The Dollar’s Ascent Could Be in Its Final Phase

Summary
• The U.S. dollar’s five-year-long bull run may be coming to an end, particularly relative to major currencies such as the euro and the yen.
• The headwind of a strong dollar should diminish for global and international stock portfolios.
• Interest rate differentials and exchange rates do not always move in lockstep, so the Federal Reserve’s rate decisions won’t necessarily dictate what’s next for the dollar.
• China’s apparent commitment to continue to devalue its currency is expected to cast a shadow over currencies in Asia and several other emerging markets.
• As emerging economies adjust to weaker global industrial activity and Chinese growth that is slower and less commodity-intensive, some currencies may continue to weaken — but there are bright spots.

Emerging Markets and Energy Exporters Have Borne the Brunt of Dollar Appreciation Since Mid-2014
Currency moves versus the dollar: June 30, 2014–December 31, 2015

<table>
<thead>
<tr>
<th>Developed Markets</th>
<th>Developing Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Pound</td>
<td>Chinese Renminbi</td>
</tr>
<tr>
<td>-14%</td>
<td>-4%</td>
</tr>
<tr>
<td>Japanese Yen</td>
<td>Indian Rupee</td>
</tr>
<tr>
<td>-16%</td>
<td>-9%</td>
</tr>
<tr>
<td>Euro</td>
<td>Mexican Peso</td>
</tr>
<tr>
<td>-21%</td>
<td>-25%</td>
</tr>
<tr>
<td>Australian Dollar</td>
<td>Brazilian Real</td>
</tr>
<tr>
<td>-23%</td>
<td>-44%</td>
</tr>
<tr>
<td>Canadian Dollar</td>
<td>Russian Ruble</td>
</tr>
<tr>
<td>-23%</td>
<td>-53%</td>
</tr>
</tbody>
</table>

Sources: Capital Group, MSCI.

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.
Virtually every currency weakened against the dollar in 2015 — in many cases recording double-digit percentage declines. Overall, currency translation has, therefore, tended to have a negative impact on international and global stock and bond portfolios for U.S. dollar-based investors. But with the U.S. Federal Reserve having raised interest rates in December for the first time since 2006, many investors are wondering what’s next for the dollar.

Conventional wisdom holds that the dollar bull market could be with us for an extended period, thanks to higher U.S. interest rates at a time when central banks in the euro zone, Japan and many other economies are still loosening monetary conditions. Investor capital, the argument goes, tends to flow toward economies where higher interest rates are available.

Those who believe the dollar bull will run and run may also be taking their cue from dollar appreciation in the 1980s. That was a classic tale of a strong U.S. economy decoupling from weak growth in the rest of the world. Among other factors, relatively high inflation outside of the U.S. gave the dollar scope to appreciate without greatly hindering U.S. competitiveness.

However, today’s backdrop looks quite different. The global economy and markets are arguably more interconnected; China’s economic clout is much greater; inflation is low in the U.S and elsewhere; and many currencies have already endured substantial declines against the dollar.

There’s actually good reason to believe that the strong dollar should become less of a headwind for global and international stock portfolios. The dollar’s current appreciation phase, which began in 2011 and accelerated in mid-2014, may run its course by the end of 2016. Why, exactly?

For starters, history shows that higher interest rates do not necessarily lead to currency appreciation. Even if the Federal Reserve does continue to raise rates, dollar appreciation is not inevitable. Arguably, trends in corporate capital expenditure can have more of an impact. For example, corporate America’s move to onshore manufacturing and operations is part of the reason that the dollar bear gave way to the bull in 2011.

On the other hand, inflation and significant trade and economic imbalances — two factors that leave currencies vulnerable to weakening — are absent from the euro zone and Japan. The concept of purchasing power parity (PPP) can be helpful in discerning whether a currency’s value seems reasonable.

The dollar ended 2015 above its 25-year average, at its highest valuation for a decade.

Source: J.P. Morgan. Mid-month monthly data for the J.P. Morgan Broad Trade-Weighted Real Exchange Rate Index, (U.S. Dollar), which reflects inflation-adjusted exchange rates for the currencies of 47 countries. Investors cannot invest directly in an index.
Amid Renminbi Devaluation, China Has Tapped Reserves to Steady the Currency

In simple terms, PPP defines the exchange rate at which two different currencies would have the same purchasing power in their respective economies. The euro entered 2016 with a value that is about 15% below where, in PPP terms, it might be expected to be versus the dollar; while for the Japanese yen the undervaluation appeared closer to 25%. Sooner or later, it is sensible to expect these exchange rates will move closer to reasonable valuations. For all these reasons, further sustained and substantial weakening of the euro and yen against the dollar appears unlikely. That said, the yen may temporarily depreciate if negative interest rates are lowered further or the Japanese government intervenes in currency markets.

China’s Transition and Devaluation Cast a Long Shadow

China’s move away from investment-led growth toward an economic structure more reliant on consumption has ushered in a painful period of adjustment for some economies. To varying degrees, the economies and currencies of commodity-exporting nations such as Australia, Brazil, Indonesia and South Africa are feeling the direct and indirect consequences of changes in the nature of Chinese demand.

