GLOBAL MARKET REVIEW & OUTLOOK

Third Quarter 2015

It's the ~~economy~~ dollar, stupid

By Richard Thies

In last quarter's market commentary, we compared the state of affairs to that of a Trojan Horse, where participants were distracted by an oddity (Greece) while something more nefarious happened elsewhere. It's three months later and our current situation is reminiscent of another story from Greek mythology. A frequent character in Greek tales, the Sphinx was a famous riddler who guarded the city gates of Thebes by asking travelers a series of near-unsolvable riddles. When they inevitably failed, she would devour them. The most famous of these travelers was Oedipus who bested the Sphinx at her own game by solving her riddle to become king.

While there are always a myriad of micro and macro stories driving the markets, sometimes just a few take primacy. We are in one of those times. Specifically, there is one riddle that needs answering. **How do you allocate capital when a stronger US dollar is the prevailing theme but a stronger US dollar is increasingly close to causing its own weakness?** The answer to that riddle has been, of all things, to hold US dollars.

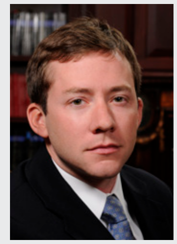
Through the end of the third quarter, holding cash was better than holding stocks and bonds for the first time since 1990. Historically, when cash is outperforming all assets, something bad is about to happen. With global equities just finishing their worst quarter (-9.9%) in four years, perhaps that "something bad" is in our rear-view mirror for the time being. While it is consensus that the dollar's level is important, we will explain why it is perhaps more important now than at any time in recent memory and also why that strength could be its own short-term undoing. We'll start by briefly describing the elevated effect the stronger dollar is having on the global economy and conclude with how the dollar remains the central theme across capital markets.

The dollar and emerging markets today

If participating in the upcoming presidential primaries, James Carville would likely edit his famous campaign slogan to read, "It's the ~~economy~~ dollar, stupid," to account for what is driving much of the recent economic performance. The strength of the dollar always has a profound effect on the global economy and our domestic strength. In its simplest terms, as the primary global reserve currency and the currency in which the majority of external debt is issued, we export our monetary policy and liquidity conditions around the world.

The dollar is unique in this role. As recent years have shown, quantitative easings in Europe and Japan have not had the same multiplier on global growth as has QE by the Federal Reserve. Unfortunately, the global economy is showing increasing signs that it is not ready for the tighter conditions a stronger dollar has brought.

Much of this can be explained by what's happening in emerging markets, including a unique situation in China that is making this truer than ever before. For over a



About the Author

Richard Thies is an assistant portfolio manager. He provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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decade, most of the difference between the global economy growing above potential (and creating inflation) and below potential (limiting inflationary potential) has been dictated by whether the emerging economies are doing well or poorly.

In simple terms, many EM nations remain capital importers. While growth potential is higher, they require capital to reach that potential. The QE period in the US allowed for an unprecedented level of capital inflows into these countries, coinciding with a peak in terms of trade, and actions by most central banks in EM that juiced conditions further. As central banks tried to stem quickly appreciating domestic currencies through intervention (buying USDs locally and selling local currency), domestic liquidity conditions increased markedly and credit growth exploded. We are now witnessing the slow-motion reversal of all three of those phenomena, which are weighing heavily on global growth.

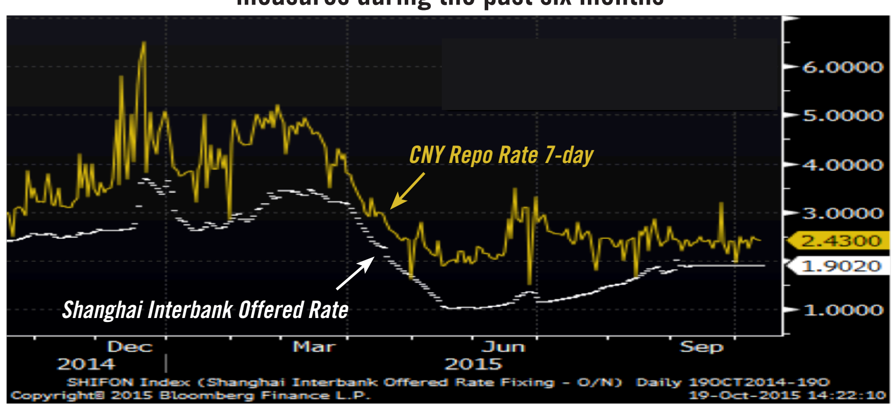
While this element of the story has multiple drivers, the level of dollar strength will intimately affect EM growth. It directly flows through to countries' terms of trade and the dollar's current level is forcing central banks to use reserves to defend their currencies (selling USD, buying local currency). This quickly tightens domestic liquidity conditions and further reverses credit supply. A cessation of dollar strength would at least stop this headwind.

