LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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CURRENCY MATTERS—EDDIES IN THE INTEREST RATE RIVER

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KEY TAKEAWAYS

Currency movements are an important determinant of relative performance of domestic versus international investments.

The U.S. dollar rallied, somewhat predictably, immediately after the U.S. presidential election.

Monetary policy differentials should be supporting the U.S. dollar, but this is not always the case.

Movement of the U.S. dollar ("dollar") is one of the primary drivers that determine the relative performance of U.S. and international investments. Over the five-year period ending February 28, 2017, the difference between international returns expressed in dollars vs. local currency was about 4.5% annually. In other words, dollar strength caused international equity investments to underperform by approximately 4.5% *annually.* This means the effective yearly return for a European investor was 4.5% higher assuming that investor did not convert his or her holdings back into dollars. Many factors influence currencies, some primary, others secondary. The resulting interactions remind us of a river. The primary direction of currency movements is the main flow of the river, determined by large forces such as major macroeconomic and monetary policies. Yet there are times when the currency markets run against what should be their longer term direction; they are like eddies in a river, places where the water runs, at least temporarily, against the river's ultimate direction. This week we look at longer- and near-term factors influencing the U.S. dollar and by extension the desirability of international investments.

INTEREST RATES SET THE COURSE

The primary direction of the currency "river" is determined by relative interest rates. All else being equal, countries with higher interest rates have their currencies appreciate relative to countries with lower interest rates. This appears to be an obvious conclusion. However, it actually goes against what had been an accepted economic theory called "interest rate parity," which assumed that higher yielding currencies would ultimately experience *depreciation*. After all, in a world of efficient markets, why should investments in a certain currency be rewarded by both higher interest rates and currency appreciation? Shouldn't the excess return come with additional risk, as traditional finance theory would require? As it turns out, economists suggest that higher than expected transaction costs sometimes prevent the system from working as predicted.

So which way is the river flowing now? U.S. interest rates are higher at almost all maturities than comparable rates for other countries considered safe with liquid bond markets. Germany is typically used as primary point of comparison in Europe across all maturities when we compare bonds across multiple maturities as the yield curve. It seems clear that the U.S. has been on a path toward a tightening monetary policy since the end of 2015. Since that first interest hike of the current

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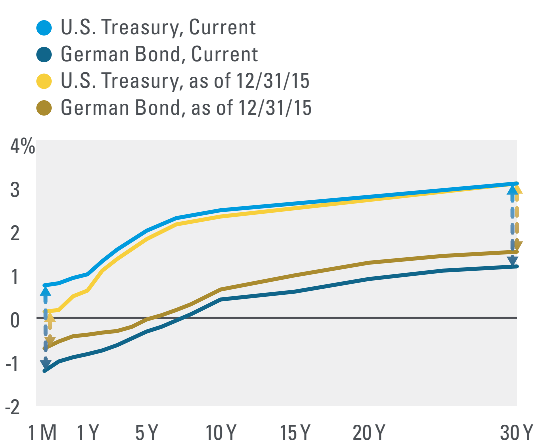
economic expansion over 15 months ago, the Federal Reserve (Fed) has raised short-term rates by 0.75% (75 basis points) with expectations of two more rate increases in 2017. No major developed market countries have raised rates in that time period, none are expected to in 2017, and the markets are only forecasting modest probabilities of interest rate increases in 2018. If we examine the U.S. yield curve since the end of 2015, we find… not much. Short-term bonds (on the left side of the curve) are most directly influenced by the Fed's tightening of monetary policy and have increased the most accordingly. Conversely, once you move past the five-year maturity bonds, the curve barely moves [Figure 1].

The market for German bonds over the same time period shows the opposite story. Yields on German bonds have declined over this period for several reasons. While the European Central Bank has not cut interest rates since 2015, the central bank did announce modifications to its quantitative easing policy of buying bonds and is considered a year or more away from tightening monetary policy.

1 WIDENING YIELDS SHOULD BE STRENGTHENING DOLLAR



Source: LPL Research; Bloomberg 03/27/17

Performance shown is historical and no guarantee of future results.

Clearly, the currency river should be flowing to the U.S., as the difference between interest rates in the U.S. and Germany have expanded across the yield curve. However, the dollar has not necessarily responded as one would have expected. After an initial rally after the U.S. presidential election, the dollar has stalled. The March 2017 Fed interest rate increase, which seemed unlikely at the beginning of the year, has failed to fuel the dollar rally.

WHAT ELSE IS IN THE RIVER?

