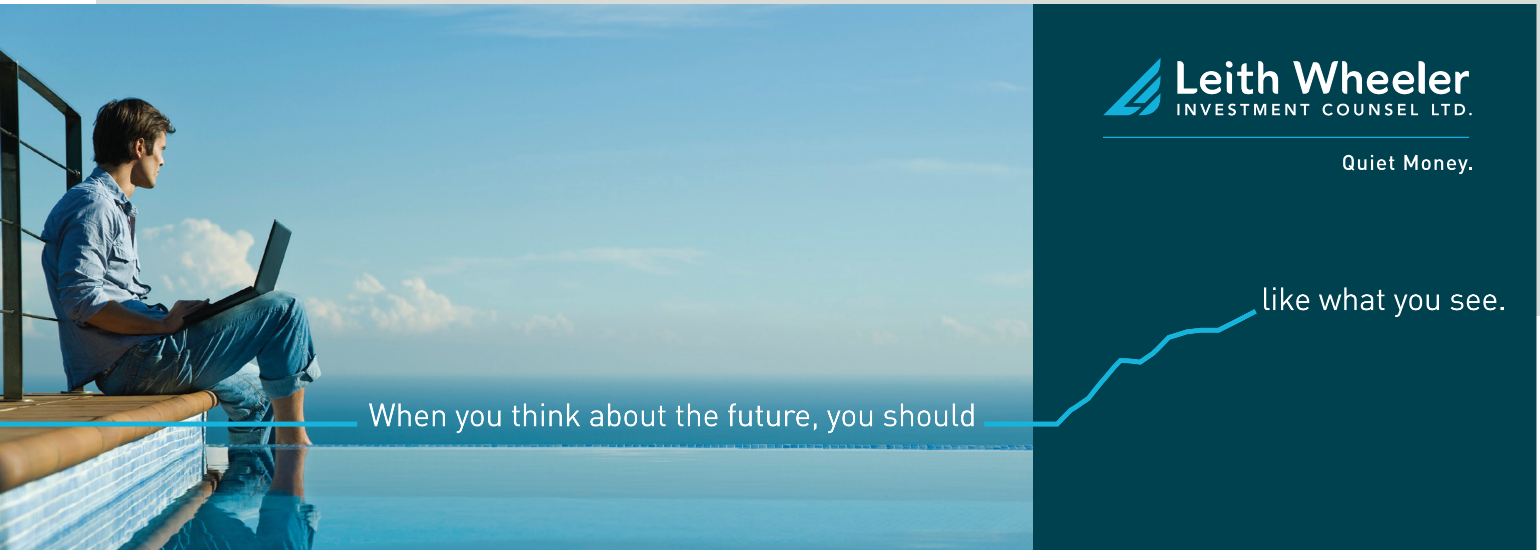
# Quiet Counsel

Spring 2015
Investment Outlook




## A Note on Our New Look

You may have noticed that there is a new look and feel to Leith Wheeler. For us, continuing the evolution of our company's brand was not only an opportunity to define how we do business, but to also express what we believe in. And that is where our new tagline "Quiet Money" comes in. It's about our belief in avoiding noisy market trends and flashy predictions. It's about always taking a long term view and staying committed to our value investing philosophy. And last but not least, it's choosing to never make noise about ourselves as we go about the business of making money for our clients. Steadily. Confidently. And ever so quietly.

Download previous newsletters, and read some of Our Ideas online at:
**LeithWheeler.com**

## U.S. Dollar, Phoenix Rising?

***The rapid ascent of the U.S. Dollar since last July has, understandably, dominated headlines and become a focal point for financial markets in 2015.*** Such a move in the world's reserve currency has important consequences for the global economy, including monetary policy, economic growth prospects and financial stability risks.

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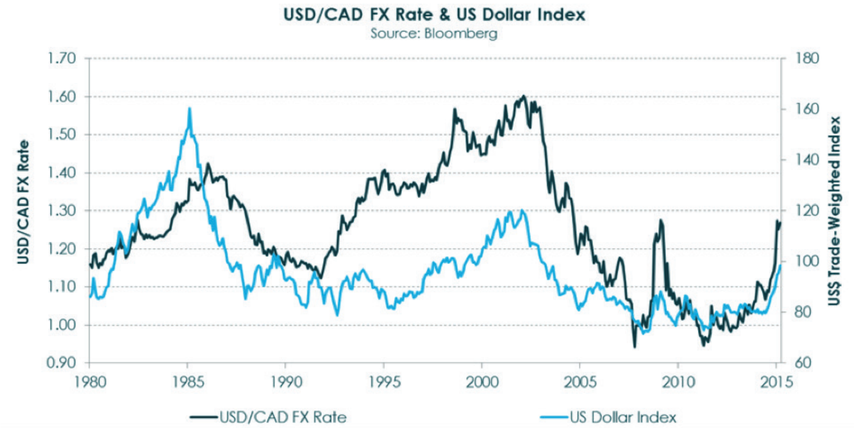
# Dispelling Common Currency Misconceptions




Since mid-2014, the U.S. Dollar has appreciated approximately 20% relative to the trade-weighted index which measures the dollar relative to other world currencies and the Canadian Dollar. The U.S. Dollar appreciation has been even larger – approximately 25% - when measured with reference to the U.S. Dollar Index ("DXY Index"). The DXY index measures the U.S. Dollar against a fixed, narrowly defined basket of currencies: The Euro, Yen, Pound Sterling, Canadian Dollar, Swedish Krona and Swiss Franc, with a significant weight given to the Euro.

