RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Implications of a peak dollar world

The greenback's day in the sun will eventually pass, so what does that mean for portfolio strategy?

Alan Robinson

For important and required non-U.S. analyst disclosures, see page 7

All values in U.S. dollars and priced as of July 31, 2017, market close, unless otherwise noted.

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Focus article

Implications of a peak dollar world

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The cyclical bull market in the dollar has touched most aspects of global portfolio positioning this decade. We can't call an end to this cycle yet, but we know it's coming, and investors need to think about how this may change their investment decisions.

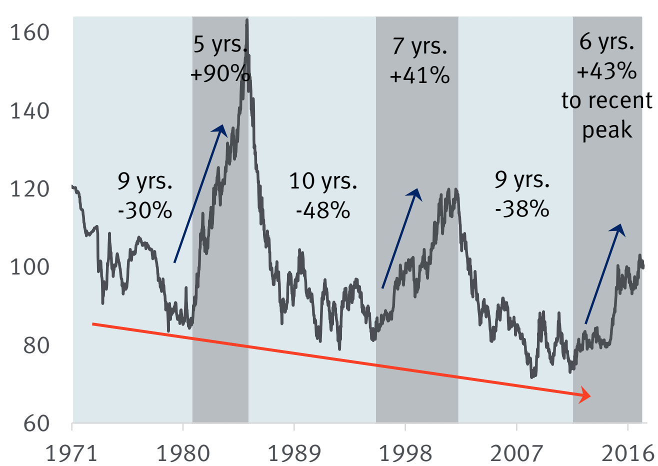
The dollar has been slowly falling in value since the era of free-floating exchange rates began in the 1970s. This declining trend is largely due to the law of large numbers—a huge economy like that of the U.S. can't grow as quickly as smaller, up-and-coming nations, so the U.S.'s share of the global economy has been slowly shrinking as others catch up. This creates incremental demand for foreign currencies, and puts pressure on the dollar.

However this gradual downtrend has been punctuated by three separate multiyear cycles of dollar strength. We believe we're close to the end of this third cycle, which, if confirmed, will require global investors to take a closer look at their portfolios.

What does history tell us?

We believe the current dollar bull cycle started in May 2011 as several broad measures of the currency and sentiment bottomed out at that time. The most recent peak in the dollar in January 2017 marked a 43% move up from the start of the cycle over nearly six years. This compares to the two previous up-cycles of 90% in five years and 41% in seven years, which ended in 1985 and 2002, respectively. We're cautious about reading too much into a small sample size, but the recent bull market seems similar in scale and duration to the previous up-cycles.

U.S. Dollar Index in the era of floating exchange rates



The dollar's latest cyclical rally may be fading.

Source - RBC Wealth Management, Bloomberg; weekly data through 7/20/17

Since the U.S. was the first to start raising rates, the market might think it will be the first to stop too, and this might be enough to cap the dollar's rise.

What causes dollar bulls to lose steam?

There are several explanations for cyclical turning points in the dollar; most relate to factors specific to individual currency pairs, and many are only apparent after the fact. We believe the following will be cited in this dollar cycle's eventual post-mortem.

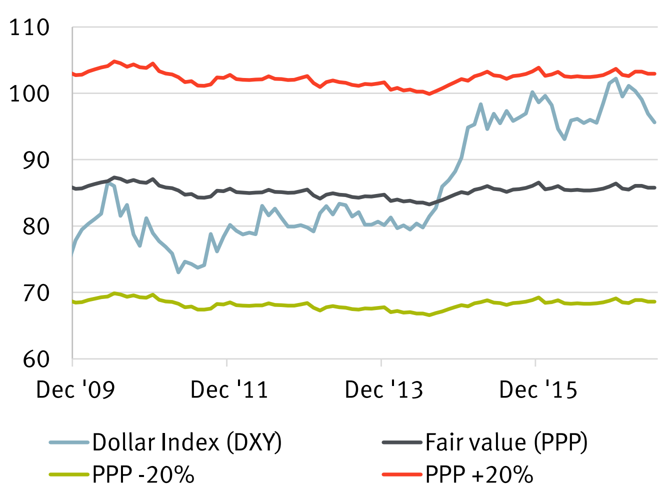
Interest rate dynamics

The U.S. economy led those of its developed nation peers coming out of the global recession, and the U.S. Federal Reserve was the first central bank to consistently raise interest rates from record low levels. Capital flows toward the best, risk-adjusted return. This supported the dollar when all its neighbors' currencies were contending with near-zero interest rates in their home markets. But in recent months a number of other central banks from Europe, Canada, and Australia have hiked rates, or discussed unwinding quantitative easing programs. Since the U.S. was the first to start raising rates, the market might think it will be the first to stop too, and this might be enough to cap the dollar's rise.

Valuation

It's hard to label a nation's currency overvalued just because certain items cost more there. But over the long term, fair-value measures such as purchasing power parity are useful in flagging instances where currencies are at extremes of valuation. In the modern era of globalization, it's unusual for major currencies to trade more than 20% above or below their fair value, and we note that these extremes tend to mark the turning points of dollar cycles. In May 2011, when the dollar rally began, it was 15% below fair value and in January 2017, when it most recently peaked, it was 18% above.

The dollar and its "fair value" bands



Extremes of valuation usually determine turning points in the dollar.

