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It's All About the Benjamins: Don't Overlook Swings in the Dollar

By Michael Arone, CFA,
Chief Investment Strategist
US SPDR Business

> "China, the European Union, and others have been manipulating their currencies and interest rates lower, while the US is raising rates while the dollar gets stronger and stronger with each passing day — taking away our big competitive advantage."
>
> — Donald Trump, Twitter, July 20, 2018

Summertime, and the livin' is uneasy. From the growing potential for a full-scale global trade war to President Trump's controversial remarks at the Helsinki summit and his scolding of the US Federal Reserve (Fed), it has been an eventful July. And it's easy to become distracted by all the outrageous headlines.

Maybe that's why writing this month's article has been such a grind. Maybe I have a severe case of the summertime blues. At first I created this way-too-cute metaphor about July's spectacular headlines and Fourth of July fireworks. Yuck! Then I figured, let's cut to the chase. It's summer. We all want to get back to backyard barbecues, the beach and baseball games or whatever else tickles our fancy for summertime fun.

So here it is: Investors struggling to kick back and enjoy a carefree summer need to block out the geopolitical noise and look for clear guideposts to help navigate increasingly challenging markets. For example, although largely unreported on this year, fluctuations in the US dollar (USD) have been providing important clues about the direction of the global economy, corporate profits, emerging markets, industrial metals and gold.

But before we explore what the USD may be telling investors about the rest of 2018, those crazy July headlines are just too tempting not to rehash.

Like a Moth to the Flame

The highlight of this summer's Say It Ain't So Tour had to be President Trump and Russian President Vladimir Putin's post-summit news conference in Helsinki on July 16. After a summit many politicians condemned before it even got started, Trump shockingly appeared to suggest he didn't believe the Russians meddled in the 2016 US elections and criticized US intelligence agencies for suggesting that they had. This prompted a stunning rebuke from both Republicans and Democrats. In fact, according to the *Financial Times*, a former CIA director, former cabinet secretaries, a leading Democratic legislator and several *New York Times* columnists accused the president of being a traitor.[1]

This resulted in an even more bizarre and uncharacteristic walk-back from President Trump. Twenty-four hours later, speaking at the White House, the president claimed that he meant the exact opposite of what he had said in Helsinki. He claimed he had mistakenly used a "sort of a double negative" and couldn't understand what all the fuss was about. To him, it should have been obvious to everyone that he meant to say, "I don't see any reason why it *wouldn't* (instead of *would*) be Russia."[2]

Seeking to refocus attention on the trade agenda so popular with his base, Trump next made headlines on July 18. According to *The Wall Street Journal*, at a Cabinet meeting, he threatened "tremendous retribution" against the European Union, specifically mentioning auto tariffs, if his meeting with EU officials on July 25 didn't yield a

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fair auto trade deal. Oddly, Trump made this threat despite widespread tariff resistance from foreign and domestic auto companies, auto dealers and auto-parts manufacturers. In addition, a bipartisan group of 149 House of Representatives members has urged the president not to move forward with the auto tariffs.[3]

And the week's hits just kept coming. In a July 20 CNBC broadcast interview, President Trump said he was prepared to impose tariffs on $500 billion worth of imports from China — virtually every import from China that enters the US — as part of his push to reduce US trade deficits. In the same interview, Trump said he was "not thrilled" about the Federal Reserve's decision to raise interest rates twice so far in 2018. That rare reprimand by a sitting president upends the longstanding White House protocol of avoiding commenting on monetary policy. Trump further expressed concerns that higher interest rates would offset all of the administration's hard work to bolster the US economy. He then went on to accuse both the European Union and China of manipulating their currencies, putting the US at a disadvantage. And he lamented the strength of the almighty buck due, of course, to people's unwavering confidence in him.

The president then summed everything up in a July 20 tweet where he claimed success for the US/Russia summit, further attacked our trading partners and admonished the Fed for rate hikes. I haven't even mentioned Trump's blistering criticism of Germany and the labeling of our allies as "delinquent" at the NATO summit earlier in July or when he reportedly tossed Starburst candies toward German Chancellor, Angela Merkel saying, "Here, Angela. Don't say I never give you anything" at a tense G-7 meeting in Canada in June.[4]

All that is a lot to digest. However, as I noted, turning away from geopolitical complexities to examine a simple relationship, the fluctuation in the USD, might just relieve investors' heartburn.

