HIGHLAND

MARKET BRIEF
MARCH 2018

ON AGAIN. OFF AGAIN.
Where Are We on the Dollar?

There has been much talk about the dollar lately. Whether it's Wall Street forecasting a continuation of 2016's dollar strength, Treasury Secretary Mnuchin's comments that a weaker dollar would be better for U.S. companies, or President Trump's stance that the White House is indifferent on the direction of the dollar, there is no shortage of views out there for investors to consider. And the direction of the dollar does have implications for investors. The trajectory of the dollar plays a key role in the decision to over- or underweight international equities relative to U.S. Having said that, we see three different scenarios for the dollar going forward.

STRENGTHENING DOLLAR—ORDER OF CONVICTION: MOST DOUBTFUL

Although a strengthening dollar is offered as the most likely scenario by most of Wall Street, we believe this is the least likely scenario. In order for the dollar to revert to its pre-2017 trend of strengthening, higher real economic growth and foreign capital inflows must dominate all other factors. Because of the mid-cycle economy and a president who is threatening to end trade agreements, we see this as an unlikely event.

Currencies are similar to equities in that they benefit from rising interest rates associated with a strong economy. For this scenario to persist, the recent tax reform and prospects for higher government spending would have to result in higher sustainable economic growth that further extends the economic expansion. However, the tax cuts and reforms that typically propel economies into longer-term expansion happen much earlier in the economic cycle, when unemployment rates are higher, the economy is growing below its potential, and the Fed is cutting rates. None of those conditions are present today. Our view is that it is more likely that the short-term lift to demand from the fiscal package will lead to overheating and inflation rather than sustained growth.

Currencies are a zero-sum game, meaning that one currency's appreciation is another's loss. Despite all these factors, the U.S. dollar could appreciate in part because of the U.S. exhibiting higher growth rates than other countries. While this is certainly plausible, we do not believe this is likely today. International economies are exhibiting higher than expected growth rates and have more room to run than the U.S., which is later in the economic cycle. The U.S. economy is at or slightly above full capacity and running higher than the Congressional Budget Office's potential growth estimate. Meanwhile international economies appear to be two to three years behind in the economic cycle, and valuations appear much lower outside of the U.S. This is supportive for capital flows out of the U.S. and into international markets. It is possible for the dollar to strengthen in the face of shorter-term economic strength, but our belief is that longer-term fundamentals favor international developed markets and are a headwind for a strengthening scenario.

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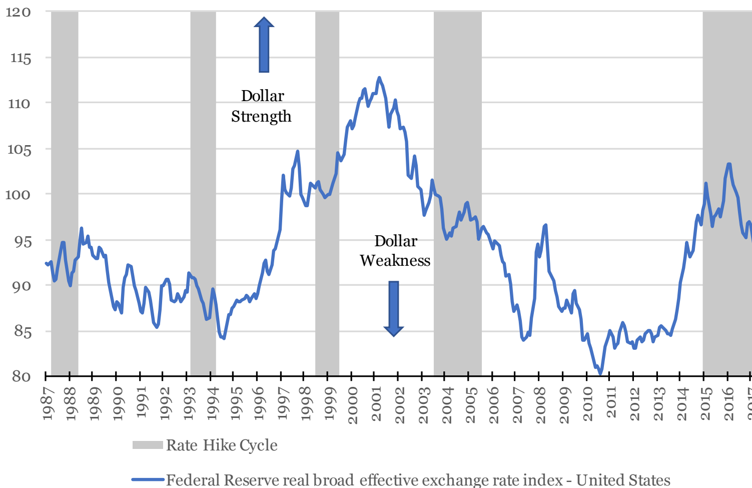
WEAKENING DOLLAR—ORDER OF CONVICTION: FAVORABLE

Even though the economic news has been favorable lately, we still believe the economy is moving closer to the end of the growth cycle. If the economy's current track persists to July 2019, then it will be the longest economic expansion in history, with records going back to 1854. Tight employment markets and compressed credit spreads coupled with the Fed raising rates and gradually reducing its balance sheet all point to this view. The late stage stimulus by the Federal government could prove to be the accelerant that pushes the dollar down for an extended period. All of this stimulus is arriving when the economy least needs it, setting the stage for higher inflation. Currencies can handle rising rates when it is tied to growth, but currencies typically fall when the cause is increasing inflation.

Moreover, the U.S.'s stance as a deficit nation whose recent tax reform adds $1.5 trillion to the deficit over the next decade plus another $300 billion in the latest budget deal and $200 billion proposed for infrastructure spending also supports a weaker dollar outlook.

The U.S. dollar has declined in every rate-hiking period over the last 30 years (see **Figure 1**). Why? Because of this adage: "Expansions do not die of old age. They are murdered by the Fed." The Fed has historically found itself behind the curve and, as inflation fears mount, overreacts, thus slowing down the economy.

*FIGURE 1: **USD in Rate-Hiking Cycles***



SOURCE: HIGHLAND ASSOCIATES; FACTSET

Although the Fed is raising rates and moving closer toward tightening, we are still in an accommodative stage. Why is this the case? First, we continue to have negative real (or inflation-adjusted) rates. There has never been a period post-WWII when the U.S. has experienced a recession with real rates below 2%. Second, the current Fed Funds rate is below most "guides," such as the formulaic Taylor rule favored by some economists, which compares where rates should be considering growth and inflation. Until we see changes in these two areas, monetary policy will remain accommodative. While we believe there's a good chance of a continued weakening dollar scenario in the long-term, we do not believe this is the most likely scenario today.

SIDEWAYS MARKET—ORDER OF CONVICTION: PROBABLE

Due to momentum and fundamentals battling for supremacy, we forecast the most likely outcome is a sideways market for the dollar, with fits and starts ultimately settling in a longer-term trend of weakness. The dollar is still plagued with uncertainty due to the unwinding of crisis-era monetary policy while under the guidance of a new Fed Chairman. The Fed must perform an almost impossible balancing act of reducing its balance sheet while gradually raising rates and not disrupting markets. Moreover, there is still doubt as to whether or not the current stimulus will result in inflation, as we have never been in a state with such action by central banks.

Furthermore, we have never experienced such high stimulus this late in the cycle. When the fiscal package first passed, the dollar strengthened on the news. After that, the dollar weakened after Treasury Secretary Steven Mnuchin expressed a desire for a weaker dollar to benefit U.S. companies. His comments were then contradicted by the President a day later, leaving the administration's stance on the dollar indeterminate.

Highland's view is that the most probable direction of the dollar is sideways movement in the near term, which differs from a consensus view of a strengthening dollar. We still believe the long-term trend is for the dollar to decline. Economic growth in non-U.S. countries is strengthening and approaching pre-crisis levels, while U.S. deficits are rising. Inflation in the U.S. is anticipated to pick up in the back half of the year, causing additional downward pressure on the currency. While the fundamentals will certainly lead the dollar down, the momentum in U.S. markets today will keep us sideways until uncertainty clears the air. This outlook underscores our tactical positioning of neutral regional weights in the short-term and our long-term fundamental view of overweight international equities.

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