Monthly Commentary 2nd August 2017

July was by and large a good month for markets. Equities were up more than 1%, with emerging markets leading the way with a gain of more than 4%, while Germany was a notable laggard with a fall of almost 2%. Fixed income was up modestly as bond markets seem to be ignoring the consensus belief that yields are heading higher. The big market stories for the month were in commodities and currencies. The former was up 4.5% (as measure by the CRB Index), helped by oil. The latter was a USD story as it fell hard – almost 3%, and even more against the euro.
This month we look at currency markets and what implications they may have on investments.

The Retreating Dollar
The dollar has been falling, and rather rapidly. What are the reasons, and what are the implications on portfolios?

While there are a multitude of factors that influence a currency's value, one of the main drivers of a currency's strength is the interest rate differential between that currency and that of its major trading partners. That is, the difference in interest rates. In anticipation of US interest rates rising in 2017, the markets drove the USD to highs not seen since 2002.

So what are current interest rates in various major currencies? Broadly speaking, there are two "benchmark" rates of interest in any economy. The first is the "policy rate", set by the central bank (The Fed, Bank of England, ECB, Bank of Japan, etc). This is a short-term rate. The second is the "market rate", which is set by the markets (supply-demand), and this is the yield on government bonds of various duration. Almost all other interest rates (mortgages, corporate loans, etc.) are priced off these too. Below we see that as of August 1st, 2017, USD interest rates are indeed much higher than all their major trading partners:

	Policy Rate	10-yr Bond Yield
USD	1.25%	2.30%
EUR	0.00%	0.52%*
GBP	0.25%	1.23%
JPY	0.00%	0.06%
CHF	-0.75%	-0.01%

* Germany

So one would think that with the USD having far higher interest rates than the four major currencies listed above, and the forecast for even higher rates in the US, the dollar would have maintained its strength and even strengthened further.

Well, markets have a way of confounding what seems logical, and here we are in early August and the dollar has fallen a (massive) 9% so far this year. Against the euro, sterling and the yen, it has fallen 11.2%, 6.6% and 5.4% respectively.

What effect has the US dollar's fall had on portfolios? "Not much" is the quick answer. The reason is that, at Elgin we take very little currency risk. Almost all our portfolios' assets are in each investor's strategy currency. Yes, we do make a tactical allocation of up to 10-12% in securities that are in other currencies, but we do this with full knowledge that it will have very little impact on the bottom line should these currencies work against the portfolio.

While the US equity markets have been stronger than Europe's (up 9% vs 5% YTD), if we had allocated the equity component of a euro portfolio to the (stronger) US equity market, the investor would have so far suffered a loss of more than 2% instead of benefitting from the 9% gain in the US markets.

Where is the dollar going? Where is the euro going? How about sterling? Frankly, we can make powerful arguments – both fundamental and technical – in favour of any target. But we won't. And that is because we know that we cannot get it right.

Below are the EURUSD forecasts of 109 global banks as of August 1st.

Region G10		Currency Euro					As of 08/01/17		
EURUSD			Q3 17	Q4 17	Q1 18	Q2 18	2018	2019	2020	2021
Spot	1.18	Median	1.14	1.15	1.15	1.16	1.18	1.20	1.22	1.22
Q2 17	Actual	Mean	1.14	1.14	1.14	1.15	1.16	1.19	1.21	1.21
	1.14	High	1.19	1.21	1.21	1.24	1.30	1.30	1.26	1.28
Q2 17	Forecast	Low	1.08	1.06	1.05	1.05	1.04	1.03	1.05	1.03

As you can see, their average forecast for yearend is 1.14, which is four cents lower than the current rate of 1.18. They might be right and might be wrong.

Below is the forecast from 1st January this year, with the rate then at 1.05.

Region G10		Currency Euro					As of 01/01/17			
EURUSD			Q1 17	Q2 17	Q3 17	Q4 17	2018	2019	2020	2021
Spot	1.05	Median	1.04	1.03	1.05	1.07	1.10	1.15	1.18	1.21
Q4 16	Actual	Mean	1.04	1.04	1.05	1.07	1.11	1.13	1.14	1.20
	1.05	High	1.12	1.15	1.18	1.19	1.25	1.23	1.25	1.27
Q4 16	Forecast	Low	.98	.96	.95	.96	.90	.85	.85	1.10

From the above, the banks collectively saw an average rate of 1.05 for Sep 30th.

That's 13 cents lower than it is today. Will it come close? We don't know, but what we do know is that we cannot manage our clients' portfolios based on experts' currency forecasts, or even our own "logical" ones.

And what does this rapid fall in the dollar mean for US, UK and European equity markets?

The "easy" answer is that a weak dollar is good for US stocks, as about 30% of their sales are abroad. It's also not that good for European and UK exporters. But this is a very simplistic answer as there are too many other, and more important factors that influence markets. For now, in our opinion, the backdrop for equities is still supportive of further gains.

Enjoy the rest of the summer!

The Elgin Analyst Team

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