A Closer Look

The Dollar Under President Trump Revisited

Holly MacDonald
Chief Investment Strategist

In Brief

- **Earlier this year, in our March 9 *A Closer Look,* "The Dollar Under President Trump," we outlined our medium-term view for a rangebound to moderately stronger U.S. dollar. While the dollar has been weaker than expected in 2017, many elements of our view are now materializing.**
- **In this *A Closer Look,* we discuss recent developments and surprises and how these have shaped portfolio adjustments during the year. A range of scenarios for the year ahead suggests to us that the risks of further dollar depreciation remain limited, and we maintain a modest overweight to the U.S. and U.S. dollar within equity portfolios.**

Looking Back at 2017: Fed on Track, but Fiscal Policy Disappoints While Rest of World Picks Up

In 2017, a trade-weighted index of the U.S. dollar has depreciated about 7%, and was down just over 10% earlier in the year before partially retracing in the past several months. While the performance of the dollar since the start of the year has surprised many market participants, including ourselves, several of the factors that we thought would be supportive of dollar strength have largely transpired, including continued progress toward the normalization of monetary policy by the Federal Reserve, ongoing economic growth, and resilient U.S. financial markets.

There were also several things that we did not expect, in particular the Trump administration's struggle to capitalize on post-election momentum to pass pro-growth legislation, which would have been supportive of the dollar. While this disappointment did not cause the equity market to stumble — with the underpinning of robust global growth intact — the dollar did feel the effect. Specifically, the weakness in the dollar followed the decline in the administration's approval rating over the course of the year, which in turn coincided with various policy disappointments.

An additional factor weighing on the dollar during this time was the administration's statements that had a weak-dollar bias, calling into question the

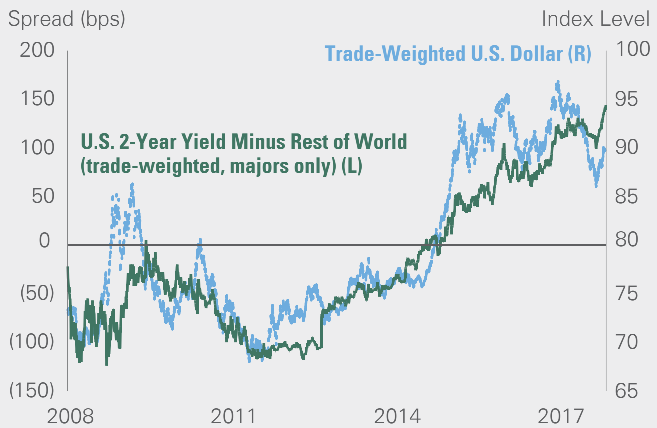
Probabilities for the Dollar into 2018

Scenario 1 Stronger USD	• U.S. passes fiscal stimulus; growth/inflation expectations elevated • Fed raises rates faster than rest of world • Repatriation part of fiscal package	**20–30%**
Scenario 2 USD rangebound	• U.S. passes fiscal stimulus with repatriation; growth/inflation expectations elevated • Fed raises rates but in line with rest of world • Steady growth overseas continues to attract U.S. capital	**40–50%**
Scenario 3 "Carry trade" – USD up vs JPY but generally weaker	• No fiscal stimulus passed • U.S. and global inflation remain moderate; central banks gradually tighten against solid growth backdrop • U.S. capital continues search for yield, including some emerging markets assets	**10–20%**

USD stands for U.S. dollar. JPY stands for Japanese yen.
Source: Bessemer Trust

Exhibit 1: Two-Year Government Bond Spread and Trade-Weighted U.S. Dollar

Key Takeaway: U.S. interest rates compared to the rest of the world has been a key driver of the dollar.



As of November 15, 2017 for 2-year yield spread and November 9, 2017 for trade-weighted dollar. Trade-weighted dollar is the Federal Reserve U.S. Trade Weighted Major Currency Dollar Index.

Source: Bloomberg, Federal Reserve

historical preference of the U.S. government for a strong-dollar policy. While we expected that such a tone could develop, we had forecast that the dollar support from policy impact would offset the drag from rhetoric.

Separately, and critically, strong growth momentum outside of the U.S. offset support for the dollar from Fed rate hikes.

We discuss both fiscal and monetary policy drivers for the dollar in more detail in the pages that follow.

Interest Rates: It Is All Relative

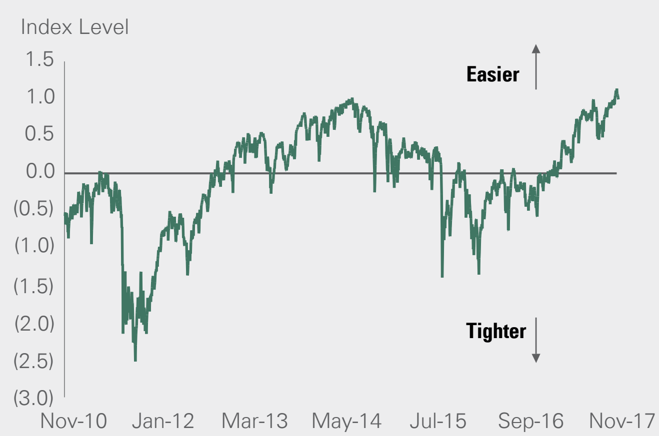
Over the last several years, a key driver of the dollar has been the difference between U.S. interest rates and interest rates in the rest of the world. Indeed, the level of this difference has largely explained the level of the dollar on a trade-weighted basis since the financial crisis. This is somewhat intuitive given that better domestic growth usually implies a greater chance of policy rates moving higher (or not moving lower), and both growth and higher rates can drive capital inflows to a country, supporting the currency. Over the past year, this interest-rate differential broadly moved in favor of the U.S., with a break in the middle of year in which rates outside of the U.S. moved higher faster (Exhibit 1). This was due to a combination of lower U.S. inflation reports alongside improving data outside of the U.S.

From the U.S. side, the Fed has continued to gradually raise interest rates as the domestic economy continued to improve, with two rate hikes already completed so far this year, and one more widely expected in December. Even though the Fed has now raised the fed funds rate four times since it initiated the current rate-hiking cycle back in December of 2015, financial conditions have continued to ease (Exhibit 2). This is not particularly unusual, as during the last tightening cycle, financial conditions did not tighten in response to initial rate hikes either.

While the increase in the fed funds rate helped to support the dollar, much of the increase in the policy rate we have seen so far this year was already discounted by financial markets at the beginning of the year and

Exhibit 2: Bloomberg Financial Conditions Index

Key Takeaway: U.S. financial conditions have continued to ease despite four interest rate hikes by the Fed since December 2015.



The Bloomberg U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

As of November 15, 2017.

Source: Bloomberg

thus brought on limited dollar support. The potential for a December rate hike, which was not expected back in August, has helped lift the dollar more recently as the probability for a December hike has risen to over 90% (Exhibit 3).

Outside of the U.S., growth data has surprised positively around the world. Unemployment rates have fallen to below pre-financial crisis levels. Investor sentiment, as measured by the Sentix Economic Global Aggregate Index, is currently 27.3, its highest level since 2007 and a notable improvement since February 2016, when it measured -3.6.

Looking at Europe specifically, there have been positive surprises this year, with continued improvement in economic growth and relatively smooth elections in France and Germany. The increase in European economic momentum has allowed the European Central Bank (ECB) to take tentative steps to reduce the extraordinary levels of monetary policy accommodation. This initial move was cited as contributing to the euro's strength in the first half of the year. The ECB has only slightly modified its policy stance by reducing the amount of its monthly asset purchases and extending the length of the program. Not surprisingly, the appreciation of the euro began to stall in early September as hopes for even faster tightening faded.

The weakness in the dollar has been more extreme than the move in rate differentials would have suggested, implying that the dollar now looks low relative to this metric. The dollar also has fallen beyond what the market consensus was at the beginning of 2017 (Exhibit 4). The euro has appreciated 13% so far this year, while the Canadian dollar (CAD) is up 6.0%, and the British pound (GBP) has appreciated by 7.9% (as of November 15).

As we consider Fed policy for the year ahead, our base case is for a continuation of moderate tightening and gradual reduction of the balance sheet. Jerome Powell, previously a member of the board of governors, will become chair of the Federal Open Market Committee (FOMC) in early 2018. Our assessment is that Powell's

Exhibit 3: Probability of a Hike at the December FOMC Meeting

Key Takeaway: The dollar has benefitted from building rate-hike hopes of late.

As of November 8, 2017.

Source: Bloomberg

Exhibit 4: Major World Currencies Versus the U.S. Dollar

Key Takeaway: The dollar has fallen below analyst forecasts from the beginning of the year.

Currency	Jan. 1, 2017	Consensus	End-Q3	Year-to-Date FX Move
JPY	117	115	113	3.9%
CAD	1.34	1.35	1.25	6.0%
GBP	1.23	1.25	1.34	7.9%
EUR	1.05	1.07	1.18	13.0%

JPY stands for Japanese yen. CAD stands for Canadian dollar. GBP stands for British pound. EUR stands for euro.

As of November 15, 2017.

Source: Bloomberg

near-term policy stance will largely mirror that of his predecessor, but at the margin, Powell could be viewed as slightly more aligned with the broader needs of government than an economic purist such as Janet Yellen. Our assessment is largely driven by his diverse background, which includes prior roles in the financial industry, Treasury Department, and a think tank in addition to his most recent responsibilities as a member of the board of governors.

The vice chair position remains open, and the White House appears in no hurry to fill it, noting only the hope to have a candidate nominated "by the end of the year."

So far, we do not view the new Fed composition as suggesting a meaningfully different approach to rates or the dollar. We also believe that the very modest pace of Fed balance sheet roll-off will have a limited impact on Treasury yields. However, as the normalization progresses, the effect could become more pronounced. In other words, we do not expect a major shock to the dollar from the Fed perspective in and of itself — without a notable change in inflation trends.

Fiscal Policy: Are We There Yet?

Heading into the year, markets were optimistic that the Trump administration was set to capitalize on post-election momentum by passing a number of pro-growth policies that had been central to its campaign platform. These expectations contributed to the rapid run-up in the dollar following President Trump's election, and consistent with this, as the administration struggled to convert political momentum into policy reality, the dollar began to depreciate notably. This took place while economic growth in the U.S. remained stable and financial market volatility remained relatively low. Only recently has the administration and the Republican party begun to make some progress on tax reform and fiscal issues, and unsurprisingly, this has also coincided with a dollar bounce.

Our base case is that tax reform will eventually be enacted but that it may take a bit longer than many had initially anticipated (first-half 2018). It is still too early to have a high degree of conviction on what the eventual tax legislation will look like, but if the administration is able to include some of the key tenets of its platform, such as a notable reduction in the corporate tax rate, it should be dollar-positive over the intermediate term. An important piece of the puzzle will be provisions that encourage repatriation of corporate earnings held abroad, which could also support dollar sentiment.

Portfolio Positioning and What Lies Ahead

While we have reduced our U.S. overweight position moderately this year and added exposure to developed Europe in response to changing economic and financial conditions, we remain overweight the U.S. in Balanced Growth (70/30 risk profile) portfolios. The increased exposure to developed Europe has helped to reduce the dollar drag on our portfolios as a significant amount of the total return in the region has been driven by the currency effect (Exhibit 5).

Looking to 2018, our base case is for a rangebound or modestly stronger dollar. We expect the Federal Reserve to continue normalizing both its balance sheet and the primary policy rate, albeit at a slow and steady pace (this assumes benign inflation trends). Given what is already discounted in the dollar's valuation, gradual monetary tightening should only provide modest dollar support (remember that the ECB will also be slowly backing away from exceptionally easy monetary policy next year as well, so interest-rate differentials are not likely to veer meaningfully one way or another).

More notable dollar appreciation could occur from the eventual passing of tax reform and/or infrastructure spending and repatriation legislation. As discussed earlier, the dollar weakened considerably in 2017 on the back of policy disappointment, so we would not be surprised to see a rebound of similar magnitude versus the level that interest rates would suggest if growth-positive policies were to become reality. The U.S. economy is already running at a pretty brisk clip, and additional stimulus this far into a growth cycle could actually cause the economy to overheat. The interplay between fiscal and monetary policy would be important in this scenario — not only could the dollar revert to fair value versus interest rates, but U.S. rates versus those of the rest of the world would likely increase as well as the market prices in more tightening. For reference, one additional rate hike (25 basis points) has historically meant a trade-weighted dollar appreciation of roughly 3%. While we would assign a probability of 20% to 30% to the scenario of a much stronger dollar on fiscal stimulus, we would assign 40% to 50% probability to the scenario of the dollar being rangebound on stronger U.S. growth amid steady overseas growth that continues to attract some U.S. capital.

A stronger dollar would also likely emerge if market volatility increases and equities weaken meaningfully on the back of broadly weak growth data or some outside shock. Repatriation flows from U.S. investors as well as foreigners increasing exposure to safe-haven markets in the U.S. tend to boost the dollar in periods of stress. While this is not our base case, defensive elements in portfolios in addition to the dollar overweight are likely to be supportive. Meanwhile, the worst-case scenario for the dollar would be a continuation of strong global growth with no direct stimulus in the U.S. Growth sentiment in the U.S. would likely retreat relative to the rest of the world, in which case incremental capital flows could favor non-U.S. markets. We would put a probability of less than 10% on this scenario.*

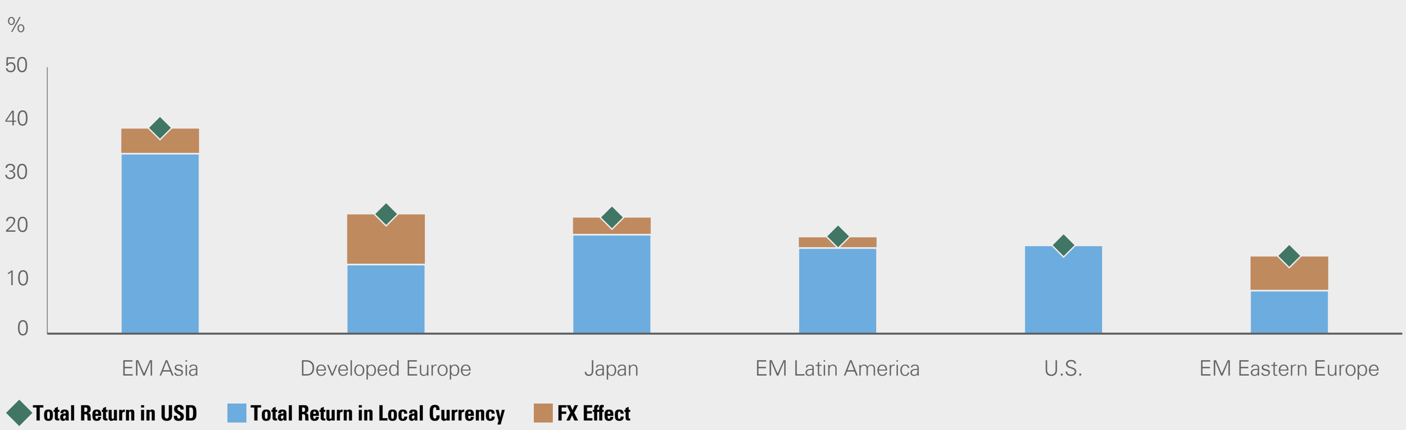
When we consider these scenarios and probabilities holistically, it leads us to believe that clients should benefit in 2018 by a modest overweight to the U.S. and the dollar in particular.

* We outline these scenarios on the front page of this research note.

Special thanks to Rebecca Patterson and John McMinn for their contributions.

Exhibit 5: 2017 Year-to-Date Total Returns of Global Equities, by Country and Region

Key Takeaway: To date this year, a significant amount of non-U.S. equity returns has been driven by currency effects.



As of November 14, 2017. Total return is gross dividends. Performance is measured using the following indices: MSCI Emerging Markets IMI (Emerging Markets), MSCI World IMI (Developed Markets), MSCI Emerging Markets Latin America IMI (Emerging Markets Latin America), MSCI Emerging Markets Eastern Europe IMI (Emerging Markets Eastern Europe), MSCI Emerging Markets Asia IMI (Emerging Markets Asia), MSCI USA IMI (U.S.A.) and MSCI Europe IMI (Developed Europe) and MSCI Japan IMI (Japan). IMI stands for Investable Market Index.

Source: FactSet, MSCI

Our Recent Insights

The Fed's Next Chapter — Investment Insights
(November 2017)

Alternative Investments and Wealth Planning Opportunities — A Closer Look and Video
(October 2017, Video Available)

How America Shops and Why it Matters
(Fourth Quarter 2017, Video Available)

Japan's Abe Gets a Second Wind — Investment Insights
(September 2017)

The Fed's Plans for Balance Sheet Normalization — Video
(September 2017)

Hurricanes, Missile Tests, and a Debt Deal: Update on Fall Risks and Positioning — Investment Insights
(September 2017)

A Bumpy Fall? — Investment Insights (August 2017)

Lessons from the Peak — Quarterly Investment Perspective
(July 2017, Video Available)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.