Monetary and exchange-rate policy in China has been evolving and it’s fair to say some official actions have proven controversial. China’s currency devaluation in January 2016 was a case in point. The move rocked financial markets, prompting accusations that China was risking a currency war as it sought to make its exports competitive.

However, with some perspective, these policy efforts shouldn’t be that much of a surprise. In the past couple of years, China has devalued four times. It has also repeatedly tapped foreign-exchange reserves to try to stabilize its currency. Rather than competitive devaluation, it seems that Chinese authorities are using currency as another tool to deal with the $15 trillion of debt that has built up in the economy since 2008. Devaluation, alongside cuts to interest rates and bank reserve requirements, creates easy monetary conditions, with the goal of promoting inflation and thereby reducing the real cost of debt. This is a textbook approach to dealing with a credit overhang, known as inflating away debt. Although the renminbi has shed more than 6% against the dollar over the past two years, it still could be overvalued by about 10%-15%.

A New Renminbi?

In December 2015, the People’s Bank of China announced that it would consider the value of the renminbi in reference to a basket of currencies. The China Foreign Exchange Trade System Renminbi Index has emerged as the de facto measure of the effective exchange rate; it reflects the renminbi’s value relative to a trade-weighted basket of currencies.

As of December 31, 2015, China’s total reserves stood at $3.3 trillion – 15% lower than 12 months earlier and 20% below the June 2014 peak.

Sources: Capital Group, MSCI.
Devaluation has shaken confidence among China’s local investors, leading to stock market volatility and capital flight as China residents move money abroad. These developments present real challenges for Chinese policymakers, and stock markets there could be quite bumpy in coming years despite authorities’ best efforts.

Looking forward, China will likely continue to have a wide-ranging impact, and not just on the currencies of commodity-exporting nations. For example, currencies of Asian nations whose economies are closely tied to the fortunes of China — either because they benefit from Chinese demand or because Chinese exporters represent their main competition in export markets — are clearly at risk of depreciating against the dollar. Even the U.S. could be affected. Chinese demand has come to account for a much greater share of U.S. corporate earnings growth over the past decade. If earnings expansion in the U.S. is held back by slower Chinese growth, the ramifications for the U.S. economy could mean that the Fed may not hike as much as currently expected. Indeed, this scenario may even increase the chances of a Fed rate cut or official bond buying (quantitative easing) — policy moves that could very well stop the dollar in its tracks.

**Emerging Markets Currencies: Amid Broad Challenges There Are Bright Spots**

Many developing economies are only partway through a difficult period of adjustment. Unfortunately, until more pronounced structural reforms are implemented, currency weakness and volatility are the mechanisms through which these necessary adjustments are unfolding.

That said, it’s important to note that emerging markets are not all the same. Some economies, such as Brazil, have much greater exposure to China by virtue of their heavy dependence on commodities exports. Others, such as Mexico, are more closely tied to U.S. economic fortunes. Healthy growth and inflation prospects are evident in India, but the economic outlook in Russia is lackluster. Consequently, not all emerging markets currencies are in the same boat.

Brazil, Russia and South Africa are confronting various economic and trade imbalances alongside inflation. They also have political environments that offer little prospect for the kinds of structural reforms that could heal their economies. Therefore, the Brazilian real, the Russian ruble and the South African rand all appear vulnerable to further declines against the dollar — even though they entered 2016 with valuations in excess of 25% below what might be considered reasonable levels.

On the other hand, the Hungarian forint, the Mexican peso and the Polish zloty appeared undervalued versus the dollar in early 2016; all three economies seem free of large imbalances and inflationary pressures. These currencies have suffered declines as part of the broader sell-off in emerging markets, and local-currency debt from these markets currently offer attractive return potential for emerging markets debt and global bond portfolios.

In the near term, weaker currencies can hurt economies by stoking inflation, but in time there is often a silver lining: improved competitiveness and, hopefully, economic reforms. The fact that most emerging markets currencies are now free floating — rather than pegged to the dollar — should, therefore, ultimately prove beneficial. What’s more, the dollar’s rate of appreciation has been slowing. A more stable dollar in the not-too-distant future could help stabilize commodity prices (which are typically priced in dollars), possibly laying the groundwork for a turnaround for many developing-country currencies.

---

**Key Takeaways**

- The dollar may not strengthen much more against the euro and the yen, and currency translation could soon become a tailwind for dollar-based investors in the euro zone and Japan.
- Some emerging markets currencies appear vulnerable to further losses against the dollar and other major currencies.
- For global bond investors, select emerging markets currencies may be approaching attractive valuations — creating compelling longer term total return potential in local currency issues.
- Compared to recent history, currency translation could soon begin to have more of a neutral or positive impact on total returns for dollar-based investors’ global stock and bond portfolios.

**Securities offered through American Funds Distributors, Inc.**

Statements attributed to an individual represent the opinions as of the date published, and do not necessarily reflect the opinions of Capital Group or its affiliates. The information provided is intended to highlight issues and not to be comprehensive or to provide advice. The Capital Group companies manage equity assets through three investment groups. These groups make investment and proxy voting decisions independently. Fixed-income investment professionals provide fixed-income research and investment management across the Capital organization; however, for securities with equity characteristics, they act solely on behalf of one of the three equity investment groups.