Currency Bulletin
April 2016

FIERA CAPITAL

Over the past several months, currencies have been at the forefront of market concerns. While world markets are always a complex affair, we believe currency concerns can be summarized neatly in two big questions centered on the countries with the biggest economies in the world:

1. Will the US dollar rally continue?
2. Will China continue to devalue its currency?

While we would encourage our readers to review the entire bulletin, the short answers to those questions are: We do not believe the dollar will rally meaningfully further. We also do not believe China will devalue significantly, at least for the foreseeable future. If you believe that currency markets have been a major source of market instability, a more stable and less volatile FX regime has important asset allocation consequences which we will discuss further in a moment.

Will the US dollar rally continue?

This question is especially important as the dollar rally has placed great strains on the world financial system. Many emerging nations have issued substantial debt in dollars and a stronger dollar makes it more difficult to repay those debts. Developing nations, including some very large ones, as well as oil exporting nations of strategic importance, have pegged their currencies to the dollar, or managed their currencies around the dollar. Dollar strength places great stains on the economies of these nations, and on their currency reserves. At this point, we believe a stronger dollar is not in America's best interest.

Exhibit 1: DXY and CYN as of March 31, 2016

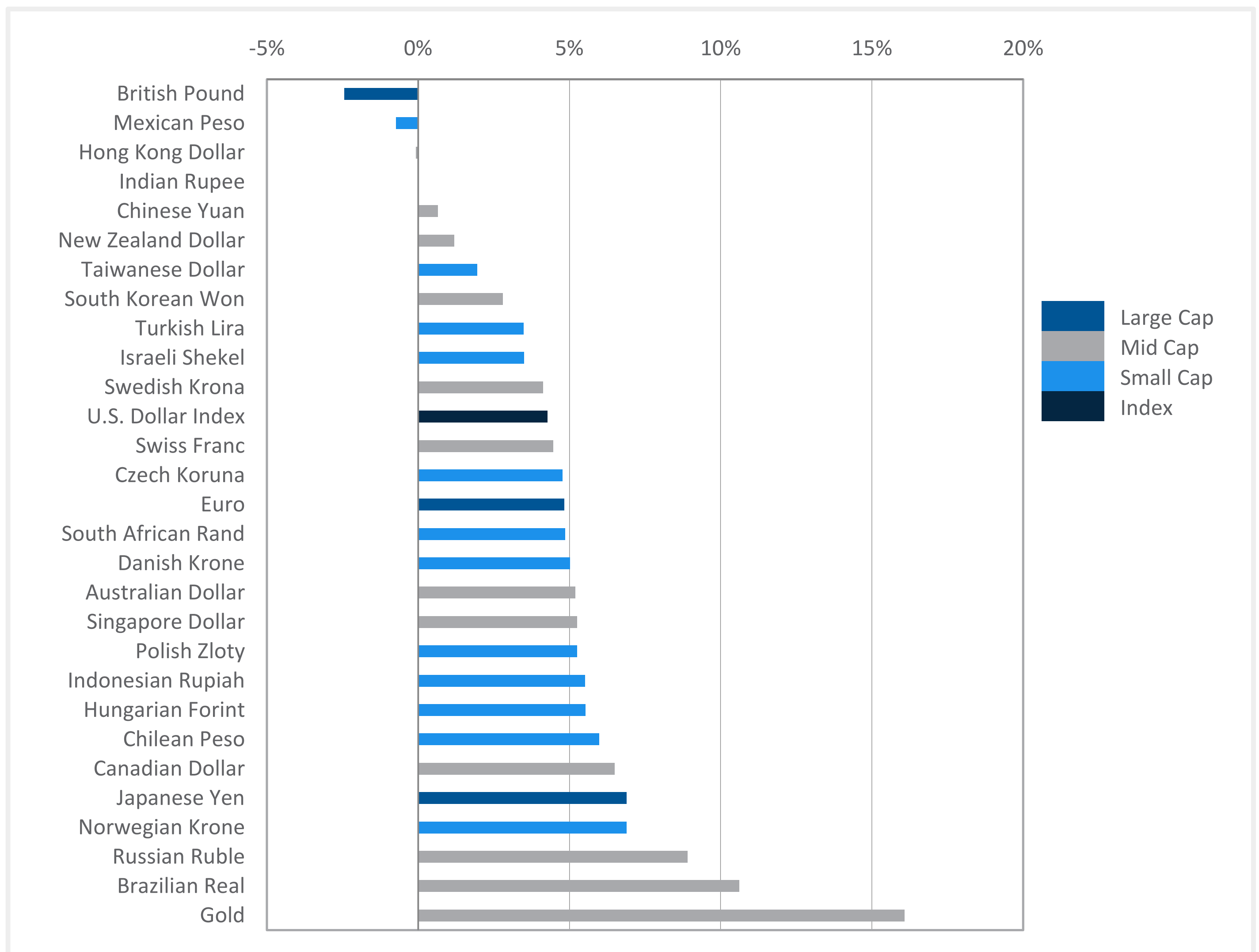
Source: Bloomberg

Will China continue to devalue its currency?

