CAMMACK RETIREMENT

Currency Movements and the Effect on Retirement Plan Investments

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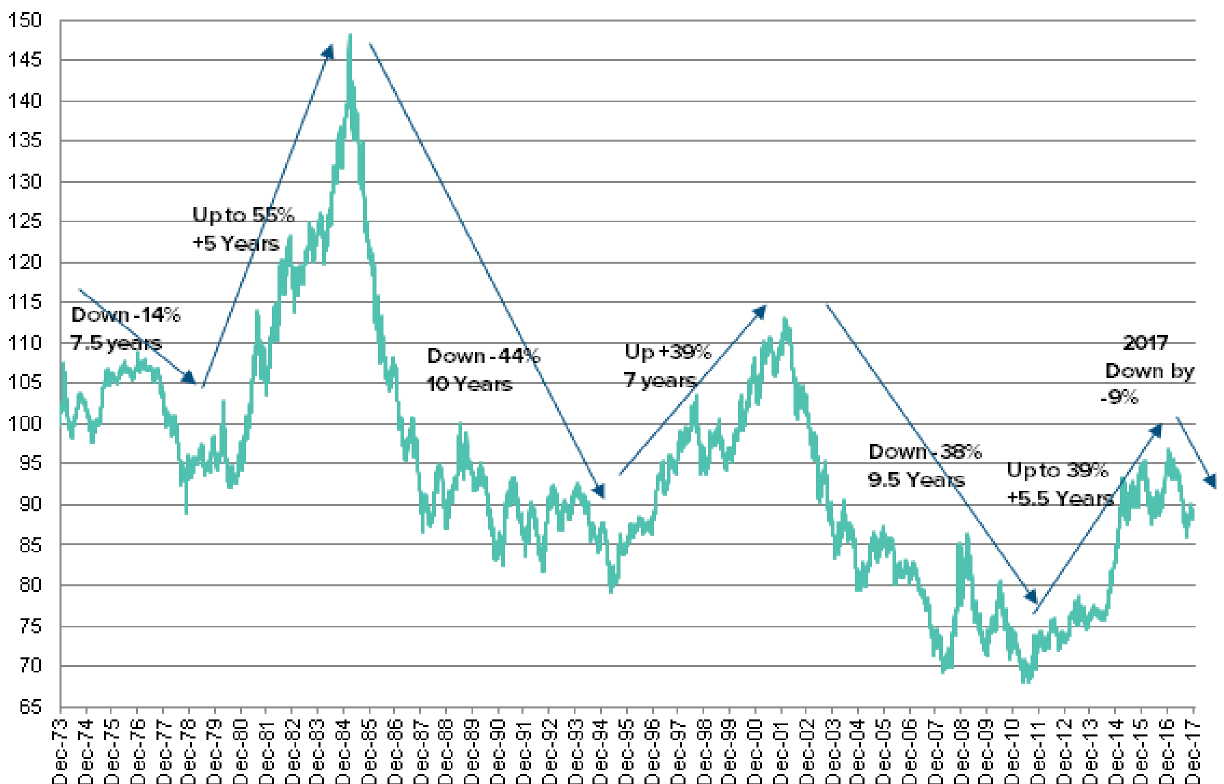
From mid-2011 to late 2016, the U.S. dollar strengthened close to 39% against its major trading partners' currencies. During this period, investment gains from foreign stocks and mutual funds invested in foreign stocks were muted by the surge in the U.S. dollar, making investing in international markets less appealing for the U.S.-based investor. However, the beginning of the 2017 marked the halt of the strong U.S. dollar rally. With the continuing broad-based recovery in international economies, investing internationally should become more attractive. The weakening dollar relative to foreign currencies should also provide a significant boost for the international returns of U.S.-based investors saving for retirement.



