

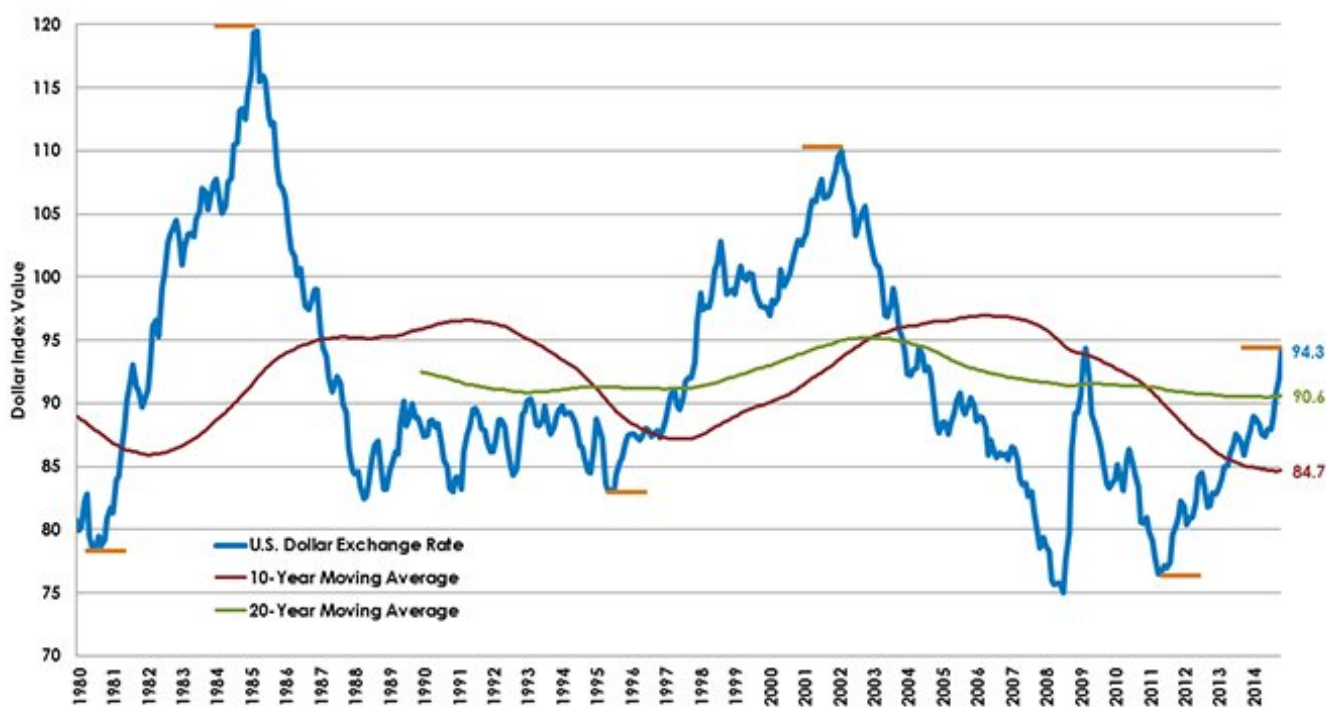
2015: Secular Appreciation in the U.S. Dollar

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While the dollar has rallied by more than 20% from its lows,¹ valuations appear anything but stretched in our view. In the long run, exchange rates reach equilibrium due to slower-moving macroeconomic factors that cycle between relative advantages. However, currencies are also prone to overshooting these norms. As one currency rises in value compared to another, the attractive elements of the economy slow down, resulting in an adjustment of the exchange rate. For this reason, currencies tend to cycle over time. We believe that previous drivers of dollar appreciation may also be driving dollar strength in the current period. As we show in the chart below, over the last 30 years, we have identified two distinct periods of secular appreciation in the value of the U.S. dollar. From June 1980 through March 1985, the dollar appreciated by more than 52% before policy makers negotiated its retracement.² From July 1995 through February 2002, the dollar rose by nearly 33%.³ Today, the dollar is trading just above its 20-year average.⁴ **Secular Bull and Bear Markets in the U.S. Dollar J.P. Morgan Real Broad Effective Exchange Rate U.S. Dollar, 12/31/79-11/30/14**



Sources: J.P. Morgan, Bloomberg, WisdomTree, as of 11/30/14. Past performance is not indicative of future results.

1980s Under Federal Reserve (Fed) chairman Paul Volcker, the dollar surged in the early 1980s as the U.S. aggressively hiked interest rates to bring inflation under control. In two years, inflation had fallen by

more than 10% to more normalized levels.⁵ With the precipitous fall in prices, the U.S. offered investors some of the highest real interest rates in the world. As a result, international capital continued to flow into the U.S., driving up the value of the dollar. However, this capital flow continued even after the Fed reversed course and began to cut rates. After a nearly 50% rise in value against other major currencies by 1985, U.S. exports began to come under considerable pressure. After modest current account surpluses to start the decade, the current account plunged to a deficit of 3.5% of GDP, an unheard of level at that time.⁶ In one of the most significant forms of international financial coordination in the modern era, the period of dollar strength ended with the signing of the Plaza Accord, which set up the dollar's precipitous revaluation. **1990s–2000s** In the second dollar bull market that we identified, the dollar appreciated against European currencies and the yen by approximately 5% per year from '95–'02.⁷ The primary driver during this period, however, was an increase in U.S. labor productivity compared to the rest of the world. During one of the most prolonged periods of real economic growth in the U.S. since World War II, monetary policy remained accommodative while U.S. manufacturing and the booming technology sector drove growth. With the economy strong, inflation subdued and borrowing costs low, the U.S. government was able to run a primary budget surplus. Ultimately, this move culminated with the bursting of the tech bubble and a decline in U.S. manufacturing. The U.S. economy eventually slipped into a recession following the terrorist attacks of September 11, 2001. **Present** Looking at the period since spring 2011, we believe that the next period of secular appreciation in the U.S. dollar may be upon us. At the start of this rally, the viability of the eurozone was being called into question. Previously, many viewed the euro as a strong competitor to the U.S. dollar as a new reserve currency of the world. However, questions arose about whether the eurozone could continue to function as a monetary union without becoming a full-fledged Fiscal union as well. With technorats riding to the euro's rescue, the dollar dipped from its trend of appreciation. In August 2011, Standard & Poor's downgraded the credit rating of the U.S. for the first time in history. In a perverse response, the dollar strengthened, and U.S. Treasury yields declined. Going forward, we believe continued dollar strength may be driven primarily by a combination of the factors that drove dollar strength in the mid-'80s and '90s: higher real interest rates and stronger economic growth. In recent years, the dollar has appreciated as global investors sought to tap into U.S. growth via stock and bonds. With volatility in markets increasing through the end of 2014, we believe many investors will continue to look at different ways to manage risk in their portfolios. In our view, a long-dollar strategy could be one way to reduce risk during uncertain markets. Should our thesis prove correct, we believe the value of the U.S. dollar could appreciate against a basket of foreign currencies in the coming year. ¹Sources: J.P. Morgan, Bloomberg. As measured by the J.P. Morgan Real Broad Effective Exchange Rate from 4/30/11 to 11/30/14. ²Sources: J.P. Morgan, Bloomberg. For the purposes of this analysis, we focus on estimates of real effective exchange rates (REERs). ³Sources: J.P. Morgan, Bloomberg. ⁴Source: WisdomTree, as of 11/30/14. ⁵Source: Bureau of Labor Statistics. ⁶Source: OECD. ⁷Source: Bloomberg.

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