US dollar – 1, Chinese policymakers – 0

There is a new dynamic at play that makes this broad dollar-driven headwind story even more significant today than usual: China. We'll take for granted that everyone is familiar with the following points on China: big increase in leverage, massive oversupply in many areas, deflation in the producer side of the economy, declining competitiveness and aging demographics. We won't take for granted that everyone is aware that the Chinese services sector is doing fine: after all, retail sales at +11% y/y by volume and nonmanufacturing PMIs safely above 50 are not indicative of a crisis. While that's good, it's not enough to support global growth or to offset the slowdown on the industrial side of the economy—and it also could be better.

The US dollar plays a surprisingly large part in this story as well. Real interest rates in China are high and rising as deflation increases. This is a dangerous position for a country with such a high debt load. In spite of an incredible amount of monetary easing (multiple rate cuts and liquidity injections from the People's Bank of China surpassing RMB 1 trillion), true monetary conditions have not eased (Exhibit 1).

Exhibit 1: Measures of interbank liquidity show that conditions in China have not eased after August's currency intervention in spite of several policy easing measures during the past six months



Source: Bloomberg

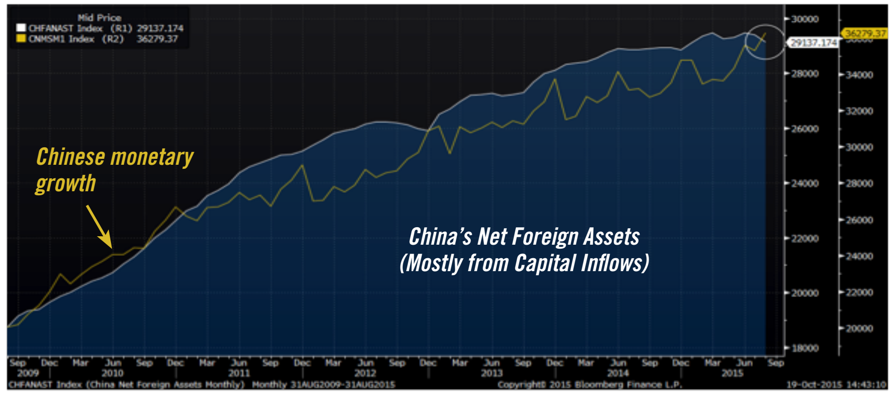
The main reason is that continued currency interventions to support the Chinese renminbi (RMB) are tightening domestic liquidity. The PBOC is effectively easing with one hand and tightening with the other. As shown in Exhibit 2, China's monetary growth has been primarily driven by capital inflows since 2009. If base money is to keep growing and support domestic growth, then either the yuan must weaken now or the capital outflows must stop. There are a number of factors driving outflows, but the perception is that a devaluation is imminent, which is particularly worrisome given the level of foreign currency borrowing (Exhibit 3).

As growth conditions moderate and rate differentials become less attractive, it's unlikely that China will be a net capital recipient anytime soon, but the pace of the outflow depends heavily on the strength of the dollar. **The broader conclusion is that a stronger dollar means that the second biggest economy in the world either loses control of its own monetary policy or it devalues its currency, neither of which are a positive for risk assets.**

