Weekly Digest
31 July 2017
The weekly insight into world stock markets

Investec
Wealth & Investment

The Fall of the Dollar

One of the biggest surprises in markets in 2017 has been the weakness of the US dollar, especially against its major currency cross partner the Euro. US visitors to Paris on their summer holidays will find that the currency-adjusted prices they are paying are 12% higher compared with the start of the year as the Euro/Dollar exchange rate has moved from 1.052 to 1.1729.

Yet, at the start of 2017 investors were mainly pricing in a stronger dollar. A number of factors contributed to this belief. First, economic growth projections for the US economy were improving as a result of rising jobs numbers and improving economic trends. For example, the Citi US economic surprise index had risen from -60 in February 2016 to +23 by the turn of the year and +56 by March 2017. The index typically trades between +60 and -80, with a positive number showing that economic data is beating estimates (with larger numbers showing a greater scale of "beats") and vice versa for negative numbers. And, of course, a strong currency is associated with a strong economy. In fact, the US President, in his campaign, suggested that he would increase US economic performance from the below-trend 2% GDP Growth that was experienced between 2010 and 2016 to 3-4%. The better growth rate was predicted to be sourced from lower taxes (for companies and individuals), greater government spending (especially in the area of infrastructure) and a deregulation of the finance sector (following years of policies to tighten standards). Second, the monetary regime was set to significantly tighten in 2017. Both US Federal Reserve monetary policy voting members and investors were pricing in higher US interest rates and a reduction in the size of the balance sheet of the US central bank, essentially leading to a tightening in monetary policy in the world's most important economic area.

However, the US dollar has been the weakest of the major currencies in 2017. What has changed? In many ways, the positives articulated above have turned into negatives. US data in the first half of the year has been more disappointing than was expected. The US economic surprise index, which was running at close to its highest point for many years in March 2017 fell to -80 (or its lowest point since 2011). It is also unlikely that the US economy will materially break the 2-2.5% GDP growth range over the next three years. Connected to the disappointing data has been the conundrum of US inflation. Despite the US unemployment rate, at 4.4%, falling to the lowest level since 2007 and 2000, there is no sign of a surge in wage inflation or general inflation rates. The most recent set of US Fed minutes suggested that the committee is surprised by the lack of inflation in the system. As a result, the number of future interest rate rises have been called into question. US politics have also taken a turn for the worse. Donald Trump made a number of promises at the start of his presidency but, so far, his attempts to push through legislation have been thwarted. The low-hanging fruit of the repeal of Obamacare, the healthcare policy despised by Republicans, has not been harvested. This has subsequently led investors to question the ability of the President to enact his policies of tax cuts, extra spending and deregulation- policies that should have led to higher US growth estimates and probably a stronger dollar.

Of course, macro factors impacting the US economy are only one part of the currency equation. The main beneficiary of dollar weakness has been the Euro. The European economy, which has been seen as the "sick man" of global economies for some time, is now showing a strong performance.
Updated estimates for the growth of economies from the IMF for July showed the European economy growing in line with other advanced economies, a major achievement given the various obstacles Europe has faced over the past few years. As a result, the very loose monetary policy of negative interest rates and central bank buying of government bonds that has been in place for more than 2 years is forecast to tighten in the near term. Finally, concerns over a break-up of the Euro from populist politicians such as France's Marine Le Pen have diminished. In all, Europe's future appears brighter and a stronger currency seems justified.

For investors, currencies have made a significant difference to returns in 2017. Despite the US providing the highest equity returns in developed markets in 2017, Sterling investors have faced lower returns as the US dollar has weakened while benefitting from strength in the euro. 2017 year to date (to Friday 28th July), total returns for the US and European equity markets in local currency terms have been 11.7% and 7.3% respectively. However, adjusted for movements against Sterling, the total returns are 5.1% and 12.4% respectively. Clearly, currency returns are an important contributor to total investments returns.

Where do we go from here? At IW&I, we believe that it is very difficult to consistently make abnormal returns from currency positioning given the propensity for exchange rates to trade away from fair value for long periods of time. Instead, explicit currency positioning is adopted only on the basis of extreme pricing. Over time, gaining exposure to different economic areas should lead to currency returns balancing out (given that it is a zero sum game). In terms of the US dollar, the momentum is currently with the Euro, but an inflation shock in the US or a more aggressive form of withdrawal of QE by the Fed could see the dollar rebound more quickly than it takes the new US President to fire one of his key staff members. Finally, the first artist to have a posthumous UK Number 1 album was Otis Redding. This week, in the Thunderbirds TV series, what was the first name of Lady Penelope's chauffeur, Parker?

Darren Ruane
Head of Fixed Interest

FTSE 100 Weekly Winners

Anglo American	12.9%
Diageo	6.8%
Antofagasta	5.9%
Glencore	5.6%
Rio Tinto	4.5%
BHP Biliton	4.5%
Burberry Group	4.4%

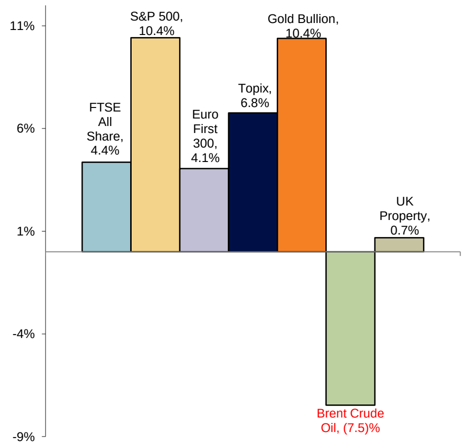
Source: FactSet

FTSE 100 Weekly Losers

AstraZeneca	-13.0%
Provident Financial	-11.8%
British American Tobacco	-9.6%
Reckitt Benckiser Group	-6.7%
SSE	-6.4%
GlaxoSmithKline	-6.0%
Imperial Brands	-5.2%

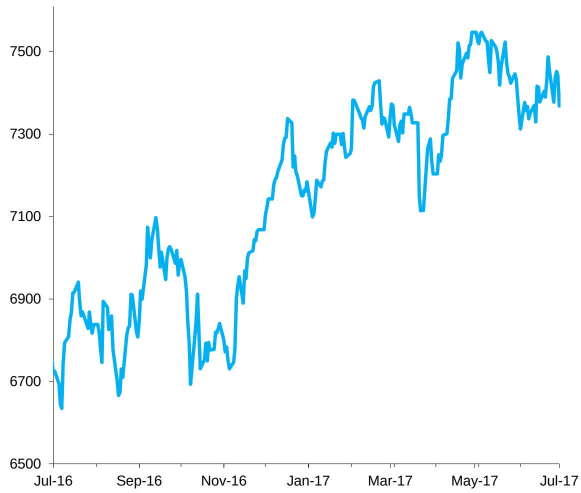
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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