JUNE 2018

OUR DOLLAR/THEIR PROBLEM

In 1971 at a G-10 meeting in Rome US Treasury Secretary, John Connally said: *"The dollar is our currency, but your problem."* The context is very different today in the time of Trump than in the time of Nixon, but it seems the US is continuing this posture today. We want the dollar as a currency to favor our economy and welfare and for others to accommodate. In business there are price takers and price setters. We want to be the price setter of our currency relative to the currencies of our trading partners. One of the reasons the US has had the upper hand is that the dollar is and has been the currency in which countries have held their reserves. Much of global trade is settled in dollars and a good deal of external foreign debt is denominated in dollars. For these reasons and many other complicated factors, the dollar and its relative strength or weakness has had an outsized effect on trade, global asset values and inflation. The current administration wants to drive its preferences. This ability to set price, however, could be undergoing change as the US international financial position is weakened by our net debtor status and growing fiscal deficits.

One of the enduring benefits to the US has been the dollar's global reserve status. When the US borrows, it borrows in its own currency. This removes the currency risk of paying the debt back in a currency that is more expensive than the dollar. One might remember the plight of Iceland with its banking and housing crisis where they took on large amounts of external debt denominated in Euros, not Icelandic Krona. The collapse of the Krona made paying back the Euro debt impossible.

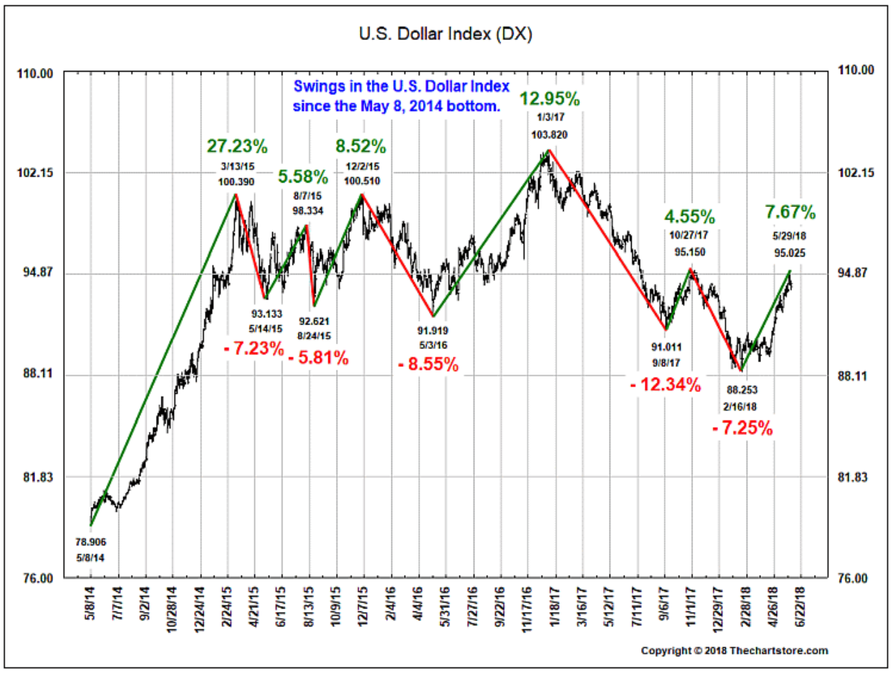
How should we want the dollar to be valued against other major currencies? Politicians usually all call for a strong dollar like it is a patriotic test. Other than the word 'strong' referring to a general reflection and picture of economic health, a strong dollar is not optimal for US interests in all circumstances.

2 Maple St., Hanover, NH 03755 603.643.0044 | 178 County Rd., New London, NH 03257 603.526.9251
1 Pillsbury St., Suite 303, Concord NH 03301 603.513.4100 ledyardbank.com

The dollar is strong today against major currencies, principally due to stronger US economic growth, but also due to the widening differences in international bond yields giving an advantage to holding dollars that can earn a higher interest rate. Interest rates in the U.K. and Europe, for instance, are still very low as central banks there (ECB primarily) need to continue an easy monetary policy. European investors buy US bonds to earn the higher rate, but must first buy dollars to do it.

