Quarterly Investment Perspective

Common "Cents" — All About the Dollar

Rebecca Patterson, Chief Investment Officer

U.S. dollar strength was one of the most widely held market forecasts at the start of this year. Indeed, the consensus view held by currency strategists (compiled by Bloomberg) was that an appreciating dollar would pull down the euro/dollar exchange rate (just over 1.37 at the end of 2013) by nearly 7% to 1.28 and lift the dollar/Japanese yen rate up by nearly 4% to 109 — each by the end of 2014.

With 2014 halfway done, the dollar bulls — ourselves included — are still waiting. The euro lost only about 1% in the first six months of the year, while the yen gained more than 3%. The trade-weighted dollar — that is, the dollar's value against a basket of the U.S.' largest trading partners and a broader measure of the currency's performance — was effectively flat. Dollar disappointment came in large part alongside lower-than-expected U.S. bond yields.

In this *Quarterly Investment Perspective*, we try to apply some common sense, or "common cents," to key questions surrounding the dollar. What drives currencies in general and the dollar in particular? What is Bessemer's forecast now for the U.S. currency, both short and longer term? And perhaps most importantly, how do foreign-exchange trends impact other asset classes and our clients' portfolios overall?

Counterintuitive Currency Markets

Before diving into the U.S. dollar (USD) and its outlook, it is worth reviewing what drives currency prices, or foreign exchange (FX), more generally. Frankly, currencies often seem counterintuitive. Indeed, this was reflected in a survey we conducted of more than 1,000 ultra high net worth individuals early this year (Exhibit 1). When asked which currency they thought had performed best versus the dollar in 2013, only 16% said the euro — respondents assumed such a currency could not do well given the euro zone's nonexistent growth and mediocre yields.

Exhibit 1: 2014 Survey of Ultra High Net Worth: Which Currency Won in 2013?

Country	GDP Growth (%)	Policy Interest Rate (%)	Budget Balance (% of GDP)	Current Account Balance (% of GDP)
Brazil	2.5	10.5	(2.9)	(3.4)
U.S.	1.6	0.3	(3.9)	(2.7)
China	7.6	6.0	(1.2)	2.5
Euro Area	**(0.4)**	**0.3**	**(1.4)**	**2.3**

As of December 31, 2013.
Source: FactSet

The euro in fact gained more than 4% last year against the dollar, outperforming all other choices in the survey, including the Chinese renminbi — also called the yuan — and Brazilian real.

It is not that growth and interest rates do not matter for currencies; the survey respondents were correct to assume they do. But growth and yields need to be considered in the context of other variables that, at the end of the day, we believe are the overarching determinants of currency trends: long-term valuation and shifts in countries' balance of payments.

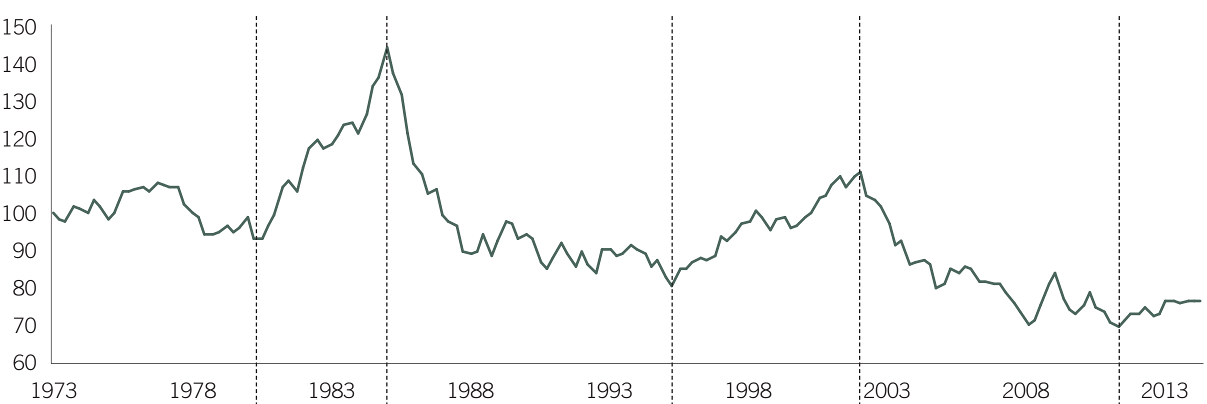
Valuation. One of the few rules governing FX markets is that floating currencies (that is, currencies that are not overly manipulated by policymakers) revert over a multi-year period around some "mean," or fair value. Some market watchers think of fair value in terms of Purchasing Power Parity (PPP), popularized by *The Economist* magazine's Big Mac index (which tells you how the same McDonald's hamburger is priced in 45 different currencies).

