HIGHLAND

CURRENCY INSIGHT

January 2015

AS THE DOLLAR STRENGTHENS

In the aftermath of the financial crisis, nations around the world have employed a wide range of monetary and fiscal policies designed to restore stability and growth to their respective economies. Results have been mixed as the pace of economic recovery and capital market price appreciation have varied considerably among both developed and emerging markets. The capital markets in the United States have experienced accelerated growth due to the influence of aggressive monetary policy, propping up the current recovery at the expense of future growth. Economic growth seems to be accelerating, but a closer look at the data shows that growth is concentrated and many indicators are fluctuating. While the U.S. economy is expanding faster than most of the developing world, it is debatable whether the trajectory of growth is transitioning from a slow growth recovery to a sustained expansion.

Europe, on the other hand, was much slower to reject austerity and enact aggressive monetary policy measures. As a result, economic growth in the region remains anemic, and European equity markets have significantly lagged their U.S. peers. Japan has also struggled to escape its decades long battle with deflation and poor equity performance, though seemingly not for lack of effort. Prime Minister Shinzo Abe has relied on a historically accommodative monetary policy as the centerpiece of his agenda, but increased consumption taxes, continuing demographic challenges, and limited reform progress have stood in the way of meaningful economic growth and sustained equity market momentum.

Emerging markets have generally benefited from accommodative monetary policy in developed markets. An abundance of cheap capital has driven stronger overall growth. However, the pace of recovery for equity markets in many of these nations has failed to keep up with more robust gains in the U.S. In addition, declines in overall emerging market growth rates appear more likely given that these nations' economies are generally overly reliant on foreign capital, poorly diversified, and less adaptive.

These dichotomies helped contribute to a recent resurgence in the U.S. dollar relative to other major currencies. Specifically, the primary drivers of dollar appreciation include the U.S.' relative economic strength, relatively higher interest rates, improving trade deficit, as well as diverging monetary policies at the world's leading central banks.

CURRENT LANDSCAPE

WHAT IS DRIVING THE RECENT STRENGTH?

The Trade Weighed U.S. Dollar Index has climbed 11.7% in 2014 and currently stands at its highest level since March 2009. **Figure 1** illustrates the dollar's recent rapid appreciation as measured by the Trade Weighted U.S. Dollar Index. For clarification

SUMMARY

- •GLOBAL DIVERGENCE HAS STRENGHTHENED THE U.S. DOLLAR TO LEVELS NOT WITNESSED SINCE 2009
- •IF THE U.S. ECONOMY CAN WITHSTAND A STRENGHTHENING U.S. DOLLAR, INVESTORS COULD BENEFIT FROM A "GLOBAL REBALANCING"
- •ON THE OTHER HAND, A STRONGER U.S. DOLLAR COULD POSE SOME SERIOUS THREATS TO ECONOMIES OUTSIDE THE U.S.

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *General support*

purposes this index is comprised of the U.S. dollar value versus a basket of 26 currencies indexed to a value of 100 as of March 1997. Looking at the value of the dollar over the past 10 years, it is also plain to see that the dollar has yet to break out to long term highs.

FIGURE 1

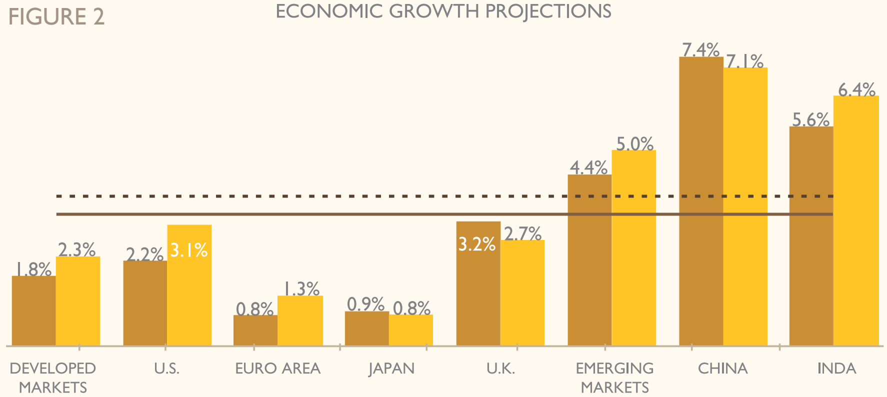
TRADE WEIGHTED U.S. DOLLAR INDEX: MAJOR CURRENCIES
Last 10-Years

