Positioning Portfolios for U.S. Dollar Weakness

The case for owning non-U.S. assets

Alex Perrin
Senior Portfolio Manager, WFAM Global Fixed Income

Lauren van Biljon, CFA
Portfolio Manager & Sovereign Analyst, WFAM Global Fixed Income

By most measures, the U.S. dollar (USD) peaked against both developed country and emerging market currencies in late 2016, having trended higher since 2011 and then declining throughout 2017. It has rallied so far in 2018. Despite the apparent flip-flop, we have a strong conviction that the dollar will weaken over the next three to five years for both fundamental and technical reasons. But why does this matter to a U.S. investor?

We see the dollar's decline as a fundamental theme over the next several years and believe that investors can use this information to build for a successful outcome, whether that is growing assets, generating income, or preserving wealth. Strategic asset allocations may offer upside return potential, and if the dollar depreciates, it will likely add to the appeal of non-U.S. investments.

The numbers are compelling. For example, in 2017, the Bloomberg Barclays Global Aggregate ex-USD Index returned 2.5% in local currency terms but 10.5% in U.S. dollar terms.

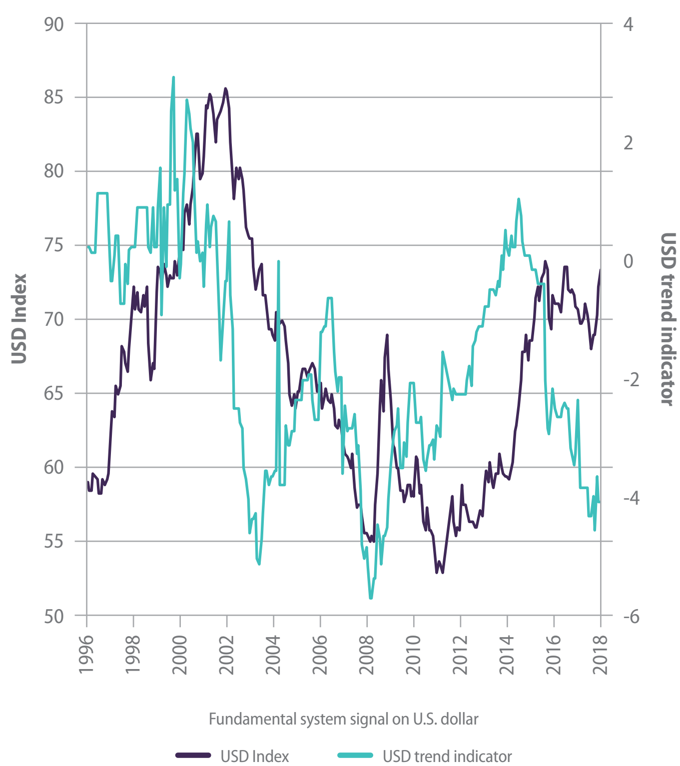
Key points:

- Long-term dollar depreciation may occur due to fundamental and technical reasons.
- Given this outlook for the dollar, non-U.S. assets may offer U.S. investors attractive opportunities for potential upside return.
- As the USD declined in 2017, non-U.S. investments in dollar terms far outpaced local currency returns.

Our high conviction in long-term dollar depreciation stems from the confluence of fundamental and technical factors. The former can be seen in our proprietary currency trend indicator. The USD trend indicator has consistently proven to lead the change in the value of a currency by 24 months. Our model's inputs include macroeconomic indicators—both historical and forecast data—for trade deficits, government deficits, relative growth, relative yields, relative interest rates, and political risk across 48 countries.

As Figure 1 shows, it is significant that the USD trend indicator peaked in late 2014 and has been declining fairly steadily since then; the dollar has largely followed the same path with a two-year lag.

Figure 1. Our model signals USD weakness ahead.



Source: WFAM Global Fixed Income team proprietary model using data from Consensus Economics and PRS Group as of June 30, 2018.

