost economic growth by making exports more competitive
- Raise inflation by pushing up the price of imported goods
- Make paying off debt easier

On the flip side, for the US, a strong currency (dollar) has negative impact on exports and lowers corporate earnings. The longer the dollar stays strong, the broader the impact it has on business spending for capital expenditures, employment and ultimately growth. Therefore, shifts in currency valuation effect everyone.

Since last May, the U.S. dollar has risen by more than 18% on a trade-weighted basis against an index of major currencies. It has also advanced quite sharply against many emerging market currencies. To date, the Fed has not "fought back" against the rising dollar with any policy action or statement. But surely they recognize a rising dollar is a headwind to growth and therefore may delay any policy action to raise rates.

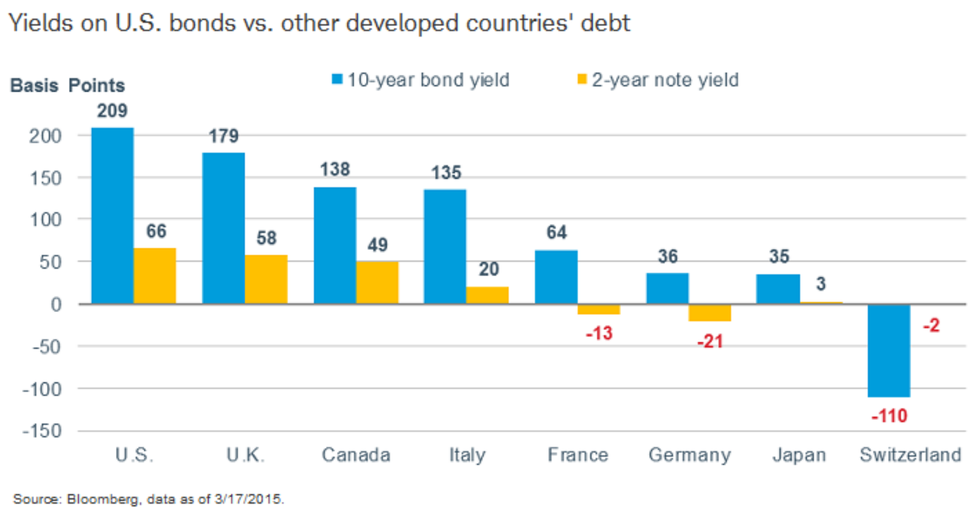
Below are two charts showing the change in value of currencies in “Developed” and ‘Emerging” countries verses the US Dollar. The decline in the local currencies is pervasive but is amplified in countries where growth has stalled or declined.





Negative Interest Rates: This war on weak growth and deflation has also led to negative interest rates. Though there isn't much historical precedent for persistently negative yields, in theory, negative yields should push investors into cash rather than lose money on their investments. However, these are not normal times, and negative yields have spread from very short-term maturities out to longer-term maturities in some European markets. One of the reasons for this is because banks and pension funds are required to hold a certain amount of sovereign bonds for regulatory purposes. These entities may be forced to hold negative-yielding bonds unless those requirements are changed. Whatever the reasoning, low or negative yields abroad make U.S. bond yields look attractive by comparison.

Below is a chart on US Bond rates verse Developed countries.



What to Expect Ahead:

- **More of the same monetary policy**: Expect the forces that have been supporting the dollar's rise to continue over the next year or longer. Given current trends, it's unlikely that the divergence between U.S. monetary policy and the policies of other major central banks will change direction soon.

- **Elevated volatility** across all market sectors is the new normal.

- **Lower yields globally**. The global search for yield should mean that strong foreign demand will keep yields lower than they might otherwise be.

- **Foreign bonds underperform**: A strong dollar means that international bonds are likely to underperform U.S. bonds due to potential currency losses.

- **EM Government Debt**: Although EM countries are less prone to currency crises than in the past because they have reduced their reliance on U.S.-dollar, they have increased their issuance of USD-denominated bonds over the past decade which could raise the potential for defaults down the road.

- **EM Corporate Debt**: As the dollar rises, it could be challenging for some companies to meet debt obligations if their revenues are being generated in a currency other than U.S. dollars. This sort of mismatch in the market is the fuel that creates a currency crises. A higher debt burden makes EM bonds risky.

Investment Strategy: Turbulence in the currency markets will continue to spill over into <u>all</u> sectors of the global markets. At the same time, the US economy continues to growth, albeit slowly. Thus returns should be positive but not spectacular. The portfolios remain well diversified to mitigate volatility and have performed well during the quarter.

As always, please contact me with any questions or concerns.

I hope you enjoy the arrival of Spring and all its splendor!

Kind Regards,

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