SOURCE: U.S. FEDERAL RESERVE

There are many factors that have contributed to the dollar's rapid appreciation in recent months. First, U.S. economic growth has accelerated as real gross domestic product has increased by at least 3.5% year-over-year in four of the last five quarters. Increases in consumer spending have been the primary driver of GDP gains, and non-residential fixed investment has also contributed materially. Meanwhile, growth in Japan and the Eurozone continues to languish below 1%. Looking forward, the IMF projects continued acceleration in U.S. economic activity and a widening of the U.S.' positive growth differential relative to other developed markets, as illustrated in **Figure 2.**

FIGURE 2

ECONOMIC GROWTH PROJECTIONS



SOURCE: IMF

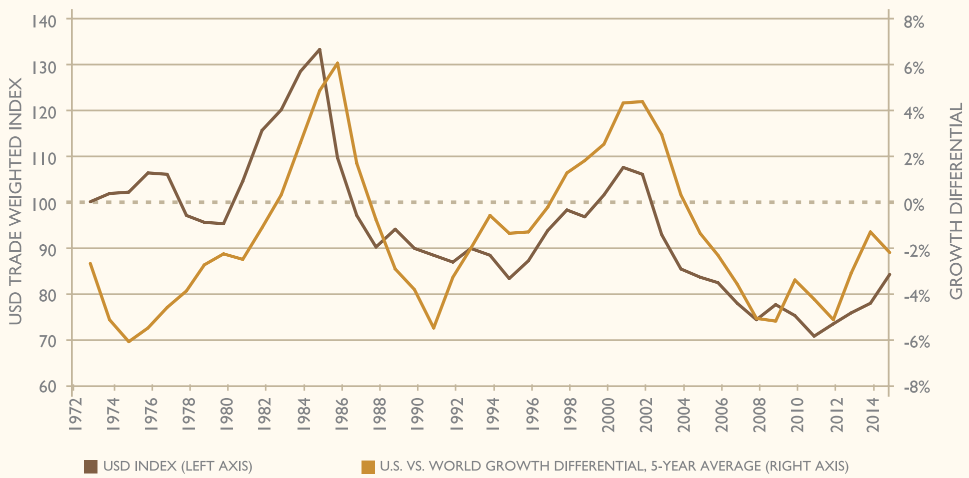
More broadly, accelerating U.S. output has begun to catch up to stronger gains in faster growing emerging markets in recent years. This has caused the differential between U.S. and total world economic growth to shrink considerably. **Figure 3** importantly illustrates how U.S. growth has actually exceeded world growth during prior periods of sustained dollar strength. Thus if U.S. growth continues to bridge the gap relative to total world growth, further appreciation in the dollar is certainly possible.

Substantial and ongoing gains in energy production are also driving higher economic output in the U.S., while simultaneously reducing dependence on foreign imports. As a result, the U.S.' current account deficit has recently declined to just 1.5% of GDP, its lowest level in over 15 years. This reduction in the U.S. trade deficit makes the U.S. less reliant on foreign capital to fund domestic investment and consumption, thereby reducing the incremental supply of dollars on the global market. This lower supply should support strength in the dollar, all else equal. The falling dollar also has profound effects on commodity prices, such as oil, which in turn leads to changes in U.S. capital expenditures (see Highland's Oil Research).

Divergences in monetary policy have also contributed to the dollar's recent appreciation. Improving economic data in the U.S. has compelled the Federal Reserve to terminate its quantitative easing program and consider interest rate hikes as early as this spring. Meanwhile, central banks in Japan and the Eurozone have recently announced massive new monetary stimulus programs. European Central Bank chief Mario Draghi has pledged to expand the ECB's balance sheet by up to €1 trillion, or 50%, in an effort to catalyze growth in commercial bank lending. Essentially, Draghi and the ECB are anticipating that such a substantial stimulus will overwhelm deflationary pressures and generate an acceleration in overall economic growth. Japan's central bank has committed to use bond purchases to increase its balance sheet by 15% of GDP each year in pursuit of its 2% inflation goal. At the same time, Japan's $1.1 trillion government pension fund has pledged to double its equity allocation from 24% to 50% while decreasing its bond exposure from 60% to 35%. With total