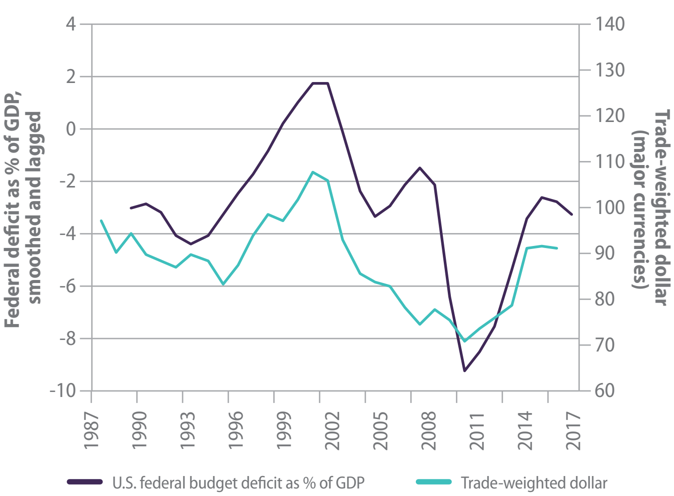
Notes: The USD Index is an unweighted index of the USD versus all other currencies within the WFAM global fixed income team universe. The USD trend indicator includes trade deficits, government deficits, relative growth, relative yields, relative interest rates, and political risk across 48 countries. You cannot invest in an index.

Fundamental reasons for dollar weakness

Several fundamental factors are putting downward pressure on the USD over the longer term. The cumulative U.S. federal deficit is expected to balloon to $11.7 trillion over the next 10 years, as calculated by the Congressional Budget Office (CBO). Meanwhile, the U.S. current account has widened to a nine-year high in 2017, reaching 2.4% of current-dollar gross domestic product (GDP), and is expected to continue growing. A larger government budget deficit and a wider current account deficit both serve to increase the supply of U.S. dollars abroad, which could have negative implications for the value of the dollar. So far, foreign investors have been financing these deficits, but their appetite for U.S. assets may wane amid high valuations in many sectors and brighter investment prospects outside the U.S. On the macro front, better growth prospects around the world should help support non-U.S. currencies relative to the USD.

A ballooning U.S. federal deficit. The federal budget deficit presents a vulnerability for the USD because the deficit must be financed and foreigners are a large source of that funding. The Tax Cuts and Jobs Act was signed into law on December 22, 2017. Highlights of the act included a lower corporate tax rate (from 35% to 21%) and lower individual tax rates for most Americans as well as a larger standard deduction. The good news: The Tax Cuts and Jobs Act is increasing fiscal stimulus, helping boost the U.S. economy. The bad news: The CBO, the nonpartisan budget scorekeeper, expects the federal budget deficit to be $804 billion in fiscal-year 2018 and $981 billion in fiscal-year 2019 and then balloon to a cumulative budget deficit of $11.7 trillion from 2018 to 2027. New assumptions based on the tax change caused the CBO to increase its estimate in April 2018 of the size of the cumulative deficit to $11.7 trillion from its previous estimate of $9.4 trillion only three months earlier.

Figure 2. The federal budget deficit tends to lead the trade-weighted dollar by about four quarters, suggesting a weaker dollar ahead.



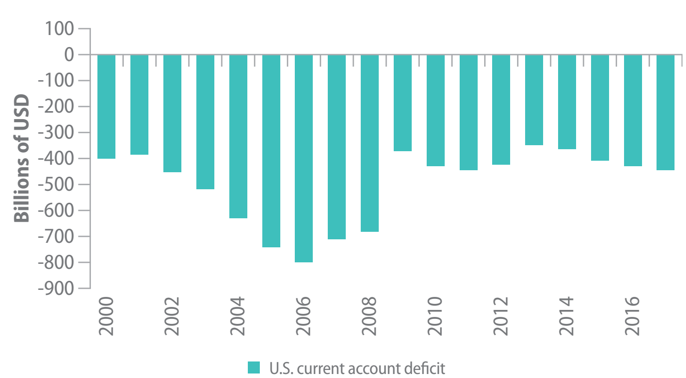
Sources: U.S. Office of Management and Budget and Federal Reserve; retrieved from FRED, Federal Reserve Bank of St. Louis as of March 31, 2018.