The extent of U.S. Dollar appreciation, however, is not without precedent. In the late 1990s, the U.S. Dollar appreciated by approximately 50% as the U.S. economy accelerated and saw significant portfolio inflows into the technology sector in the early 2000s. The U.S. Dollar also appreciated almost 100% in the early 1980s following the aggressive monetary tightening under Federal Reserve Chair Paul Volker, which ended only with the 1985 Plaza Accord, an agreement between Germany, France, the United Kingdom, Japan and the United States to intervene and depreciate the U.S. Dollar.

This short recap on U.S. Dollar history is intended to remind investors that recent U.S. Dollar strength, although larger than we have seen in the past decade, should not be viewed as outsized relative to U.S. Dollar moves over the past century, and does not preclude further appreciation.

For Canadian-based investors, the move in the Canadian / U.S. Dollar exchange rate has been entirely driven by the U.S. Dollar component of the equation. In fact, since mid-2014, the Canadian Dollar is 6% stronger against both the Euro (Canada's 2nd largest trading partner after the United States) and 2% stronger against the Mexican Peso (one of Canada's largest export competitors). This is despite a 50% decline in oil prices which, many argue, is the primary driver for the Canadian Dollar's weakness.

# Justification For U.S. Dollar Strength

Although the extent and pace of recent U.S. dollar strength has been swift, our view is that the currency moves are largely justified and further appreciation is a distinct possibility should the U.S. economy continue to recover, and U.S. monetary policy starts to be normalized with the raising of the Federal Funds rate later this year.

There are several reasons for this. First, the U.S. economy has recovered from the Great Recession far more quickly than many other developed economies and is now leading the global economy out of a sustained period of below trend growth.

Second, the relative strength of the U.S. economy and comparative weakness globally, has prompted a marked divergence in monetary policies around the world. Nearly every major economy has eased monetary policy in the past 12 months, including Europe, Japan, China and Canada amongst others. While, in contrast, the United States has been preparing to raise interest rates. Even without interest rate hikes from the U.S. Federal Reserve, the relative size of central bank balance sheets – an alternative form of monetary easing – are expected to diverge over the coming year as Europe, Japan and other countries ramp up their asset purchase programs and expand their

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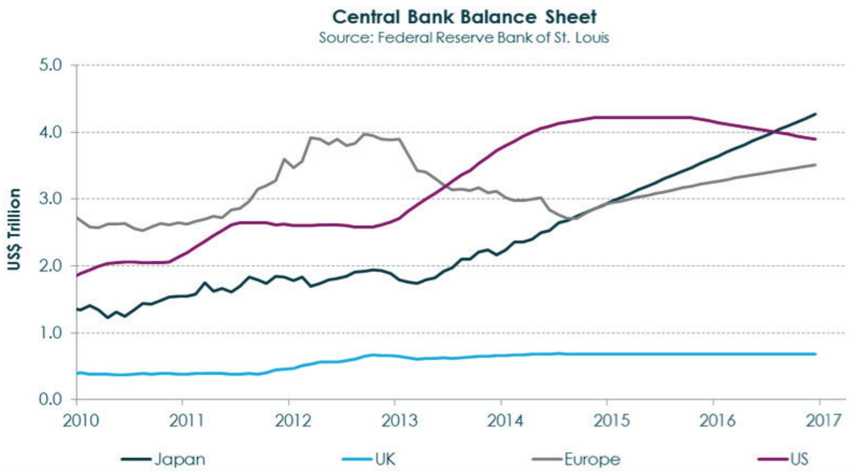


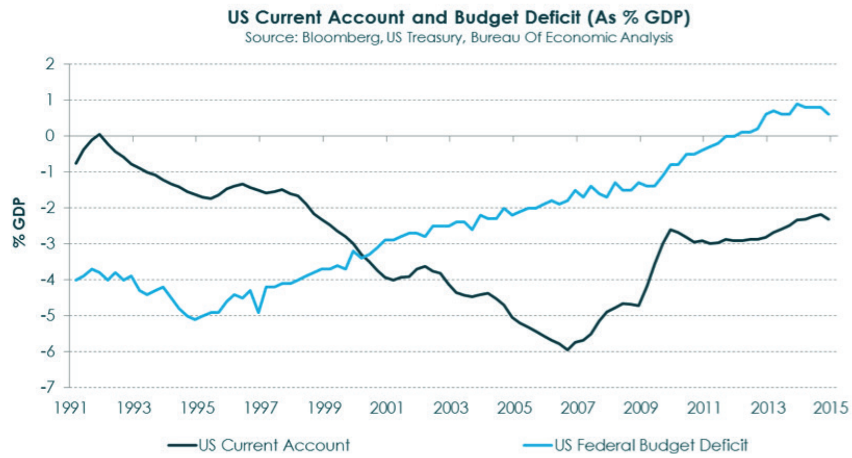


balance sheets while the Federal Reserve begins to unwind theirs.

