

October 9 2017

TIME FOR A STRONGER DOLLAR?

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KEY TAKEAWAYS

Dollar weakness over the past year has put the currency near the bottom of its three-year range, though we believe it may be poised for a near-term bounce.

The dollar may benefit from fundamental factors such as divergent central bank policy in the near term.

Sentiment indicators show the potential for a contrarian bounce, and some technical indicators also show the potential for dollar strength in the near term.

The U.S. dollar has lagged other currencies so far this year, as persistently low inflation suggested that the Federal Reserve (Fed) would not be as aggressive as global investors originally feared. However, recent Fed announcements—including an official start to long-awaited balance sheet normalization, as well as a refusal to back away from a potential rate hike in December—have caused market participants to reexamine the dovish Fed thesis, which has led to a stronger dollar over the past month. So, where does the dollar go from here? We believe that the combination of fundamental factors, such as disparities in major central bank policies and technical indicators, could lead to dollar strength in the near term.

FUNDAMENTAL TAILWINDS

Forecasting currency movements with any accuracy over the short term can be difficult. Many academic theories attempt to explain the movement of currencies, including inflation differentials, relative interest rate levels, and the balance of payments between a country and its trading partners. The mechanics of each are slightly different, but most go back to one major idea: a country with stronger relative economic growth (which could lead to higher rates of interest and inflation) should see a stronger relative currency. In recent years, however, confusion related to central bank policies has been a major wildcard for currency forecasters.

In theory, the U.S. dollar should see some strength from divergent policies between central banks. The Fed has raised interest rates four times since December 2015, and markets are expecting another increase this December. The Bank of England is widely expected to increase interest rates in the coming months as well (though with continued headlines related to Brexit and potential leadership concerns surrounding Theresa May, this is far from certain), as is the Bank of Canada. However, the U.S. Dollar Index basket puts heavier emphasis on the euro and the Japanese yen, and the central banks responsible for these currencies are not expected to hike rates anytime soon (though the European Central Bank [ECB] could potentially slow its quantitative easing program in coming months).

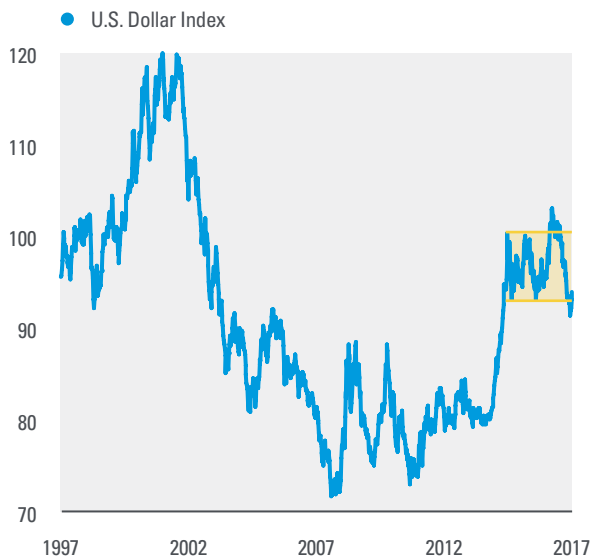
This tightening bias of the Fed is one of the reasons that short-term rates have soared this year, with the six-month, one-year, and two-year Treasury yields all at their highest point in nine years, which should support a higher U.S. dollar.

Central bank policy is not set in stone, and most major banks remain data dependent. However, the U.S. has shown a clear tightening bias in recent years, while the ECB and Bank of Japan remain in easing mode.

There are other reasons to potentially expect a higher U.S. dollar going forward. For one, the House-adopted version of the federal budget released last week is another step toward tax reform. Any tax cut could help spur economic growth and push yields and the U.S. dollar higher as a result. Furthermore, Kevin Warsh appears to be a frontrunner for the next Fed Chair which is set to be announced on February 4, 2018. He was one of four candidates to interview for the job and his views on easing up on bank regulation seemed to have put him in the driver's seat. Given he is decidedly more hawkish (supporting higher rates), this is another potential bullish catalyst for the U.S. dollar.

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U.S. DOLLAR REMAINS RANGEBOUND AND COULD BE READY TO BOUNCE



Source: LPL Research, Bloomberg 10/06/17

The U.S. Dollar Index is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

TIME FOR A CONTRARIAN BOUNCE?

As [Figure 1](#) shows, the U.S. dollar is near the low end of a range and bouncing, but even more important is the fact that it has been virtually flat the past three years. Many have characterized this as a strong dollar environment, but we would argue that isn't the case. Yes, the U.S. dollar had a historic jump in late 2014 and early 2015, which is why many consider this a strong environment, but the past few years it has simply been rangebound. We would characterize the early 2000s and mid-1980s as strong dollar periods, but not today's.