In the summer of 2015, China's surprise devaluation of its currency unleased waves of volatility that rippled outward from currency markets, disrupting everything from bonds, to stocks, to commodities. It was as though the leaders of the dictatorial regime had a panic attack. Devaluation was a grasp for economic oxygen to kick-start tired quasi-private sector muscles that are doing the heavy lifting for an economy still laboring under central planning, state police, and no freedom. A cheaper currency may help China's export engine regain its footing, but it was also like a currency market B-52 bombing for other Asian economies that need exports to support growth. This unleashed waves of uncertainty, falling stock prices, and exacerbated the oil crisis that developed in late 2015 and continued to dominate headlines in 2016. At this point, a devaluation of the yuan is not in China's best interest in the near term.

We believe that the Fed is well aware of the role the dollar rally has played in destabilizing markets and possibly economic growth globally. In fact, in the recent FOMC announcement the Fed has acknowledged that global concerns are likely to influence the character of the Fed's tightening cycle. A stronger dollar contributes to the global strains noted above, pressures the US manufacturing sector, and accelerates the disinflationary forces that make imports cheaper and push the US closer to deflation rather than the Fed's 2% inflation target. In our currency bulletins in March and May of 2015, we noted that the dollar rally was likely near a peak, and that the market's expectations for Fed tightening were excessive. Though the rally lasted slightly longer than we expected, the lion's share of the rally indeed occurred before last spring, and the dollar has now begun to roll over in earnest.

Exhibit 3: Currency Returns (12/31/15-3/31/16)



Source: Bloomberg

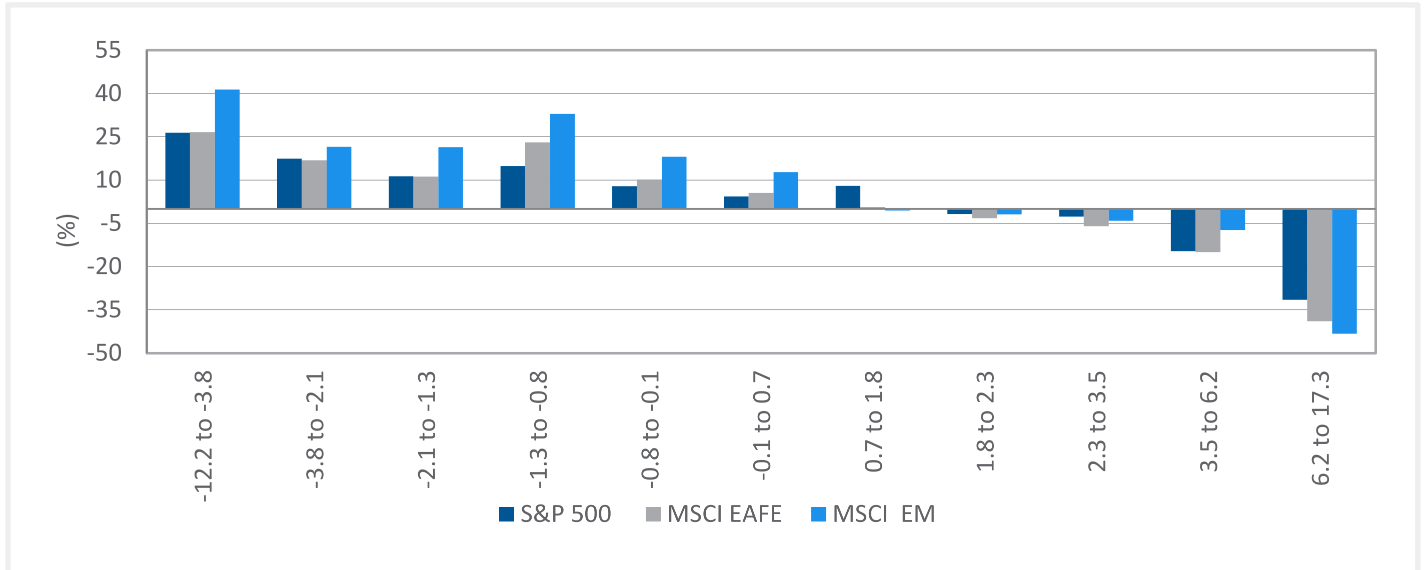
Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.

