

The Details In The Dollar

In the same week the Federal Reserve shut off the printing presses, the Bank of Japan ordered more ink and paper! On Halloween, Haruhiko Kuroda, the Governor of the Bank of Japan shocked the investing community by announcing the central bank would increase its quantitative easing program, boosting its monetary base at an even faster pace, bringing its annual bond buying purchases to 80 trillion yen (approximately \$724 billion). The monetary policy surprise sent local equity markets soaring and currency investors scrambling. Before I discuss the potential global impact of this surprise announcement, I feel a brief economics review of currency markets necessary, yet quite boring.

Currency investing has always been a fascinating subject to me. I routinely discuss that non-dollar denominated assets generally have two return components, (1) the actual investment's results and (2) the currency impact. Theoretically, the currency market should be a haven for active investment managers because it is generally the largest, most liquid investment market in the world and is dominated by non-profit motivated buyers and sellers (travelers, corporations hedging risk, central banks), which makes it very inefficient.

There are many factors that impact currency exchange rates between two countries, but three of the most important factors are interest rates, inflation and supply/demand. Historically, interest rates and inflation rates have been the primary drivers of exchange rate movements, and investors attempt to calculate the impact of the two by relying on the theory of interest rate parity and the theory of purchasing power parity.

Interest rate parity simply means a currency's premium/discount against another currency should reflect the interest rate differential between the two countries. For example, if the true risk-free rate in country A is 5% and the true risk-free rate in country B is 3%, the theory of interest rate parity would conclude that country B's currency is projected to weaken by 2% over the period, eliminating any potential for arbitrage. **All else being equal, higher interest rates generally translate to a stronger currency.**

Purchasing power parity essentially says that identical goods should have one real price absent of transaction costs. For example, if the current inflation rate in country A is 5% and the current inflation rate in country B is 3%, the theory of purchasing power parity would predict the currency of country B would strengthen 2% over the period to eliminate the potential to earn

an arbitrage profit. **All else being equal, lower inflation generally translates to a stronger currency.**

Interest rates and inflation have historically been the drivers behind exchange rates, but in this era of monetary manipulation through massive liquidity injections by central bankers, currency supply and demand has overwhelmed the fundamental theories.

Why is the understanding of currency movements so important? A country's currency position relative to others can dramatically alter future economic activity. A few of the benefits of a strong currency are (1) imports are cheaper, taking fewer dollars to make foreign purchases, putting downward pressure on inflation; (2) stronger currencies attract foreign capital, keeping interest rates stable and; (3) individuals feel "wealthy." Conversely, two significant disadvantages of a strong currency are (1) exports become more expensive for foreign purchasers, impacting the sales of multi-national companies; and (2) corporate earnings are threatened as foreign sales are not "worth" as much.

Let's return to Japan's announcement and why my first reaction was...who's going to be next... everyone? It's a frightening time to think that the United States 2.5% economic growth represents a global strength. However, this slow, but steady pace compares favorably to the rapidly declining growth in many emerging markets and deflation fears in Europe and Japan. Unlike the United States, which is more capable of sustaining economic activity internally, many of these areas rely on exports for economic stability, a perilous position when Japan, the world's third largest economy, took direct aim at its currency. Particularly vulnerable is China, an export dominated country.

Unlike most countries that have a floating exchange rate, China has pegged its currency, the renminbi, to the U.S. dollar and has been very reluctant to modify its valuation despite demands from U.S. policy-makers, believing the Chinese government maintains an artificially weak currency to advantage their exports. As a result, the renminbi's movement mirrors the dollar, which has strengthened against nearly all currencies over the last six months and has surged in value versus the yen and euro.

According to Trading Economics, the European Union and Japan account for 16% and 7% of China's exports, respectively. These exports could be at risk given the strength of the dollar/renminbi, putting even more pressure on the country's weakening economic growth. Despite statements by Chinese officials that the valuation is stable, pressure to devalue the renminbi will continue to build if export growth slows and internal demand does not pick up the slack.

What's the potential impact to the United States? While the U.S. economy is relatively strong, that strength is likely limited. An increasingly strong dollar will create a stiff headwind for corporations as their products will be less competitively priced globally, with foreign earnings contributing less to profits due to translation losses. More alarming, a weakening yen, euro and renminbi will send a wave of deflationary pressures toward the U.S. economy as the cost of any goods and services we import from these areas will decline. If we had a strong inflation foundation, we could most likely absorb these deflationary pressures; however, our economic foundation is fragile, and I believe deflation is the Federal Reserve's worst fear.

Why are potentially lower prices dangerous? I have mentioned many times four ways the U.S. can manage its long-term debt situation — raise taxes, cut spending, economic growth and inflation. We are unable to raise enough taxes or cut enough spending to “fix” our debt problems. **Growth and inflation are a must.**

Growth - The Federal Reserve has made the cost of delaying discretionary expenditures very high by keeping interest rates low and building inflation expectations. If a consumer is earning nothing on their cash and believes the price of a desired discretionary good is rising, they are likely to make the purchase. However, if the consumer feels the price is falling, they could potentially delay the purchase, essentially earning a real return on their cash (the decline in price), contributing to slower economic growth.

Inflation - is equally critical. Inflation reduces the value of past debt as you pay off past debt with cheaper future dollars. Conversely, deflation would increase the real value of past debt, requiring more real resources in the future to service existing debt, a scenario the United States cannot afford.

Going Forward

I anticipate the Federal Reserve will likely intervene to try to pump the brakes on the dollar's recent rise. Following their last meeting, forward interest rate guidance was slightly toned down, pausing the dollar's climb temporarily. More deliberate steps may be required if we see the perfect storm coming from Europe, China and Japan. And, should we see signs of deflation or disinflation, I would expect another wave of “unprecedented” responses, predominately aimed at boosting inflation and reducing the value of the U.S. dollar.

From an investment standpoint, we remain cautious. The inflation that has failed to materialize on “Main Street” from the global central bank activities has been very evident on “Wall Street.” We anticipate currency volatility remaining high with the dollar having bouts of strength and weakness. We continue to target non-dollar denominated assets between 15 – 30% of balanced portfolios and are looking for opportunities to increase exposure to real assets to protect against a longer-term currency debasement outlook.

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