FIGURE 3

U.S. GROWTH DIFFERENTIAL AND THE US DOLLAR

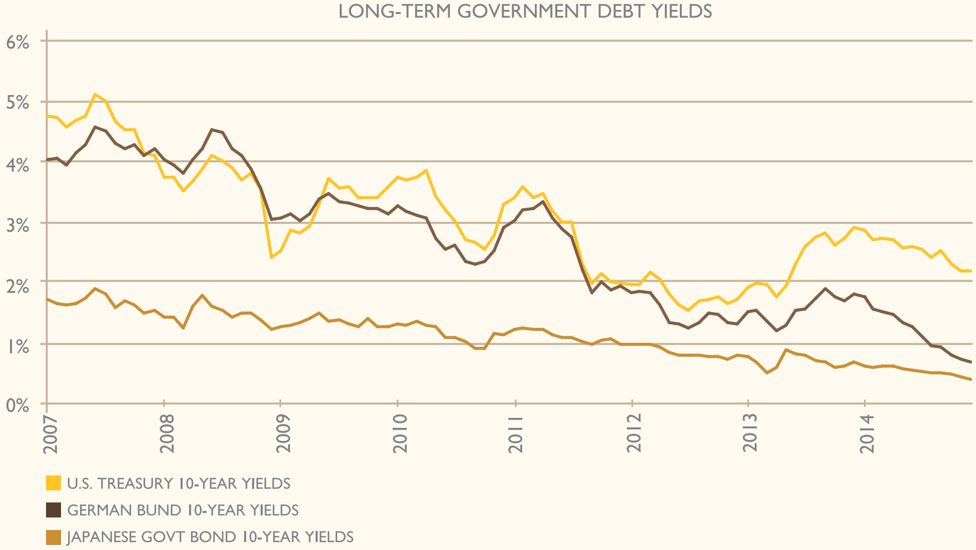


SOURCES: U.S. FEDERAL RESERVE; IMF

BOJ assets already accounting for almost 60% of GDP (versus just 20-25% for the Fed, the ECB, and the Bank of England), this new program represents by far the largest monetary stimulus ever considered by a major central bank.

FIGURE 4

LONG-TERM GOVERNMENT DEBT YIELDS



SOURCES: U.S. FEDERAL RESERVE; OECD

The ECB and the BOJ are attempting to use asset purchases to create inflation and devalue their currencies in an effort to make their corporations more competitive. Their hope is that lower currency values will make their exports more attractive and stimulate growth in the process. To the extent that these programs achieve their intended effect, the dollar could continue to appreciate relative to these other major currencies. Finally, the level of interest rates in the U.S., Europe, and Japan reinforce the important differences in each region's stage of policy accommodation and economic recovery. As shown in **Figure 4**, interest rates are materially higher in the U.S., and the spread differential has grown in recent quarters. In fact, the yield spread between 10-year U.S. Treasuries and 10-year German bunds is currently at record levels. These higher U.S. rates reflect expectations for continued relative economic strength and potentially tighter monetary policy, as low rates in other developed markets are indicative of poor economic prospects, deflationary concerns, and increasingly accommodative monetary policy.

In analyzing potential opportunities and threats created by sustained dollar strength, one must consider two opposing viewpoints. From the first perspective, one could argue that the dollar's recent appreciation indicates a firmly entrenched recovery in the U.S. that is strong enough to withstand new challenges while also supporting more robust growth internationally. From the second perspective, one must question whether dollar strength could actually undermine recent resiliency in the U.S. economy and ultimately act as a catalyst for decelerating growth domestically and abroad.

OPPORTUNITIES

WHAT ARE THE BENEFITS A STRONGER DOLLAR?

Let's assume that the U.S. economy is healthy enough to sustain its recent momentum. A strengthening dollar creates meaningful benefits for a variety of economic stakeholders. From a broader perspective, a strong dollar could be a harbinger of what Allianz chief economist Mohamed El-Erian calls a "global rebalancing." Specifically, continued dollar strength will create weakness in the euro and the yen that should allow corporations in those regions to compete more effectively in the global marketplace, ultimately translating into stronger economic growth. At the same time, a weaker euro and yen will cause an increase in import prices in Europe and Japan, helping to combat deflationary pressures. Again, this is the precise goal of the recent monetary policy measures taken by both the European Central Bank and the Bank of Japan.

By the same token, a stronger dollar increases the purchasing power of U.S. consumers, who account for nearly 70% of U.S. GDP and roughly 16% of world GDP and thus represent the single largest economic growth engine in the world. With a stronger dollar, goods and services imported into the U.S. become cheaper, as do commodities priced in dollars. In this context, a stronger dollar is a welcome relief to the vast majority of U.S. consumers who have struggled with stagnant wage growth. At the same time, the dollar's contribution to the recent plunge in oil prices also provides a much needed boost to discretionary income, which should disproportionately support the spending habits of the majority of Americans who live from one paycheck to the next. For wealthier Americans, a stronger dollar incentivizes travel abroad and could potentially benefit tourism revenues around the world.