Such longer-term FX fluctuations are fairly easily explained by economics. When a currency value rises to a certain point and/or for a sustained length of time, that country's exports usually become less competitive — their higher relative cost becomes a drag on growth, all else being equal. At the same time, the stronger currency helps control inflation pressure. The change in outlook, toward slower growth and relatively less inflation risk, tends to lead investors to reduce their expectations for central bank policy interest rates (the currency's "yield").

This change in expectations, as well as actual growth/inflation dynamics, often leads investors to pare back exposure to assets denominated in that currency, which in turn generates FX depreciation. The FX trend historically has continued, not just leading the currency to its fair value, but overshooting to a point where the now-weak currency reverses the macro tide again (that is, lifting exports and raising growth expectations). Obviously, there are going to be exceptions to

Exhibit 2: U.S. Dollar Has Mean-Reverted Over the Long Term

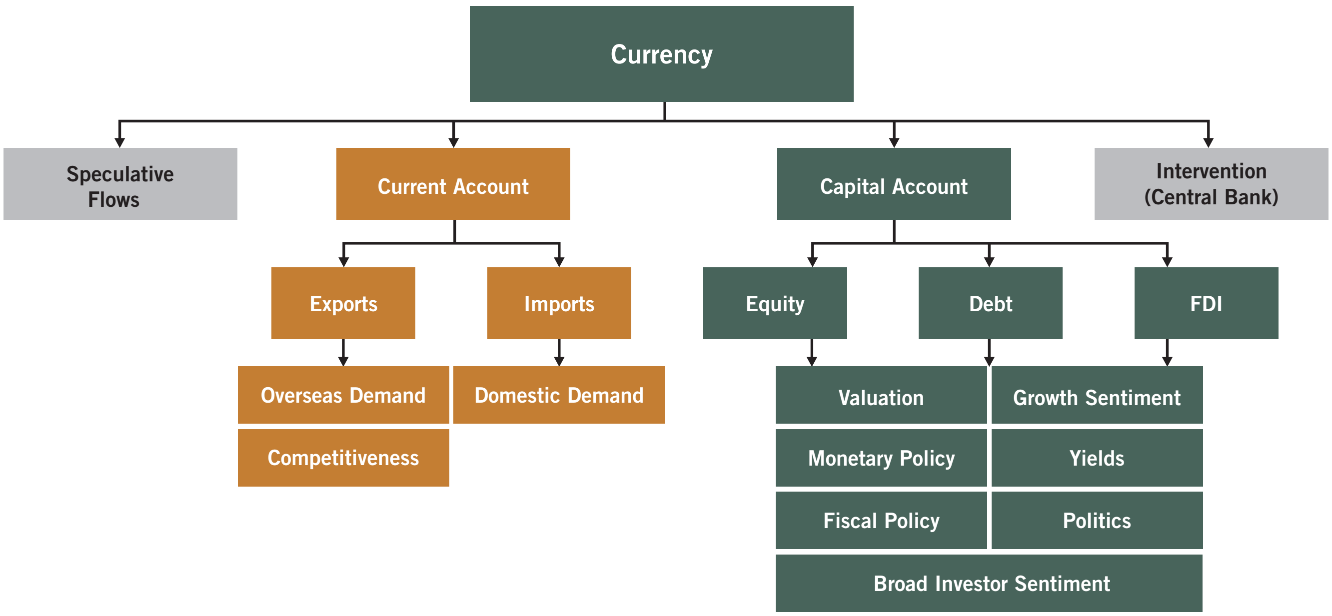
U.S. Trade-Weighted Dollar Index



Duration (Years)	7.8	5.0	10.5	7.0	9.5	3.2
Percent Change	(6.9)%	54.5%	(43.9)%	37.6%	(37.5)%	10.0%

As of June 20, 2014. Represents the U.S. Trade-Weighted Major Currency Dollar Index.
Source: Bloomberg, Federal Reserve

Exhibit 3: What Drives Currency Markets?



this simplified process — including periods of unusually high inflation weighing on currencies — but more often than not, this general pattern does repeat, with valuation cycles lasting an average of five to seven years. Exhibit 2, which shows the trade-weighted dollar, provides an idea of how these cycles can play out.