Notes: Purchasing power parity (PPP) measures a currency's fair value using a basket of common goods. The DXY is a weighted average of 6 major currencies. Source - RBC Wealth Management, RBC Capital Markets, Thomson Reuters; data through June 2017

Political uncertainty

It may be a coincidence that the dollar peaked around the time of political transition within the U.S. But the markets crave certainty, and currencies often reflect sentiment toward economic and fiscal policies. Policy paralysis can weaken

The current lack of political consensus and strains within the U.S. may act as a headwind to the dollar.

a currency, and the current lack of political consensus and strains within the U.S. may act as a headwind to the dollar. Key near-term risks include delays to tax reform and to increases in the federal debt ceiling, as well as uncertainty around trade policies.

Importantly, we believe the dollar's reserve currency status is safe for the foreseeable future. There simply isn't an alternative vehicle that enjoys the liquidity and ease of convertibility of U.S. dollar-denominated assets.

Positioning for a peak dollar world

History provides a few pointers toward investment themes that might work in a dollar bear market, some more reliably than others.

Commodities

Products that are priced in dollars tend to be in more demand during a dollar bear cycle. On the surface, it would seem that the currency used for a transaction should have little bearing on aggregate demand for that product, but in the real world oil and hard industrial commodities enjoy a demand tailwind when the dollar is weak as those commodities appear cheaper to buyers outside of the U.S.

These tailwinds are most pronounced when industrial commodities are already in a bull market, as was the case during the last dollar bear cycle. Most commodities peaked by 2011–12 and have been under pressure since, but a weakening dollar may give commodity prices a boost over the next few years.

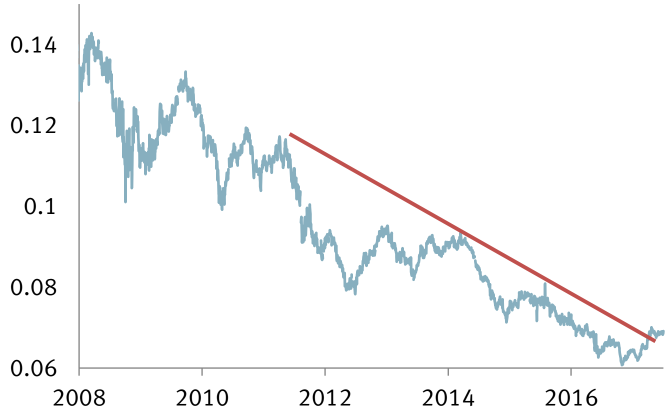
International stocks

Similarly, equity markets outside of the U.S. tend to do well when the dollar is weak. In contrast to commodities, international stocks currently appear to be at the start of their own bull cycle, and we believe a weakening dollar will add to their outperformance.

On a global basis, money has scaled out of U.S. stocks this year and into international stocks. We believe this has been primarily driven by cheaper valuations and faster earnings growth outside of the U.S. as the global recovery finally picked up steam. But the pause in the dollar bull this year probably played its part too.

Relative performance of European stocks to U.S. stocks

Ratio of MSCI Europe Index to S&P 500 Index



Will a weaker dollar add fuel to the recent bounce in international markets?

Source - RBC Wealth Management, Bloomberg; data through 7/27/17

In this weakening dollar environment, a U.S.-based investor with foreign holdings has captured the outperformance of overseas markets along with the benefit of stronger overseas currencies when their returns are translated back into dollars. For this reason, at this stage we tend to favor foreign equity vehicles in which the currency exposure is unhedged for long-term U.S.-based investors.

U.S. equity sectors

The picture is a little less clear for U.S. stocks in a dollar bear market. Large caps and particularly multinational companies tend to perform relatively well as they have a higher proportion of profits generated from outside the U.S., most of which are denominated in appreciating foreign currencies.

We analyzed the five-year returns of each U.S. sector from the start of the most recent dollar bear and bull cycles, and the results of this admittedly small sample are mixed. We believe this is because the longer-term investment cycles of equities, coupled with rapid technological and business changes this century, tend to outweigh the effect of the dollar cycle.

We note that Energy and Materials companies tend to outperform when the dollar is weak.

However, we note that Energy and Materials companies tend to outperform when the dollar is weak, as one would expect, due to the currency tailwind enjoyed by commodities generally. These sectors also perform poorly in a dollar bull market, which suggests a consistent theme.

Outside of these two sectors it's been a mixed bag, although Health Care and Technology returns correlated positively with the dollar. However, most Tech companies have developed relatively high overseas revenue streams so the pattern of Tech sector weakness may not hold in the next cycle. Furthermore, Tech was working its way out of a post-bubble phase during the last dollar bear, a difficult and unique period for the sector that had little to do with the currency.

U.S. sector performance during the first five years of the last dollar bear and bull markets

Dollar bear market January 2002 to January 2007 (S&P 500: 4.9%)	Winners	Energy 16.6%	Materials 10.8%	Financials 7.4%
	Losers	Technology 0.2%	Telecom 0.7%	Health Care 1.0%
Dollar bull market May 2011 to May 2016 (S&P 500: 9.3%)	Losers	Energy -2.7%	Materials 3.5%	Telecom 4.1%
	Winners	Health Care 14.6%	Discretionary 14.5%	Technology 11.7%

Source - RBC Wealth Management, Thomson Reuters, FactSet; returns are compound average price returns, annualized; data through 7/20/17

Endgame approaching

We can't say that the dollar bull cycle is over yet, and the rally that started in 2011 may still have several quarters to run. RBC Capital Markets analysts currently project a dollar peak in March 2018, while consensus forecasts imply we've already seen the high-water mark. We won't know for sure until after the fact, but if history is a guide we're probably close to the end of the dollar bull cycle. We think it's worth considering how to position portfolios in anticipation of a sea change in the dollar.

Research resources

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