A growing current account deficit. The U.S. current account deficit widened to a nine-year high in 2017. The current account measures international transactions—in this case, the U.S. and the rest of the world—and includes net trade in goods and services, net earnings on cross-border investments, and net transfer payments. A persistent trade deficit in goods was the largest reason for the deficit, far exceeding the surplus in the services trade balance.

In terms of its effect on the U.S. dollar, the U.S. current account deficit of $449 billion is moving in the wrong direction. Consensus Economics, a firm that aggregates economic and financial forecasts of leading forecasters, pegs the 2018 U.S. current account deficit at $548 billion and the 2019 deficit at $598 billion. The increasing size of the deficit is causing concern about its sustainability. In contrast, major trading partners—the European Union ($315 billion), Japan ($186 billion), and China ($155 billion)—have current account surpluses.[1] Because a deficit develops due to greater demand for foreign goods from Americans and greater demand for U.S. financial assets from foreigners, the main vulnerability is that non-U.S. investors may decide to limit their investments in the U.S. for better prospects elsewhere.

To what extent will foreigners continue to finance the U.S. current account deficit? Looking at history, foreign direct investment coming into the U.S. during 2017 amounted to $355 billion, less than the prior two years but still a healthy amount. Portfolio investments are a large category within international asset flows, albeit a volatile one, because portfolio flows can reverse at a rapid pace if investor sentiment changes. Foreign portfolio investments in the U.S. surged in 2017 (as the dollar fell), and foreign investors bought a broad spectrum of security types, including equities, Treasury securities, agency debt, and private sector debt. In fact, foreign portfolio investments in U.S. securities were the strongest they had been in a decade. But this demand from foreigners may fade if a full-blown trade war results from antagonistic trade negotiations and tariff levies. Foreign central banks remain a sizable holder of U.S. securities, thereby helping finance the current account deficit, but they have become less of an influence in recent years.

Figure 3. A growing current account deficit leaves the dollar vulnerable.

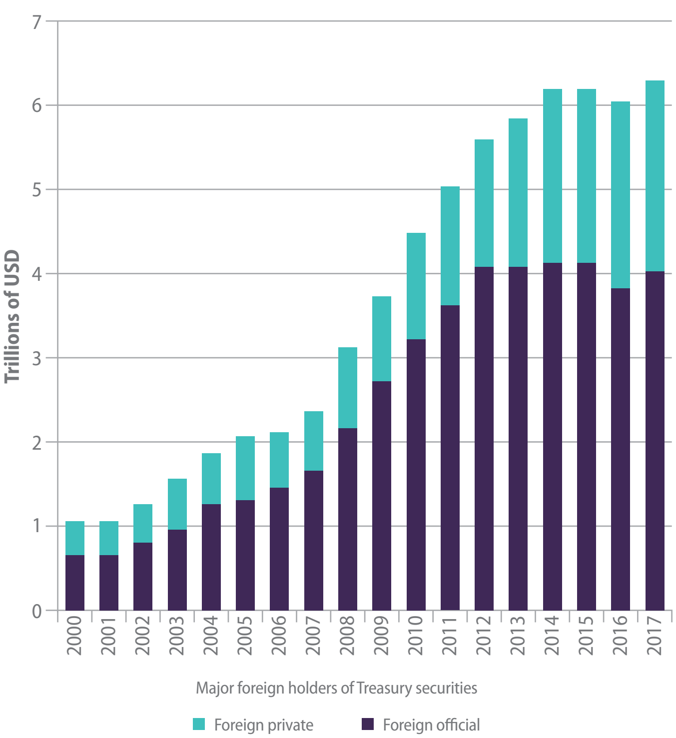


Source: U.S. Bureau of Economic Analysis as of June 30, 2018.