Balance of payments. Valuation helps set the stage for understanding if a currency seems unusually cheap or expensive longer term. But balance-of-payments (BoP) flows — that is, cross-border trade and capital flows — dominate how currencies behave in the shorter run (Exhibit 3). Until the mid- or even late-1990s, cross-border trade flows were the key driver of currencies. A country like the United States, with a current-account deficit, would sell dollars to buy foreign currency, in turn to pay for imports. All other factors being equal, such flows weighed on the dollar, at least relative to currencies where the respective countries ran current-account surpluses. However, recent years have seen a shift in BoP flows. While trade still matters, global *capital* flows have become the dominant factor behind currency markets. Greater availability of information (media coverage of global markets and economies, the Internet, etc.) has helped give investors confidence to move capital overseas.

Currency investors therefore have to understand what drives cross-border capital flows: mainly equity and fixed-income flows as well as foreign direct investment, including cross-border, cash-funded flows from merger-and-acquisition (M&A) activity.

While not straightforward, there are a few general "rules of thumb" used in tracking these flows. One of the most notable over the last decade relates to global-growth sentiment, resulting in what is called the currency "carry trade." Positive sentiment toward a major economy and/or toward global growth tends to fuel greater cross-border capital flows. More optimistic investors seem to be increasingly willing to take risks overseas. In such environments, countries offering relatively high yields and improving underlying fundamentals attract capital into local stocks and bonds, often offsetting current-account deficits and resulting in stronger local currencies. Currencies with lower yields used to fund such investments (historically the yen and Swiss franc have been among these low-yielding FX) tend to weaken.

Intervention. Last year, China had strong growth and high interest rates versus many of its peers. Yet its currency didn't gain as much as the euro against the dollar. This is where another variable comes in: intervention. While a growing number of central banks around the world let their currencies "float freely" (i.e., market forces determine their values), there are still several central banks that actively manage their currencies, fighting against capital and trade flows, to different degrees.

Hong Kong is at one extreme: It "pegs" its currency to the dollar, with intervention holding the USD/Hong Kong dollar rate around 7.75 regardless of trade or capital-flow pressures. Other policymakers use combinations of intervention (buying or selling currency) and capital controls (such as taxes on foreign buying or selling of local assets) to help direct the currency's value. In China's case, the central bank allows some flexibility in the exchange rate but intervenes regularly to determine how much, and in what direction, the renminbi moves against other major currencies.

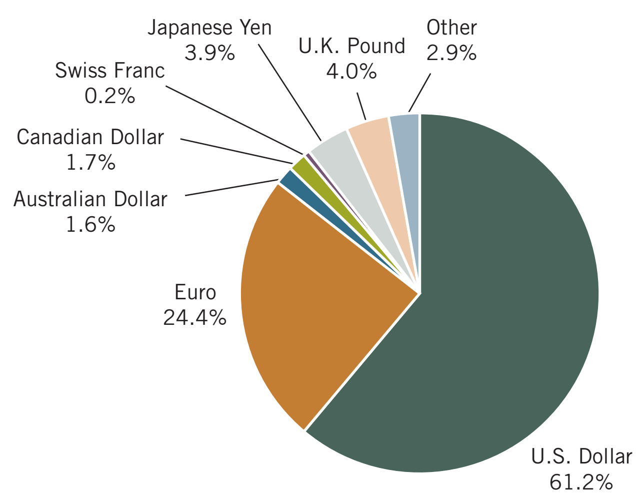
King Dollar? Looking for Gradual U.S. Dollar Strength

So how do we apply this framework to the U.S. currency? Before doing anything else, we need to acknowledge that, at least for now and the foreseeable future, the dollar is in a league of its own. The U.S. remains by far the world's largest economy, accounting for about one-quarter of global GDP. The dollar, meanwhile, continues to enjoy its place as the most-traded currency in the world: The Bank for International Settlements' latest survey in 2013 showed that the dollar was used in nearly 44% of currency transactions worldwide.

