LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

January 29 2018

DOLLAR VOLATILITY PERSISTS

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KEY TAKEAWAYS

Looking forward, we continue to believe the dollar may see moderate strength in 2018, based on tightening monetary policy and pro-growth fiscal policy in the United States.

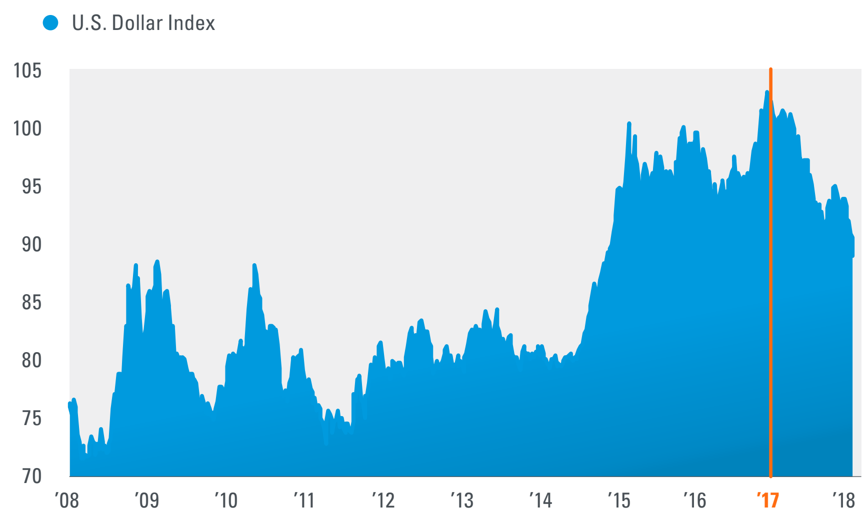
A stronger dollar could at some point be a small headwind for otherwise strong corporate earnings in 2018, and may keep downward pressure on inflation.

The dollar's direction over the long run will be driven by fundamentals, including economic growth, budget and trade deficits, and monetary policy.

The U.S. dollar was in the news recently after comments from Treasury Secretary Mnuchin, European Central Bank (ECB) President Draghi, and President Trump created volatility in the world's reserve currency. Mnuchin indicated that a weak dollar could benefit the United States as it relates to trade and opportunities. Draghi said that a strong euro (and by extension a weaker dollar) is understandable given strong European growth, but he also raised concerns that if other countries start targeting specific currency levels, it could have an impact on the ECB's ability to meet its inflation goals. Trump then followed up saying that he ultimately wants a strong dollar. This mixed messaging has led some to ask why there seems to be disagreement on the path the dollar should take, and what it means for markets.

Historically, a strong dollar has been beneficial for the United States, as it makes foreign goods and services cheaper and helps to keep inflation low; however, some dollar weakness may serve a purpose by improving the trade

1 THE DOLLAR WEAKENED IN 2017



Source: LPL Research, Bloomberg, DXY Dollar Index 01/26/18

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deficit (as U.S. goods become more attractive to overseas buyers, potentially increasing exports). A weak dollar can also help corporate earnings. In 2016 (the last year for which data are available), approximately 43% of S&P 500 Index revenues came from overseas. Relatively cheaper U.S. goods for foreign buyers can help corporations increase sales, and it also means that more dollars can be purchased with the proceeds of foreign sales, which can serve to boost revenue and earnings per share numbers. That said, we wouldn't want to see too much weakness in the dollar, as it could lead to higher than expected inflation—driven both by higher commodity costs and more expensive imports—and a number of other issues.

WHAT IS DRIVING DOLLAR WEAKNESS?

The U.S. economic situation would seem to augur for a stronger dollar, but that has not been the case over the past year. The dollar did see significant strength in 2014 as the Federal Reserve (Fed) ended its most recent quantitative easing program known as QE3. That momentum continued into late 2016 as rates moved higher and markets started pricing in the potential for pro-growth policies that could push inflation higher [Figure 1]. However, even though many market participants expected a stronger dollar heading into 2017, the dollar weakened instead, and has since given up about half of its post-2014 gains. What has caused this recent weakness?

The value of the dollar is measured relative to other currencies, and stronger global growth led the currencies of many major trading partners to strengthen. The euro makes up 57.6% of the DXY dollar basket (which is often used to measure movement in the dollar); and stronger than expected economic growth, along with a cut to ECB bond purchases announced in October 2017, led the euro to significant gains versus the dollar. The Japanese yen, which makes up another 13.6% of the dollar basket, also saw strength versus the dollar on better-than-expected economic growth, as did the British pound (with an 11.9% weight in the basket) as increasing inflation pushed the Bank of England to raise rates in November 2017 for the first time in 10 years.