And to what extent will foreigners be willing to continue funding the fiscal deficit? Foreigners own 44% of U.S. Treasury debt. As of December 31, 2017, China held nearly $1.2 trillion of U.S. debt and Japan had about $1.1 trillion, making those two countries the largest holders of U.S. debt. China owns a large amount of U.S. debt because it has a large trade surplus with the U.S. and invests in U.S. Treasuries as a way to use its excess dollars. Further, it manages its currency, the renminbi, in a predetermined range against the dollar and therefore uses Treasuries to raise dollars to buy or sell in its effort to maintain a stable currency. China's demand for Treasuries thus could be affected by a change in its exchange rate policy. While a material devaluation of the Chinese currency is not our base-case scenario, it can't be ruled out as a weapon in an all-out trade war. Trade tensions with the U.S. also could dampen China's enthusiasm for Treasuries through another avenue, as a smaller Chinese trade surplus would mean China has fewer dollars that need to be invested. Meanwhile, Japanese investors also have curtailed their investments in Treasuries over the past couple of years—sometimes due to technical reasons, such as currency-hedging costs—but continue to hold a large amount.

Looking ahead, if the federal budget deficit explodes as expected, net Treasury issuance over the next decade would nearly double the size of today's $15 trillion Treasury market because the U.S. government issues bonds to finance itself. The worry is that large budget imbalances could become unsustainable at some point, and the dollar would be vulnerable to a reversal of those imbalances.

Figure 4. Foreigners own 44% of U.S. Treasury debt.



Source: Department of U.S. Treasury/Federal Reserve Board as of May 15, 2018. Reported monthly under the Treasury International Capital (TIC) reporting system

Prospects for global economic growth are improving.
Strengthening economies in other regions support the idea that the euro, the yen, and other currencies may rise relative to the dollar. Other developed countries, notably the eurozone and Japan, have shown solid economic growth, lower unemployment rates, and slowly rising inflation moving toward central bank targets of 2%. This is true despite second-quarter data in Europe that was less robust but still positive. (For example, manufacturing data slowed from its pace earlier in the year but still signals growth.)

Emerging markets are also bright spots, benefiting from better manufacturing and consumer sentiment, higher commodity prices, and improved global trade conditions. Because non-U.S. developed countries and emerging markets are at an earlier stage in their economic recovery than the U.S., there may be further room for expansion. Along with continued economic growth historically comes currency appreciation.

Figure 5. The economies of other countries are expanding, helping support their currencies.

Source: Consensus Economics as of June 30, 2018. Countries included to represent emerging markets: Chile, Colombia, Dominion Rep., Malaysia, Mexico, Nigeria, Pakistan, Peru, Philippines, Sri Lanka, Taiwan, Thailand, Ukraine, Uruguay, and Vietnam. Countries included to represent the G20 ex-U.S.: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, South Africa, South Korea, Turkey, and the U.K. Countries included to represent the G10 ex-U.S.: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, and the U.K.

Satiated foreign demand for U.S. assets. Demand for U.S. assets from foreigners may be near a peak, and as a result, demand for dollars may have peaked. We believe this to be the case for a couple of reasons. First, U.S. assets are already at relatively high prices, which reduces their attractiveness to foreign buyers. Many assets with higher risk/higher return potential—such as equities, for example—have had an extraordinary run since 2009. Equity markets, corporate bonds, and property markets are a few asset classes that have done particularly well, and this is especially true in the U.S. because it is furthest in its economic cycle with still-low interest rates. For example, with the S&P 500 Index at 2,718 as of June 30, its trailing 12-month price/earnings ratio has risen to 21 times earnings, which is well above its historical average of 17 times earnings.[2] Second, foreign investors are already overweight U.S. assets and may have limited appetite to add to their allocations.

Technicals, too, make the case for dollar depreciation

The perception of shrinking interest rate differentials. Yields have risen more in the U.S. than in other developed countries because the U.S. Federal Reserve (Fed) is further ahead in removing its accommodative monetary policy. Divergent monetary policies had favored the dollar, but now medium-term policy convergence is poised to hurt the dollar. While it may be some time before interest rates in other countries converge with the U.S., markets will likely anticipate the convergence and price in the change ahead of time.

Monetary policy has diverged as the Fed has raised its target rate from a range between 0.00% and 0.50% to between 1.75% and 2.00% over the past 2.5 years and is methodically reversing its quantitative easing program. Other developed country central banks also are moving toward less accommodative policy stances but glacially. For example, the European Central Bank's deposit rate remains negative and it intends to maintain its asset purchases through December 2018. The Bank of Japan also maintains a negative short-term policy rate and controls its yield curve by purchasing Japanese government bonds (JGBs) so that 10-year JGB yields should remain around 0%.

