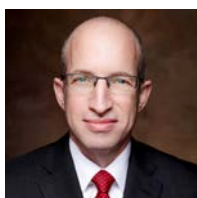




THE ANGLE

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Fresh perspectives on the market outlook.



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US DOLLAR: A NEW TREND THAT COULD SHAKE THE WORLD?

KEY POINTS

- The dollar changed direction in April. The big question now is whether this is the beginning of a new trend.
- A strong dollar has wide implications for financial markets and investors, particularly those with overseas assets.
- Dollar strength could, among other things, have an impact on emerging markets, commodity prices and US corporate earnings.

A fundamental shift in financial markets may have started in the middle of April. After the US dollar lost about 10% in 2017 against a basket of major world currencies, it moved roughly sideways in the first quarter of 2018. It then rallied over 4.0% from the end of March¹. Could this be the beginning of a new trend?

CURRENCY FORCES

Back in 2017 there were several good reasons for the dollar to rise. The American economy was growing faster than those of the EU, the UK and Japan. The US Federal Reserve (Fed) was raising rates, while central banks in the EU and Japan were on hold and the Bank of England only raised rates once in November 2017. This opened up a positive interest rate differential in favour of the dollar. Nonetheless, the dollar kept falling.

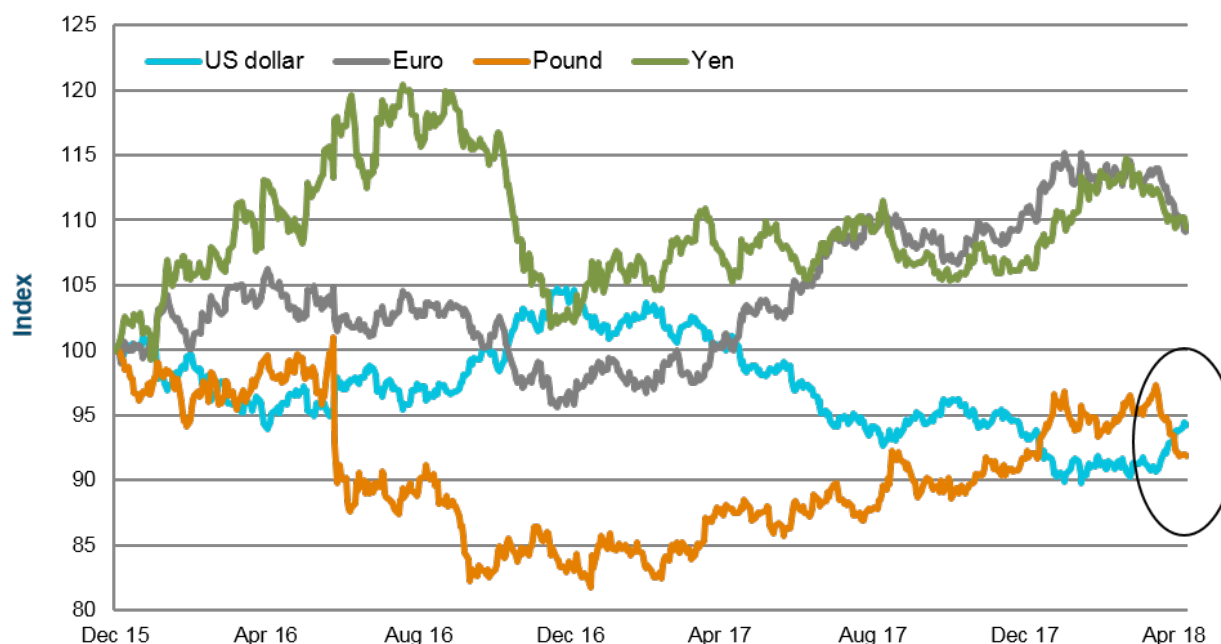
With hindsight, it's easy to explain why the dollar lost ground last year. Political tensions in Europe eased and the EU's economies began to accelerate. More investors were placing bets that the European Central Bank (ECB) would unwind its massive bond-buying programme sooner than expected. Brexit negotiations started to take a positive turn, with the pound rebounding from the fall that followed the EU referendum. In addition, the election of President Trump cast a shadow of uncertainty on the trajectory of the US. Things were not bad in the US, but they seemed to be improving elsewhere.

