Within *Focus* we comment on extraordinary market events and analyse capital market related special topics.

End of US dollar strength – implications for the financial markets[1]

In 2018, the trade-weighted US-dollar was one of the few assets with a positive performance.

In 2018, there was hardly any asset class that showed an overall positive performance. One exception was the US dollar, which appreciated both in trade-weighted terms and against the euro, contrary to market participants' expectations. The main drivers of this strength were the booming US economy, the US Fed's cycle of interest rate hikes, numerous political risks and higher volatility in the capital markets.

The US dollar appears to have peaked in November 2018 and has been loosing support.

Since the end of last year, however, the Fed has made a U-turn in its communication. It indicated that it would pause its cycle of interest rate hikes and await further economic and inflation developments. Thus, the dollar has been losing support. As the relative growth and interest rate advantage of the US is likely to decline overall, there are increasing signs of a weakening of the dollar, especially as it appears expensive on the basis of many valuation models. On a trade-weighted basis, the US dollar appears to have peaked in November 2018. Since then, the emerging markets' currencies and the Japanese yen have appreciated against the dollar in contrast to the euro, which is suffering from its own political and economic problems. What does an end to dollar strength mean for the financial markets and how can investors benefit from it?

Commodities are not attractive by the exchange rate effect but rather by the fundamentals, that tend to be good when the dollar weakens.

Let's first look at commodities. For customers outside the dollar area, a weakening of the dollar initially means falling raw material costs, because raw materials are traditionally invoiced in dollars. As a result, the demand of international customers increases – for example because the incentive to save resources is reduced or the possibility of replenishing raw material stocks at lower prices is exploited. At the same time, supply is falling because producers are producing less due to falling prices in local currency terms. This in turn results in higher raw material prices. This price increase is largely offset by the dollar depreciation. The US dollar sensitivity of commodities is thus almost -1. This means that euro investors cannot earn money with commodities if, in addition to the exchange rate effect, the fundamental macroeconomic picture does not support fundamentally higher prices. However, this is often the case when the dollar tends to weaken.

Emerging markets benefit by a weakening US dollar. Local emerging market bonds are attractive in this environment.

Emerging markets are strongly affected by changes in the dollar exchange rate. While production-oriented emerging markets import many commodities and benefit from falling commodity prices in their local currency as the dollar falls, commodity-exporting countries tend to be among the losers. In addition, for countries with high debt levels, the dollar exchange rate is significant because of the financing costs, as these debts are usually denominated in dollars. If the dollar depreciates, the country's debt falls in local currency terms and it is easier for the country to service it. The improved ability to service the debt is then also reflected in falling credit spreads and thus rising bond prices in the country concerned. At the same time, a weakening of the dollar tends to be accompanied by an appreciation of emerging market currencies. This means that euro investors in local-currency emerging market bonds will benefit twofold from a dollar weakness, namely through price appre-

[1] This article is based on a guest commentary published in the Börsen-Zeitung on 13 April 2019.

ciation and currency appreciation. By contrast, euro investors in dollar-denominated emerging market bonds are benefiting from the rise in the price of bonds, but are losing ground due to the depreciation of the dollar. Hence, if the dollar strength ends, local currency bonds from emerging markets should be preferred.
Equity investments in emerging markets are also attractive in this environment. As emerging market companies benefit from falling commodity prices and financing costs, and thus higher earnings growth, the performance of emerging market equity markets should outperform that of developed markets.

Emerging markets equity markets should outperform developed markets indices.

An end to the dollar's strength will have an immediate impact on the US equity market. From a real economic perspective, US companies are firstly becoming more internationally competitive and secondly foreign profits are worth more in dollars (translation effect). However, companies hedge a large part of this currency risk, so that this effect only takes effect over time. Moreover, the share of sales generated by US companies outside their home currency is comparatively small. Thus, rising profits from the translation effect do not tend to compensate for the currency devaluation. If foreign investors expect the dollar to depreciate in the medium term, they also sell dollar investments to invest the money in their own currency. It will keep the dollar under pressure. Should the dollar weaken sustainably, the "flow" effect should clearly dominate the fundamental effects. A depreciation of the dollar thus speaks for fundamentally rising US equities, but on historical average only half of the currency losses are compensated.

