It's All About Currencies

August 17, 2015

This year has provided little in the way of assurance for capital markets other than the assurance that volatility will persist. Stocks, bonds, commodities and currencies have experienced dramatic moves in price over the past number of months and, while there are always a variety of variables at play when determining the cause for any move in an asset's price, the common denominator found in the midst of all of the volatility of late is simply currencies. What follows is a brief explanation of the currency fluctuations we're experiencing, and what we believe it means to investors in assessing risk and making decisions about their investment allocations for the future.

We find ourselves at a unique time in economic history where the developed world economies, most notably Europe, Japan, and the United States, are struggling with growing debt burdens and aging populations. Both of these factors have economic consequences as debt represents future consumption brought into the present; the more debt you have now, the less capacity you have to consume later which ultimately reduces future growth. Demographics are critical to grasp as aging populations are less inclined to consume in aggregate, while certain portions of consumption, such as health care, might increase. The reality of debt and demographics for the developed world means that growth is harder to come by, and that there is greater temptation to encourage, and even manufacture that growth via changes in the value of one's currency. But how do currency values affect rates of growth? The answer is simply "in every way."

When a country such as the United States prints money, as we did from 2009 until Oct of 2014, the supply of dollars expands, interest rates go down, and in theory economic activity should increase. This is because our goods are now cheaper, given a cheaper dollar, and it is less expensive to borrow and invest. It is this "expansionary" monetary policy that has helped the US stock market dramatically over the past few years. When we signal a potential increase in interest rates, while the rest of the world is busy printing their own money and suppressing interest rates, as is happening in places like China, Japan and Europe, the dollar increases in value as money seeks to find a return. A dramatic rise in the value of the US dollar over the past year has been the single most significant factor affecting all asset classes.

A stronger dollar means US companies' goods are more expensive and less attractive to buyers abroad, which in turn means that a stronger dollar can hurt corporate profits. This has indeed been the refrain from corporate America in 2015. A stronger dollar can mean that the market expects interest rates to increase making current, lower-yielding bonds less attractive. This has led to increased volatility in the bond market in 2015 as fixed income investors seek to protect themselves from an eventual increase in interest rates. Finally, a stronger dollar generally means weaker commodity prices, particularly for crude oil and gold. This has indeed been the case for the past number of months as crude prices continue to languish, and gold has dropped further. The evidence is clear that currency moves, particularly in the dollar, are having dramatic impacts in the capital markets. The question remains, where do we go from here?

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The answer to this question must be informed by the most recent moves by the Chinese to devalue their "dollar", called the Yuan. The rhetoric from China states that this is in an effort to allow the currency to trade more freely, and with less constraint, but the suspicion is that it is yet another effort to prop up a slowing Chinese economy. Again, all else being equal, if the currency of a country goes down, the goods and services of that country become more attractive. This makes a cheaper Yuan highly advantageous to Chinese exporters. This event seems to underscore the idea that in a world challenged to produce meaningful economic growth, we are in a race to the bottom as central bankers around the world print and devalue in an effort to spark inflation and remain attractive in the global marketplace. If all nations are pursuing these "easy money" policies simultaneously, it is problematic to say the least.

We believe the short term path of least resistance for currencies is weakness, and that includes the US dollar, as the moves by the Chinese the past two days make it less likely in our minds that rates in the US will rise in September. This means that stocks in Japan, Europe and the US can do well in an environment of continued ultra-low interest rates. Additionally, we believe that fixed income in general can likewise do well given the lower odds of a rate increase. The fear that rates in the US will rise quickly and aggressively is excessive in our view, and should not dissuade investors who require fixed income as part of a balanced portfolio from selectively owning the asset class.

Finally, we believe it can be beneficial to own hard assets such as gold and companies that have claims on hard assets, such as energy producers, in a world awash with paper money. The greatest concern should not be "what happens if we don't get growth?" but rather "what happens if we do?" While hyper-inflation is a highly unlikely outcome, it remains to be seen how any central banks printing money ad nauseam will deal with that money beginning to circulate in the economy, and the potential inflation that could ensue. Today, the prospect for inflation is not taken seriously by most in the markets which makes the insurance for inflation, such as gold and commodities, quite cheap and potentially advantageous in guarding against such an outcome.

What is clear is that the events of today do not alter the need for clearly identifying one's investment objectives and risk tolerance. We put assets to work in accordance with those goals, and not subject to the whims of daily headlines. We invite you to contact us if you have any questions or concerns whatsoever, and we look forward to our next opportunity to see you.

Yours Most Sincerely,

CAPSTONE Investment Group, LLC

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2401 BRISTOL COURT SW, SUITE D-101, OLYMPIA, WA 98502
P: (360) 570-9888 F: (360) 528-2017 E: PS@CAPSTONEIG.NET

WWW.WISDOMANDDISCIPLINE.COM