From a corporate perspective, firms that import raw materials and component parts should also profit from the dollar's increased purchasing power. At the same time, a stronger dollar could support increased merger and acquisition activity for U.S.-based multinational companies looking to use their large cash reserves to buy foreign firms in an effort to diversify end markets and enhance growth prospects.

Finally, the performance of the U.S. economy in the aftermath of the financial crisis has reaffirmed the greenback's status as the preeminent world reserve currency. The euro and the yen have failed to prove to be viable alternatives, and the size, safety, and liquidity of the U.S. market remains unparalleled around the world. Thus the dollar's safe haven status should also support its strength going forward as other regions struggle to reclaim a more normalized growth trajectory. More specifically, higher interest rates in the U.S. should continue to attract foreign capital, providing further demand for the dollar and potentially greater appreciation. Notably, foreign investors' holdings of U.S. Treasuries were on pace to grow by over $300 billion (or nearly 6%) in 2014, which would be the largest annual gain on record.

THREATS

WHAT ARE THE RISKS OF A STRONGER DOLLAR?

While the U.S. has achieved stronger growth recently, it is unclear whether the economy is sturdy enough to endure the potential changes and challenges associated with a strong dollar. As discussed previously, appreciation in the dollar is likely to drive a meaningful shift in demand toward other countries. Weaker euro and yen values could entice demand for competing goods and services in those countries at the expense of U.S. businesses (particularly exporters), derailing economic momentum on the home front. At the same time, dollar appreciation creates a disinflationary effect that could threaten to slow U.S. economic growth. If lower inflation occurs alongside accelerating economic growth, real interest rates could rise materially. This cycle could create a sort of feedback loop that sends the dollar even higher relative to other currencies. It's possible that further appreciation of the dollar could negatively impact U.S. economic growth. Monetary policy measures could mitigate this risk, as a mixture of slowing growth and slowing inflation could in turn compel the Fed to delay interest rate hikes in order to sustain the current pace of recovery.

Outside of the U.S., continued strength in the dollar represents a substantial threat to emerging market economies, especially those with significant sensitivity to commodities priced in dollars. As discussed above, a strong dollar typically drives increases in real U.S. interest rates. Emerging market economies are especially vulnerable to dollar strength in this regard, as rising U.S. real rates have historically been negatively correlated with commodity prices. Dollar strength also impacts emerging markets' access to capital. During past periods where the dollar is weak and U.S. interest rates are low, emerging market governments have ratcheted up borrowing in general. These governments borrowed especially from U.S. fixed income investors who were seeking to enhance the yield on their portfolios. Eventually, however, as an improving U.S. economy gives way to periods of dollar strength and rising U.S. rates, capital tends to rush out of emerging markets and into the more stable and suddenly higher yielding U.S. market. Essentially, investors decide that emerging markets' dwindling yield advantage is not enough to offset the risk of currency losses. The most memorable examples of this phenomenon include the early 1980s Latin American debt crisis and the late 1990s "Asian contagion" that sent emerging market economies, currency values, and equity values into a deep downward spiral.

In the past, emerging market governments have been the lion's share of U.S. dollar denominated debt. This trend has now changed, as they have accumulated far less dollar debt and emerging market corporations are now the bulk of the issuance. In the current cycle, corporate bond issuance in dollars increased by $550 billion since 2009. In total, it is estimated that approximately $2 trillion in total foreign capital is currently invested in the local debt of emerging market corporations and governments, and the Bank for International Settlements notes that total foreign ownership in emerging bond markets has more than doubled from 8% in 2007 to over 17% currently. Continued dollar strength could begin to entice this enormous supply of foreign capital out of emerging markets and back into the U.S., with potentially violent impacts on credit-dependent emerging market growth. If there are significant capital outflows from these emerging markets, their governments are likely to substantially raise interest rates and restrict credit expansion, which could further stifle economic growth. Given that emerging markets are home to the strongest economic growth rates in the world, the reverberations from this scenario could be felt in the U.S. and around the world.

PORTFOLIO IMPLICATIONS

DOES A STRONGER DOLLAR CHANGE MY PORTFOLIO?

