

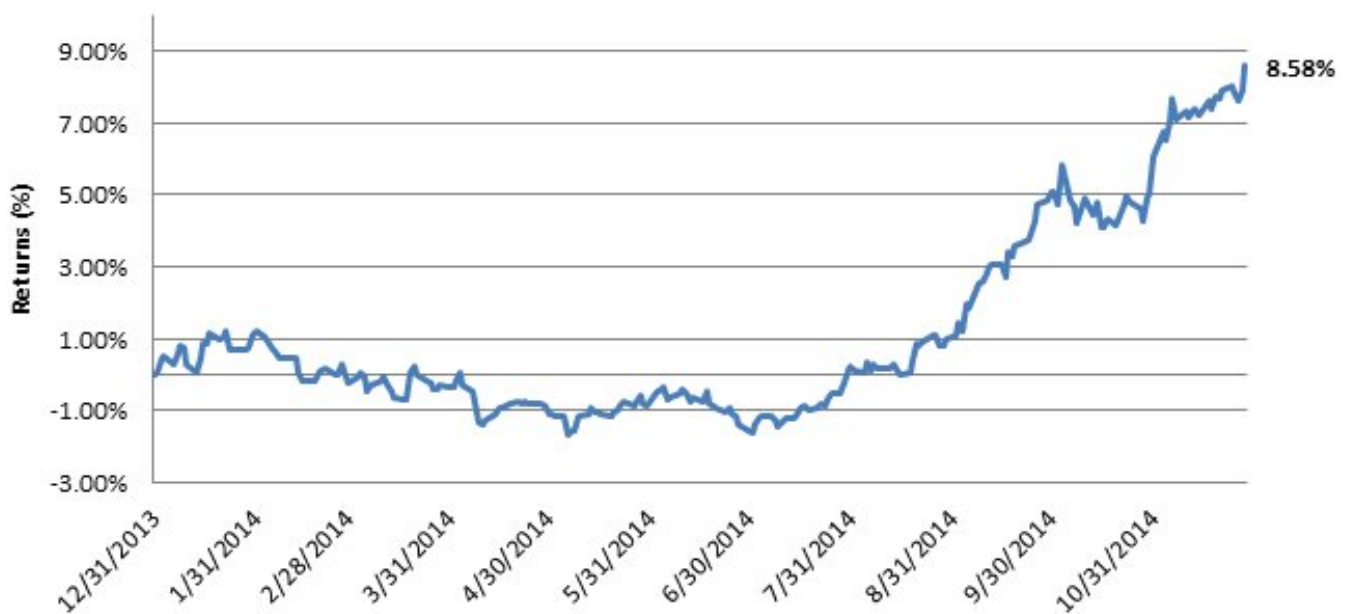
Making Sense of Dollar Strength

Published December 2, 2014

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Over the last several months, investors and economists alike have started to take note of the broad-based appreciation of the U.S. dollar.¹ Should markets remain near current levels through the end of the year, the dollar will have appreciated by approximately 8.6% against a basket of developed and emerging market currencies, its strongest performance since 2005.² However, we believe the magnitude of this year's move tells only a portion of the story. In our view, this summer's rally does not represent a correction or near-term adjustment, but rather the continuation of a broader trend that started in the middle of 2011. Should our analysis prove correct, we believe this period of dollar strength could just be getting started. A key factor driving our view is the breadth and persistence of the most recent move: Of the 55 currencies that WisdomTree tracks, none have managed to appreciate against the U.S. dollar in 2014.³ Across developed, emerging and frontier markets, the theme of dollar strength is persisting. To us, this signals that this move is primarily being driven by idiosyncratic factors pertaining to U.S. markets and the economy. Below, we discuss three drivers and provide rationale for why we believe these factors are likely to persist. [Bloomberg Dollar Spot Index \(12/31/13–11/28/14\)](#)



Source: Bloomberg, as of 11/28/14. Past performance is not indicative of future results. You cannot invest directly in an index.

Divergence relates to relative growth rates, potential changes in monetary policy and the outlook for inflation in the U.S. compared to its trading partners. In all three instances, the U.S. economy appears

to be on the opposite end of the spectrum from its developed market peers. While the Federal Reserve (Fed) and the Bank of England (BOE) are expected to hike interest rates in 2015, the Bank of Japan (BOJ) and the European Central Bank (ECB) show an increasing desire to expand their balance sheets, engage in nontraditional monetary policy and experiment with negative interest rates. With the Fed ending its quantitative easing (QE) program in October, the European and Japanese central banks are now being seen as primary providers of liquidity to global capital markets. As a result, we have seen a marked divergence in the yields of 2- Year Treasury notes compared to European and Japanese 2-years. Additionally, as short-term interest rate differentials rise in the U.S. compared to the rest of the world, we expect the trend of dollar strength to continue. With rates higher in the U.S., the cost of being long currencies with negative or zero short-term rates would logically drive flows out of those currencies and into dollar-denominated assets. **Differentiation** is primarily a distinction relating to emerging markets. In our view, taking a one-size-fits-all approach to investing in emerging markets has negatively impacted performance. Over the last year, investment flows (and trade), a strong driver of EM exchange rates, have negatively impacted performance. In the same way that we see central bank policy occurring at varying speeds, we believe that emerging markets also fall along a continuum in terms of their opportunities, risks and stages of economic development. For example, certain EM economies have grown due to commodity wealth and investment, while others have struggled with inflationary pressures due to the high cost of energy imports. Today, lower energy prices for exporters have the exact opposite effect on the economies of importers such as India. Geopolitical risk and corruption inquiries continue to complicate fundamental views. While we believe the long-term emerging market growth story remains intact, currencies could continue to face near-term headwinds. Opportunities remain, but growth prospects in some emerging markets appear less attractive in an environment of 3% U.S. economic growth.⁴ **Disinflation** has proved to be a difficult hurdle for central bankers to overcome since the global financial crisis. Overcoming it can, in many ways, prove to the market that central bank policies are having their desired effect. While disinflation has been most acutely felt in Europe, prices around the world remain constrained. Historically, moderate levels of inflation signaled healthy economic expansion. However, prolonged periods of low or negative inflation can make investors nervous. This is precisely why central banks have been employing aggressive monetary policy. A clear byproduct of QE is a weakening exchange rate. Weaker exchange rates may lead to an uptick in economic growth and, eventually, higher inflation. In the U.S., despite inflation staying below long-term targets, it remains substantially higher than readings in other developed economies. As a result, the recent upswing in U.S. economic momentum has caused not just a rebound in U.S. asset prices, but an increase in the strength of the U.S. dollar as well. While high levels of inflation often cause trouble for currencies, falling prices could be a larger risk due to potential concerns about debt sustainability. While all of these points can help explain a portion of the current market moves, we believe this trend may just be getting started. In all three instances, there is a distinct element of persistence. In other words, these factors are unlikely to change overnight. As a result, we believe investors should consider allocating to currency strategies that are long the U.S. dollar rather than to a basket of foreign currencies. ¹As represented by the Bloomberg Dollar Spot Index. ²Source: Bloomberg, as of 11/28/14. ³Source: Bloomberg, as of 11/28/14. ⁴Source: Bloomberg composite 2015 forecast, as of 11/28/14.

Important Risks Related to this Article

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