This is part of what creates the dollar's "reserve currency" status: critical mass. Given the amount of global trade done with the U.S., central banks try to hold a correspondingly large amount of U.S. securities (usually government bonds) in their reserves (Exhibit 4). Those holdings help to lower U.S. borrowing costs. (Clients often ask about the risks to the dollar's reserve-currency status, possibly due to growing government debt levels. While we would not underestimate risks, we believe a change in the dollar's status would first require another credible currency with a well-developed government bond market that investors could switch into. At least looking at the coming years and through this liquid-debt market lens, there simply does not seem to be any competition for the dollar.)

The dollar's reserve currency status, as well as the U.S. economy and capital markets' size and composition, makes the dollar unique in terms

Exhibit 4: Central Bank Reserves Focused on USD



Data as of March 31, 2014.
Source: International Monetary Fund

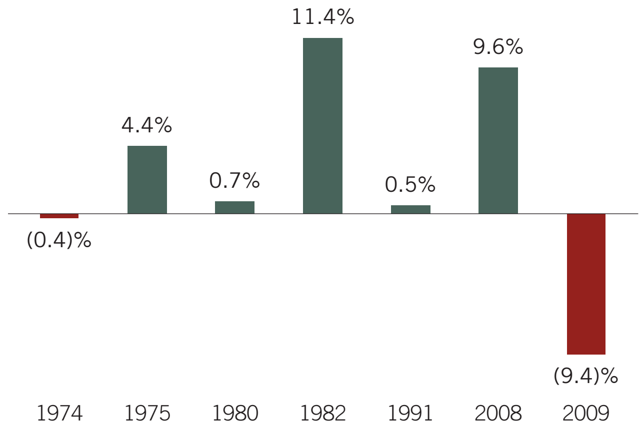
of its drivers. Consider trade flows within the balance of payments: The U.S. is a country of consumers — indeed, consumption tends to account for some 70% of overall GDP. When U.S. growth is improving and Americans spend more, what they buy is often produced overseas. That is reflected in the U.S.' current account, which has been in deficit (as a percentage of GDP) for 34 out of the last 41 years (since the dollar began floating). All else being equal, this almost chronic deficit is a drag on the dollar; what is more variable is the degree of the drag.

A home bias. As noted earlier, currency trends reflect capital, as well as trade, flows. Here the dollar's story gets more complicated. Historically, the U.S. investor base exhibited a strong "home bias" — that is, American investors tended to heavily favor dollar-denominated stocks and bonds.

This bias has faded somewhat in the last two decades, thanks in large part to improved information about, and the openness of, global markets. Today, when the U.S. economy is doing well, Americans (corporate, institutional, and retail investors) often put more money to work overseas, as they look for investments that can "leverage" or benefit from the U.S. expansion. This can exacerbate the dollar drag from the widening trade deficit, leaving the dollar weaker during growth periods and stronger during recessions (the latter as the trade deficit shrinks and capital is repatriated for cash or liquid, "safe" domestic assets like Treasury bills). Going back to 1972, when annual U.S. GDP growth was positive, annual changes in the trade-weighted dollar were negative more than half the time. However, when annual GDP growth was negative, USD changes were positive more than 70% of the time. In other words, when growth has been positive, the dollar could go either way, but when growth was negative (often the U.S. was in recession), the dollar was more likely than not to appreciate (Exhibit 5).

Exhibit 5: U.S. Dollar Tends to Gain During Contractions

Trade-Weighted USD Performance (Annual % Change)



Reflects annual percent change in the U.S. Trade-Weighted Major Currency Dollar Index during calendar years when GDP growth was negative.
Source: Bloomberg, Federal Reserve

Capital flows. As of late June, the trade-weighted dollar was nearly 20% below its long-term average (going back to 1973), and only about 10% above its record low, the latter recorded in July 2011. Valuation suggests the dollar is at least somewhat cheap on this basis, setting the stage for a stronger dollar ahead. Will capital and trade flows support or work against this backdrop?

Let's first consider capital flows. To get dollar strength, we would ideally want to see more capital coming to the U.S. than leaving, be it via stocks, bonds, or foreign direct investment (the latter often cash-funded M&A). Different forces drive these flows. In the case of bonds, foreign investors may find U.S. bonds attractive when they have relatively high yields (often occurring alongside stronger U.S. growth and tightening U.S. monetary policy) or, in sharp contrast, in times of severe risk aversion (often occurring alongside a global economic downturn or a crisis of some sort). In 2013, foreign investors bought a monthly average of $10.3 billion worth of U.S. fixed-income securities (data from U.S. Treasury). In the first quarter of 2014, that monthly average rose notably, to nearly $36 billion. Even adjusted for U.S. purchases of foreign bonds, the trend in net bond flows has been clearly dollar-positive.