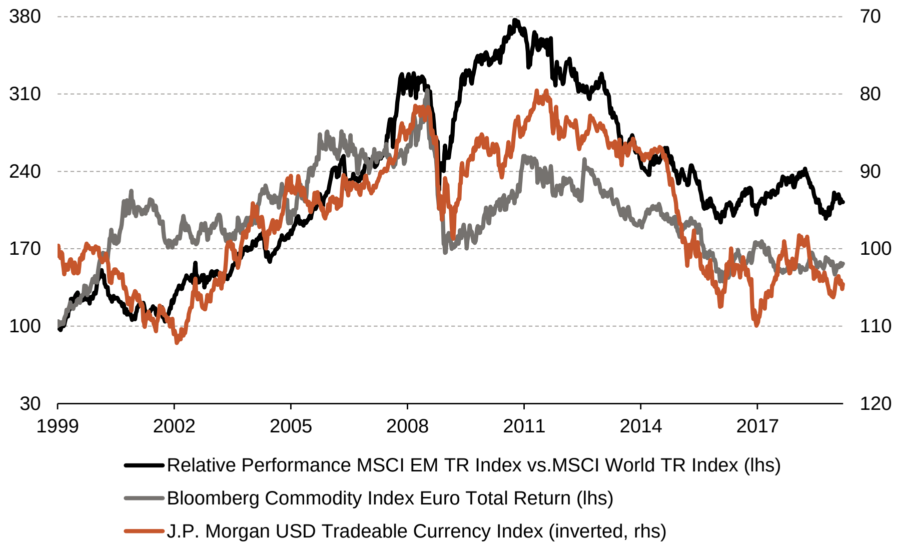
US equities should benefit by a weaker US dollar, but euro investors lose due to the currency depreciation.

On the bond side, we should first note the positive relationship between US government bonds and the trade-weighted dollar. In a risk-off environment, the US-dollar and US Treasuries are often in demand as "safe havens". In a risk-on environment, however, US government bonds usually do not appear attractive for euro investors, as losses are threatened by price developments and the currency side. However, US Treasuries are currently yielding considerably higher yields than German government bonds. However, a falling dollar could more than offset this advantage. The cost of currency hedging also nullifies the yield advantage. Nevertheless, from a portfolio perspective, US government bonds can make sense as a hedge for a risk-off environment.

US Treasuries are not attractive in a risk-on environment with a depreciating US dollar.

Emerging Market Equities and Commodities are attractive when the US-dollar weakens

The developments of the indices or ratios are scaled to 100 as of 01.01.1999.



Source: Bloomberg, own calculations
Period: 01.01.1999-15.03.2019, weekly data

The impact of a depreciation of the trade-weighted dollar on European equity markets is complex. European companies benefit at least temporarily from lower prices for imported raw materials. In addition, they are expected to generate slightly higher sales and profits from domestic demand, boosted by cheaper imports. However, this effect could be neutralised by the translation effect and declining relative competitiveness. The overall effect on the real economy and corporate earnings is thus likely to vary depending on the dependence on foreign trade. More important for the development of the European stock markets are the international capital flows. A sustained depreciation of the dollar should be positive for European equities, as capital should flow from the dollar area into euro investments. However, as with a recovery of the euro, the political and trade risks would have to be resolved first before international investors can see investment opportunities again. Then both the European stock markets and the euro have potential for a recovery. When selecting stocks, companies with a high price-setting power should be preferred, as these can best compensate for fluctuations in input costs and exchange rates.

European equities usually benefit from capital flows in case of a sustained US dollar depreciation.

In summary, if the trade-weighted dollar weakens, equity investments in the eurozone and emerging markets, as well as emerging market local currency bonds, appear to be the most promising for euro investors. Commodity investments also offer opportunities if economic growth stabilizes at the same time, especially in China, which is hungry for raw materials. Nevertheless, due to the dominance of the US economy and for diversification reasons, investments in US dollars are always justified in the portfolio.

If the US dollar weakens, emerging markets and European equities as well as EM local currency bonds should outperform.

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