The dollar and the United States economy

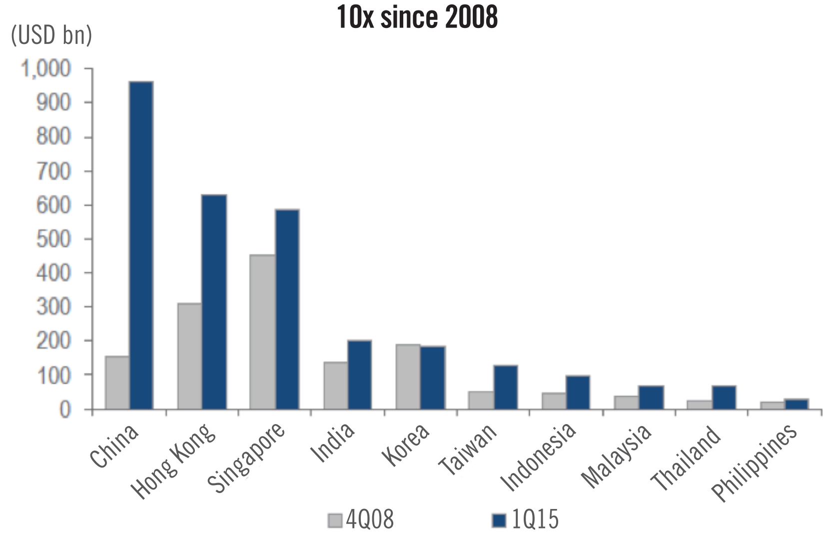
Finally, we get to what may answer our riddle about whether the dollar's strength will be its own undoing. To start, it is important to remember that the dollar's fundamental underpinnings against all major currencies are rate differentials, not balance sheet differentials (Exhibit 4). If we were at a point where US rates were on par with EU and Japanese peers, then relative balance sheet sizes would be more important. As an aside, we believe both will increase their balance sheets again imminently, giving the dollar additional short-term support. Thus, assuming the current negative short-term rates in Europe and low rates in Japan maintain

Exhibit 2: Chinese monetary growth (yellow) has tracked its accumulation of capital inflows (white). If that reverses, it will be impossible for China to keep monetary growth positive enough to support growth without currency depreciation



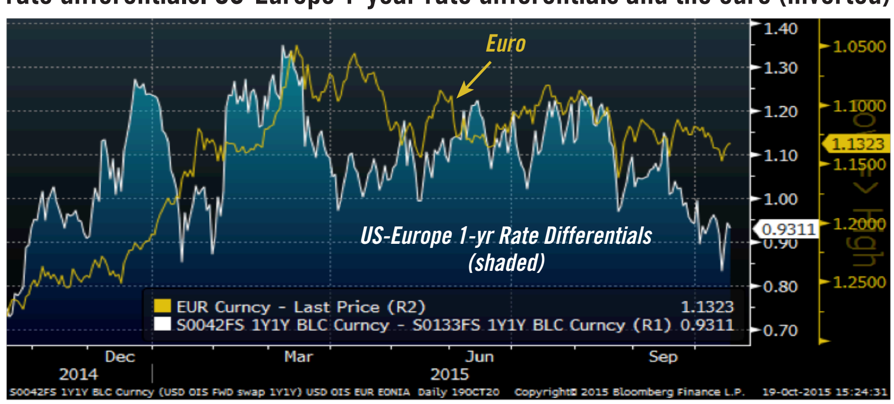
Source: Bloomberg

Exhibit 3: Cross-border borrowings by Chinese corporates has grown by nearly 10x since 2008



Source: BIS and Daiwa

Exhibit 4: As an example, the dollar's value remains fundamentally a question of rate differentials. US-Europe 1-year rate differentials and the euro (inverted)



Source: Bloomberg

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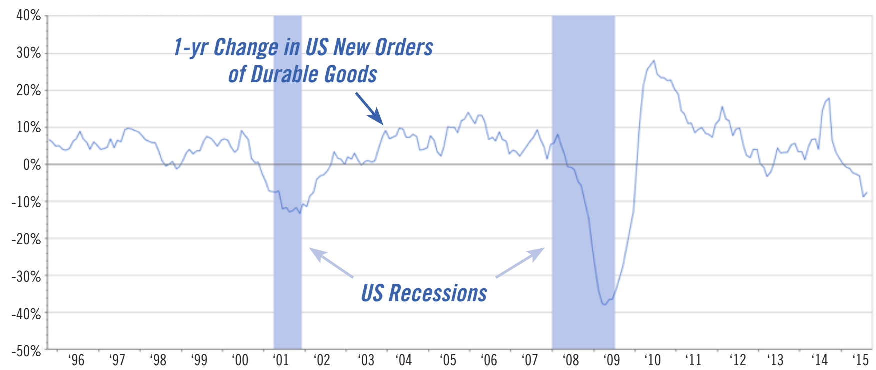
their floors, the key question is whether US rate expectations will fall even further and take the dollar with it. The only way that will happen in this environment is if the global manufacturing weakness is significant enough to hit the US services sector and starts to create some additional slack in the labor market.