Due to divergent monetary policies, interest rates are higher in the U.S. than in other developed countries. While the common wisdom is that higher rates support a currency, it isn't a one-to-one relationship, as the dollar's fall in 2017 alongside three hikes by the Fed makes clear. Looking ahead, modest inflation pressures in the U.S. are unlikely to require the Fed to hike rates to a higher terminal rate than the Federal Open Market Committee's dot plot calls for, which is a federal funds rate of 2.9% in the longer run. Therefore, as the Fed nears the end of its tightening policy and other central banks embark their paths to policy normalization with higher rates and a reduction in their balance sheets, the gap between U.S. yields and non-U.S. yields will likely shrink. Our conclusion is that less yield advantage also may add downward pressure on the dollar.

Prohibitive hedging costs. As recently as six months ago, foreigners were still flocking to the higher-yielding assets in the U.S. By the beginning of 2018, however, higher hedging costs made buying U.S. assets expensive for European and Japanese investors, and this lack of demand is putting pressure on the USD.

To explain more fully, a non-U.S. investor would find value in buying a U.S. bond when its yield is more than the cost of hedging the currency. Hedging costs are determined by the forward rates of the two currencies in question, which are calculated by the difference in the two short-term interest rates of the currency pair. In terms of cost, it is more expensive to hedge the currency of a country with the highest short-term rates, and the cost increases as the interest rate differential increases.

After years of little variation between yields due to a global low-yield environment, by 2018 yields in the U.S. were enough higher than yields in other developed countries to make it uneconomical for European and Japanese investors to buy U.S. bonds and hedge them back into their respective currencies. As of June 30, for a European investor, the U.S. 10-year Treasury yield (2.86%) less the cost of the three-month forward currency rate (2.73%) would have earned a paltry 0.13%.

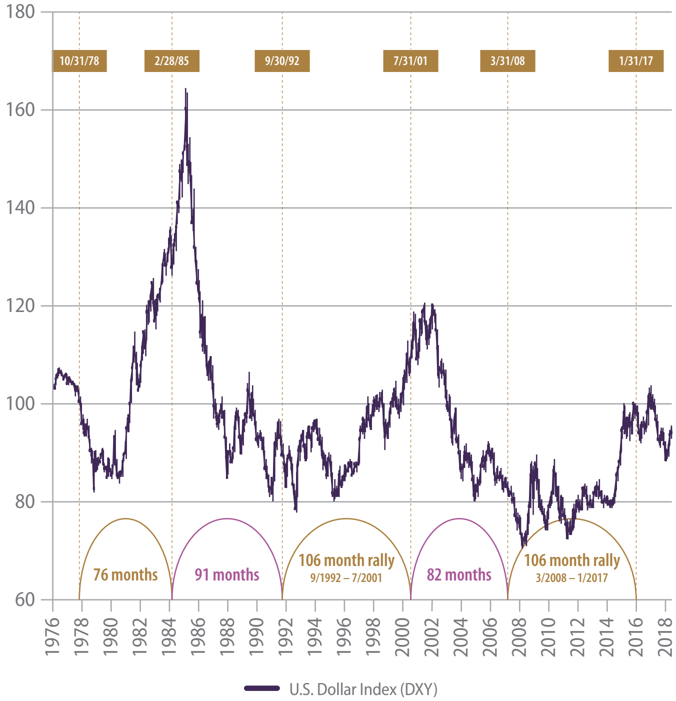
Figure 6. Hedging costs have made it expensive for foreigners to buy U.S. assets and hedge back into their own currencies.

Example	European investor	Japanese investor
Yield at which investor buys a 10-year U.S. Treasury bond	2.86%	2.86%
Yield investor pays to hedge currency back to euro or yen	2.73%	2.54%
Yield advantage after hedging	**0.13%**	**0.32%**

Source: Bloomberg L.P. As of June 30, 2018. For illustrative purposes only.