Finally, the structural drivers behind the U.S. Dollar, the budget deficit and the current account deficit – often referred to as the U.S. "twin deficits" – have improved considerably since 2006. Political division between the U.S. house and senate, combined with an improving economy, has resulted in a significant reduction in the U.S. budget deficit. In addition, the deleveraging U.S. consumer and the U.S. energy renaissance has allowed the U.S. to scale back imports relative to exports and consequently reduce the current account deficit from a peak of 6% of GDP in 2006 to about 2% in 2014.

Nonetheless, the pace of U.S. Dollar appreciation – rather than the extent – is reason for pause. The U.S. Dollar has appreciated at an annualized pace of over 30% since mid-2014 and was realizing closer to 40% prior to the recent dovish U.S. Federal Reserve statement. This is a significantly faster pace of currency appreciation than was achieved, on average, during both the early 1980 and late 1990 periods. Desmond Lachman of the American Enterprise Institute in Washington refers to the recent ascent of the dollar as the "second fastest six-month rise in the U.S. dollar since floating began some 40 years ago"*.

*Financial Times

# Implications Of A Stronger U.S. Dollar

**A stronger U.S. Dollar can have significant repercussions for the global economy.**

One example of the impact from a stronger U.S. Dollar is on global inflationary pressures. On the positive side, a stronger U.S. Dollar results in softer import prices for the U.S. and lower inflation domestically, which in turn influences U.S. monetary policy, something that the Fed has had to more explicitly acknowledge in their most recent statement. U.S exports, however, become more expensive due to the rising currency, thereby exporting inflation to the rest of the world.

A stronger U.S. Dollar also helps export-led economies (most notably the Euro Zone and Japan) become more competitive relative to the United States. These economies have lagged the U.S. in their recovery from the financial crisis. In the long run, this will lead to a healthier and more balanced global economy.

# How Does this Impact Your Portfolio?

Currency can impact portfolio holdings and is one of several considerations in our bottom-up analysis of a business. Take the Canadian banks for example, approximately 25% of TD's earnings now come from the U.S., a higher U.S. dollar helps the translation of those earnings to Canadian dollars. A stronger dollar is also a positive for some of the insurance companies we own such as Manulife and Sunlife Financial who have diversified their businesses over the years and now have about a 50% exposure to the U.S. dollar. Cameco, another portfolio holding, is one of the world's largest uranium producers, accounting for 16% of global uranium production. Though it has mines in the U.S. and Kazakhstan, the majority of its production comes from its mine in Saskatchewan. Cameco's costs are mostly in Canadian dollars but, like most commodity producers, its sales are in U.S. dollars so it also benefits from a strong U.S. dollar. On the other hand, for large multinational U.S. companies in our portfolio like Coca Cola and Procter & Gamble, a higher dollar means a cut to the translation of its foreign revenues suggesting a considerable drag on earnings. In summary, many of your holdings are global businesses and we must factor in the impact of a rising or falling U.S. dollar in a variety of different contexts.

It is unusual for us to make decisions with regards to asset mix based on currency movements, however, one example of when we did was back in 2007. In response to the dramatic rise to par by the Canadian dollar relative to the U.S. dollar, we decided to reduce client's exposure to Canadian equities and add to their U.S. equity holdings. While the valuations of our Canadian and U.S. portfolios were quite similar, we felt that the currency changes would begin to negatively impact the Canadian economy and Canadian corporate earnings, while positively impacting those of the U.S. Recall this was a period when the U.S. dollar had been in decline since 2002 and the U.S. stock market had been unwinding the excess from the technology bubble days of the late nineties and had underperformed other markets, including the Canadian stock market. The decline in the U.S. dollar at the time only amplified the unease. In fact, most investors were looking for us to reduce their exposure to U.S. equities rather than increase it.

Clients invested in U.S. markets have had a tremendous tailwind from the rising U.S. dollar. However, outside of rebalancing portfolios to account for recent outperformance of U.S. based securities, we have no plans to shift asset mix for clients based on the recent strength in the U.S. Dollar. In fact, as previously mentioned, we feel this strength is warranted and don't see a problem with overvaluation like we did with the Canadian dollar back in 2007. For long term investors, we continue to believe in a balanced approach that allocates a part of an investor's portfolio to U.S. and International stocks, alongside their Canadian securities. Exposure to different currencies is another way to obtain added diversification in your portfolio.



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