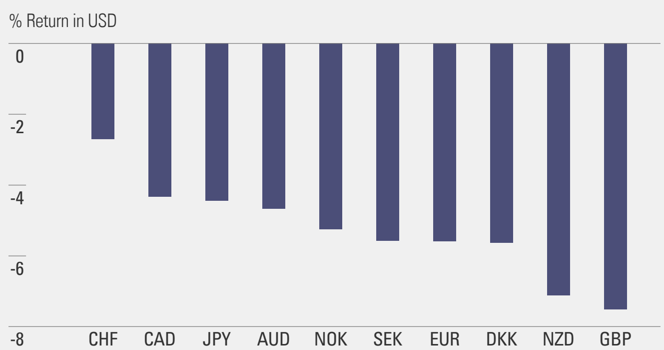
Two Buck Chuck: Race to the Bottom

Expectations for the USD were low to start the year, with many investors simply extrapolating its poor performance from 2017 into 2018. Progress on the massive fiscal stimulus package dampened dollar enthusiasm. Tax cuts for corporations and individuals, a sizeable increase in government spending and growing deficits created perceived headwinds for dollar strength. Although the Fed was raising interest rates, market participants were expecting them to do so only gradually, keeping monetary policy very accommodative in the near term. Trade negotiations were in their infancy and not a hot button issue yet. Lastly, nascent economic growth in Europe, Japan and emerging markets was expected to accelerate, further fueling already healthy fund flows from US investors into international and emerging markets investments.

Figure 1: Investors Are Now Net Long the Dollar After Having Been Net Short for the Past Year

Source: Bloomberg Finance, L.P., as of July 19, 2018.

Figure 2: The USD Has Appreciated vs. All G-10 Currencies in the Past 3 Months

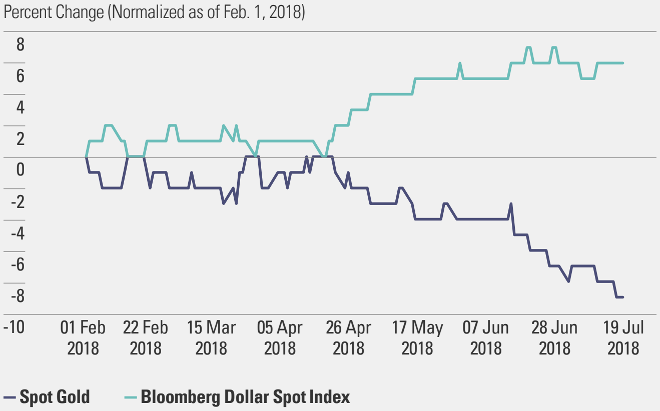


Source: Bloomberg Finance, L.P., as of July 19, 2018.

This powerful combination weighed on the USD early in 2018. Interestingly, dollar weakness continued to support several important market narratives. Global synchronized growth that was so instrumental in boosting asset prices in 2017 was expected to continue throughout 2018. Large multinational companies that generate significant portions of their revenues from overseas were considered natural beneficiaries of dollar frailty. Global cyclicals, industrial metals, commodities and gold were all expected to perform well, too. And US-based investors' appetite for international and emerging markets funds was expected to remain healthy.

Simply stated, USD softness was expected to keep 2017's good times rolling into 2018.

Figure 3: A Strong USD Has Weighed on Gold Prices in 2018



Source: Bloomberg Finance, L.P., as of July 19, 2018.

Mighty Moolah: Show Me the Money

As the first quarter gave way to the second quarter, a series of events caused the USD to climb. With the gigantic fiscal stimulus package solidly in the rearview mirror, US trade negotiations with China and other major trading partners soured. On March 21, to no one's surprise, the Fed raised rates for the first time in 2018 and signaled that more rate hikes were likely throughout the year. However, as time passed, US economic data signaled continued strength, the labor market tightened and inflation measures finally breached the Fed's 2 percent target. As a result, the Fed became more confident that perhaps a fourth rate hike would be needed this year to normalize interest rates and balance growth and inflation results. This hadn't been priced in by market participants and soon short-term interest rates and the USD rose to reflect the new reality.

Simultaneously, European economic data, which held such promise in early 2018, also began to weaken. Soon after, little cracks started to appear in Japan's surprising economic revival. And, finally, with interest rates, inflation and the USD all rising, it was only a matter of time before emerging markets equity and debt investments began to suffer.

