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Sell the News - The US Dollar and Multi-Asset Class Investing

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A market saying is to "sell the news", implying that by the time news is released, it is already priced into an asset's price. Exhibit A: On January 24, 2018, a prominent media outlet hyped a headline touting, "The stock market is off to its best start in 31 years and that bodes well for the rest of 2018." Instead, 2018 staggered to a close with the lowest percentage of global asset classes posting positive returns since 1920, according to Deutsche Bank. As the table below highlights, there were two parts to 2018: Pre-Hype, positive growth expectations drove risk appetite, reflected in a weakening US dollar, a steepening yield curve, strong global asset returns, negative bond returns, and tepid volatility; Post-Hype, these flipped.

2018: A Tale of Two Parts

	Pre - Hype 12/31/17 1/24/18	Post - Hype 1/24/18 12/31/18
Change in Key Variables		
US Dollar	-3%	11%
Yield Curve (10 Yr Yield - 2 Yr Yield)	Steepened	Flattened
Volatility Index	4%	122%
Returns for Key Assets		
S&P 500	6%	-10%
Industrials	5%	-17%
MSCI All Country World ex-US	7%	-19%
MSCI Emerging Markets	9%	-22%
Bloomberg Commodity Index	3%	-16%
Global Natural Resource Equities	6%	-14%
Global Real Estate	0%	-6%
Barclays Aggregate Bond	-1%	1%

Source: FactSet, OPCM

While the US dollar is not the sole driver of global asset class returns, it captures the major 2018 dynamics that impacted the Post-Hype regime, particularly Foreign Equity and Natural Resource returns, and it is informative as to how 2019 could unfold.

The US Dollar's Historic Strength and Shifting Drivers

The US dollar's shift from a high-single digit decline in late January, to low-teen increase in late November, was the strongest shift from trough to peak in over 20-plus years outside of the financial crisis, as the following chart shows.

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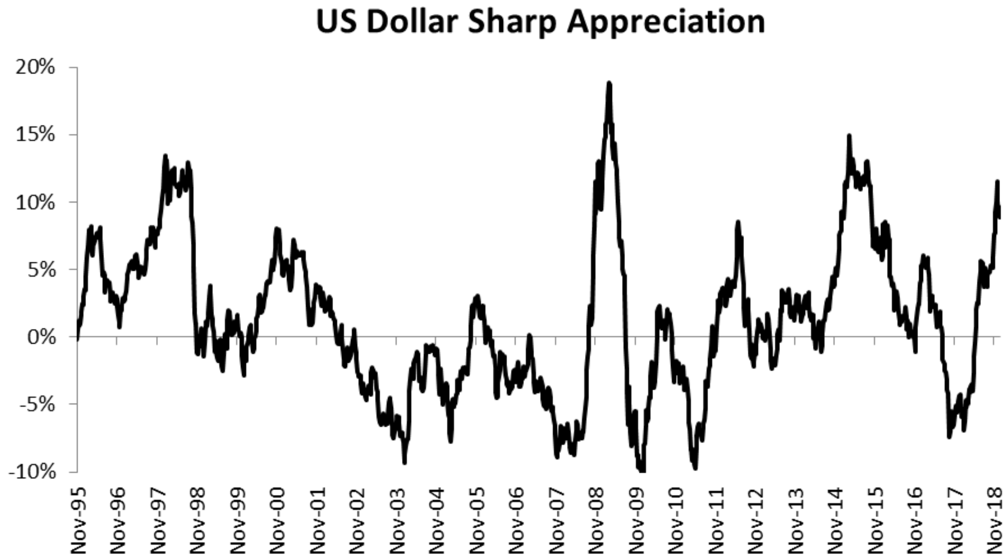

43-Week % Change in Trade-Weighted Dollar Broad Index
Source: FRED, OPCM

Drivers of the US dollar fall into three main categories:

1) Relative Interest Rates
2) Relative Growth Rates
3) Technical Factors

All three were tailwinds for the US dollar, helping it in 2018. These tailwinds could shift and potentially turn into headwinds in 2019.

Relative interest rates shifted in the US dollar's favor in 2018. The Federal Reserve raised US benchmark interest rates four times while most other central banks did not raise rates, thus widening the US yield advantage, incentivizing investors to demand US-denominated assets and strengthening the US dollar. In 2019, however, interest rate futures imply that consensus expects no Federal Reserve interest rate hikes in 2019, but even if there is one or two, 2019 could have fewer than 2018. The European Central Bank, meanwhile, ceased its bond-buying program in December 2018 as it edges toward raising interest rates. Less frequent interest rate hikes by the Federal Reserve, coupled with foreign central banks incrementally moving to tighter policy, could prove a headwind for the US dollar.

Relative growth for the US accelerated versus global peers in 2018, which helped attract foreign inflows to purchase US assets, buoying the US dollar. US growth was helped by tax cuts and easier growth comparisons. US Manufacturing PMI was in line with the Global Manufacturing PMI in November 2017, but expanded to a

4 point premium in October 2018, indicating stronger US growth. This growth advantage shrank from 4 points to 2 points by the end of 2018. During this reversal period, foreign markets performed relatively well versus US equity markets. Entering 2019, the US faces tougher growth comparisons than foreign markets. US earnings growth is estimated by consensus to be only 1% higher than MSCI All-Country World ex-US in 2019 after being 14% higher in 2018. In such an environment, US dollar-denominated assets could appear less compelling, removing a tailwind for the US dollar.

Why the Dollar Matters for Portfolios

As the initial table demonstrated, the surge in the US dollar coincided with a sharp sell-off in cyclical US equities, Foreign Equities, and Natural Resources.

For cyclical US equities, a stronger dollar makes exporting to foreign countries less competitive since US dollar -denominated goods are more expensive for foreign buyers. Inasmuch as the stronger US dollar reflects a flight to safety, lower risk appetite also means less corporate confidence and investment in capital expenditures, among other behavior not supportive of cyclical sector returns.

For Foreign Equities, returns are a function of the local currency return and changes in that country's currency versus the US dollar. As the US dollar appreciates, the US investor's return in Foreign Equities declines.

For Natural Resources, commodities are priced in US dollars, so a rising US dollar makes commodities less attractive for foreign buyers. Further, a stronger dollar driven by fears about global trade and growth hurts commodities, from oil to industrial metals, particularly given how important Chinese demand is for global commodities.

Conclusion

Just as getting caught up in the hype headlines of January 2018 was imprudent, becoming overly bullish on the US dollar and bearish on most other assets at this point seems unwise. Tailwinds aiding the US dollar in 2018 could dissipate in 2019, aiding Foreign Equities, Natural Resources, and other global assets. Now could be another case where it is wise to sell the news.