While dollar strength can have significant positive or negative influences on certain asset classes, its effect is less pronounced on others. With public equities, for example, changes in the value of the dollar can meaningfully impact developed and emerging international equity returns, but do not appear to have much effect at all on domestic stock returns.

FIGURE 5

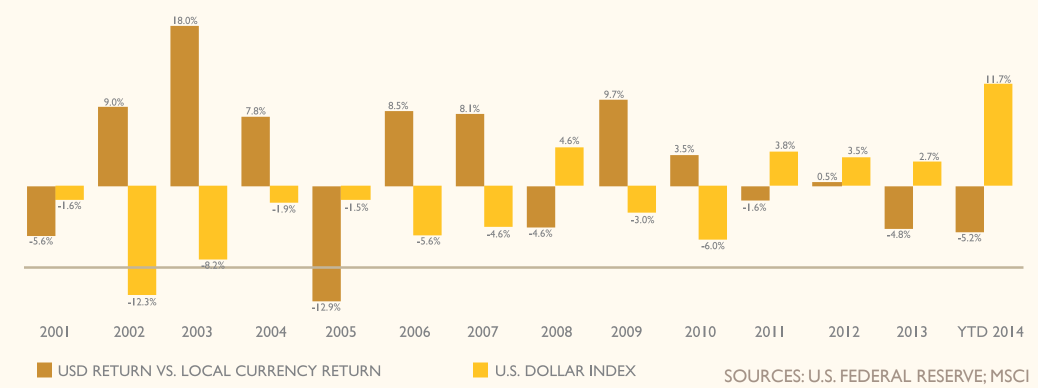
U.S. GROWTH DIFFERENTIAL AND THE US DOLLAR

SOURCES: U.S. FEDERAL RESERVE; S&P

As illustrated in **Figure 5**, U.S. equities have generally performed well in periods of both dollar strength and weakness. The value of the dollar does have long-term impacts on the overall U.S. economy, which in turn effects the secular direction of the stock market. While the dollar does have some effect on the secular environment, Highland believes that valuations, earnings growth rates, and interest rates have proven to have greater predictive power for domestic equity returns. International equity returns, however, can be more strongly influenced by the value of the dollar because returns achieved abroad in local currency terms must be converted back to dollars for U.S. investors. Essentially, a declining dollar should enhance international equity returns while a strengthening dollar should reduce them. Our research reveals that movements in the dollar explain a significant portion of the variability of international equity returns, as illustrated in the chart in **Figure 6**.

FIGURE 6

MSCI AC WORLD EXCLUDING U.S.
USD RETURNS VS. LOCAL CURRENCY RETURN



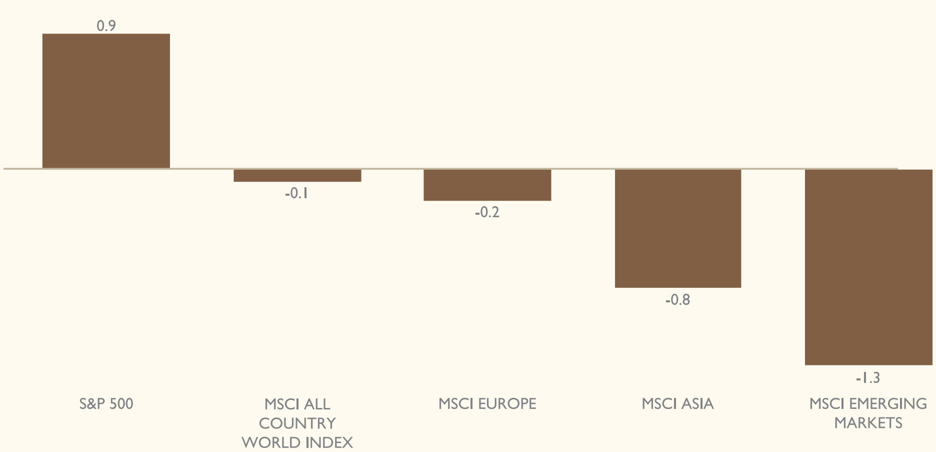
SOURCES: U.S. FEDERAL RESERVE; MSCI

Of course, as with domestic equities, valuations, earnings growth, and interest rates are also important drivers of international equity returns. In Europe, stocks remain cheap relative to both their U.S. counterparts and their own history, while corporate earnings growth actually appears to be gaining momentum. A recent report from the Pictet Group noted that of the more than half of Stoxx 600 companies to report third quarter results, earnings growth averaged 13% despite a total lack of revenue growth. This suggests that efficiency initiatives have the potential to drive earnings acceleration despite weak aggregate demand. Relying on these measures will have diminishing effects the more they are employed. At the same time, if recent dollar strength is sustained, a weaker euro should stimulate revenue growth, and earnings could grow even faster. On the other hand, if dollar strength destabilizes U.S. economic growth, this could have negative earnings implications for companies with substantial exposure to end markets in the U.S. In emerging markets, equities are even more sensitive to dollar strength. As outlined previously, continuing strength in the dollar could prompt a significant withdrawal of dollar investment in emerging markets that could severely hamper prospects for sustained economic recovery and equity appreciation. Of course, if dollar strength fizzles somewhat, emerging markets may have some breathing room.

