LPL RESEARCH

WEEKLY MARKET COMMENTARY

January 26 2015

NO DEFLATING THE U.S. DOLLAR

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KEY TAKEAWAYS

The latest leg up for the U.S. dollar has been driven by anticipation and arrival of QE by the ECB.

The dollar has been strong for a number of reasons, all of them good things.

Though not the end all and be all, currency is an important consideration when determining asset allocation.

Unlike the footballs that the New England Patriots used in the AFC Championship game against the Indianapolis Colts, the U.S. dollar has remained well inflated. The dollar, which has been trending higher for nearly four years now, rose 13% in 2014 and is up another 5% so far in 2015. The latest leg up has been driven by anticipation and arrival of quantitative easing (QE) by the European Central Bank (ECB). Bold stimulus from the ECB, and other central banks around the world including the Bank of Japan, has put substantial downward pressure on the euro, the yen, and other currencies, while boosting the dollar. In general, more supply of a currency drives down its value. In this week's commentary, we discuss some of the causes of the strong U.S. dollar and some of the most important implications for investors.

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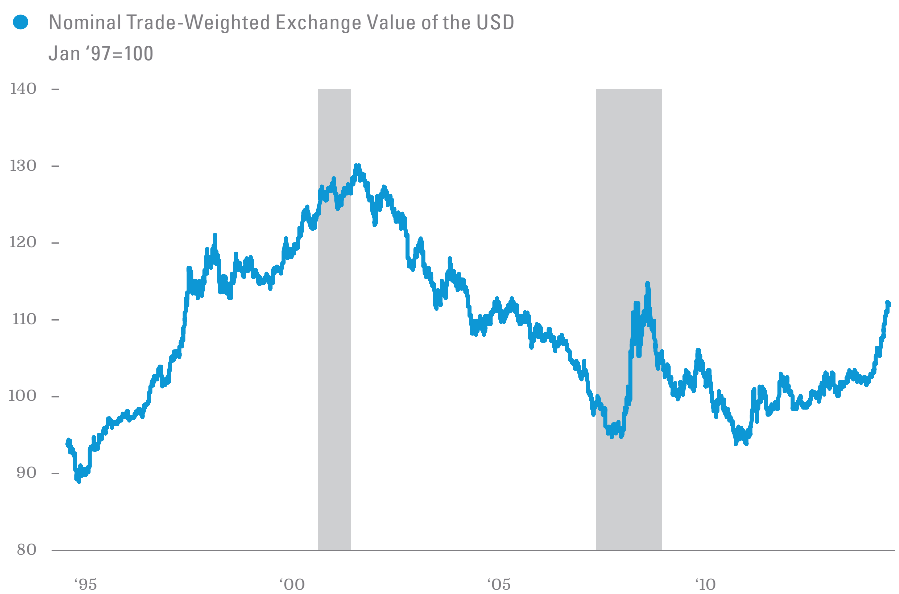
1 LATEST LEG OF U.S. DOLLAR RALLY HAS BEEN DRIVEN BY THE ECB



Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 01/23/15

Shaded areas indicate recession.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

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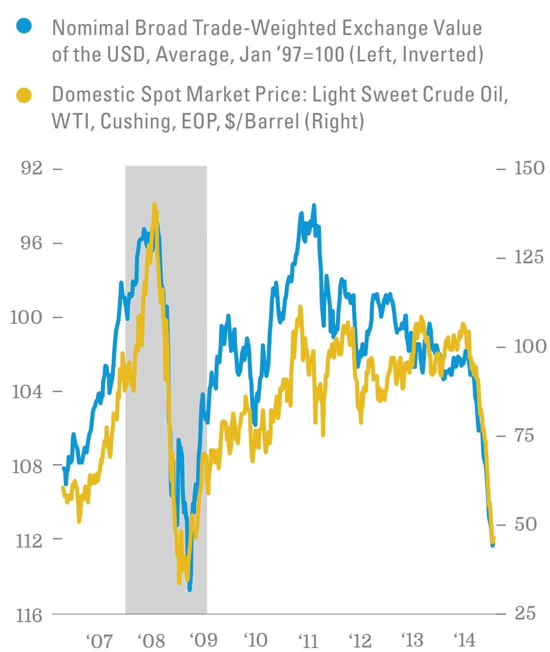
WHY SO STRONG?

The U.S. dollar is strong for a number of reasons, all of them good things.

Relatively strong U.S. economy. Our economy has been outperforming most international economies in recent years—especially the developed economies that are our biggest trading partners in Europe and Japan. A relatively good (even if not great) economy has helped boost U.S. financial markets and made the U.S. a more attractive destination for foreign capital.

Improving trade balance. The U.S. trade balance has improved dramatically, thanks in large part to the boom in U.S. energy production and resulting drop in oil prices that has reduced U.S. imports and increased exports. By keeping more dollars here at home, a smaller trade gap is bullish for the dollar.

2 CRUDE OIL AND THE U.S. DOLLAR (INVERTED SCALE) HAVE BEEN INVERSELY CORRELATED



Source: LPL Financial Research, Federal Reserve Board, U.S. Energy Information Administration, CME Group, Haver Analytics 01/23/15

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Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets, as well as weather, geopolitical events, and regulatory developments.