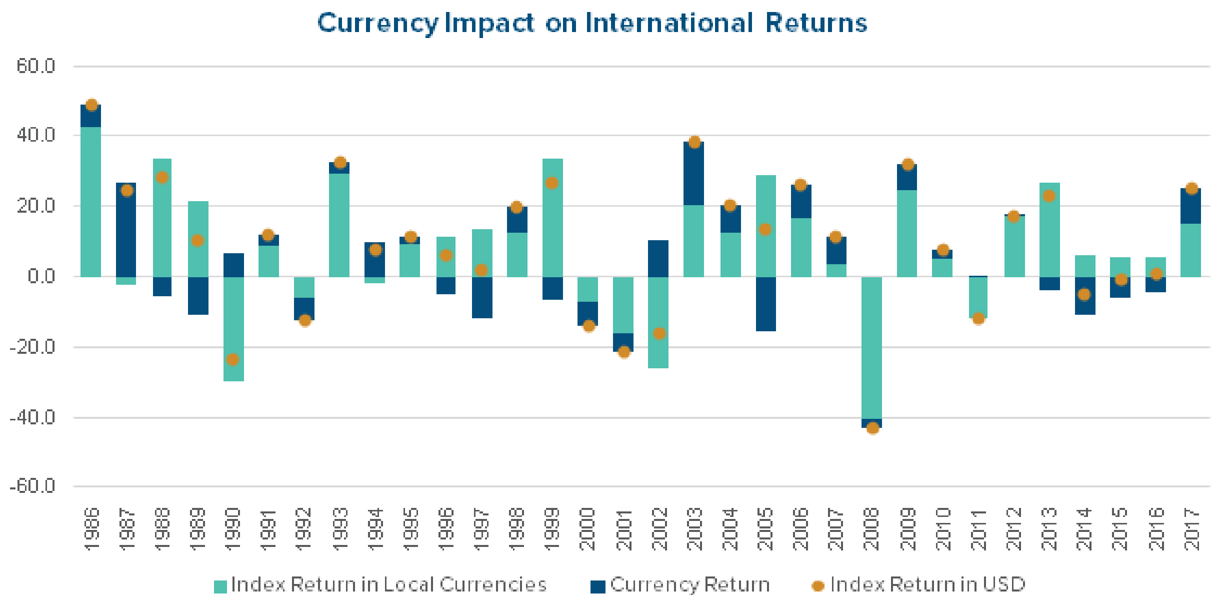
Source: Federal Reserve Bank of St. Louis

THE IMPACT OF CURRENCY MOVEMENTS

Historically, currency cycles last for five to eight years (source: Capital Group). After an extended era of dollar strength, many currency analysts believe that we are entering a period of dollar weakness. In 2017, increasing skepticism in expectations for the new administration, the Federal Reserve's cautious approach to interest rate hikes, and pickup in global growth all contributed to the weakening of the dollar relative to other currencies. Given that the dollar has rallied hard over the last five years, there is greater conviction that it has peaked and will continue to weaken throughout the next few years.

The dollar movement can impact the returns of global and international portfolios for dollar-based investors, since local returns are translated into the U.S. dollar. For U.S.-based investors, converting their foreign returns into U.S. dollars results in lower numbers because the foreign currency has gotten weaker. Since most equity managers do not hedge their currency risk, the dollar's strength has dampened the performance of some U.S. stock funds that regularly invest in shares of foreign companies.

Historically, in periods of dollar weakness, a significant portion of the total return from international and global equity has accrued from the currency portion.



Source: Morningstar Advisor, MSCI EAFE Index

The weakening of the U.S. dollar also impacts U.S. equity investors investing in domestic markets. Since 43% of revenue generated from S&P 500 companies is derived from overseas, the dollar's strength (or weakness) has substantial effects on multi-national corporations. The soaring dollar can apply pressure to the corporate earnings of U.S. multi-nationals that earn a significant portion of their revenues overseas. Morgan Stanley estimates a 1% improvement in corporate revenues for every 2% drop in the dollar. Since the start of the year, the weakening dollar has been a factor in the rebound of the corporate earnings for U.S. companies. A weaker dollar is also good for shares of U.S. exporters, making their product cheaper for overseas buyers. This increases revenues for U.S. exporting corporations and therefore boosts equity

prices. S&P 500 earnings are pacing for 16% year over year growth in 2017 higher than the consensus forecast.

