ACG | ASSET CONSULTING GROUP

Time To Bet Against The US Dollar? June 2021

OVERVIEW

- **A strengthening or weakening US dollar has proven to impact asset class performance differently.**
- **Historically a rising or falling US dollar market has lasted an average of 7-8 years, and for the past decade the US dollar has risen.**
- **The dollar began a downward trend in 2020, only to reverse course in 2021.**

Background

The movement of currencies is a reflection on the conditions of one country relative to another. Whether one country's outlook is rosier than another depends on three main factors: relative interest rates, inflation, and economic growth. This is all worth paying attention to because it can greatly affect investment performance. A strengthening currency is generally positive for domestic stocks, as it often reflects a growing economy and enables purchasing power abroad. Alternatively, investment returns denominated in a foreign currency will shrink when profits are converted from a weaker to a stronger currency. Currently, we are experiencing one of the longest US dollar strengthening markets since the US Dollar Index (USDX) was created in 1973, leading some to question if it's time for a reversal.

What Drives the Dollar

During a strengthening market, the US dollar (USD) appreciates relative to other currencies. The USD tends to have long cycles with extended periods of strength and weakness, as shown in the graph below. Over the past decade, we have seen a rising dollar due to stronger US economic growth, higher relative interest rates and the USD's role as a safe haven during periods of geopolitical concern. The dollar's upward trend came to a pause in early 2020 as the pandemic swept across the world, and we experienced unprecedented federal spending, strong forecasted growth from other countries, and concern regarding the USD's reserve currency status. As this negative outlook persisted, betting against the dollar became a popular trade late last year.

US Dollar Markets Over Time

Source: Koyfin, ACG Research

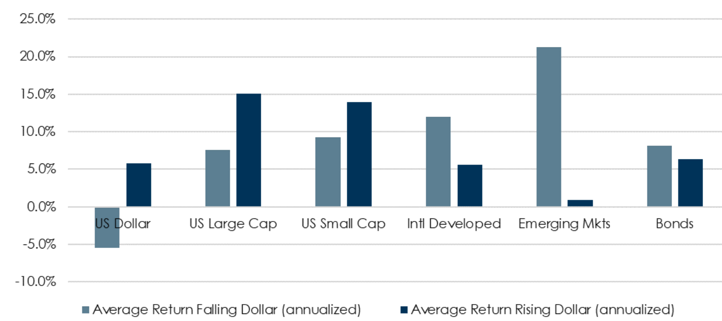
Surprise Dollar Strength

Earlier this year, news in the US and abroad led to a surprise reversal in the weakening dollar trend. The Federal Reserve signaled its ultra-accommodative policy stance is nearing an end, leading to upward pressure on the 10-year Treasury yield. Rising rates may continue if the Biden administration's recent stimulus package (and potential infrastructure deal) leads to earlier policy normalization by the Fed. Conversely, the European Central Bank is moving toward additional easing and approximately $12T of debt around the globe is still in negative yield territory. If we do see continued dollar strength, this could force many investors that have expected a dollar decline to unwind those positions, pushing its valuation even higher.

Investment Return Impact

Over the past five decades, we have seen three rising and three falling dollar markets; this has proven to be a meaningful indicator of asset class performance. US Equities (both large and small cap) have performed the strongest in a rising dollar environment, while Non-US Equities and Emerging Markets have performed best when the dollar was falling. Emerging Markets have had the greatest dispersion during the strengthening and weakening parts of the cycle, likely due to the heightened volatility of currencies in less established economies. Fixed Income has historically been less affected by currency movements than equity markets.

US Dollar Impact on Asset Class Performance



Source: Koyfin, ACG Research

For investors seeking to minimize currency risk or take advantage of dislocations across currency markets, there are strategies that hedge and/or allocate money based on perceived arbitrage opportunities. Broadly speaking, however, managers often avoid such positions as currency management is expensive and can be a drag on performance over longer periods of time. As evidence of this difficulty, the number of active currency managers has declined by 66% since 2008. From an asset allocation standpoint, multiple currency exposures in your portfolio can be a benefit as it adds to the diversification of return drivers over time.

ACG's Position

Over time it has proven difficult to consistently add value by timing currency movements and over long time periods their movements will cancel out. For individual investors that have outsized currency exposure or liabilities denominated in another currency, management of this exposure may be customized to meet their return objectives and risk tolerance. For most investors, however, it is prudent to refrain from active currency management and maintain a well diversified portfolio that will provide resiliency and value throughout the currency cycle.

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