Chart #1 shows the dollar's current relative strength against a basket of six currencies.

Chart #1



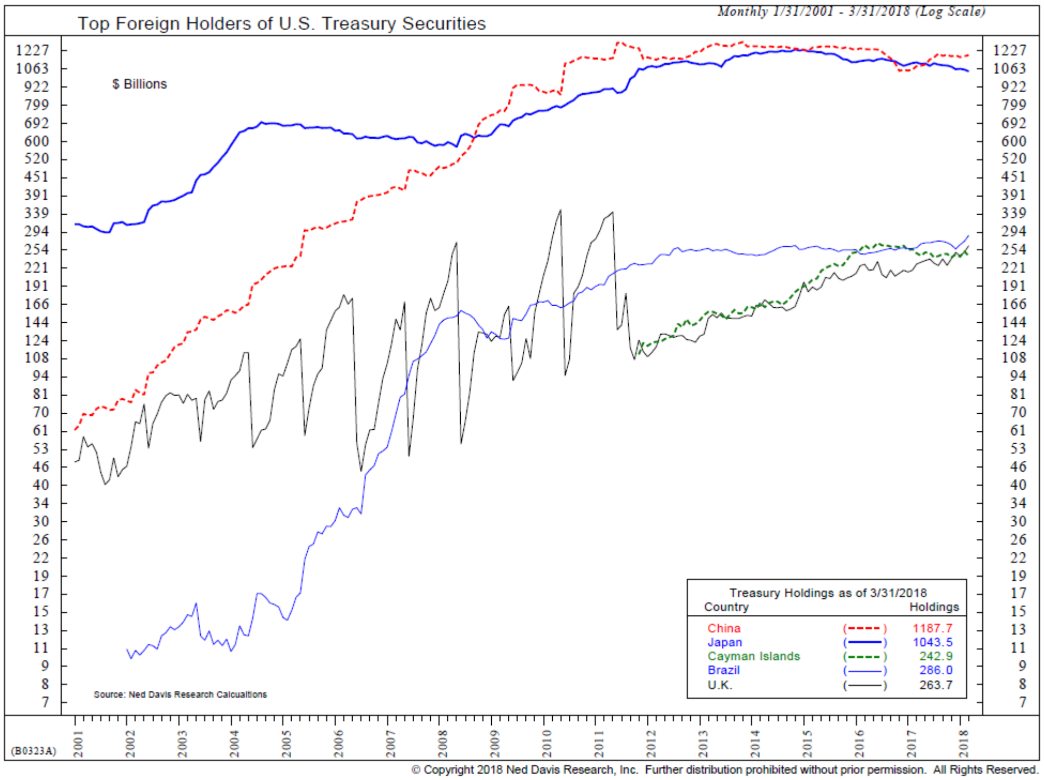
The U.S. Dollar Index is based on six currencies. The currencies and their weights are:

Euro	57.6%
Yen	13.6
Pound	11.9
Canadian Dollar	9.1
Krona	4.2
Swiss Franc	3.6

Is the dollar's current strength a good thing for the US today? Will or should dollar strength continue? From the point of view of consumers or businesses that import resources (materials, services or labor), the strong dollar is a positive. It also dampens inflation to this group. Seen from an exporter's view, the strong dollar means other currencies have become relatively weaker and can buy less from US exporters or may want to buy less. While in total US exports are about 12% of GDP there is much greater exposure to foreign sales with respect to the stock market where sales are slightly above 50% for the S&P 500. The sensitivity is greater for big exporters like technology, basic materials, energy and agriculture. These are examples where relative dollar strength can either help or hurt the US.