Currency trends suggest more dollar weakness. Currencies tend to move in distinct cycles, as the graph of the dollar versus 10 leading global currencies shows. The yellow-shaded months show cycles when the dollar strengthened. Since the 1970s, the USD has experienced three bull markets, ending in February 1985, July 2001, and January 2017. The latter two bull cycles were similar in terms of length of cycle, price movements, and the magnitude of dollar strength. These periods were interspersed with bear markets that lasted seven years, on average. Now, the cyclical chart is pointing toward another six years of dollar weakness. The takeaway from this technical chart is similar to the findings of our proprietary USD trend indicator—the dollar is likely to weaken over the next several years. We recognize the rise in the dollar so far in 2018, but we believe this is a corrective rally rather than a change in the downward trend.

Figure 7. Technical price patterns suggest more weakness ahead for the USD.



Source: Bloomberg as of July 31, 2018. You cannot invest in an index.

Note: The DXY Index is a measure of the value of the U.S. dollar relative to a basket of foreign currencies, 83% versus the euro, yen, and sterling.

Risk to this outlook

We believe the dollar rally of recent months is a corrective move and does not change its longer-term trend outlook. But there are some risks to this view. History shows that imbalances—such as large trade and budget deficits—can exist for some time without a one-way discernible effect. In addition, the status of the dollar as the world's reserve currency lends support in times of market stress and risk aversion.

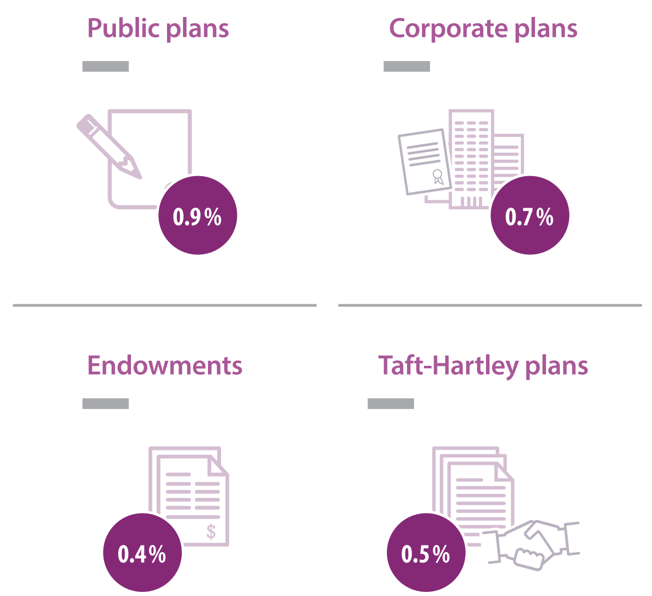
2018 has been marked by a more combative tone to trade and international relations, which could delay the effect of negative fundamentals and technical factors. Higher trade tariffs would weigh on global economic growth as well as raise prices and inflation. The latter could force a more aggressive pace of monetary policy tightening. Tax cuts in the U.S. will work to boost domestic growth in the quarters ahead before the impulse fades, and this could allow the U.S. economy to outperform its peers for longer than expected.

Strategic asset allocation takeaways

Investing in securities in a local currency outside the U.S. often is perceived as a riskier strategy than deploying those assets domestically, especially with the added currency risk. While this perception of risk may have merit when viewed as a stand-alone investment, in the context of a global multi-strategy portfolio similar to those that most institutions manage today, allocations to international securities—international fixed income, emerging markets (both debt and equity), and international equity—may be a compelling proposition.

Despite the abundance of evidence regarding returns and the greater diversification that comes with international investing, many investors have been reluctant to broaden their opportunity set. Home bias—the preference of investors to invest in their own country and currency despite evidence that expanding the opportunity set globally may bolster risk-adjusted returns—continues to be seen even in the asset allocations of sophisticated investors. According to Callan's first-quarter fund sponsor report, U.S. fund sponsors of all types held only negligible percentages of non-U.S. fixed income in their portfolios.

