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THE WEEKLY VIEW

From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Growth, the Dollar and Earnings

The US has what the rest of the developed world wants: steady employment growth and a self-sustaining economic expansion. The benefits have been reflected in US companies' earnings and stock prices rising significantly faster over the last five years. The US now faces the consequences of its outperformance in the form of a stronger currency. This week, we examine the ramifications of a stronger dollar on US earnings.

Over the last 35 years, the dollar (as measured by the US Dollar Index[1]) has increased by 10% or more five times prior to last year. Three of those times — 1981, 1982, and 1984 — were in a very different economic environment. 1982 was a recession year, and the 18% earnings decline should be viewed in that context. The others were not recessions, and earnings grew, but those were periods of high inflation, high interest rates, and low profit margins.

During the other two years — 1997 and 2000 — the economy had been growing for a while, yet earnings managed 8% and 9% growth, respectively, despite a strong dollar. In both years, the global economy, especially growth in Europe, was stronger.

We expect the dollar to be a headwind for US multinational companies (several high profile US multinationals have already missed earnings citing dollar strength) and a tailwind to those countries whose currencies have fallen.

A 3% rise in the trade-weighted dollar would reduce 2015 earnings per share by about $1, or 0.8 percentage points, according to estimates by Goldman Sachs. The dollar index rose 12.5% in 2014 and is up 5% this year. Thus, the impact on overall earnings should not be significant. The reliability of such models is muted by the many other variables affecting earnings, and lower oil prices will provide offsetting benefits for some companies while severely affecting the earnings of the energy sector.

We therefore expect stronger earnings growth from the companies we own in Europe and Japan.

Since we expect a mild acceleration in global economic growth, we expect S&P 500 earnings to rise, but at a low single-digit pace. In our view, the impact of the dollar will be a headwind for US companies, which is one of the reasons we don't expect valuation multiple expansion for U.S. equities in 2015. But a stronger US dollar should be a tailwind to those countries whose currencies have fallen, and we expect stronger earnings growth from the companies we own in Europe and Japan.

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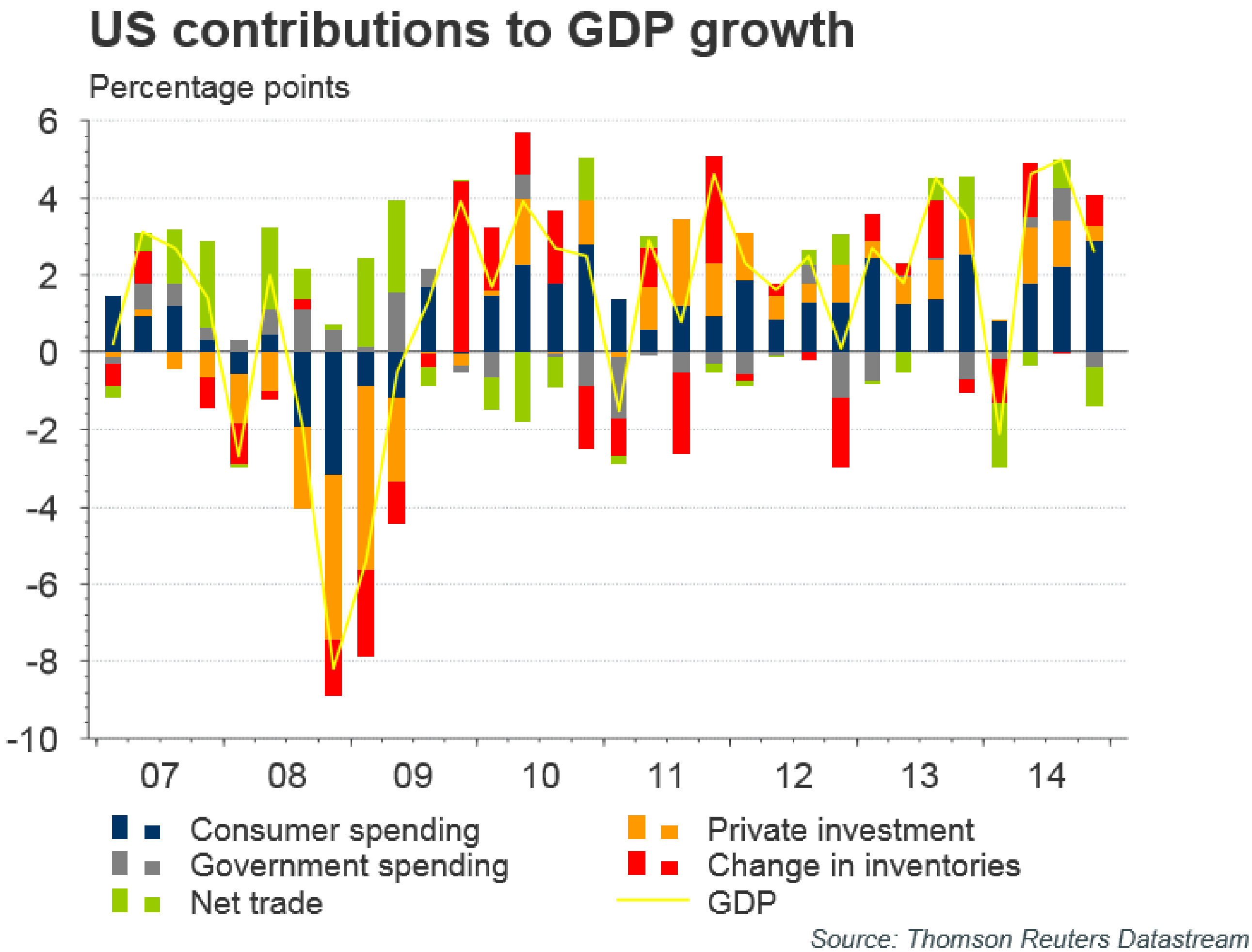
[1] *The index is a weighted geometric mean of the euro (57.6%), yen (13.6%), pound (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%), and Swiss franc (3.6%).*

Last week, the Commerce department released its first estimate of fourth-quarter GDP. Our Weekly Chart breaks the data down into some of its components and contains two trends that we think will persist into 2015:

1. Consumer spending is getting stronger
2. Private investment spending is getting weaker

Both of these make sense following the 50%-plus decline in oil prices since last June, and they are incorporated into our thinking for 2015. We expected to see a decline in private investment spending coming from the energy sector and to see that offset by a pickup in consumer spending.

THE WEEKLY CHART: CONSUMER DEMAND SUPPORTING THE ECONOMY



Our chart highlights the collapse in private investment during the 2008-2009 recession. Consumer spending started to grow in the third quarter of 2009, and private investment followed two to three quarters later. The government sector has mostly been a small drag on growth since 2011. This is a private sector expansion during which the annual deficit has fallen from almost 10% of GDP to around 3%. Extremely low interest rates and flat spending, combined with accelerating tax revenues, explain the improvement. In this context, the dollar's strength seems logical and likely to continue.