DOLLAR STRENGTH: POLITICAL, TECHNICAL AND SEASONAL FACTORS ALIGN IN NOVEMBER

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11/17/2016

While markets may have been ill prepared for the election of Donald Trump, the early reaction appears to be favorable for USD-based investors. For much of 2016, the U.S. dollar has experienced a period of consolidation on the heels of a more dovish Federal Reserve (Fed) than many expected. However, after breaking through resistance in October, an upward trend in the dollar (and U.S. interest rates) may well be under way. Below, we outline the macroeconomic, technical and seasonal factors we believe may lead to a resumption in U.S. dollar appreciation heading into 2017.

Politics

As election results rolled in on the night of November 8, it seemed like markets were bracing for a repeat of Brexit, i.e., when the United Kingdom voted to leave the European Union. However, with the exception of some emerging markets, risky assets appear to have shrugged off the more divisive elements of Trump's rhetoric and viewed his policies with an open mind. While more concrete plans will be forthcoming, it remains essential that Republicans learn from the mistakes made by Democrats in 2008 and not overstep their mandate.

Macro

In general, an oft-cited driver of asset class performance this year has been the market's recalibration to the likely pace and timing of a change in U.S. monetary policy. During the first half of the year, interest rates around the world declined, defensive equities outperformed cyclicals, and the U.S. dollar generally fell against a basket[1] of foreign currencies. Since July 8, rates were rising as the market grew increasingly comfortable with the prospect of a Fed rate hike at its December 14 meeting. Since November 8, longer-term interest rates have risen dramatically, fueling the strength of the U.S. dollar.

In light of the perceived divergence in the path of policy, virtually all foreign currencies have depreciated against the U.S. dollar. Additionally, while many emerging market (EM) currencies have rallied in 2016, several major EM central banks may be poised to cut rates in 2017.[2] And while many EM currencies remain well below their five-year averages, this divergence in central bank policies will need to be closely monitored.

Technical Factors

As many investors can attest, the success of a tactical shift in allocation often boils down to timing. To help make this determination, investors often look to the market's technical positioning. As illustrated below, after retesting previous highs set in August, it seems like the dollar has finally broken through. In much of our work on currency markets, our favored technical indicator compares the 10-day against the 240-day moving average. On October 20, the 10-day crossed above the 240-day, signaling a potential shift in trend. Additionally, on the back of Trump's victory, the dollar blew through both the 50% and 61.8% Fibonacci retracement, two other widely watched technical levels.

Bloomberg Dollar Spot Index (BBDXY)

10/31/15–11/9/16

BBDXY

Seasonal Factors

Finally, we previously highlighted that "sell in May" does not necessarily apply to the U.S. dollar. In a similar analysis, it appears that November also exhibits a strong seasonal track record for U.S. dollar strength. While we are currently struggling to identify the primary catalysts of this phenomenon, it seems that the Japanese yen as well as many emerging market currencies have tended to depreciate against the U.S. dollar in November. Regardless, positive seasonal momentum combined with fundamental and technical strength could help corroborate a resumption of the trend in the dollar.

Seasonal Factors

In sum, investors should consider what impact a resurgence in U.S. dollar strength may have on their portfolios. In our view, the intersection of global macro, technical positioning, political and seasonal factors may support broad-based appreciation of the U.S. dollar in the coming months.

[1]As proxied by the Bloomberg Dollar Spot Index.

[2]Source: Bloomberg. As of 10/31/16, Mexico is the only major EM central bank forecast to hike rates in 2017.

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DEFINITIONS

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Defensive characteristics : Greater exposure to the so-called more defensive sectors, especially Telecommunication Services and Utilities.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Moving Average : is a calculation to analyze data points by creating a series of averages of different subsets of the full data set.

Fibonacci retracement : A technical analysis tool displaying percentage lines which look at support and resistance levels, potentially signaling short-term price/yield reversals. The concept of retracement suggests that after a period of market movement, prices/yields can retrace a portion of their prior pattern before returning to their original trend.

Bloomberg Dollar Spot Index (BBDXY) : Tracks the performance of a basket of ten leading global currencies versus the U.S. dollar. Each currency in the basket and their weight is determined annually based on their share of international trade and FX liquidity.