EXAMINING THE CURRENT DOLLAR BULL MARKET AGAINST HISTORY.

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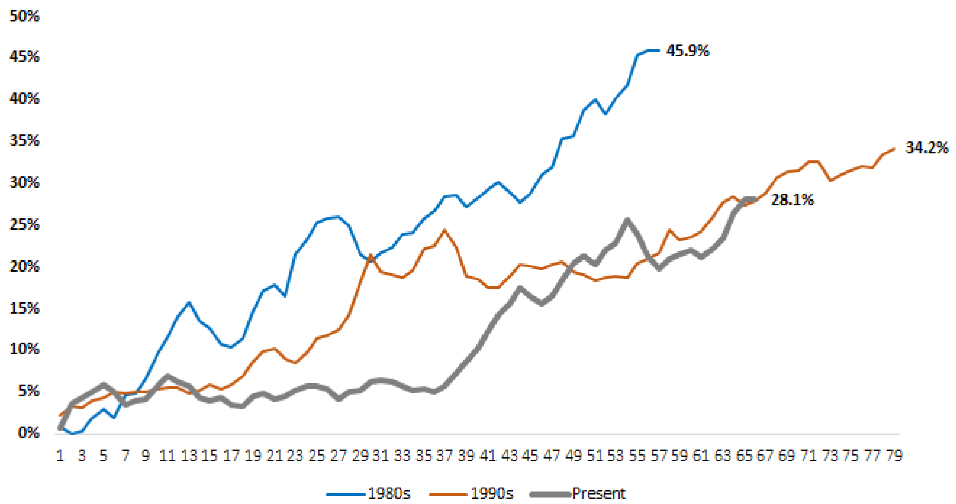
In our view, the single most important factor for navigating markets in 2017 will be the value of the U.S. dollar. Monetary policy, corporate earnings, trade policy, capital budgeting decisions and macro stability will all be heavily influenced by the direction of the dollar in global markets. Despite recent grumblings by the incoming administration about dollar strength (specifically against the Chinese yuan), the overwhelming consensus view among strategists is for another year of broad-based appreciation. While we also subscribe to this view, we believe it is important to provide context about current levels relative to history in order to understand where we may be in the cycle. Below, we compare the current[1] U.S. dollar[2] rally against the two previous periods of broad-based dollar appreciation from the 1980s[3] and '90s[4].

Are We There Yet?

In the chart below, we show that the dollar has appreciated by approximately 28% over the last 66 months in real terms.[5] Relative to the 1980s, the pace and magnitude of the current appreciation in the dollar is more subdued. However, temporally, it has already outlasted that cycle by nine months. Compared to the period of the mid-1990s, we're approximately on track. While the pace of appreciation accelerated in mid-2014, when the European Central Bank (ECB) cut rates into negative territory and the Bank of Japan (BOJ) expanded its qualitative and quantitative easing program, we remain somewhat comforted by the fact that very few strategists currently see the dollar as grossly overvalued. In our experience, markets are prone to overshoot to the upside and the downside. As a result, we believe that the dollar cycle could continue for at least another 12–18 months, likely appreciating by approximately 5% in 2017.[6]

Federal Reserve Real Trade Weighted U.S. Dollar Index: Broad



Sources: Bloomberg, Federal Reserve, as of 12/31/16. Past performance is not indicative of future results. You cannot invest directly in an index.

While many investors are currently thinking of how the dollar rally may end, I believe it's also important to think about how it started. Notably, that the current rally began from the most undervalued point in the dollar's history.[7] While current appreciation trends appear similar, the dollar must potentially move even higher before reaching equilibrium. Additionally, many investors remain skeptical of dollar upside, because the longer this cycle extends, the greater the likelihood the U.S. tips into recession. While we could debate the prospects of recession being delayed due to the results of the U.S. election, the dollar strengthened through two recessions during the 1980s as well as after the 2001 terrorist attacks and ensuing recession in the second cycle. In sum, recessions don't end dollar bull markets.

Conclusion

In our view, the dollar is likely to appreciate due to Federal Reserve tightening, higher real interest rates in the U.S. attracting assets from abroad, and the TINA principle: Brexit and politics weaken the standing of the euro and the pound for international reserves, while Japan is actively promoting a weaker yen to boost growth and inflation. No other currency can rival the liquidity of the dollar. Ultimately, a strong dollar strengthens the Trump administration's hand in international trade negotiations, particularly with many emerging market countries. While we remain skeptical of a second Plaza Accord to quickly close global imbalances, a strong dollar remains in America's interest for 2017.

[1]Beginning 7/31/11 through 12/31/16.

[2]As proxied by the Federal Reserve Real Trade Weighted U.S. Dollar Index: Broad.

[3]7/31/80–3/31/85 (57 months).

[4]7/31/1995–2/28/2002 (79 months).

[5]7/31/11–12/31/16.

[6]Source: WisdomTree.

[7]Source: Federal Reserve.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

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.

Quantitative and qualitative monetary easing (QQE) : A central bank monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Bullish : a position that benefits when asset prices rise.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Inflation : Characterized by rising price levels.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Real Trade Weighted U.S. Dollar Index : A weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners.