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GLOBAL INSIGHT

SPECIAL REPORT

Strong Dollar Here to Stay

The dollar juggernaut should roll on and flex its muscle for the next few years.

Alan Robinson

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Special Report

Strong Dollar Here to Stay

A strengthening U.S. economy has ushered in a dollar bull market that may have several more years to run. Investors should position for a "strong dollar" world.

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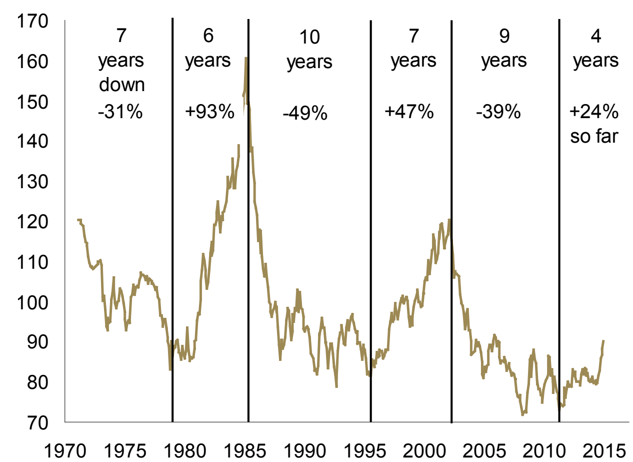
In April 2014 we suggested the U.S. dollar was entering a period of sustained outperformance, but the magnitude of the currency's rally has surprised us. The dollar ended 2014 up 13% against a trade-weighted basket of currencies, its largest annual gain since 1997, and was up against all 25 currencies followed by RBC Capital Markets.

Despite a broad-based rally that has now lasted four years, we expect this cycle to persist for several more years, with the larger part of the gains for the dollar likely still ahead.

Entering a Cyclical Bull Phase Within a Secular Decline



Trade-Weighted Dollar Index (DXY) calculated through 12/31/14. Pre-euro calculations use an equivalent trade-weighted basket of European currencies.
Source - RBC Wealth Management, Thomson Reuters

Overall, the dollar has declined during the era of free-floating exchange rates. But this decline has been punctuated by multiyear bull cycles during which the dollar has risen significantly.

Last year we cited four factors driving the dollar higher:

- Stronger U.S. GDP growth relative to most developed economies
- The imminent end of quantitative easing (QE) in the U.S.
- A clearer path to Fed rate hikes
- An improving balance of trade, driven partly by an increase in U.S. oil and gas production

The end of QE came as expected in October 2014, but the other three factors are still in play. U.S. GDP growth in 2014 outpaced that of most of the developed world, and the gap looks set to widen in 2015 as Europe and Japan struggle with deflation.

Strong Dollar

We expect the first Fed interest rate hike in June 2015, and we note that U.S. oil production continues to grow even in the face of lower oil prices.

But with these factors now widely appreciated by the market, is all the good news "in the price" and will the greenback start to run out of steam in 2015?

We think not.

Shifting Into Third Gear

There are several longer-term factors that should continue to push the dollar higher over the next few years, in our view:

An added benefit of the dollar's reserve currency status is its use as a safe-haven currency.

The dollar remains the world's reserve currency. There are no realistic challengers for this title and none likely through the end of the decade because the U.S. government bond market is the world's largest liquid asset market. Other potential reserve currencies are either not freely convertible (Chinese yuan) and/or do not have a large enough sovereign bond market (the euro).

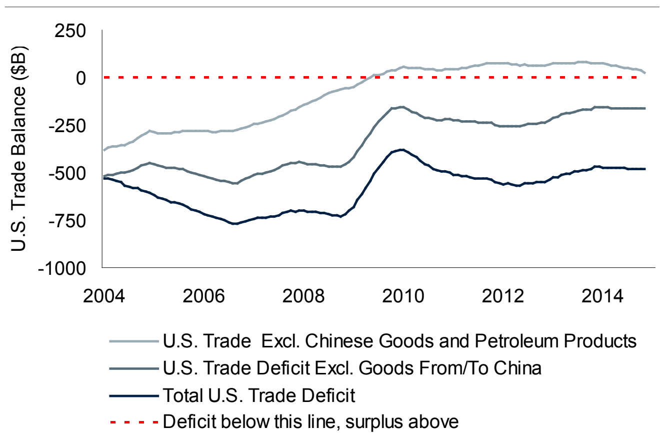
Dollar bears point to the size of the U.S. debt as a major vulnerability, but most foreign-held U.S government bonds are now held as reserves by central banks. These bonds are "sticky" in that they are seldom liquidated by their holders.

An added benefit of the dollar's reserve currency status is its use as a safe-haven currency. So even in periods of global turmoil, the dollar has good support.

U.S. current account and budget deficits continue to improve. The current account is determined largely by net investment into a country minus its trade deficit. Foreign direct investment into the U.S. has increased due to superior economic growth, cheaper overall manufacturing costs, and a desire by foreign companies to get closer to the buoyant U.S. consumer market.

At the same time, the trade balance has improved as the two largest traditional deficits have shrunk. China's surplus with the U.S. is moderating as the country pivots to a consumer-led economy, and U.S. energy imports are declining on the back of a surge in domestic oil and gas production.

U.S. Trade Deficit Turns Into Surplus If We Exclude China and Energy



Trailing 12-month data through 11/30/14
Source - RBC Wealth Management, U.S. Bureau of Economic Analysis, Bloomberg

The U.S. trade deficit's two largest factors appear to be moderating. The surplus excluding these items implies an increased demand for dollars from other foreign trade partners.

Strong Dollar

Weakness around the world should persist for some time, especially relative to growth experienced in the U.S. Many foreign central banks are happy to see their own currencies slowly weaken for competitive reasons, and they often try to "talk down" their currencies whenever the dollar starts to weaken. The Bank of Japan and the European Central Bank have both expressed comfort with their weakening currencies as they see this as a tool to combat deflation.

But Beware the Crowded Trade

We do not expect the same rapid pace of appreciation we saw in the second half of 2014.

It's rare for the dollar to post successive years of double-digit gains; the last occurrence was in 1984. Instead, we expect a moderate rise, with some emerging market currencies even gaining against the dollar.

And we don't think the rise will be a one-way street. Whenever market views become too one-sided, countertrend sell-offs can be dramatic. As 2015 gets underway, long-dollar positioning in the currency futures market is at historical highs.

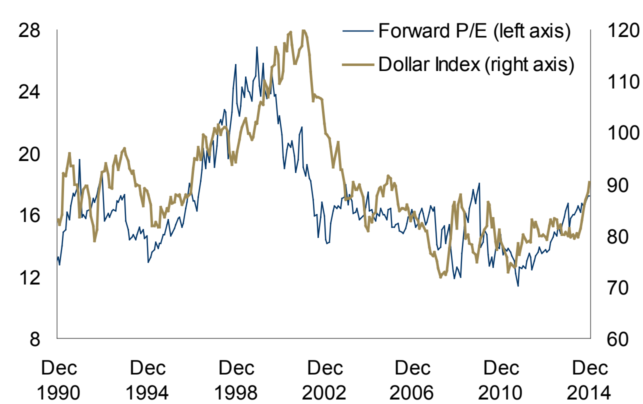
Any near-term weakness in U.S. economic data could also stall the dollar's rise as this might dampen the Fed's desire to raise interest rates. But we'd still recommend using pullbacks as opportunities to add to long dollar positions for investors with longer-term views.

Winners and Losers

Historically, global equities have performed better during periods of dollar strength than during dollar bear markets. Overall, U.S. stocks tend to benefit from the strong domestic economy that usually accompanies dollar rallies, and they also enjoy a tailwind from expanding valuations.

This multiple expansion reflects a perceived improvement in corporate earnings growth, and increased fund flows into U.S. equities by foreign investors seeking assets denominated in a rising currency.

A Stronger Dollar Can Raise U.S. Valuation Multiples



P/E multiple of the S&P 500 index, using next-12-month consensus earnings forecasts.
Source - RBC Wealth Management, Thomson Reuters, Bloomberg, data through 12/31/14

Periods of cyclical dollar appreciation are associated with rising P/E multiples for U.S. stocks.

Dollar-based investors can also achieve above-market returns from selected foreign stocks. The key, in our view, is to find stocks (or ADRs) for which the positive profit effect of a weak currency outweighs the negative effect of owning a security denominated in a declining currency.

As an example, a foreign company selling its products to U.S customers will receive a large share of its revenue in U.S. dollars. If it makes these products outside the U.S., its costs will be largely denominated in foreign currencies. So in a strong dollar cycle, its dollar-based revenues will grow more quickly than its foreign currency costs, and its profitability will grow. As long as the pace of dollar appreciation is not too fast, the added profit growth can outpace the weaker currency, and the stock can potentially outperform in dollar terms too.

The impact of a strong dollar can be felt in different ways.

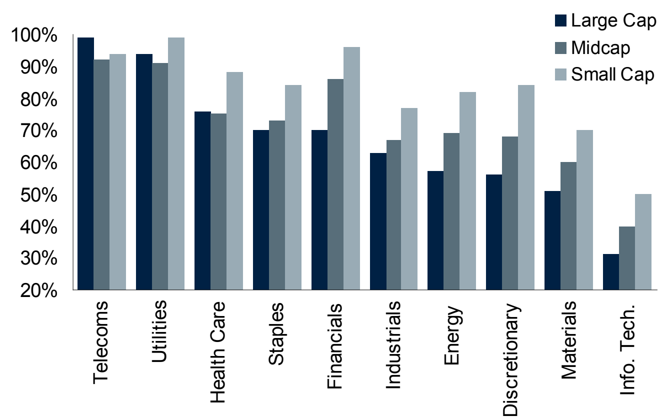
U.S. multinationals often experience the opposite effect. If the dollar is strong, revenues from their foreign subsidiaries decline in dollar terms, as do their repatriated profits. Savvy CFOs can mitigate this impact by hedging their overseas currency exposure, but this can be costly in volatile markets or if currency trends are changing.