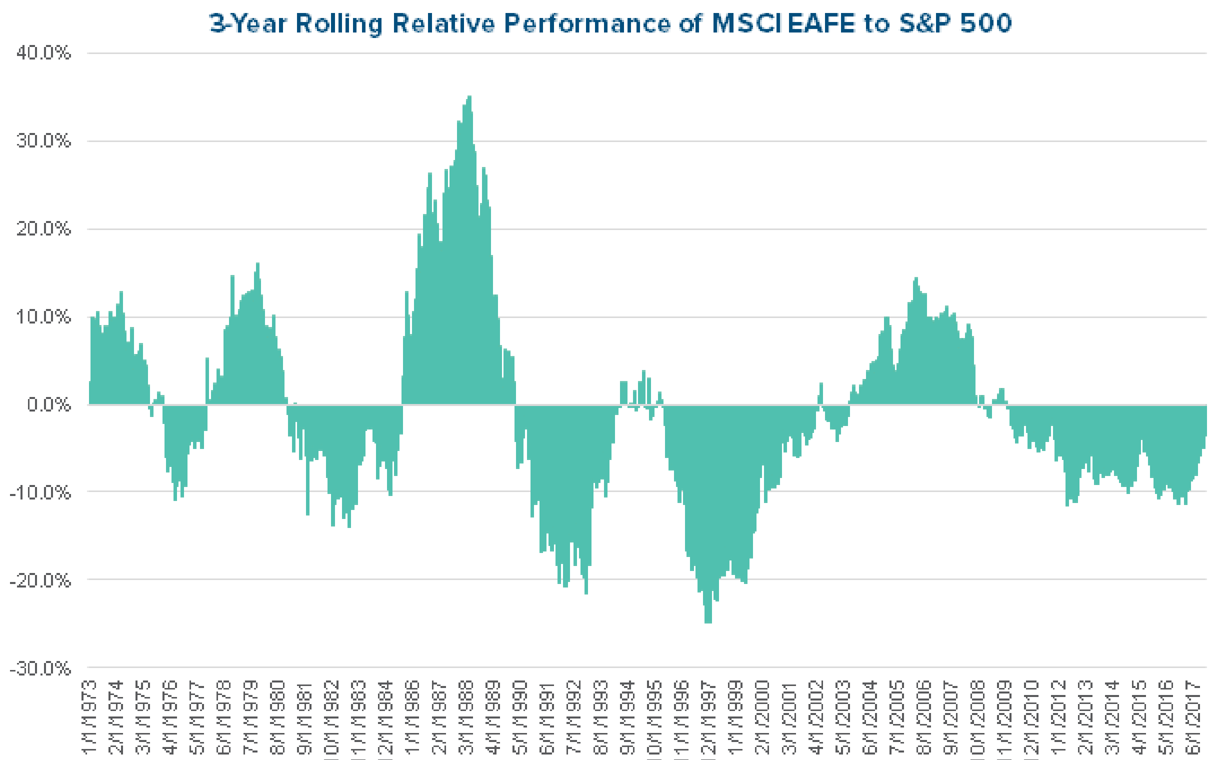
Since most commodities are priced in dollars, the weaker dollar boosts commodity prices. This benefits energy companies and emerging market commodity exporters. Therefore, investing in emerging market economies in a weakening dollar environment may be beneficial for investors' returns. Emerging market equities continue to be the best-performing equity class, with returns up nearly 37% in 2017.

TO HEDGE OR NOT TO HEDGE

For investors concerned about currency effects on portfolio returns, hedging currency risk is an option. The decision to hedge or not depends on the personal preferences of the individual investor or portfolio manager. As currencies are cyclical, the impact tends to level out over the long term; however, in the short term, it can cause significant performance differences. Hedging currency risk is more prevalent with global bond portfolios, as equity funds do not use hedging as an option. Investors hedging currency give up any potential return if the foreign currency strengthens. Therefore, in periods of dollar weakness, it could be detrimental for investors to have their international and global equity exposure through hedged vehicles. Still, for some investors, hedging might be attractive for its ability to lessen the volatility of a portfolio.

INTERNATIONAL EQUITIES ARE MAKING A COMEBACK

Historically, periods of underperformance by international equities have been followed by periods of outperformance. Four factors suggest that international equities will continue to lead the domestic equities market in the future: growth, earnings, valuations and currencies.



Source: Morningstar Advisor, Data as of December 31, 2017

One of the biggest themes in 2017 was the synchronized global growth, with most of the major economies growing at a positive rate. The economic data has been surprisingly positive, especially in European counties and Japan, as they have been surpassing economists' expectations since the start of 2017. Profit growth is very strong globally, particularly outside of the U.S., where many economies are in the early stages of recovery. International equities have not yet recovered to their pre-crisis peak; therefore, they have more room to grow relative to U.S. domestic equities.

With the U.S. bull market now well into its ninth year, U.S. equities are no longer inexpensive relative to other equity markets. Overseas markets trade at lower valuations, making it the least expensive it has been, relative to the U.S., in fifteen years. Emerging markets trade at an even steeper discount and appear to have more room to run; earnings are rebounding, cash flows are improving, and the dollar is weakening. All of these have been a recipe that drives share prices in developing markets.