Valuation data clearly indicates the favored nation status of the U.S. at the present time. As depicted in **Figure 7**, overall valuations for U.S. equities based on cyclically adjusted real price-to-earnings ratios were nearly one full standard deviation above their long-term average as of September 30, 2014. This same valuation metric indicates that European equities appear reasonably valued while emerging market equities look substantially undervalued. For these reasons, Highland remains quite comfortable with significant global equity exposure in client portfolios. At the same time, we are avoiding direct client allocations to standalone emerging market equity mandates in order to limit overall exposure to these riskier assets.

FIGURE 7

NORMALIZED REAL PRICE-TO-EARNINGS RATIOS
Z-SCORES (AS OF 9/30/14)



SOURCES: SHILLER; BLS; S&P; MSCI; U.S. TREASURY; IMF

Within fixed income, continued strength in the dollar could support strong returns for domestic bonds relative to international developed and emerging market bonds. U.S. debt already carries significantly higher yield than international developed debt. This yield differential could increase as long as a stronger U.S. dollar does not negatively impact U.S. economic growth. At the same time, currency appreciation or depreciation accounts for a significant portion of total return for international bonds, and thus continued dollar strength further favors U.S. bonds over international bonds.

In the event that dollar strength begins to stifle U.S. economic growth, Highland would still expect superior performance from domestic bond strategies relative to international offerings. A stronger dollar should theoretically induce increased incremental demand for U.S. securities, supporting prices. In addition, it is unlikely that the Federal Reserve would aggressively raise interest rates if economic data begins to soften, thus providing further defense for U.S. bonds. AS A RESULT, HIGHLAND IS COMFORTABLE WITH ITS DECISION NOT TO RECOMMEND SEPARATE ALLOCATIONS TO INTERNATIONAL DEVELOPED AND EMERGING MARKET DEBT STRATEGIES. INSTEAD WE PREFER TO ALLOW OUR TRUSTED MANAGERS TO MAKE TACTICAL ALLOCATIONS TO THESE MARKETS.

Finally, as alluded to previously, commodities are especially sensitive to changes in the dollar. Our analysis suggests that movements in the dollar explain a substantial portion of the variation in returns for agricultural commodities, energy, and precious metals. To be clear, the inverse relationship between the value of the dollar and commodity prices could act as a headwind for commodity returns. Of course, at a certain point, falling commodity prices should eventually spur increased demand that provides support for prices. On the other hand, if dollar strength curtails U.S. economic growth, commodity returns could suffer as demand declines. Most importantly, commodities offer investors protection from unexpected inflationary shocks. Given the amount of monetary policy utilized around the world today, there still remains a risk of an unexpected spike in inflation. Therefore, Highland recommends continued commodity exposure as a means to enhancing overall risk-adjusted returns.

HIGHLAND'S CONCLUSION

Continued dollar strength is by no means a foregone conclusion. In the pages above, we have outlined the circumstances under which recent gains in the dollar may or may not be sustainable, as well as the associated implications of both of these scenarios. As discussed previously, Japan and Europe appear welcoming of the dollar's appreciation, as it provides an opportunity for companies At the same time, the fact remains that the U.S. needs stronger end markets abroad to support its domestic businesses in an increasingly globalized economy. As a result, some level of dollar strength would appear to benefit each of these major developed markets. To the extent that improved growth abroad threatens domestic output, we would expect monetary and fiscal policy responses from the U.S. These responses may include delays in interest rate hikes. Our focus on adding value while protecting principal causes us to carefully position client portfolios so that future portfolio returns are not overly dependent on changes in the dollar in either direction.

HIGHLAND'S CURRENT POSITIONING

↓ DEFLATION/CRISIS HEDGES
⟷ GROWTH
↑ VOLATILITY CONTROLLED GROWTH
⟷ INFLATION SENSITIVE

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