With the USD climbing steadily from mid-April to mid-June, new market narratives formed and leadership changed. Global synchronized growth gave way to greater divergence between countries and regions with the US emerging as the clear leader. This led to a transition in leadership from large multinational companies that would likely suffer from a prolonged trade war and rising dollar to domestic small-cap companies that tend to be insulated from trade conflict and bolstered by domestic growth. Not surprisingly, with the renewed interest in small-cap domestic stocks and a slowdown in non-US economies, fund flows by US investors to international developed and emerging markets began to shift.

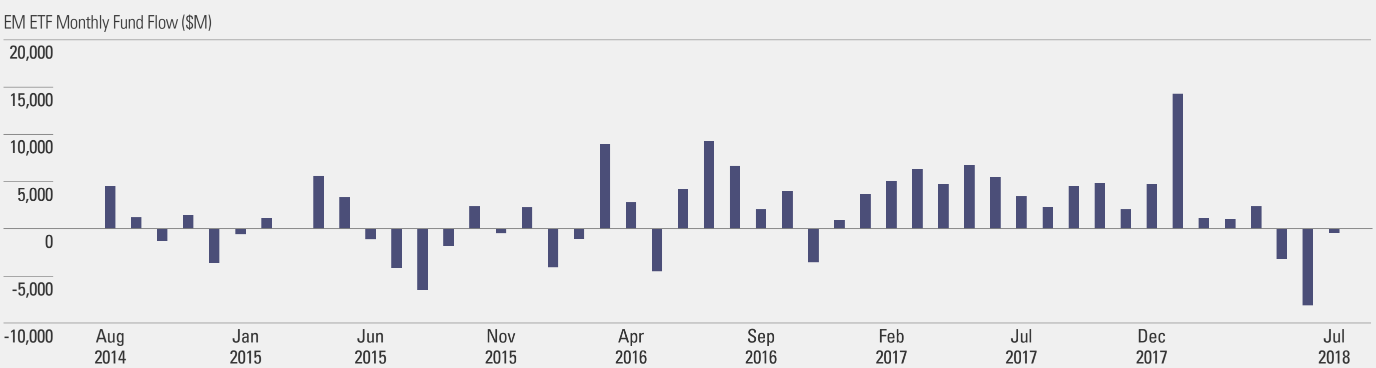
Domestically, as the yield curve flattened and trade negotiations flared, defensive sectors received a boost to the detriment of previous cyclical leadership. And, as the dollar rose, optimism for industrial metals, commodities and gold began to wane.

Wilting Greenbacks: Summertime Swoon

The binary relationship of USD fluctuations may seem simple, but it is driving underlying market dynamics. That's certainly been true with the USD's sudden and unexpected ascent over the last couple of months.

Therefore, rather than struggle to make sense of all the wild summer headlines, it is incredibly important at this juncture to understand the factors that move the USD and

Figure 4: EM ETFs Are on Track for Three Consecutive Months of Outflows for the First Time in Three Years



Source: Bloomberg Finance, L.P., as of July 23, 2018.

how those swings impact your portfolio. Currently, the Fed is on a path to higher rates. However, in his testimony to Congress on July 17, Fed Chairman Powell introduced the term “for now” when describing the path for future rate hikes. This new qualifier suggests that the Fed may begin using forward guidance sooner than the markets expect to indicate that they are nearing the end of this interest rate cycle. Meanwhile, President Trump is talking the dollar down and jawboning the Fed. And trade negotiations are getting even more tenuous.

All this leads me to believe that with the dog days of August approaching, the rapid climb that we have observed in the USD over the last couple months is just about over.

Additional pressure on the USD from the president and his administration could spawn another round of sensational headlines that could weigh further on the dollar. As a result, look for large multinationals, global cyclicals, international developed and emerging markets, industrial metals, commodities and gold to rebound in the coming months, especially if we get clarity on trade and a more accommodative Fed. Maybe then the livin’ finally gets easy.

[1] Edward Luce, “The risk of calling Trump a traitor,” *Financial Times*, July 19, 2018.

[2] Matt Flegenheimer, “Would It or Wouldn’t It Be Russia: Trump Goes Double Negative, *New York Times*, July 17, 2018.

[3] Chester Dawson and Joshua Zumbrun, “Trump Threatens Auto Tariffs Despite Widespread Opposition,” *Wall Street Journal*, July 18, 2018.

[4] Tom Barnes, “Trump threw two Starburst towards Angela Merkel at G7 summit,” *The Independent*, June 21, 2018.

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State Street Global Advisors One Iron Street, Boston MA 02210.
T: +1 866 787 2257.

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