In our view, the threatened Fed tightening cycle is a supply-driven one, not one driven by exuberant growth or present inflation concerns. As such, to conclude that the dollar's strength will remain a headwind to the US manufacturing sector and headline growth overall, is not very helpful. The only thing that matters for the Federal Reserve is whether it proves disruptive to the labor market, and thereby changes its medium-term inflation outlook. On this question, we admit the outlook is much murkier than is typical. Looking solely at the industrial side of the economy, you might conclude that a recession is a distinct possibility. Private capital expenditure data is rolling over (Exhibit 5), inventory-to-sales ratios are spiking even in consumer areas, and the current profits slowdown in the US has historically led unemployment readings (Exhibit 6).

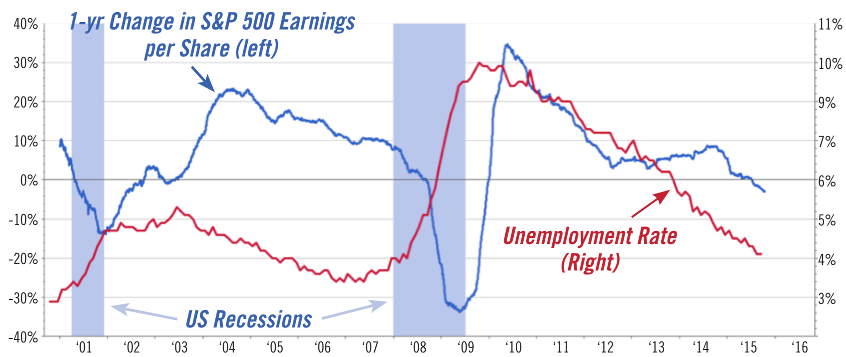
Simultaneously, with jobless claims at cycle lows, real incomes having bottomed, a strong housing market, and consumer confidence at 2006 levels, it's hard to get overly negative. Similarly, it's hard for the Fed to get overly concerned just yet. Despite that, investors would do well to consider whether this will hold up. In short, the weakness in the US is concentrated in the production side of the economy, but if the services sector remained unfazed under these conditions, it would be a rare occurrence (Exhibit 7).

Exhibit 5: US new orders of durable goods are consistent with recessionary levels



Source: Driehaus Capital Management, FactSet

Exhibit 6: S&P 500 next-12 months EPS growth (blue) turning negative has led to an increase in unemployment (red) in the past



Source: Driehaus Capital Management, FactSet

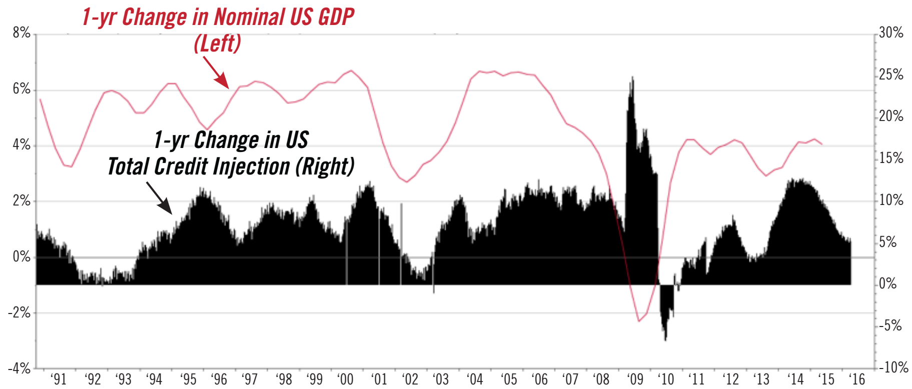
Exhibit 7: US manufacturing ISM (yellow) is near contraction with soft internal components, while the services PMI (white) has thus far remained resilient

Source: Bloomberg

Despite the US being a relatively closed economy and with limited direct exposure to trade, a prolonged chill in the manufacturing sector will ultimately weigh on other areas.

