U.S. DOLLAR & DIVERGENT GLOBAL CENTRAL BANK POLICIES

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Last week Professor Jeremy Siegel and I spoke with Bill Stone, Executive Vice President and Chief Investment Strategist of PNC Institutional Asset Management, and James Wood-Collins, CEO of Record Currency Management, about their outlook on the markets, diverging central bank policies and the role of currency in portfolios. **Looming Fed Hike** Professor Siegel highlighted the increasing probability of a Federal Reserve (Fed) rate hike, stating, "The Fed couldn't be any clearer on a December 16 liftoff and that it will be Christmas wrapped," implying that subsequent hikes could be deliberate and gradual in nature. He anticipates one increase per quarter—and that, too, will be highly market dependent. Professor Siegel also believes it is possible the second rate hike does not occur until June. Bill Stone corroborates Professor Siegel's thoughts and believes that December is "go time" for the Fed and that the markets have to a large degree priced this in. He is somewhat surprised by the sudden re-pricing of Fed probabilities that has had a beneficial impact on market performance. **Positioning for a Hike: Growers over Yielders** Stone is most concerned about the hidden duration exposure that many portfolios may contain. Hidden exposure implies allocations to high-dividend yielders that tend to behave like bonds with ultra-long duration. This is different from dividend growers, which have the capability to grow dividends in an environment of rising rates. Stone also notes that dividend yielders—namely companies in the Telecommunication and Utilities sectors—appear expensive, given investors' desperation for yield in this low-interest-rate environment. Dividend growth, on the other hand, is more attractive from a valuation standpoint, in his view, and is growing in importance, given an environment of potentially rising rates. **Positioning for a Hike: King U.S. Dollar** James Wood-Collins believes that the best expression for divergent central bank policies—the U.S. on the one hand, and the eurozone and Japan on the other—is a long U.S. dollar trade. Given that currencies are a pair trade, and that they are driven primarily by interest rate differentials, a hike on the part of the Fed would push interest rates in favor of the dollar against both the euro and the yen, whose central banks have pledged to keep monetary policy as easy as possible. According to Wood-Collins, this market backdrop makes a strong case for U.S. investors to hedge currency exposure in Europe and Japan. Given the strongly divergent Fed and ECB policies, both Professor Siegel and Stone see a strong possibility for the euro to trade below parity in the near future. Wood-Collins also believes that divergent central bank policies may signal a resurgence of currency strategies that are based on interest rate differentials and carry. He also foresees higher volatility in this market environment. **The Valuation Case for Emerging Market (EM) Stocks and Currencies** Professor Siegel, Stone and Wood-Collins all reiterate their conviction that EM stocks and currencies are selling low relative to historic fundamentals. More importantly, much of the EM region trades based on sensitivities to commodities. Stone favors dividend growers in EM, namely the consumer names that coincidentally earn 4%, 5% or 6% in dividend yield. Despite its "growth-ier" qualities, this yield is tough to rival. Wood-Collins, in particular, believes that EM currencies could be a rewarding opportunity in the long term, given their convergence in productivity and gross domestic product (GDP) per capita to the developed markets and the higher real interest rates borne by EM currencies. **Currencies Decoded** Unlike investment markets, currency markets are transactional. According to the Bank for International Settlements, there are $5 trillion in daily transactions—which dwarfs trades on the NYSE. Since currencies are a pair trade, one should ask where the risk arrow might be pointing. Wood-Collins lists a few measures on which currencies can be valued or assessed: 1. Carry: Driven by interest rate differentials. 2. Value: Looks at indicators such as purchasing power parity and potential reversion to mean. 3. Momentum: Picks up on trend-following strategies—and Wood-Collins points out the importance of following its signals in a disciplined fashion. **Bottom Line** In summary, our guests are looking to position for the future via stronger U.S. dollar plays and currency-hedged strategies in Europe and Japan. The Fed ought to utilize this market environment to get its first rate hike out of the way to ease investor sentiment. Read the Conversations with Professor Siegel Series.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Dividend yields : Refers to the trailing 12-month dividend yield. Dividends over the prior 12 months are added together and divided by the current share price. Higher values indicate more dividends are being generated per unit of share price.

Dividend growth : The growth in trailing 12-month dividends for the specified universe.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Pair trade : The quotation and pricing structure of the currencies traded in the forex market: the value of a currency is determined by its comparison to another currency. The currency pair shows how much of the quote currency is needed to purchase one unit of the base currency.

Interest Rate Differentials : The Difference between the 2 Year interest rate swaps of the United Kingdom vs. the United States.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Parity : Euro at parity means the euro would be trading at rate of $1 equals €1.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.