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# DOLLAR OUTLOOK

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## KEY TAKEAWAYS

The U.S. dollar has staged a strong rally recently after significant weakness in 2017.

In the near term, the dollar may strengthen further because of rising interest rates in the U.S., weak economic data overseas, and repatriation of overseas cash.

Longer-term structural downward forces remain, primarily the twin deficits (current/trade and federal budget twin deficits), suggesting further gains in the dollar may be contained.

**The U.S. dollar has come back strongly.** After losing nearly 10% in 2017 and an additional 4% in January, the U.S. Dollar Index has rallied more than 5% off of its February lows [Figure 1]. Gains have been driven by several factors, particularly rising U.S. interest rates, partially due to increasing Federal Reserve (Fed) rate hike expectations, and repatriation of overseas profits as prescribed by the new U.S. tax law. Weakness in emerging market (EM) currencies as a result of several flare-ups in trouble spots such as Turkey and Argentina, along with the populist wave in Italy, have added to support for the dollar. The dollar is important for many reasons, including its impact on international trade and on overseas corporate profits. So, where does the dollar go from here?

## DRIVERS OF RECENT STRENGTH

Forecasting currency movements with any accuracy over the short term can be difficult, a lesson that was reinforced for us last year when we called for an end to the dollar's slide. Although some fundamental factors that impact currencies can be measured and perhaps predicted with some accuracy, even the most logical relationships don't always hold.

### 1 U.S. DOLLAR FINDS SUPPORT AND COULD CONTINUE TO RALLY

● U.S. Dollar Index



Sources: LPL Research, FactSet 05/18/18

Indexes are unmanaged and cannot be invested into directly. Performance is historical and no guarantee of future results.

Case in point, the Fed, which began to hike its target short-term interest rate in December 2015, hiked rates three times in 2017. Meanwhile, the European Central Bank (ECB) did not hike rates at all—and wasn't expected to until well into 2018. Sounds like a positive environment for the dollar, right? Not so much. The euro rallied 15% last year versus the dollar amid strong data and relative political stability.

Something clearly changed this year with the latest rally. We attribute the gains to the following:

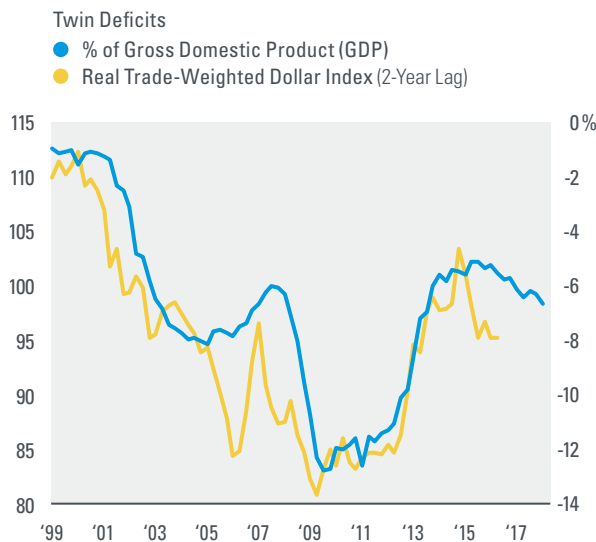
**1. Faster pace of rate hikes by the Fed.** While Fed rate hikes on the surface may have been expected to boost the dollar in 2017, they were largely anticipated. But expectations for 2018 rate hikes have been rising all year, amid a pickup in inflation and improving economic growth. Four rate hikes in 2018 has become consensus (more than 50% probability), compared with late last year when three hikes

were much more likely based on what the bond market was pricing in.

**2. Weaker growth in Europe.** Economic data have been missing expectations in Europe at an alarming rate. In fact, based on the collapse of the Eurozone Citigroup Economic Surprise Index, European data have been missing at a rate similar to that during the heart of the 2011 European debt crisis. European inflation data have been weak too, pushing out expectations for ECB rate hikes. Slower growth has pushed out the timetable for monetary policy tightening from the ECB, potentially a positive for the dollar.

By the way, Japanese economic data have also disappointed recently, including a contraction in Japanese first quarter gross domestic product (GDP). As a result, the Bank of Japan's timetable for halting securities purchases (quantitative easing) and increasing interest rates has been pushed out, potentially adding additional support for the dollar against its major trading partners.

## 2 TWIN DEFICITS PUTTING STRUCTURAL LONG-TERM DOWNWARD PRESSURE ON THE U.S. DOLLAR



Sources: LPL Research, Strategas Research Partners, LLC 05/18/18

The twin deficits is defined by current account deficit and budget deficit added together as a percent of GDP. Those two deficits combined are putting downward pressure on the dollar.

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**3. Repatriation of overseas profits.** The Tax Cuts and Jobs Act passed in December 2017 included a required tax on overseas profits, which set the stage for repatriation of a huge corporate cash pile previously held overseas. Strategas Research Partners, LLC estimates \$500–700 billion in repatriation funds will be made available to U.S. corporations in 2018 that would not have been otherwise. Many have debated about how much of those funds were already in dollars (it is probably a good-sized amount), but even a portion of this converted from other currencies to dollars could be impactful for the greenback.

## STRUCTURAL FORCES MAY LIMIT ADDITIONAL UPSIDE

The aforementioned factors have driven the dollar higher recently, but that does not change the challenging long-term picture. As shown in [Figure 2](#), the so-called twin deficits (current

account and budget) are structural downward forces pushing against the dollar. The figure shows the two deficits added together expressed as a percentage of GDP (blue line) relative to the trade-weighted dollar adjusted for inflation (yellow line), with a two-year lag.

This relationship is important because of the United States' substantial needs to fund the budget deficit and trade, notably imports. Interestingly, the dollar has underperformed this relationship over the past couple of years, and may need to play some catch up. Once done, we would expect the dollar to eventually run into resistance. There is no reason to expect the deficit to narrow anytime soon—in fact, it is going in the opposite direction. While ongoing negotiations with China and on the North American Free Trade Agreement (NAFTA) may eventually lead to some narrowing of the trade deficit, it will take years, not months.

Bottom line, we see a cyclical dollar uptrend continuing in the near term but anticipate the return of the long-term secular downtrend as the greenback succumbs to the forces of the twin deficits.

## CONCLUSION

The dollar has staged a solid comeback recently, and strength may continue in the near term, driven by divergences in monetary policy between the Fed and other major central banks, repatriation of foreign cash, and weaker-than-expected economic data overseas. Currency weakness in some overseas trouble spots such as Turkey and Argentina may persist. However, structural forces including U.S. current account and budget deficits, may ultimately limit dollar gains and eventually lead to a resumption of the long-term downtrend in the greenback. ■

*Thanks to Jeffrey Buchbinder, CFA for his contributions to this commentary.*

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

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#### INDEX DESCRIPTIONS

The U.S. Dollar Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

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