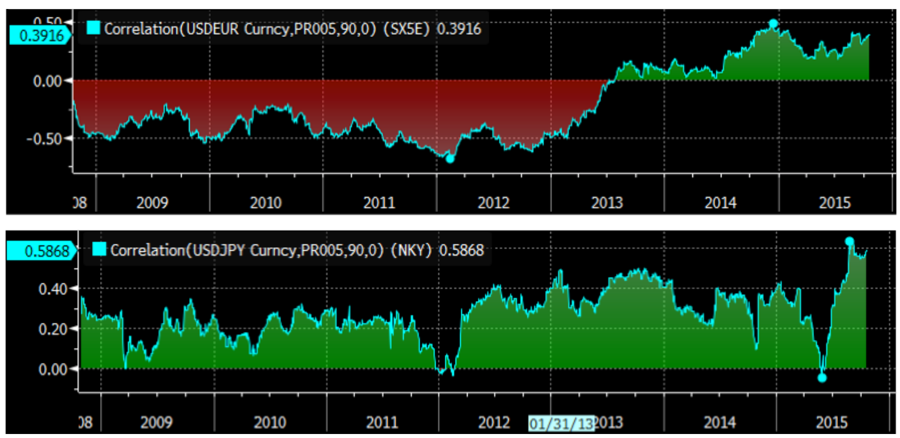
Finally, we reiterate our long-standing view that the US economy will slow in the second half of 2015. This view stems from our position that the cessation of quantitative easing is a negative for the US economy only if the commercial banks do not take up the slack on credit creation. Initially, that happened but commercial bank credit has seen a large second-derivative slowdown of late. If past relationships hold, this suggests a slowing of US growth could be coming (Exhibit 8). If that happens, it would spark a tactical selloff in the dollar, the extent of which would be determined by the scale of the slowdown and how long it takes US banks to start lending again.

Exhibit 8: The slowdown in commercial bank credit growth has exacerbated a slowdown in the US credit impulse, which portends a potentially more challenging growth outlook for the US than many realize



Source: Driehaus Capital Management, FactSet

Exhibit 9: Correlations (90 day) of the Euro Stoxx and Nikkei indices to their respective currency's weakness has never been higher in Japan and is a completely new relationship in Europe



Source: Bloomberg

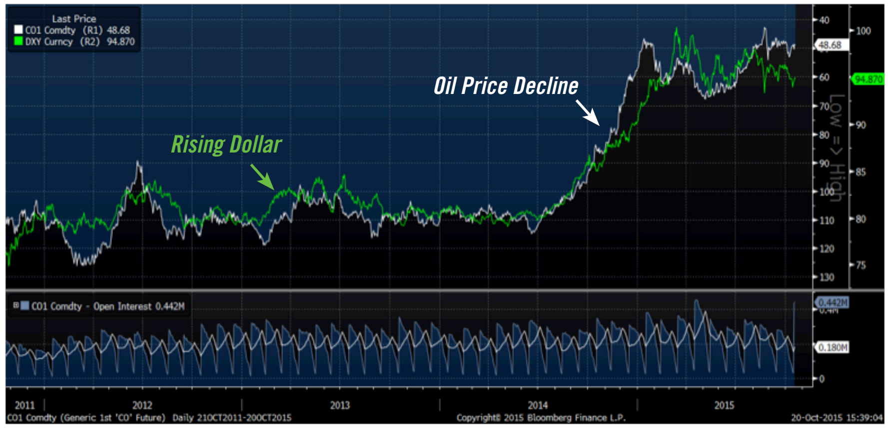
Why does this all matter so much to asset markets going forward?

The dollar's central role as a driver of relative asset performances will become significantly more important than during previous episodes. This is due to elevated currency-driven correlations, the dollar's effect on the commodity complex, and its effect on aggregate earnings growth.

First, the fluctuations in the dollar have had a profound effect on market performance, especially in developed markets. For example, both European and Japanese indices have shown extremely high levels of correlation with their respective currencies the past six months. In the case of Japan, this is a relationship that investors have been familiar with for some time, but for Europe it's a new phenomenon (Exhibit 9).

