From right to left:

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We believe the upturn in the dollar is part of a new multi-year (secular) trend following an extended bottoming process that has lasted five years.

The implications of this trend are the increasing need to employ currency hedging for overseas investments, and that commodity prices will have a new headwind.

We believe overseas markets offer greater value and the potential for better earnings growth, but for that to be realized, overseas economies, especially those in Europe, have to find the formula for a sustainable recovery.

Dollar Bulls

There were some significant market moves in the third quarter of 2014, including crude oil (WTI) down 13.5%; commodities (Commodity Research Bureau Index) down 10.5%; and the US dollar up 7.7% versus the euro and 7.5% versus the yen. We believe the dollar's third-quarter strength is the beginning of a new multi-year (secular) uptrend following a five-year bottoming process, which was preceded by six years of dollar weakness (2002 to 2008). The implications of this trend are the increasing need to employ currency hedging for overseas investments, and that commodity prices will have a new headwind. Key employment and purchasing manager surveys released last week continue to point towards eventual Federal Reserve rate hikes next year, even as the European Central Bank (ECB) and Bank of Japan provide ongoing monetary stimulus. While the dollar may have risen 'too far, too fast' in the short-term, both the data and policy suggest to us that the dollar could move considerably higher over the next year.

Oil's decline partly reflects dollar strength, but is more a function of weaker global demand and increased supply, in our view. It is also a significant boost to consumers' disposable income worldwide and a benefit to oil-importing countries. Last week, Saudi Arabia announced its intention to maintain crude oil production levels despite falling prices, to defend their market share (i.e., engage in a price war). We wonder if this is purely an economic strategy. The moderate Arab world is increasingly united against ISIS, and the developed world's two primary geopolitical struggles are with Russia, Iran, and Middle East extremists, all of whom would be weakened by falling oil prices.

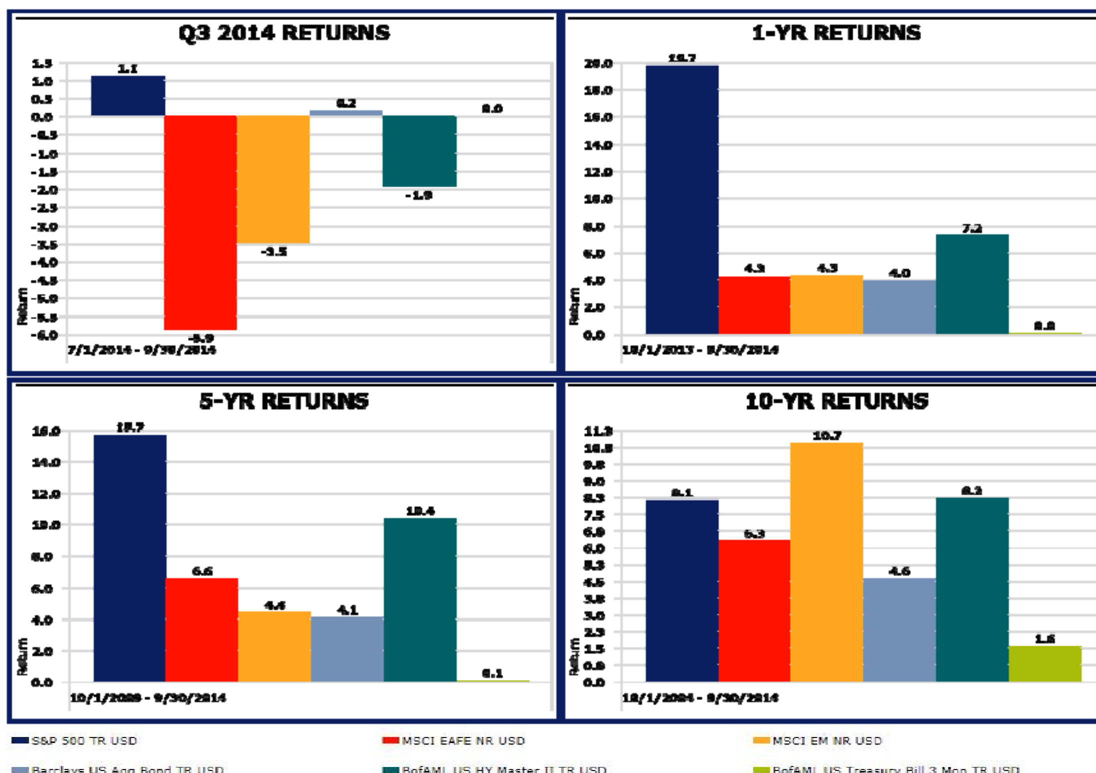
US large cap stocks rose 1% in the third quarter, but most other stock categories (small, mid-, and micro-caps, along with international) declined. We believe foreign markets offer greater value and the *potential* for better earnings growth, but for that to be realized, overseas economies, especially in Europe, have to find the formula for a sustainable recovery. Last week, ECB president Mario Draghi outlined plans to stimulate growth by initiating quantitative easing (QE) for the Eurozone starting later this month, just as the Fed is ending its QE program, which continues for at least two years and is expected to expand the ECB's balance sheet by around €1 trillion, in combination with measures enacted so far. The ECB is already using negative interest rates (unique among the world's major central banks), a funding-for-lending scheme (to help transmit lowered rates to new loans) and forward guidance (committing to ease policy until inflation goals are met). We think all of these measures reflect Draghi's commitment to do 'whatever it takes' to prevent deflation, move medium-term inflation expectations back towards target, support economic growth and preserve the Eurozone.