Uncertainty around inflation expectations (and the resultant impact on Fed policy), the potential for rising U.S. budget deficits, and an increasing trade deficit have likely been additional reasons for dollar weakness in 2017 and early 2018. Although the DXY dollar basket is often used to measure the dollar's moves versus other major currencies, another way of looking at dollar strength is with a basket of currencies weighted by trade volume with the United States, such as the Fed's Real Trade Weighted U.S. Dollar Index. This measure has historically tracked with an indicator known as the twin deficits which is simply the combined federal budget deficit and trade deficit as a percentage of gross domestic product (GDP). According to analysis done by Strategas Research Partners based on this data, the current weakness in the dollar may be overdone [Figure 2].

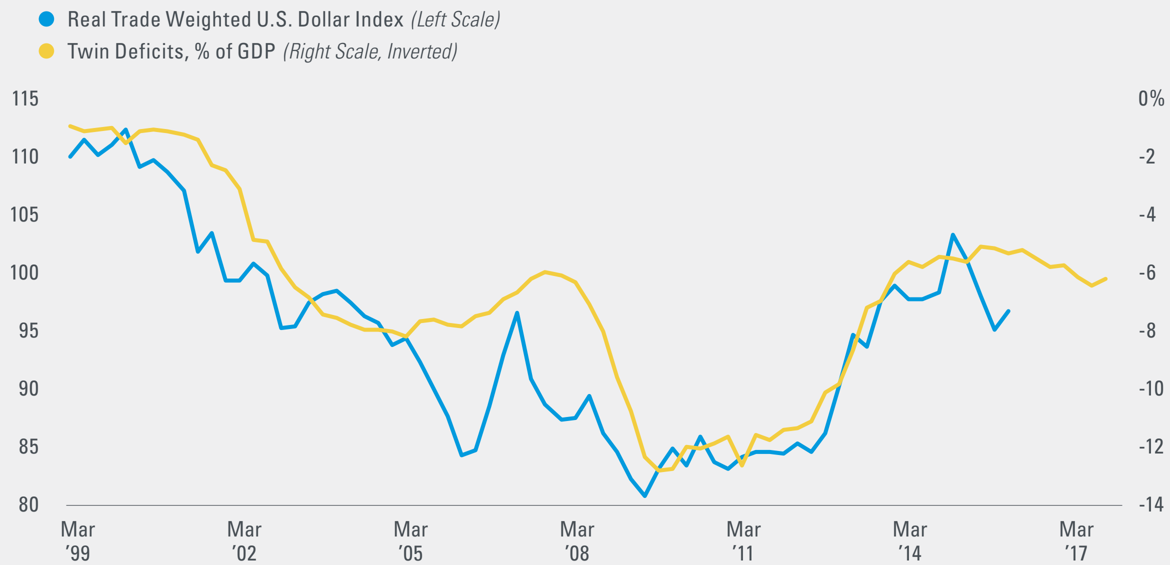
WEAKNESS EXPECTED TO ABATE IN 2018

As outlined in our *Outlook 2018*, we expect that the dollar may see moderate strength in 2018. The Fed is allowing maturing assets to roll off its balance sheet at a measured pace (as opposed to the ECB and Bank of Japan [BOJ], which are still buying assets), and we continue to expect three Fed rate hikes in 2018, with the first likely in March, while we don't expect any rate hikes from the ECB or BOJ. Additionally, as markets get more clarity around new Fed leadership, the impact of tax reform, and the potential for additional pro-growth policies such as an infrastructure plan and a pivot toward regulatory relief for banks (see this week's *Bond Market Perspectives*, due out tomorrow, for more on this topic), we believe we may see dollar stabilization, or even some outright strength, in the year ahead. This also feeds into our slightly below consensus view on S&P 500 earnings growth given that dollar stabilization could introduce a headwind for earnings that the market isn't necessarily expecting.

CONCLUSION

Even though the past week has been a tough one for the dollar, we expect that we may see some dollar strength over the balance of 2018 as markets get more clarity on U.S. monetary and fiscal policy. Markets have already largely priced in stronger global growth, including higher expectations (relative to the beginning of last year) for Europe, Japan, and China, which may make it harder for these countries to beat their current economic targets, perhaps limiting strength in those currencies. And finally, we believe the market's expectations of slow removal of monetary accommodation in Europe, and continuing accommodation in Japan, may prove out in 2018, limiting the potential for a major upward move in the euro or yen. ■

2 RECENT DOLLAR WEAKNESS MAY BE OVERDONE



Source: LPL Research, Strategas Research Partners 01/26/18

GDP – Gross Domestic Product

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Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Quantitative easing (QE) refers to the Federal Reserve's (Fed) current and/or past programs whereby the Fed purchases a set amount of Treasury and/or mortgage-backed securities each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The U.S. Dollar Index (DXY) indicates the general international value of the U.S. dollar. The DXY Index does this by averaging the exchange rates between the US dollar and six major world currencies.

The Federal Reserve's Trade Weighted U.S. Dollar Index, also known as the broad index, is a measure of the value of the U.S. dollar relative to other world currencies. It improves on the older U.S. Dollar Index by using more currencies and then updating the weights yearly.

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