Beacon Trust Quarterly

April 24, 2015

Dollar Doubts

We recently published a piece (see latest Commentary dated April 20, 2015 on our website) casting doubt on the strong dollar outlook. Admittedly, numerous variables influence foreign exchange (fx) trends, or else we would all be prosperous fx traders. During much of the last year, dollar strength has been attributed to several divergences: (1) divergent monetary policies, with the US tightening and the eurozone, Japan, China and others easing; (2) divergent growth prospects, with US growth prospects better than the eurozone, Japan and a slowing China; (3) divergent bond yields, with US yields higher than much of the developed world; and (4) divergent risk, with the dollar enjoying safe currency status. These variables have contributed to a 24% rise in the US Dollar Index, DXY, against major world currencies since May 6, 2014. This optimism has recently been challenged by soft economic data in the US, which may or may not be weather related and temporary. In addition, the consensus view on Fed rate hikes is that the inaugural date will be later (September or December) rather than sooner (June).

One perhaps overlooked part of the dollar outlook is the trend in the twin deficits – the budget and trade deficits. The twin deficits tend to lead dollar performance by about a year. As can be observed in the accompanying chart, the deficits have come down as a percent of GDP in recent years, thereby bolstering DXY. Our analysis indicates that the twin deficits explain about two-thirds of the change in DXY since 1995. The twin deficit result for 2014 and Bloomberg consensus forecast for 2015 suggest a peak DXY level of 100 for both 2015 and 2016. Ironically, the year-to-date closing high for DXY is 100.4. Our takeaway is that we doubt the dollar can rally significantly and sustainably above 100.

So, why should we care about the dollar's outlook aside from a cheap European vacation? There are far reaching knock-on effects. To begin with, first quarter earnings releases have been filled with distressed revenue and earnings results attributable to a strong dollar. The currency translation effect from foreign-sourced revenues is negative. On average, S&P 500 companies derive 46% of revenues from abroad. A less robust dollar implies stronger S&P 500 company revenues and earnings, particularly for sectors with high foreign sales such as Information Technology, Energy, Materials and Industrials. We anticipate upward earnings revisions for both the S&P 500 overall and specific companies with high foreign sales exposure. All else equal, oil prices will have less downside if the dollar stabilizes.

This suggests energy stocks could benefit from better pricing as well as muted currency effects. Another beneficiary would be Emerging Markets. A strong dollar renders dollar-denominated debt more costly for EM corporate and government borrowers. Indicative of the exposure is EM hard currency corporate bonds which amount to an estimated $2 trillion, or more than the $1.6 trillion US high-yield corporate bond market. Dollar credit to non-bank borrowers in the eurozone, UK and other developed countries has also risen significantly since 2008. Clearly, some cessation in the dollar's ascent would bring welcome relief.

Stock Buybacks: A Good or Bad Thing?

For many years, we have fervently believed that supply matters to the price of financial assets. It could be mathematically proven that when US budget deficits and Treasury supply ballooned, bond yields would spike as well. Of course supply is not the only variable impacting bond yields, but neither can it be ignored. Recently, the price of oil has been pressured by oversupply from OPEC and US shale producers. The price decline was exacerbated by sluggish demand and a strong dollar. When it comes to the US stock market, it's no secret that corporations have been plowing excess cash into stock buybacks and dividend hikes rather than investing in their businesses. Some have even borrowed to fund stock buybacks. A recent newspaper headline indicating that the combination of buybacks and dividends would reach a record $1 trillion in 2015 got our attention. The S&P Dow Jones Indices indicates the buyback portion rose 16% in 2014 to $553 billion, and they expect double-digit growth this year. These figures imply a significant amount of supply shrink for S&P 500 stocks. All else equal, shrinking supply should mean higher stock prices. We've witnessed this effect with individual stocks but does it hold true for the market as a whole? We sensed that this could be another tailwind for US stock prices. To test what seemed obvious, we added Buyback Yield (Buybacks as a % Market Value) to our S&P 500 Price Return Model, which includes Corporate Credit Spread and Dividend Return. The good news is that Buyback Yield was statistically significant as an independent variable. The bad news was that the correlation was negative, meaning that increasing buybacks penalized stock returns. We believe the explanation lies in company's poor timing of buybacks. These programs are typically very active when stock prices are rising or at the top of the market. One reason for this is to offset dilution from increased shares due to executives exercising stock options. Buying company stock at high valuations destroys value.