¹ All numbers are as of May 22, 2018. Source: Bloomberg. Used with permission of Bloomberg Finance L.P

THE TIPPING POINT

A possible catalyst for change in the dollar's direction came in April with signs of cracks in the synchronised global economic expansion. As the US economy is expected to accelerate due to fiscal stimulus (tax cuts), Europe and the UK show signs of slowing down. Add to that the Fed's ongoing normalisation of rates, and we may have reached a tipping point towards the dollar. The European Central Bank (ECB) isn't expected to hike before the second half of 2019, and the Bank of Japan is still far away from its first hike. Sentiment globally is more fragile than it was in 2017, so some investors prefer to hold dollars as a safe-haven currency. At the end of the day, supply and demand move currencies and a myriad reasons drive these forces.

THE JOURNEYS OF THE DOLLAR, EURO, BRITISH POUND AND YEN SINCE JANUARY 2016



Source: T. Rowe Price and Bloomberg Index Services, Inc. 1 January 2016 through 10 May 2018. The US Dollar Index indicates a general international value of the US dollar by averaging the exchange rates between the dollar and major world currencies. Euro, pound and yen reflect the exchange rates of the respective currencies with the dollar. All indices were based at 100 on 31 December 2015 for easy comparison.

FOUR IMPLICATIONS OF A STRONG DOLLAR

1. A strong dollar has wide implications for financial markets and investors, particularly those with overseas assets. Take the S&P 500 Index in 2018 as an example. Measured in US dollars, the index has returned about 2.7% year-to-date. But measured in euro, the return grows to 4.8%, while in yen it drops to 1.2%. Currencies can have a big impact on results. This is especially important as the US dollar is the currency of denomination for many global financial assets.

However, currency risk can be managed. It's fairly straightforward for portfolio managers to hedge currency exposure by using derivatives (e.g. forward contracts), and investors can access currency-hedged share classes of funds. The challenge lies in the different interest rates between the US and other countries, which increase the costs of hedging. For example, with the Fed Funds target rate at 1.75% and the ECB main rate at 0%, hedging dollars to euros would cost over 1.75%. In a low-yield world, that could be significant.

2. A second implication of a strong dollar is its impact on emerging markets (EM). EM countries rely heavily on foreign inflows to fund their fiscal and current account deficits. However, a stronger dollar and higher US interest rates may reverse capital flows from EM to the US. Another problem for EM is that local EM currency devaluation (when the dollar appreciates, currencies on the other side of the trade tend to depreciate) might make it more difficult for EM countries to service any dollar-denominated debt.

3. The third implication of a strong dollar is its influence on commodity prices. Normally, there is an inverse relationship between the dollar's value and commodity prices. Historically, the price of commodities has tended to drop when the dollar has strengthened. Falling commodity prices could have wide implications, ranging from corporate earnings to inflation and the fortunes of national economies (benefitting commodity importers; disadvantaging commodity exporters).

4. The fourth implication of dollar strength is its impact on the global economy. A rising dollar might hurt earnings of US companies with large foreign operations, while boosting those of European and Asian companies with large exports to the US. This can impact not only corporate earnings but also the labour market, due to changing hiring trends and corporate investment. Inflation in the US may ease (lowering the price of imports), while US inflation may be exported overseas, potentially affecting the decisions of central banks. Finally, large movements in the dollar may impact the sentiment and behaviour of consumers, leading to rising or falling confidence in different countries.

ALL CHANGE AHEAD?

A change in the direction of the US dollar, the world's most widely-used currency, would have an impact on investors, the performance of some asset classes and the global economy. Investors should assess whether their portfolios are positioned to benefit from an appreciating dollar and decide whether to hedge the risks it might generate. Such an important regime change should prompt a discussion and a review of portfolios.

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