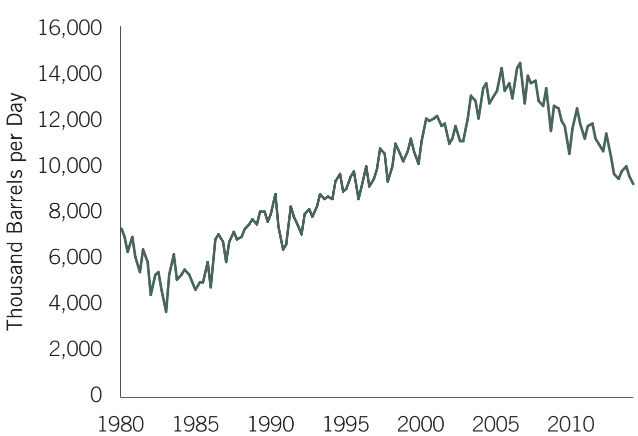
Equity flows are a bit trickier in that global equity investors more frequently "hedge" currency (that is, buy a foreign stock but sell the currency at the same time). So net equity flows into or out of the U.S. may not tell as much about cross-border currency trends as bond flows would (bond investors typically do not hedge currency risk). In any case, a dollar-friendly bias most often occurs when U.S. stock valuations and profit and earnings outlooks appear more attractive than respective outlooks overseas. Using global mutual-fund and exchange-traded fund flow data, investors leaned more towards U.S. equities in 2012 and 2013 but have tilted more towards non-U.S. stocks thus far in 2014.

M&A flows are usually smaller, and therefore less important, for U.S. dollar-related capital flows. However, in periods when firms are cash-rich (and thus more likely to fund deals with cash rather than equity or debt), and when M&A volumes rise significantly, M&A flows can certainly impact currency trends. Last year, the U.S. saw net M&A-related outflows of $46.2 billion. So far, 2014 has been more dollar-friendly, with net inflows of more than $22 billion (through mid-June).

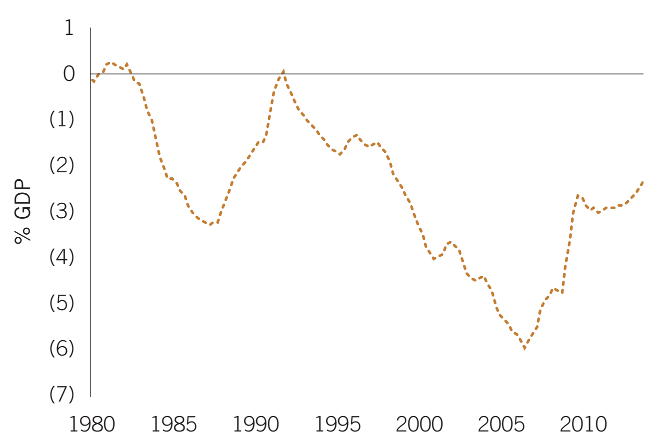
Improving current account. On the current-account side, the dollar's outlook has gotten less negative. The deficit, reaching 5.9% of GDP in 2006, narrowed to 2.3% of GDP in 2013 (the smallest deficit as a percentage of GDP since 1998). Behind this change is energy — specifically, new technology that has allowed the U.S. to sharply reduce net imports of energy products (Exhibit 6). According to the U.S. Energy Information Administration (EIA), this dollar-positive influence on the current account should continue. The EIA forecasts that the net import share of total U.S. energy consumption will fall to 4% in 2040, down from 16% in 2012 and 30% in 2005. Even if the U.S. economy recovers further and Americans import more goods, a return of the deficit to mid-2000s levels seems unlikely.