CONCLUSION

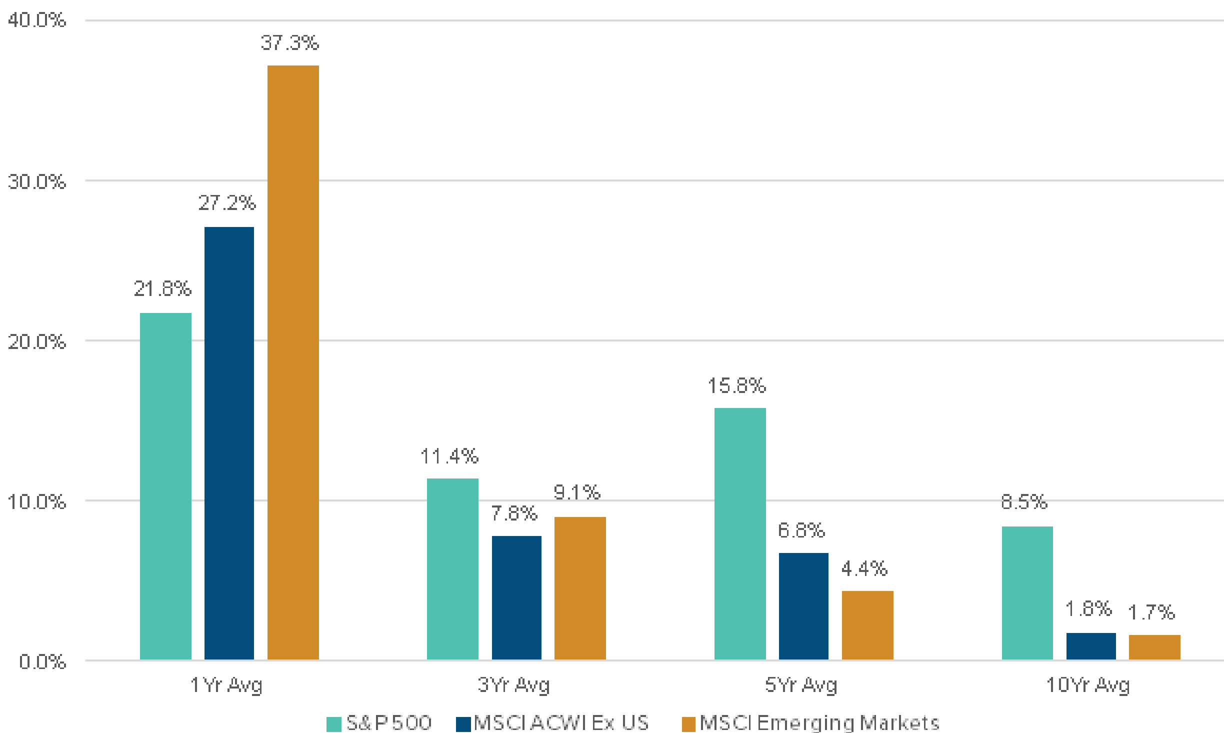
Currencies impact international travel, exports and imports, and the overall economy. Because the dollar is the global currency, any significant change in its value ripples throughout financial markets. After prolonged appreciation, the weakening of the U.S. dollar is likely to provide a boost for international investing, as well as for domestic equities. While the weakening dollar presents some risks, we believe it will bring more positives than negatives.

Valuations and Dividend Yields are More Attractive Overseas

	Forward P/E (X)	15 yr avg	Dividend Yield (%)	15 yr avg (%)
Domestic (S&P 500)	17.9	15.0	1.9%	1.9%
International Developed (EAFE)	14.8	13.3	3.1%	3.1%
World (ACWI)	15.9	13.8	2.4%	2.5%
Emerging Markets (EM)	12.9	11.1	2.4%	2.7%

Source: JPMorgan Asset Management: Guide to the Markets, Data as of September 30, 2017

Depending on whether it is suitable, investors saving for retirement may consider exposure to international equities. Over the next decade, a meaningful allocation to international equities may potentially improve overall equity returns. The case for international equities is particularly appealing now, given the acceleration in growth outside of the U.S., faster earnings growth abroad, and more attractive valuations. The tailwinds from the weaker U.S. dollar may create greater returns from investing internationally. Despite the dominance of U.S. stocks during the seven-year period of the strong dollar, there are many compelling reasons to remain invested in international stocks as a part of a well-diversified retirement portfolio.



Source: Morningstar Advisor, Data as of December 31, 2017

Note: The securities discussed in this material may not be suitable or appropriate for all investors. Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

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For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@ cammackretirement.com**.

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