The US is currently a net debtor borrowing from the world. Under current fiscal spending and tax policy the US will be increasing its need to sell Treasury securities to finance this debt. Our need to borrow can shift some political and economic power to our creditors, namely China and Japan. **Chart #2** demonstrates the rapid rise of China as a buyer of Treasury securities as they sought to recycle the dollars received for their exports to the US. This permitted China to limit the appreciation of its own currency, protecting the competitiveness of their exports.

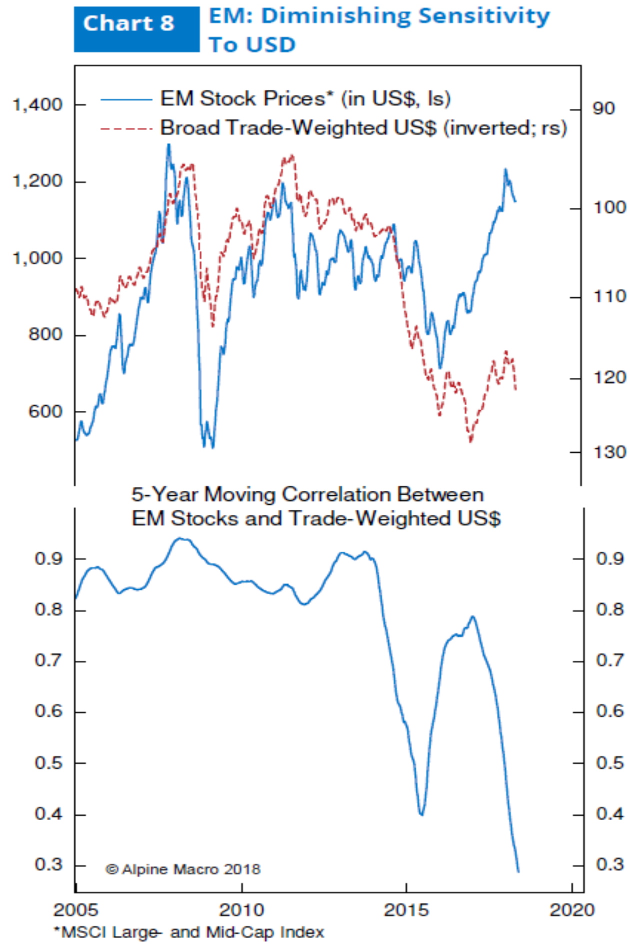
Chart #2



Today, China's exports to the US as a percent of their total are waning and their need to buy our bonds has diminished. This could give them power in trade talks, or at least a lever for negotiation. We note diminishing sensitivity in the emerging stock markets to the dollar, partly from changing patterns of trade within the emerging market, but also from stronger fiscal positions compared to the troubled 1990's. Nevertheless, there is a certain faddish risk on, risk off behavior by financial market portfolio flows in and out of emerging markets. It is the behavior of these investors driving current risks. These flows are presently negative, presumably reacting to the strong dollar after the fashion of past episodes. However, capital flows seeking direct investment are rising. China, for its part, is settling more of its trade in its own currency, away from the dollar.

Chart #3 portrays a divergence from past sensitivity that we believe is attributable to more China-centric trade and less dollar denominated debt, although there are some strong exceptions (Turkey, Brazil and Argentina).

Chart #3



<u>Investment implications:</u>

Current dollar strength will be supported while the Fed is in tightening mode. It poses a problem for our trading partners and all foreign borrowers of dollar denominated debt. As the US moves to the end of the current economic expansion cycle, mounting debt levels will make holding dollars less attractive as inflation erodes purchasing power, like a quasi-tax. A weaker dollar trend will then re-establish itself in favor of US exporters and emerging market equities. Contrarily, if the strong dollar continues with rising rates, then pressure on foreign economies will dampen global corporate earnings and asset prices will weaken. US exporter’s large share of S&P 500 sales would decline. Our currency in the end could become our problem.

J.T. Underwood
Chief Investment Strategist