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## Return of an Old Favorite

Remember back in high school, where the most popular guy was the varsity quarterback? At my school, he was the quintessential 'cool kid.' Others could give him a challenge outside of football, but he was still the best all-around athlete in our class. He always had good grades and was never in short supply of friends or dates. He was an all-American. I remember him as that class favorite everyone could rely on to show up at the 20-year reunion and still manage to charm the entire room.

It appears today that an old market favorite is once again beginning to reaffirm its global dominance. The U.S. has reemerged not because it has done all the right things (although that is somewhat true), but more because its competitors seem to have fallen behind. This resurgence of a class favorite should be good for those invested in U.S. securities. However, it also presents another ramification that should be considered carefully: the impact on the U.S. dollar.

## Dollar Reverses a Downward Trend

The dollar has been on a tear since July. As illustrated in Exhibit 1, the trade weighted dollar index, which measures the value of the dollar to other world currencies, has not seen these levels since June 2010. Currencies have a reputation of being a 'first mover,' meaning that they typically signal the future direction of interest rates and relative economic strength.

## Exhibit 1—The Dollar

### Trade-Weighted Dollar



Source: Bloomberg. Data represents the JPMX USD Index. As of 10/31/14.

So what is the dollar's recent firmness telling us? Much of its recent strength can be attributed to the corresponding strength of the U.S. economy relative to the rest of the world. With the divergence in growth rates becoming more prominent, there are increased expectations that the central banks of Europe and Japan will be easing monetary policy as the Federal Reserve (Fed) begins to tighten at home.

The U.S. has grown an average of 2% per year since the economic trough of early 2009. That pace should accelerate over the next several years, however. Thus, the U.S. economy seems to be ahead of most of the world. The same cannot be said for Europe, which is now threatening to move into its third recession since 2009, or Japan, which has been mired in disinflation since its stock market hit an all-time high in late 1989. Yes, 1989.

Now that the Fed has concluded its bond buying program, or quantitative easing, attention is turning to the question of when it will begin raising rates. Assuming economic data released over the next few quarters remain in line with the Fed's forecast, expectations are that rates will begin to rise by the middle of 2015.

As the Fed has plans to tighten rates, other central banks are preparing to move in the opposite direction. Both the European Central Bank (ECB) and the Bank of Japan (BoJ) have embarked on either outright quantitative easing or have been talking about it. These actions have put downward pressure

on local and regional rates and their respective currencies. As a result, U.S. interest rates are some of the highest in the developed world—higher even than those in Italy and Spain.

Given the divergence in monetary policy, we anticipate that a global rate differential will be in place for several years, allowing for the U.S. dollar to rally against the Euro and the Yen, as interest rates in the regions move in the opposite direction of those in the U.S.

### Ramifications of a Strong Dollar

The impact of a strengthening dollar should range from a decrease in commodities prices, to lower inflation, to advantages for U.S. equity markets. Since most commodities are priced in dollars, a strengthening currency leads to lower commodity prices, as fewer of the (now) stronger dollars are needed to buy the same barrel of oil, for example. Weaker commodity prices will help to restrain inflationary pressures as economic growth accelerates from 2% to 3%. The U.S. stock market likely will continue to benefit from a strong dollar as foreign investors see the U.S. as a good place to invest their capital for the foreseeable future.

### Investment Implications

While we have been anticipating shifts in monetary policy, dollar strength and growth trends, our Investment Strategy Committee has been evaluating modest portfolio changes that can further capitalize on these dynamics. At our latest meeting, we recommended an increase in small and mid cap equities given their limited exposure to international trade (and, hence, a strengthening dollar) than large cap domestic stocks. Large companies, which generate a large percentage of their revenue outside the U.S. may be negatively impacted as the revenue in foreign markets loses value. The recent pullback in small cap stocks also allowed a more favorable entry point, as we recommended a more neutral position in small and mid cap equities.

On the opposite side of the coin, we also recommended more modest exposure to international equities, specifically emerging markets, which are negatively impacted by a rising dollar. Many emerging markets are commodity-producing nations, so as commodity prices fall these nations receive fewer dollars for their goods. In addition to currency risk, emerging markets continue to be driven by top-down macroeconomic events and issues, such as the narrow re-election of Brazil's president. So, while emerging market equities trade at reasonable valuations, these unpredictable

macroeconomic factors make us less certain about potential appreciation opportunities over the next 12-18 month. While we continue to view the emerging markets asset class favorably over the long term, and also see specific individual opportunities within the asset class, it is a prudent decision to reduce exposure at this time.

Lastly, we continue to favor an underweight position to commodities due to excess supply, more muted demand as a result of slower global growth, and little signs of inflationary pressures. Dollar-related risks only reinforce our belief in a modest exposure to the asset class.

### Conclusion

Just as we trust our high school varsity quarterback will succeed, even years later, we also can rely on the U.S. to remain attractive. We continue to see a positive economic backdrop domestically, which means the U.S. dollar should continue to strengthen from current levels. Consequently, we are adjusting portfolio positioning, and will continue to do so, to take advantage of what we view as the beginning of a multi-year run of U.S. outperformance.



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