Buyback programs are not so active when the stock market is in decline. For instance, companies pared buying substantially during the 2007-09 market decline. A second explanation has to do with lost potential growth when a company defers investment in its business to buy shares and the message it sends regarding growth opportunities. Could it be the market is smart enough to discern this latter point? It seems plausible. With stock buybacks a potential headwind to performance, does this change our stock market outlook?

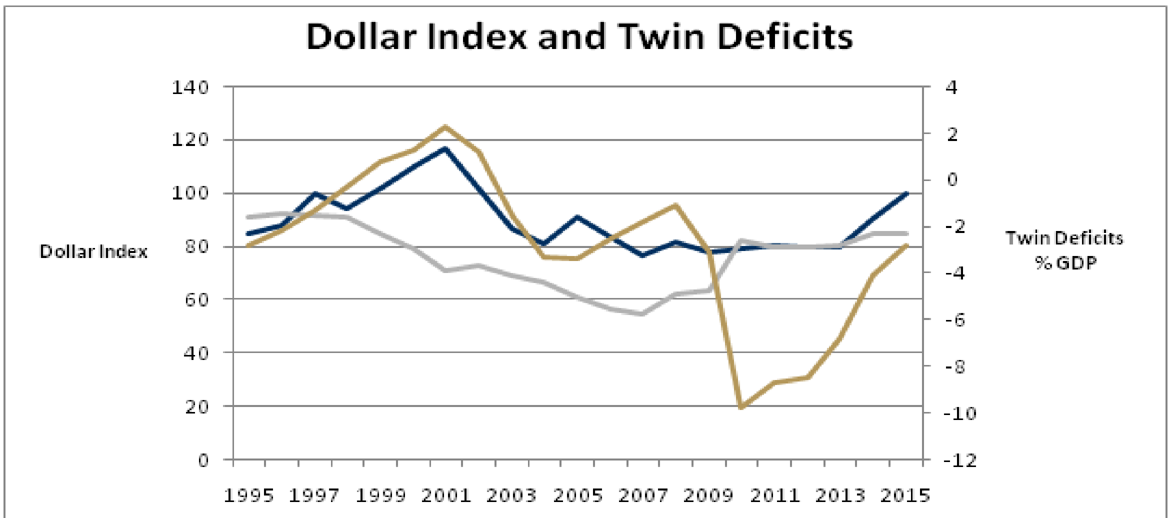
US Market Expectations

Although the stock buyback variable represents a potential negative for the stock market, our calculations suggest it may not override impetus from a narrow Corporate Credit Spread and rising Dividend Return.

Our call for a stable dollar could provide a modest earnings tailwind and better energy sector results. We are maintaining our 2,240 S&P 500 upside target which represents a 9% return from the December 2014 average. Total return for the S&P 500 in 1Q15 was 1.0%. Fund flows benefited international developed and emerging markets reflecting quantitative easing and more reasonable valuations. We still believe bond yields will be down modestly, on average, versus 2014. Disinflation and strong institutional and foreign demand will limit any rise in yields. The bond market returned 1.5% in 1Q15.

Our Asset Allocation Strategy continues to favor Domestic Equities over Domestic Bonds. During the quarter, we implemented an over weight position in International Equity, which should benefit from easy monetary policies, economic recovery and lower oil prices. The Short-Term Credit position was pared.

Alan D. Segars, CFA
Chief Investment Officer



[1]One Year Lag
[2]Dollar Index 2015 data point is an estimate
R^2 = 64%
Sources: Intercontinental Exchange; Bloomberg; Congressional Budget Office