Improving budget deficit. The measures that the United States has taken— in some cases painfully—to reduce the deficit by cutting spending (remember the sequester) and increasing taxes (remember the fiscal cliff) have reduced the U.S. federal deficit from as high as 11% of gross domestic product (GDP) in 2010 to about 3% as of the end of 2014. By strengthening the U.S. balance sheet, a shrinking budget deficit is bullish for the dollar.

Higher interest rates relative to developed alternatives. The 10-year U.S. Treasury yield, at 1.80% as of January 23, 2014, has been more than cut in half over the past five years. Still, it is much higher than the equivalent yields in Europe, where the German 10-year bund yield stands at 0.36%, and Japan, where the 10-year Japanese government bond (JGB) yields 0.22%. Higher interest rates in the United States have made U.S. bonds more attractive to foreign investors and enhanced the attractiveness of the dollar.

IMPLICATIONS OF A STRONG U.S. DOLLAR

A strong dollar has important investment implications for inflation, commodity prices, earnings, and foreign exporters.

Downward pressure on inflation. The U.S. imports a lot of goods from trading partners overseas, which it pays for with foreign currencies. A stronger U.S. dollar makes those goods cheaper, putting downward pressure on inflation and providing support for consumer spending on imported goods. Less inflation means the Federal Reserve (Fed) can keep interest rates lower for longer, which may help mitigate potential losses in the high-quality bonds this year by slowing the rise in yields while also supporting further gains for U.S. stocks.

Downward pressure on commodity prices. The world generally buys commodities in U.S. dollars, so a strong dollar makes these commodities more expensive. There is no better example right now of the dollar's impact on commodities than oil [Figure 2]. The accompanying chart shows the relationship between oil and the inverse of the U.S. dollar (so think of the U.S. dollar line as foreign currencies). This relationship (dollar up, oil down) has been strikingly close for a while, which has two important implications: 1) U.S. dollar strength may prolong the bottoming process for oil; and 2) lower commodity prices may put even more downward pressure on inflation readings and may keep the Fed on hold until early 2016 (though our base case remains late 2015).

Earnings drag. This implication is especially pertinent with fourth quarter earnings season in full swing. The S&P 500 derives an estimated 35–40% of its profits from overseas, most of it in foreign currencies. When the U.S. dollar strengthens versus those currencies, those profits are translated into fewer U.S. dollars. The euro depreciated by 8% versus the U.S dollar from the fourth quarter of 2013 to the fourth quarter of 2014 (using average quarterly prices), while the yen lost an even larger 14% of its value relative to the dollar during this time. This currency drag will likely cost many U.S.-based multinationals 3–4% of revenue, despite currency hedging, a drag already announced by such big names as Johnson & Johnson, McDonald's, and Oracle. At the same time, the strong dollar has helped lower costs sourced overseas; but currency is still one of the biggest reasons (along with energy and financials) that fourth quarter earnings season is off to a disappointing start.

Foreign exporters get a boost. The weak euro means European exports are on sale for U.S. buyers (same story for Japan and the yen). So while U.S. companies are hurt by higher prices for their goods overseas, European companies should be able to sell more of their goods overseas to buyers with more purchasing power—particularly in the United States. Improved trade terms may give a small boost to the overall European economy.

INVESTING IMPLICATIONS

Though not the end and all be all (like the air pressure in those footballs), currency is an important consideration when determining asset allocation.

Here are some of the investing implications we see from the strong U.S. dollar:

Favor U.S. We continue to favor the U.S. over European and Japanese equity markets despite the headwinds created by the strong dollar and potential boost to exports for those economies. Weak currencies are symptoms of economic growth and deflation challenges that are not easily overcome, and any benefits from weaker currencies are unlikely to be sustained for very long. Consumer discretionary may be well positioned in our view.

Commodities caution. We suggest waiting to add investments in the energy sector until the dollar rally shows signs of taking a pause, given its negative correlation with crude oil. We are watching a number of other factors that suggest a patient approach to the energy sector is prudent, but the strong dollar may prevent oil from staging a sharp turnaround.

Don't avoid bonds entirely. We recommend investors own fewer bonds than their benchmarks and limit duration. But in an environment where several powerful forces are putting downward pressure on inflation—including the strong dollar and low commodity prices—we can take some comfort in our fixed income holdings.

Alternative opportunities. We believe the environment may be favorable for global macro alternative managers to potentially take advantage of currency volatility related to diverging central bank policies.

CONCLUSION

There has been no deflating the U.S. dollar and its strong run may possibly continue. While the strong dollar does create some headwinds for U.S. corporations doing business overseas and worsens the terms of trade for the U.S., the dollar is up for good reasons, and it curbs inflation. Dollar strength is a byproduct of relatively good growth in the U.S., compared with stagnation in Europe and Japan that has led to bold moves by their central banks. So unlike those New England Patriots' footballs, there appears to be plenty of air in the U.S. dollar. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor’s 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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