Exhibit 6: U.S. Importing Less Oil...Narrowing U.S. Current Account Deficit

U.S. Energy Imports

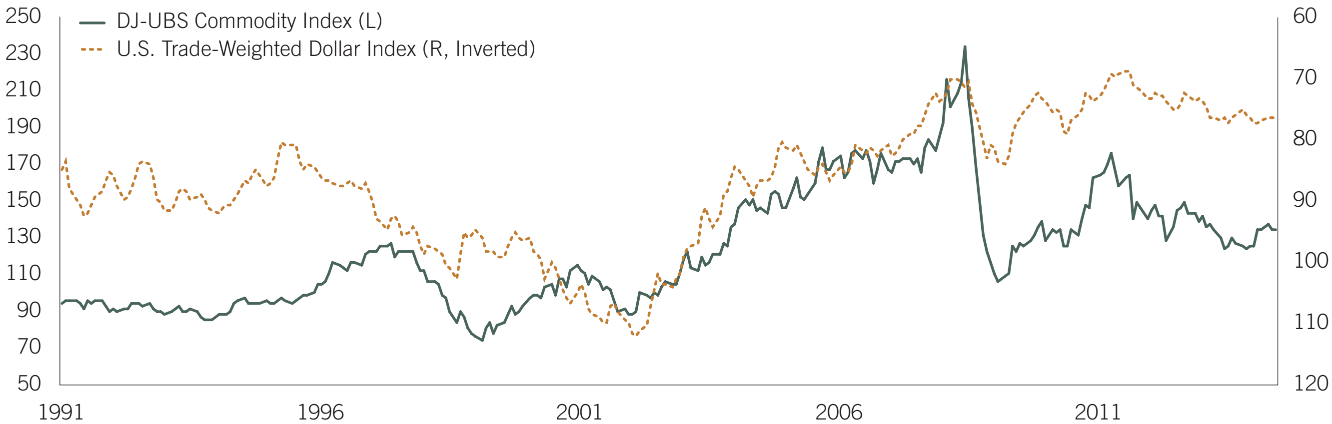


U.S. Current Account



As of March 31, 2014. Left chart represents U.S. imports of crude oil and petroleum.
Source: Bloomberg, Energy Information Administration

Exhibit 7: On the Surface, Stronger Dollar Looks Negative for Commodities



Commodity Index as of June 30, 2014. USD Index represents the U.S. Trade-Weighted Major Currency Dollar Index, as of June 20, 2014.
Source: Bloomberg, Dow Jones, Federal Reserve, UBS

Let's put these puzzle pieces together:

- **Valuation biases the dollar higher.** The dollar has appreciated somewhat since 2011 but remains below longer-term historical averages.
- **The U.S.' current account deficit is diminishing, which drags less on the dollar.** While an increase in U.S. imports is a risk we will monitor, it seems likely to be offset, and possibly overwhelmed, by a continued reduction of energy imports.
- **Net capital flows are a modest positive for the dollar today.** Looking ahead, we expect flows to be balanced but with a decent chance of further support for a bullish dollar trend (particularly via M&A and, longer term, via bonds providing relatively more attractive yields).

Now, just because we believe the dollar is biased higher in the year — and possibly years — ahead does not mean that the dollar will appreciate against every other currency. As evidenced by the first half of 2014, dollar performance can deviate significantly when we look at currency pairs (the first half of the year saw the Brazilian currency gain nearly 6% against the dollar while the Argentine peso lost 20% versus the dollar, for instance).

In general, the dollar will perform best against currencies that have (a) large and/or widening current-account deficits, (b) low and falling interest rates, (c) poor inflation/growth/policy outlooks that limit capital inflows, and (d) high valuations versus historical averages — all in absolute terms but also in relation to the dollar's fundamentals. Using this framework, among developed-nation currencies, we see the dollar biased higher over the coming year against the Japanese yen, Swiss franc, and euro.

What a Strong Dollar Means for Investors

Forecasting FX is not just about investing in this one asset class but also about extrapolating what currency trends mean for other asset classes. In the dollar's case, perhaps its most profound influence is on commodities and equities.

The dollar and commodities. Conventional wisdom holds that a stronger dollar is bad for commodity prices, and vice versa. At first glance, historical relationships appear to support this theory: The correlation between monthly returns for the trade-weighted dollar and the Dow Jones-UBS Commodity Index since 1991 is -0.3 (Exhibit 7).