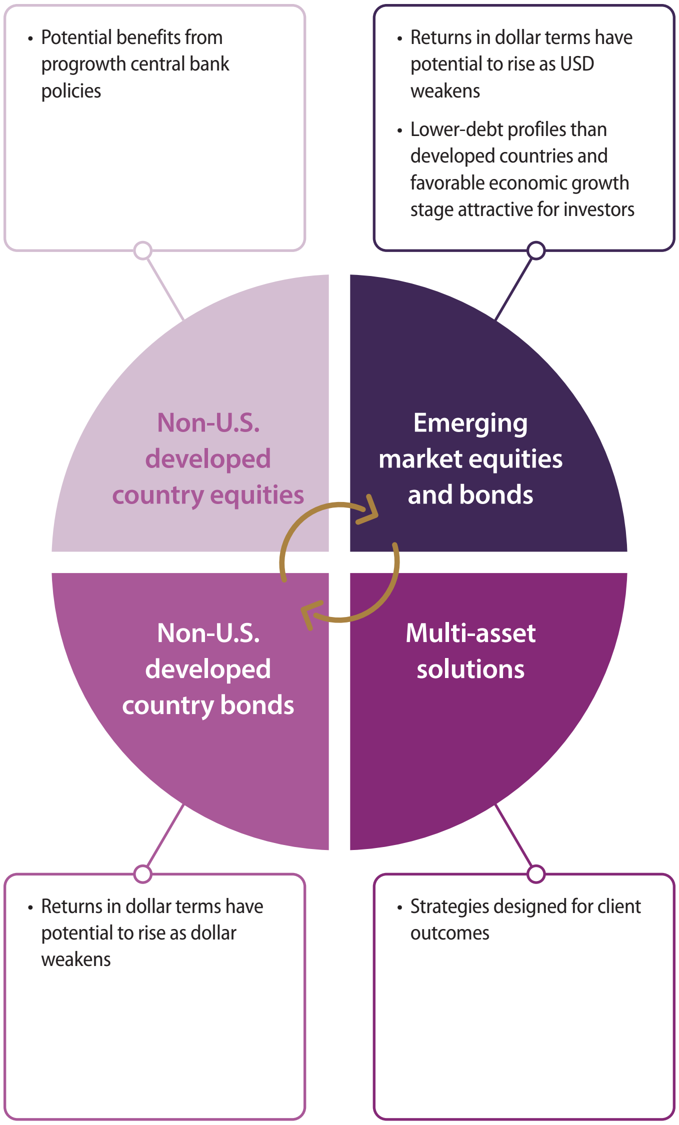
Figure 8. Callan fund sponsor average asset allocation to non-U.S. fixed income.



Source: Callan LLC. *Capital Market Review*, first quarter 2018.

The opportunity for U.S. investors in non-U.S. assets remains a high conviction for us. Below are several asset classes that we believe merit consideration, especially for those with medium to longer-term investment horizons, because their risk-adjusted returns may benefit client outcomes.

Figure 9. Opportunities for U.S. investors in non-U.S. asset classes.



In conclusion, positioning portfolios for a weaker dollar over the long run may mean adding allocations to sectors that are poised to benefit from appreciating currencies elsewhere. Again, our currency forecast model predicts dollar weakness for a number of years.

We want to help our clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To discuss your investment needs, please contact us:

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at WFAMInstitutional@wellsfargo.com.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at 1-888-877-9275.
- To reach our U.S.-based retirement professionals, contact **Nathaniel Miles**, head of Defined Contribution at Wells Fargo Asset Management, at nathaniel.s.miles@wellsfargo.com.
- To reach our international investment professionals, contact your regional client relations or sales director, or contact **Ben Foley** at either ben.foley@wellsfargo.com or +44 20 7518 2947.
- To discuss environmental, social, and governance (ESG) investing solutions, contact **Jessica Mann**, head of ESG at Wells Fargo Asset Management, at jessica.mann@wellsfargo.com.

Footnotes:

1. Consensus Economics, 2018 forecast

2. Bloomberg

Index definitions

The Bloomberg Barclays Global Aggregate ex-USD Index is an unmanaged index that provides a broad-based measure of the global investment-grade fixed-income markets excluding the U.S.-dollar-denominated debt market. You cannot invest directly in an index.

The U.S. Dollar Index (DXY) is a measure of the value of the U.S. dollar relative to a basket of foreign currencies.

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