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On1Page: Going Nowhere Fast

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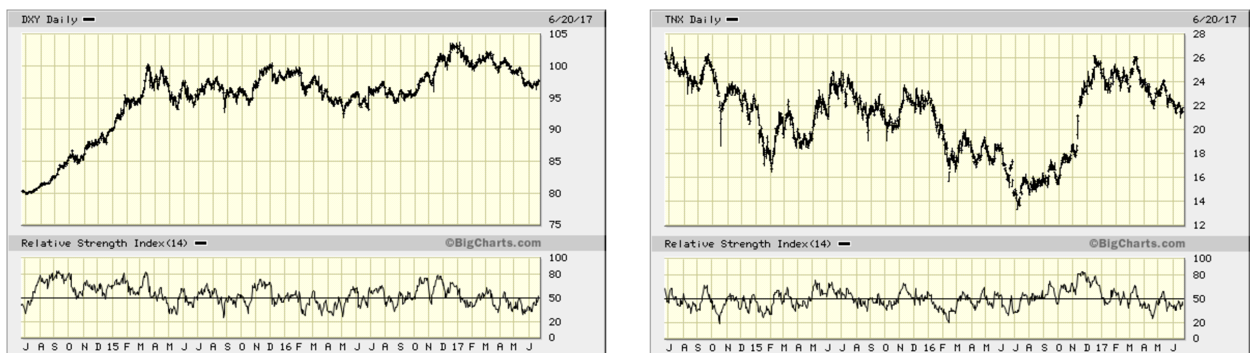
For much of the last two years, the financial news media has focused on the commonly held belief that the U.S. Dollar would rise in response to the Federal Reserve's initiation of increases in the Fed Funds Rate. The foundation for this belief is that funds from around the world would flow to the U.S. seeking the higher yields, and in the process, U.S. dollars would be bought, thereby making the U.S. currency rise relative to other major currencies. The problem with this analysis is threefold: 1) It assumes that the available foreign funds were not already residing in the U.S. (remember, the U.S. capital markets have been offering premium interest rates for several years now); 2) It disregards the fact that inflation in the U.S. has been rising (despite more recent weakness) which has a downward effect on the value of the U.S. Dollar; and 3) It ignores the fact that many foreign entities invest in U.S. government/corporate bonds (i.e. not money market funds/cash equivalents) and that a rise in U.S. interest rates makes holding longer-term U.S. dollar denominated securities less attractive since their holdings decline in value on a "mark-to-market" basis.

U.S. Dollar Index (DXY) & 10-Year U.S. Treasury Yield (TNX) Over the Past 3 Years



(divide the above index level by 10 to translate into yield; currently 2.2%)

<u>After 4 Federal Reserve Rate hikes: "Where's the Belief (now)?"</u>

Despite four Federal Reserve rate hikes (four quarter point moves/one full 1%), the U.S. Dollar Index is lower than it was in December 2015 (before the first rate hike) and the yield on the U.S. Treasury Bond is lower than it was in December 2015 or 2014. This is likely the result of: 1) the U.S. equity and bond markets have been a "safe harbor" for foreign investors since the more recent peak in China's GDP growth in 2010 and the "Euro Debt Crisis" in 2011. As a result, additional foreign capital was not likely attracted by higher short-term interest rates, therefore not causing a rise in the U.S. Dollar. Instead, foreign capital is now in the process of moving back offshore as economic activity in Europe and Asia is accelerating; 2) Despite some foreign selling of U.S. Debt, longer-term U.S. Treasury yields have pulled back from over a 1% rise from the lows of last summer to the end of last year as inflationary indicators have weakened since the beginning of the current year. We believe that this is only temporary since the U.S. economy is nearing full employment, productivity gains are meager, increased global economic activity has kept commodity prices well above the lows we saw in late 2015, and there are few indications that a U.S. recession is likely within the next 12 months.

If U.S. economic growth does not accelerate, (either in response to economic measures implemented by the Trump administration, or by other means), and the U.S. Federal Reserve continues to raise interest rates at a measured pace such that interest rates are not fully reflective of the growing inflationary environment, the U.S. dollar will likely continue to fall while at the same time short-term interest rates are rising, contrary to what many people expect (and have expected). Further, if the U.S. dollar falls, that will add to the inflationary pressures due to the higher cost of imported goods. Last, if U.S. economic growth does not accelerate, but in fact decelerates, longer-term interests (10-year yields and longer) can continue to decline at the same time short-term rates rise. This is called a "flattening yield curve" and it is not a positive harbinger of future U.S. equity market performance.

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