Industry Sectors

The impact of a strong dollar can be felt in different ways, even by companies within the same industry. But certain industry groups have more exposure to non-U.S. customers than others, which can act as a headwind unless other non-currency factors offset the strong dollar impact.

U.S. Stocks' North American Revenue Exposure

by Sector and Market Cap



Source - RBC Wealth Management, Russell Investments, Bloomberg, National Research Correspondent, data through Q3 2014

In a strong dollar environment, U.S. companies with a high exposure to overseas revenues will require faster growth to keep up with their domestically focused peers.

This observation is backed up by correlations between sector stock returns and dollar strength.

Since the recession, the performance of U.S. companies in the **telecoms, health care, financials, and technology** sectors have correlated most strongly with dollar strength, while those of **energy and materials** companies have performed the worst.

Although technology stocks typically have significant exposure to foreign revenues, they often have a high proportion of operating costs denominated in foreign currencies, which acts as a natural hedge to a strong dollar. In addition, the U.S. technology sector is a key beneficiary of foreign portfolio inflows from growth investors. These flows can enhance valuations and help finance R&D investment, thereby boosting long-term growth.

Large Caps versus Small Caps

Another counterintuitive conclusion can be found in the style debate.

Small-cap stocks have a relatively high exposure to domestic (dollar paying) clients and might be expected to outperform their large-cap peers in a strong dollar environment.

But the actual performance of small caps in the current dollar bull market has failed to match that of large caps. A similar underperforming trend was seen in the strong dollar cycle of the late 1990s. We need to look back to the 1980s to find the last time small caps outperformed large caps while the dollar was rising.

We think this can be explained by risk appetite. The most recent strong dollar cycles have been associated with "risk-off" behavior, which has favored large caps over small caps. Those small-cap stocks that were able to perform well in these cycles generally benefitted from good earnings visibility and reasonable valuations.

Subsector Ideas

Within the larger industry categories, a handful of specific businesses show strong correlations, both positive and negative, to dollar strength.

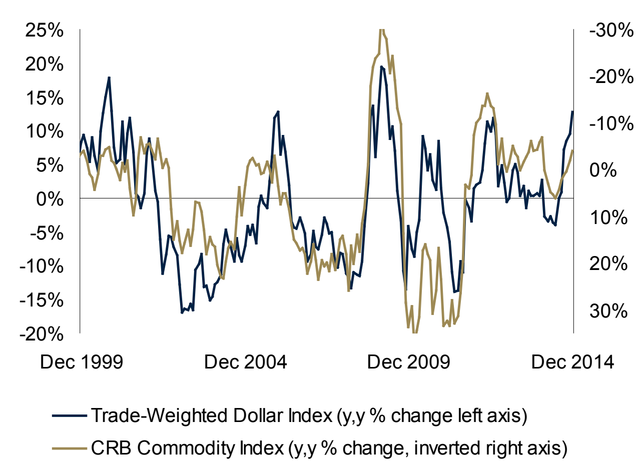
Notable outperformers include:

- **Regional banks:** These companies have limited exposure to international assets and are levered to a healthy U.S. consumer sector.
- **Airlines:** A strong dollar drives down fuel costs, and boosts passenger miles and margins.
- **Pharmaceuticals:** Discretionary health care spending in the U.S. tends to grow in tandem with a strong dollar.
- **Retailers:** Margins improve on foreign-sourced goods sold in dollars, and volumes increase if dollar strength keeps a lid on price inflation.

Areas to avoid during dollar bull markets include:

- **Commodity companies:** With prices of most industrial commodities denominated in dollars, global demand declines in a strong dollar market. Within the materials

Commodity Markets Struggle in a Strong Dollar Environment



Source - RBC Wealth Management, Thomson Reuters, Bloomberg, data through 12/31/14

Most global commodities trade in U.S. dollars, so periods of dollar strength make them less affordable for non-U.S. based buyers.

We expect pullbacks to offer opportunities to increase exposure.

sector, metals and mining companies have a strongly negative correlation to a rising dollar, as do drilling companies within the energy sector.

A slowing commodity market can also act as a headwind to emerging market stocks, particularly those based in countries that are net exporters of commodities.

- **Machinery sales and manufacturing:** This subsector has a high exposure to foreign sales, and is particularly sensitive to dollar-induced deflation overseas.

The Trend Is Your Friend

Globalization has made the impact of a strong dollar even more pervasive than during previous cycles. As the U.S. economy continues to pull ahead of the slower recoveries experienced by many of its trading partners, we believe the dollar rally will continue, perhaps for several more years.

While the extent of the dollar rally seen in 2014 is unlikely to be repeated in 2015, we expect pullbacks to be temporary and to offer good opportunities to increase exposure to stocks and sectors that do well in dollar bull markets.

And while U.S. stock multiples are currently at a premium to those of other developed market peers, we note a "reasonable" premium is justified, although we also believe select high-quality foreign-domiciled stocks with exposure to dollar-denominated revenues should perform well during this cycle.

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