

U.S. Dollar & Divergent Global Central Bank Policies

Published November 25, 2015

Jeremy Schwartz, CFA

Global Chief Investment Officer

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.](#)

Important Risks Related to this Article

Investments focused in Japan or Europe increase the impact of events and developments associated with the regions, which can adversely affect performance.

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but can hurt when the foreign currency appreciates against the U.S. dollar.