With regard to China's currency policy, devaluation unleashes volatility that destabilizes the economies of China's trading partners. In the current political environment, this policy also feeds the forces of protectionism in America. China-bashing has become increasing popular as markets have become ever more volatile. It is in China's interest to stabilize its currency, at least through the November US presidential elections. This should give adequate time for China's leaders to see if the renewed rounds of fiscal stimulus are having an impact.

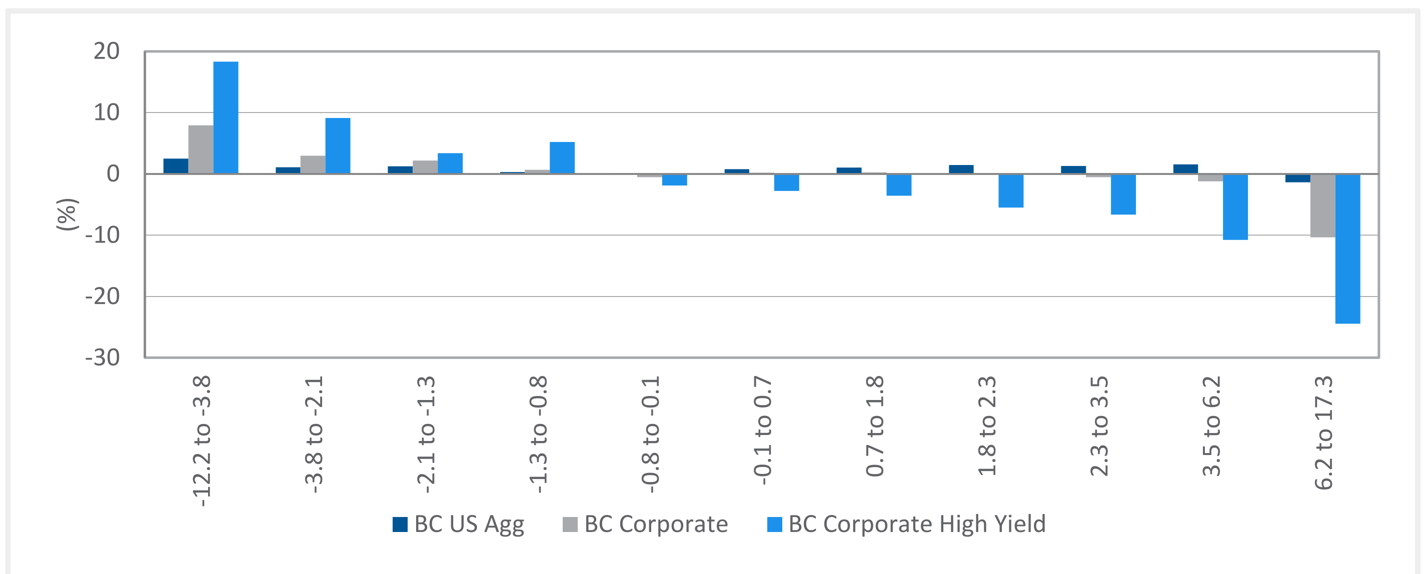
If both the United States and China, two of the most powerful countries on earth economically, have an interest in a stabile FX regime – it is likely to be more stable. Our analysis suggests this is positive for stocks, particularly in emerging markets, as well as corporate bonds, especially high yield. The charts below provide a quantitative overview of our thinking.

Exhibit 4: Assets Returns vs. Emerging Market FX Volatility — Percentile Analysis (12/31/01-2/29/16)

12-month Rolling Period Asset Return in EM Volatility Buckets



12-month Rolling Period Asset Return in EM Volatility Buckets



Source: Bloomberg

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The first chart shows how various equity benchmarks perform in varying periods of FX volatility. As can be seen, less FX volatility supports a risk-on equity view. The second chart uses the same framework to analyze high quality and low quality bonds. The conclusion is similar – a fall in EM FX volatility is consistent with the outperformance of riskier corporate bonds.

While some may argue that viewing the world exclusively through the prism of FX volatility may oversimplify matters, a valid concern, we none the less have been in a period where the dominant concern is indeed currencies. Our conviction is that FX volatility will likely fall in the period immediately ahead of us and we believe that will positive for risk assets and foreign currencies.

Jonathan Lewis
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Index Definitions:

- The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
- Morgan Stanley Capital International (MSCI) EAFE Index serves as a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia.
- Morgan Stanley Capital International (MSCI) Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 835 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
- The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.
- Barclays U.S. Corporate Investment Grade Index is a rules-based and market value weighted index of publicly issued U.S. corporate bonds. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody’s, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued.
- Barclays U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody’s, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.