THE FED TO PERPETUATE A STRONG DOLLAR

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Last week, Professor Siegel and I chatted with Marc Chandler, Head of Global Markets Strategy at Brown Brothers Harriman, about his views on divergent central bank policy actions, implications for the U.S. dollar, euro and yen, as well as his thoughts regarding emerging markets (EM). Below is a summary of our conversation. **Spotlight on the Federal Reserve (Fed) and the European Central Bank (ECB)** Markets have become increasingly convinced that the Fed will embark on interest rate normalization at its policy meeting today. Professor Siegel agreed it would happen, barring a large market swoon early in the week. As a result, divergent central bank policy in the developed markets is anticipated to be in focus. With the ECB pledging to extend its quantitative easing (QE) program and taking its monetary policy rate deeper into negative territory, and the Bank of Japan (BOJ) in the midst of QE, the question remains how policy divergence will impact their local currencies. **Understanding Fed Funds Futures** The Fed Funds Target Rate implied by futures market pricing is the average effective rate over the course of the month. Many pricing models assume the Fed will target its effective rate at the midpoint of the Fed's target range (currently 0 to 25 basis points [bps]). But that is not necessarily the case, and the Fed may actually target a lower half of the range when setting the policy rate. Given that the board includes a large number of doves, this may be the more likely scenario, in which case the Federal Funds futures market probabilities estimating a rate hike—those based on the midpoint of the range—are understating the actual chance of a hike. That said, a hike today is widely anticipated, and it would be more disruptive to markets if the Fed did not move. **Would a Rate Hike Be Good for Stocks?** Professor Siegel and Marc Chandler both believe that markets may continue to perform well, despite a rate hike from the Fed. Chandler states that investors have had a long time to digest this rate hike and it could be seen as good housekeeping, where the economy is strong enough to withstand policy normalization. While the markets do not typically respond well to tightening policy rates, the removal of uncertainty over this hike may become a positive force going into the end of the year. **Interest Rate Differentials to Drive Euro Lower** Interest rate differentials are a large driver of currency trends. Chandler outlines the current market environment: at the end of 2007, Germany's two-year bund yielded more than 100 basis points higher than the U.S. two-year. Today the U.S. two-year yields more than 125 basis points above the German two-year bund. This could drive capital flows to the U.S. Against the backdrop of the Fed's continuing to hike next year and the ECB potentially having to do more QE if inflation remains low, interest rate differentials may stay in favor of the U.S. As a result, it is likely that the U.S. dollar will remain well supported from the perspective of interest rate differentials. **Challenging Environment for EM Currencies** While EM currencies are currently inexpensive based on historical measures of valuations, Chandler states that they are likely to get even less expensive. There are a host of factors that contribute to this general pessimism, the first of which being lower-for-longer commodity prices that are likely to push EM currencies lower. Additionally, lower commodity prices have led to a decrease in companies' profitability—particularly in the metals, mining and energy sectors—which have, subsequently, led to cuts in dividends. EM currencies can account for a large chunk of underperformance across both the equity (historically one-third of returns) and fixed income asset classes (historically two-thirds of volatility in returns). Secondly, there are serious geopolitical issues in the EM block. The geopolitical landscape for many EM countries—Russia, Brazil, South Africa, Turkey and Malaysia, to name a few—makes the perspectives for EM currencies less encouraging. **China Unlikely to Drastically Weaken Currency** Chandler believes it is more likely that China will weaken its currency only modestly. While a strong dollar is appropriate for the U.S., it is increasingly inappropriate for China, given the country's growth considerations—having pegged its currency to a large degree to the U.S. dollar. Chandler believes it is likely for the Chinese yuan to experience a slow depreciation, possibly moving 3%–5% next year. Given China's large trade surplus, which ranges between $50 and $60 billion per month, the political backlash may be severe if China depreciates its currency drastically. **Bottom Line** In summary, divergent central bank policies in developed markets are likely to result in further U.S. dollar strength against the euro and the yen. While the current market environment may be challenging for EM, a first rate hike from the Fed and a subsequent slow pace of hikes may provide the region with some temporary reprieve. 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.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

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.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Basis point : 1/100th of 1 percent.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

Dividend : A portion of corporate profits paid out to shareholders.

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

Trade Surplus : occurs when the value of exports exceeds that of its imports of any one country.