We think Draghi and the ECB are doing what they can to support economic growth, which has been lackluster and disappointing. However, they also acknowledge that to escape any liquidity trap — where money and credit do not circulate — fiscal policy and structural reforms are necessary to achieve a lasting impact. We think consolidation and reform in Spain and Ireland have set an example for countries like Italy and France, which have yet to respond. The ECB's policies should gain the most traction where banks have restructured, and the upcoming stress tests will show more clearly where this is. Perhaps the best evidence of Draghi's policies impacting markets is that over the past five months, the euro has fallen to two year lows. The last time the euro was this low the currency union was threatening to break apart and peripheral countries' interest rates were rising rapidly. Today, Spain and Italy's 10-year bond yields are below those in the US, a strong endorsement of the ECB's monetary and credit expansion.

Third Quarter review: Global stock and bond markets were relatively flat during the third quarter, but when foreign returns are converted into dollars, dollar gains produced negative returns of -5.9% and -3.5% for developed markets and emerging markets, respectively (see Weekly Chart). Credit spreads widened, causing high yield bonds to underperform Barclays Aggregate Bond Index. The magnitude of US stocks' one- and five-year outperformance relative to other asset classes is partly a function of Fed policies that have delivered a sustainable economic recovery and allowed good corporate governance to double corporate earnings. The challenge for the US now is that with margins at record levels, returns are likely to be limited to single digit gains, which is consistent with our expectations for earnings growth. We emphasize that changing the starting and ending points can significantly alter the results, when evaluating point-to-point performance returns. For example, dropping the third quarter of 2009 from five-year returns hurt EAFE's (foreign developed markets) five-year performance because that quarter was the end of two strong recovery quarters and the beginning of the three-year Eurozone crisis. Similarly, EAFE's strong outperformance during the third quarter of 2013 has now dropped out of one-year return data.

THE WEEKLY CHART: DOLLAR STRENGTH LEADS TO US OUTPERFORMANCE

MAJOR INDEX COMPARISONS AS OF 9/30/14



Source: Morningstar Direct; Past performance is no guarantee of future results.

__S&P 500 TR USD__ — Standard & Poor's (S&P) 500 Index (Total Return) measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. __MSCI EAFE NR USD__ — MSCI EAFE Index (Net Return) US Dollar denominated measures the equity market performance of developed markets, excluding the US & Canada. The index consisted of indices from 22 developed markets. __MSCI EM NR USD__ —MSCI Emerging Markets Index (Net Return) US Dollar denominated measures equity market performance of emerging markets. As of June 2009 the index consisted of 22 emerging market country indices. __Barclays US Agg Bond TR USD__ — Barclays US Aggregate Bond Index (Total Return) is an unmanaged index that covers the investment grade fixed rate bond market with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The issues must be rated investment grade, be publicly traded, and meet certain maturity and issue size requirements. __BofAML US HY Master II TR USD__ — The Bank of America Merrill Lynch High Yield Master II Index (Total Return) is composed of US currency high-yield bonds issued by US and non-US issuers. __BofAML US Treasury Bill 3 Mon TR USD__ — Bank of America Merrill Lynch Treasury Bill Index (3-Month) tracks 3-month US government securities. It is not possible to invest directly in an index.

Total Return (TR) includes interest, capital gains, dividends and distributions realized over a given period of time.

Net Total Return (NR) indices reinvest dividends after the deduction of withholding taxes, using (for international indices) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties.

High-yield securities are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

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