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IAIN STEWART: WHY I REVERSED MY US DOLLAR ALLOCATION

By Esther Armstrong, BNY Mellon IM EMEA

Newton Real Return's team leader Iain Stewart deemed it prudent to reduce US dollar exposure at the start of 2015 as he believes the currency's strength is "overdone".

The Newton Real Return strategy has scaled back its US dollar position, believing the drivers behind its strength to be overhyped.

This reverses the positive view held by the team in 2014 when the US dollar provided a cheap way to hedge risk assets and also benefited from the tailwind of rising interest rate differentials.

In what he views as a "dollar-centric world", Newton's Iain Stewart says the market seems to be dominated by what US investors are thinking.

The result of this – pinching market share in a low growth world – is what quantitative easing has ultimately been about, he says.

Last year the Newton Real Return strategy, run by the BNY Mellon Investment Management-owned boutique, carried some 20% US dollar exposure through its underlying investments, but has since hedged the US currency back to base.

"This is not because we are constructive on sterling but because there is not much of an option for it to debase against any other currency because a lot of other currency markets have already competitively moved. The US dollar has migrated from being a 'risk-off' asset, which was our reason for holding it, to being more of a 'pro-risk' asset because people are enthusiastic about the strength of the US economy," Stewart explains.

Dollar risk

The lack of US dollar liquidity is one of the primary risks facing investors, he says: "People do not tend to pay much attention to it but about half the balance sheet in the world is held in developing markets, which comes from the fact that those authorities have been operating in the forex markets to keep their currencies down against the dollar. This created huge stimulus for those economies.

"Meanwhile, non-US borrowing denominated in US dollars is said to be US$9 trillion globally and we feel there may not be enough dollars around to fulfil those obligations."

If short-term rates in the US do not go up as quickly as people expect there could be some softening in the US dollar against other currencies. In the event of this Stewart says the Real Return team would likely go back to holding a dollar position.

"We have seen rate expectations coming down but investors are still predicting between June and November for the first hike. We think it could be longer and we could go into the next cycle with rates still on the floor.

"The Federal Reserve is walking a tightrope – if it disappoints and does not raise rates in that window it is not great, and if the economy is too strong and it raises earlier than expected that is not great either," he says.

The 'TINA' trade

The team has been surprised by the strength of equity markets, especially those in the US, and Stewart says perhaps they should have been more "cynically bullish".

Ultimately he puts equity market resilience down to what he calls the 'TINA' (there is no alternative) trade: "We have been hanging back and have been very hedged in our equity exposure. I think what we need is a bit of a regime change. I would like to see some lower prices and better expected returns before getting more involved in equity markets.

"If something changes very quickly or stimulus stops working because investors start to question it there could be a rapid reversal of fortune in equity markets. Everybody is telling you the Federal Reserve has got your back, but it is a risky prospect. At some point it could do more stimulus and markets will just shrug."

Stewart believes deep down policymakers are realising they are distorting the system and at some stage will need to change tack.

To re-align economies with market performance, one option could be to go back to fiscally driven policies, such as infrastructure spending, but this could prove difficult since governments already have so much debt to contend with.

President Barack Obama's proposal to tax overseas earnings of US companies to provide funding for infrastructure is one imaginative work-around that has hit the press in recent days.[1]

But Stewart thinks authorities could go even further: "We have a sneaking suspicion they may move to tell us what bond yields are, as yields have fallen to such low levels that they might feel the need to fix the curve," he concludes.

[1] Wall Street Journal, *Obama proposes one-time 14% tax on overseas earnings*, 2 February 2015

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