Many other events may be influencing the dollar's decline, at least temporarily, creating the eddy in what should otherwise be a strong U.S. dollar current. These include:

U.S. Trade Policy – China Tensions

Then-candidate Trump promised to name China a "currency manipulator" on his first day in office. As with all other measures early in a presidency, analysis of promises made, fulfilled, and yet to be fulfilled should be considered premature. Decisions on labeling a particular country a currency manipulator are under the purview of the Treasury Department; Secretary Mnuchin has taken the lead on this issue, stating that no decision will be made until April at the earliest. However, President Trump has other advisors that have been very hawkish on China, and this view might carry the day.

How this issue ultimately gets resolved will say a lot about the balance of power within the Trump administration, which may be more meaningful than the issue itself. If the Trump administration adopts the more skeptical view on either China or trade in general, that could create weakness for the dollar.

Border Adjustment Tax

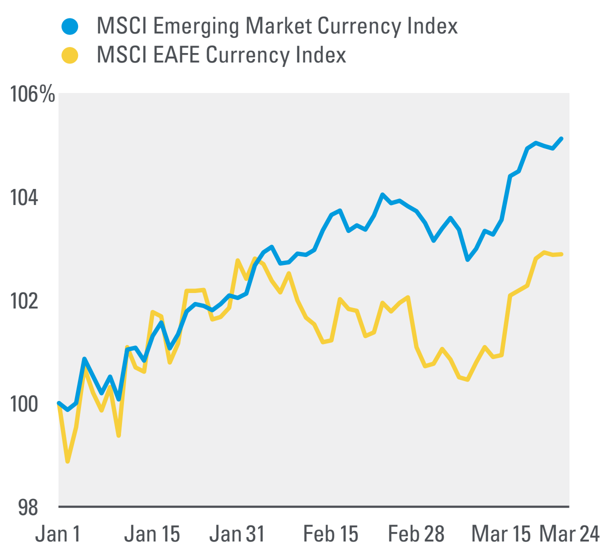
The border adjustment tax (BAT) is a piece of the broader corporate tax reform plan proposed by the House that is being considered by the Trump administration. In concept, the BAT would place an additional tax burden on companies that import goods to the U.S. (by disallowing certain tax deductions) but grant favorable tax treatment to companies that export goods from the U.S. (by fully allowing tax deductions). Such a system would be controversial under global trade law, which does not allow extra tariffs on goods beyond those broadly agreed to through the World Trade Organization (WTO). However, many countries, including most European countries, have a value added tax (VAT) that operates in a similar fashion.

The consensus among economists, as well the proposal's sponsors, is that the BAT would strengthen the dollar. Indeed, the presumed strengthening of the dollar is cited by the sponsors as offsetting the harm to consumers caused by the increased tax. The BAT was facing a difficult future even before Friday's failure to bring the Republican's healthcare bill to a vote on the House floor. Several key senators have expressed doubt on its wisdom and its ability to pass through Congress. The failure to repeal the Affordable Care Act (ACA) highlights the risk associated with President Trump's bold agenda. Concerns about the BAT may also be creating an eddy for the dollar.

Repatriation of Corporate Cash Held Overseas

One issue that we do not believe has been supporting the dollar is the possibility of repatriating money held overseas by U.S. corporations seeking to postpone paying income tax. This amount is believed to be potentially over $2 trillion. Congress may well pass a tax amnesty, a one-time reduced tax rate, in order to encourage companies to bring that money back to the U.S. Congress has enacted tax amnesties before to help repatriate assets, but these have been limited to taxpayers who may have "forgot" to file appropriately. Nothing on this scale has been proposed before. However, as we believe that most of this money is held in dollar-denominated deposits overseas, we do not believe that repatriation would have a significant impact on the dollar.

2 EMERGING MARKET CURRENCIES HAVE OUTPERFORMED DEVELOPED ONES



Source: LPL Research, Bloomberg 03/27/17

All indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

CONCLUSION

Dollar strength must be watched for investors who have diversified a portion of their portfolios with overseas investments [Figure 2]. Our view has been the fundamental strength of those investments—in particular emerging market equities—could overcome the modestly stronger dollar we would expect based on the interest rate dynamic between the U.S. and other major countries. But other factors have appeared that have hampered the dollar's rise recently, benefiting international investments, but creating risks in other aspects of investors' portfolios. Political analysis will be an important part of our investment process as new policies unfold. ■

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.

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

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.

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.

The fast price swings in currencies will result in significant volatility in an investor's holdings.

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.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

INDEX DESCRIPTIONS

The MSCI Emerging Markets (EM) Currency Index will track the performance of twenty-five emerging-market currencies relative to the U.S. dollar.

The MSCI EAFE Currency Index will track the performance of currencies in the developed markets outside of North America: Europe, Australasia, and the Far East, relative to the U.S. dollar.

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