In regards to the U.S. dollar, few trades were more crowded to start the year. It was widely assumed that a stronger U.S. economy would lead to higher interest rates, which would then lead to a stronger dollar; however, that didn't happen. In fact, the U.S. dollar was down 9.5% year to date as of the end of August, which was the worst start to a new year since 1986.

Therefore, paying attention to sentiment can be a powerful indicator. Late last year there were magazine covers showing George Washington with his shirt off, touting the strong dollar. When sentiment becomes that lopsided, a change in trend can take place. To quote Humphrey B. Neil, "The public is often right during the trends, but wrong at both ends." That is what we saw with the U.S. dollar late last year, but the exact opposite could be taking place now.

Now we are seeing articles talking about why the U.S. dollar could plunge in October, with more losses in store—quite the change from 11 months ago. Additionally, a recent survey of global fund managers found that one of the most crowded trades is being short the U.S. dollar. Last, data from the U.S. Commodity Futures Trading Commission (CTFC) shows that commercial hedgers, widely considered to be smart money, are the most net long they've been since previous U.S. dollar lows [[Figure 2](#)].

CONCLUSION

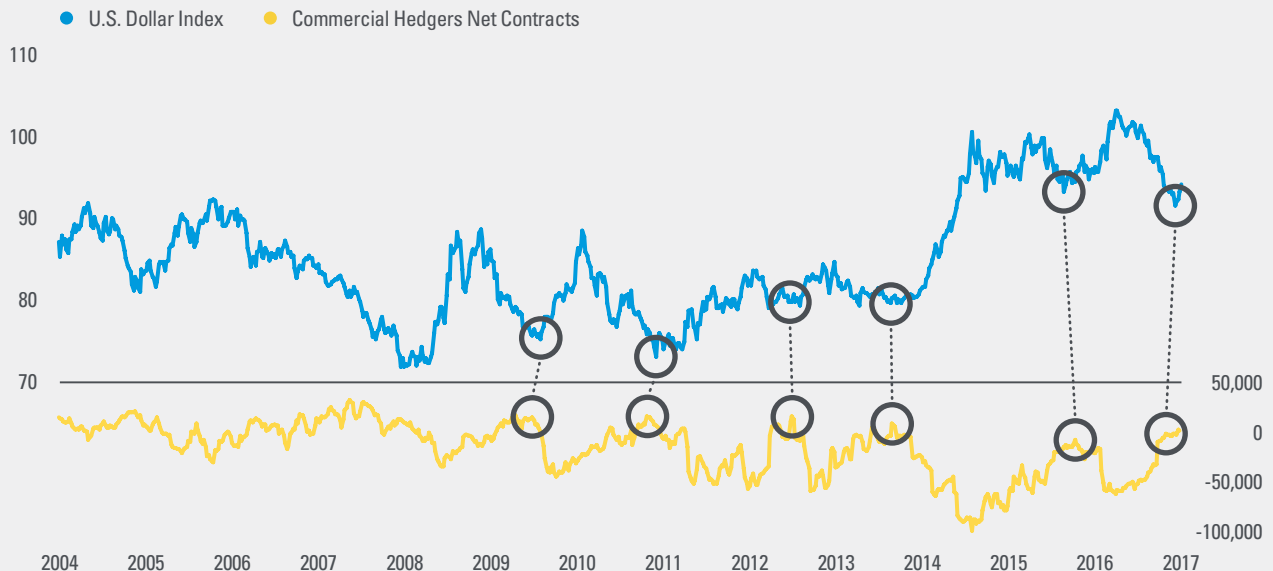
Significant weakness over the past year has driven the dollar to the low end of its three-year range. We believe this weakness may be overdone, and fundamental and technical factors may combine to lead to near-term dollar strength. On the fundamental side, divergent central bank policies, including a tightening Fed and continued easing bias in Europe and Japan, may be beneficial for the dollar. On the technical side, weak sentiment may lead to a contrarian bounce, while smart money positions in the futures market may also point to potential strength ahead. ■

COMMITMENTS OF TRADERS REPORT

Every week, the CFTC releases the Commitments of Traders Report, which shows participants' holdings in various futures markets. A commercial hedger is a large trader who also deals in the commodity on a cash basis and is usually smart money—money bet or invested by people with expert knowledge—while a small speculator doesn't always deal in the commodity and is generally wrong and used as a contrarian indicator.

Special thanks to Shawn Doty for his contributions to this week's publication.

2 SMART MONEY IS BULLISH TOWARD THE U.S. DOLLAR



Source: LPL Research, Bloomberg 10/06/17

Smart money is cash invested or wagered by those considered to be experienced, well-informed, "in-the-know," or all three.

The U.S. Dollar Index is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors.

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The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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INDEX DESCRIPTIONS

The U.S. Dollar Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

This research material has been prepared by LPL Financial LLC.

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