In a world where earnings growth has been more a function of margins than top-line revenues the last few years, this makes complete sense. And as Europe's prospects have become more tied to external growth, this also makes sense (look at the composition of the German DAX Index: chemicals, autos, industrials, etc.; makes it a China proxy in many ways). It also means that so far this year being "right" has resulted less from being correct that European growth surprises to the upside and more from determining the direction of the euro. We do not think this is a temporary phenomenon. Going forward, we expect the positive correlation between European equities and the euro will remain high and that it won't return to its historical negative correlations. We continue to expect the yen-Nikkei correlation will remain tight as well. Therefore, sound allocation among developed markets requires a view on the dollar.

Exhibit 10: The oil price decline (inverted , white) has been largely a response to a rising dollar (green)



Source: Bloomberg

Second, the effect of the dollar on the commodity complex has increased in importance due to the stress in the energy sector. Commodity prices and oil prices are always somewhat related, and in spite of the many narratives surrounding declining oil prices (e.g., breakdown in OPEC, shale production, etc.), much of the fall remains a dollar phenomenon (Exhibit 10). This is particularly important now due to the heightened role of energy companies' fortunes in determining risk sentiment. Given the level of energy-debt held by credit investors and the banks themselves, the default rates with oil at $30 look significantly scarier than with oil at $50, and the dollar will play a key role in determining that price. Additionally, the relationship between breakeven inflation rates and oil prices remains extremely high. So much so that the oil price will have a large role in determining the steepness of the US yield curve, regardless of what the Fed does.

Finally, the dollar's value will have a significant effect on earnings growth, or lack thereof, going forward. While earnings are always important, we are of the belief that they are taking more primacy. It's difficult to quantify the exact drag the dollar has had on earnings but once again this quarter a majority of companies in the US have cited it as a major headwind to earnings. The issue is that we are still seeing debt levels and leverage increasing in the US. Independent of what happens with interest rates or the energy sector's credit quality, leverage outpacing profits will result in wider spreads and, ultimately, lower equity valuations at a time when equity risk premia are already very low in the US. With corporate debt issuance still running higher and leverage-fueled corporate transactions moving equity markets, we must see better earnings growth soon, something that will prove difficult if the dollar's rise continues.

Looking ahead

Investors face a challenging backdrop as the dollar's value is likely to direct much of the relative asset returns. We are closely watching the data on the US services sector for clues as to whether the manufacturing slowdown is starting to infect the rest of the economy, and whether the robust housing market can offset maturing momentum in many other areas. Equally important, we are monitoring the inflation backdrop. Specifically, we are watching the reaction to fading transitory deflationary pressures from the commodities fall, and whether wage pressures build before the economy loses momentum.

From a positioning standpoint, the binary nature of the dollar and its effect on the likely forward returns of different assets advocates for increasing the weight to 'weak dollar' assets in the event that the US economy stumbles, the Fed does not raise rates as much as is currently priced, and the dollar subsequently weakens. Judging by positioning data, most investors are significantly underweight these 'weak dollar' areas and a reversal in the dollar would cause a sharp reaction.

While many have overlooked emerging market equities, they may provide the best hedge to US weakness. Valuations have improved for the asset class and a positive rebalancing has taken place as domestic weakness within some countries has completely erased external deficits. While these improvements are good, they still require capital outflows to slow, which is impossible to forecast. However, you can forecast that if investors rethink their dollar view, emerging market currencies' returns would be substantial, which would be likely to bring capital flows back into EM markets.

At the company level, margins in emerging markets still look poor but the multiyear deterioration has abated. Being dependent on capital flows, the timing of relative EM equity outperformance is difficult to precisely identify, but it is clear that the diversification benefit of the asset has greatly increased as a result of the binary reactions to US dollar strength. Additionally, we continue to prefer macro fundamentals in Europe on a tactical basis and find it an attractive backdrop for stock selection despite that, on the aggregate, index performance will be led by the euro. The healing of the banking sector combined with excess liquidity creation by the European Central Bank should ultimately be a powerful driver of risk assets, just as it was in the US.

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