While accepting this general premise, we would add that the links between commodities and the dollar are numerous and more nuanced than a simple correlation would suggest; further, the links can change over time. Let's consider some of the most critical drivers of commodity prices and how they may or may not tie back to the dollar:

- **Managing currency risk.** While there have been some shifts in recent years (mainly towards the euro), the vast majority of commodities remain priced and traded in U.S. dollars. When the dollar depreciates, and a foreign commodity producer wants to hold revenues steady in a local currency, that producer (all other factors being equal) needs to raise prices to compensate for the reduced dollar revenues.
- **Global growth.** Historically, commodity prices have been better supported during periods of improving global growth, as stronger economies usually have reflected relatively greater demand for commodity inputs. That said, the strength of that linkage has depended in part on how the dollar was faring: In periods where improving global growth has gone hand in hand with a stronger dollar (for instance, in a period when the U.S. was driving the global recovery and capital flows favored U.S. assets), commodity-price increases have generally proven more modest.
- **Inflation.** Historically, investors have looked at inflation and commodity prices as circular: Rising commodity prices have been seen as fueling broader inflation, and increasing inflation fears have, at times, led investors to buy commodities as a hedge against potential losses in other cyclical asset values. Commodities have tended to do best when rising inflation emerged alongside a weaker dollar, as was the case between 2002 and 2007.
- **Supply.** One of the most important factors differentiating commodity price trends from other cyclical assets (such as equities) is supply. A variety of factors can impact commodity supplies, from geopolitics to weather to innovation. An abrupt and/or meaningful shift in supply perceptions can cause commodity prices to diverge from other asset classes, including foreign exchange — at times dramatically.

Assuming the dollar continues its broadly bullish trend over the next few years, we would expect it will act as a headwind for commodity prices in aggregate. That said, improving global demand and a turn higher in inflation could provide offsets. For investors, such a backdrop would likely mean focusing more on supply factors that differentiate the commodity winners.

The dollar and stocks. The relationship between the dollar and stock markets has changed dramatically over time, in particular as more investors have grown comfortable investing overseas. Up until the early 2000s, the dollar and the S&P 500 Index had a strong, fairly consistent positive relationship: When the dollar rose, so did U.S. equities, and vice versa. However, as noted earlier, this changed as the investing "home bias" started to dissipate. For most of the last decade, when the dollar rose, it was a reflection of diminished risk appetite and a flight to cash and "safe" assets like U.S. Treasuries — usually U.S. investors were reducing their foreign equity holdings and "bringing money home." This was perhaps most dramatically seen in September 2011.

Over just a few weeks, following the downgrade of the U.S.' sovereign credit rating, the trade-weighted dollar climbed some 7% while U.S. equities and U.S. bond yields fell sharply (Exhibit 8).

As we look ahead, we believe this dollar-equity relationship may be shifting again, at least at the margin. For sure, as the U.S. economy improves and American investors' confidence brightens, capital may head overseas toward stocks offering attractive valuations and where the respective firms are seen as likely to benefit from the U.S. growth trend. But even if some capital goes out of the U.S., an environment where the U.S.' balance of payments is still broadly improving (potentially thanks to a narrowing current-account deficit, and supportive bond and M&A-related inflows) could result in net capital flows still helping the dollar. We could see a repeat of the pattern where the dollar and U.S. equities rise together.

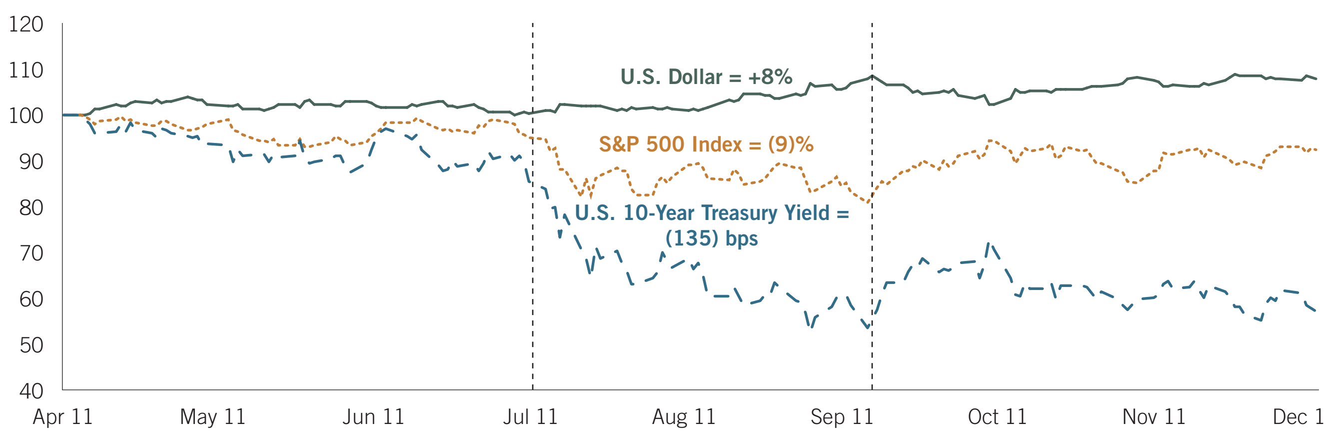
Thinking about equities more broadly, what does a stronger dollar mean for investors? We think we can draw at least a few broad conclusions:

- **Exporters.** Non-U.S. firms exporting to the U.S. benefit as weaker local currencies make their goods in the U.S. relatively more attractive.
- **Domestically focused firms.** U.S. firms with more extensive foreign operations will tend to underperform more domestically U.S.-focused firms (we would note here that this pattern has been observed historically despite currency hedging).
- **Cyclical sectors.** Within the U.S. market, cyclical sectors tend to have more foreign exposure than defensive sectors, and as a result tend to struggle more in a strong dollar environment, all else being equal.
- **Commodity buyers.** If the stronger dollar were to weigh on commodity prices (something we see as commodity-specific in the years ahead), U.S. firms with significant commodity inputs stand to benefit.

Connecting the Dots: Bessemer Portfolios in the Year Ahead

Forecasting FX is challenging. Indeed, former U.S. Federal Reserve (Fed) Chairman Alan Greenspan once likened predicting currency markets to rolling

Exhibit 8: After U.S. Credit Downgrade, Dollar Rose While Stocks and Bond Yields Fell



Indexed to 100 on April 30, 2011.
Source: Bloomberg, Federal Reserve, Standard & Poor's

dice. When subsequently asked why financial firms would invest in currency businesses if the chances of success were so poor, he replied that "some people are better at rolling dice than others."

With that in mind, we approach our currency views as probabilities rather than certainties; we tilt portfolios but only when we have strong views, and even then we have the flexibility to adjust currency tilts quickly. Our Balanced Growth model portfolio as of June was overweight the dollar — both looking across the entire portfolio and specifically within equities. We remain overweight U.S. equities and, overseas, have notable exposure to firms that will benefit from a stronger dollar, in part through U.S. sales (Exhibit 9).

We are now neutral on commodities, remaining cautious in instances where supply constraints may not provide enough support to offset the dollar headwind. Gold provides one example where we are underweight primarily because of supply, but also because of dollar-related risks.

The dollar itself does not tend to drive fixed-income markets. However, Fed tapering and a gradual rise in U.S. yields (we continue to expect the U.S. 10-year Treasury yield to top 3% before year-end) both weigh on bond returns and help lift the dollar. We remain underweight traditional fixed income, and have a bias for shorter-duration maturities. Looking at extended fixed income, emerging-market debt is most sensitive to dollar trends: A stronger dollar can hinder total returns as profits are translated back into dollars for U.S.-based investors. Our Strategic Opportunities mandate reduced its emerging-market debt position in 2013 and today appears focused mainly on relative investment opportunities between different emerging markets — both debt and currencies.

For many years, the U.S. Treasury has stated that "a strong dollar is in America's interest." We would consider turning that phrase on its head: A stronger American economy may today be in the dollar's interest. It is our responsibility as investors to explore and understand not only where the dollar may be headed, but also how to interpret trends and risks for all aspects of our portfolios.

Exhibit 9: What a Stronger Dollar Means for Bessemer Portfolios

Asset Class	Portfolio Positioning
Fixed Income	• Rising U.S. yields good for the dollar, bad for bond returns — we remain underweight and short duration
U.S. Equities	• Improving U.S. growth and M&A should benefit U.S. equities — we remain overweight and look for firms with manageable foreign exposures
Non-U.S. Equities	• Global growth is broadening; capital leaving the U.S. for foreign investments is a risk to a strong dollar view • Focus on firms that will benefit from U.S. exports and operations
Commodities	• Strong dollar is a headwind but can be offset by improving global demand, rising U.S. inflation and, in some cases, supply constraints — we remain neutral

As of June 30, 2014. Reflects the views of Bessemer Trust and may not be realized for a variety of reasons.

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