BARROW STREET
ADVISORS

Advisor Insights

March 17, 2015

The Consequences of a **Strengthening Dollar**

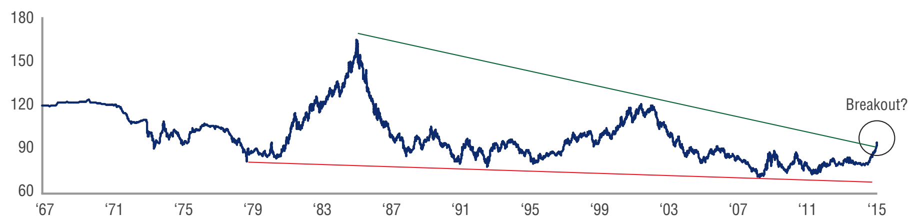
As the dollar continues to grow in strength relative to other currencies, the impact is beginning to be felt by those U.S. companies more heavily dependent on foreign revenue. While there may be benefits to a strengthening dollar, it can be a double-edged sword to investors. We believe the negative ramifications of a stronger dollar and its potential implications bear consideration when repositioning client portfolios.

"While a strong dollar is good for our fuel purchasing, it reduces the revenue we receive from international ticket sales."
- United Continental, 1/22/15

Why is the Dollar Strengthening?

Since 1985 the U.S. Dollar has been in a secular downtrend. However, in early 2014, the environment began to change, with the dollar steadily increasing in value and seemingly breaking out from its downward trajectory. We believe a number of key factors have contributed to a stronger dollar including the relative fundamental strength and value offered by the U.S. and increasing competitive devaluations from the world's other central banks.

FIGURE 1 **U.S. Dollar Breakout** (U.S. Dollar Index, January 1967 - January 2015)



Source: Bloomberg

1. *The U.S. Offers Fundamental Strength and Value*

We believe the U.S. economy provides investors a firmer foundation for the following three reasons:

Strong GDP: Relative to the Euro Zone, Japan and the rest of the developed world, U.S. GDP has outperformed, including most recently by increasing at an annual rate of 2.2% in the fourth quarter of 2014. Japan, in comparison, experienced an anemic 0.6% increase in GDP, while the Euro Zone saw a lackluster 0.3% increase for the same time period.

Attractive Relative Yields: An attractive destination for yield-starved investors on a global basis, the U.S. offers a much higher rate of interest on its government bonds even without higher perceived credit risk. The 10-year U.S. Treasury yield was 1.64%, compared with the Japanese 10-year government bond yield of 0.28%, and the German 10-year government bond yield of 0.27% as of January 31, 2015.

Improving Trade Balance: U.S. growth has been complemented by a steadily improving trade balance. As increased domestic energy production has lessened U.S. dependence on foreign oil, the resulting reduction in oil imports has tightened the dollar's global circulation, decreasing the supply of dollars.

2. ***Foreign Competitive Devaluations***

Waning Influence: In our 2014 outlook, we warned of the possibility of waning global central bank influence. So far, however, the impact of ongoing monetary policy actions remains at the forefront. With the U.S. officially ending its Quantitative Easing program, Japan and the European Central Bank have increased their programs, which has supported the dollar's strength relative to these weakening currencies.

What Does A Stronger Dollar Mean For Your Clients' Portfolios?

"We, like many other global companies, had a significant negative impact on our growth rates this quarter from the Strengthening U.S. Dollar"

– American Express 1/21/15

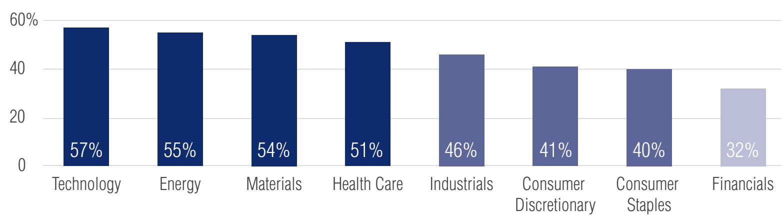
In light of these strengthening dollar dynamics, revisiting the composition of your clients' portfolios may be in order. We believe a stronger dollar translates to potential headwinds for U.S. large-cap companies, challenges for those sectors with greater dependency on foreign sales, falling commodity prices and a potential for crisis in dollar-denominated emerging market debt.

1. ***Headwinds for U.S. Large-Cap Companies***

Foreign Exposure: Historically, a strong dollar has resulted in headwinds for large U.S. companies with foreign revenue exposure. Typically, large-cap companies tend to have greater foreign revenue exposure than small- or mid-cap companies. In fact, U.S. large-cap companies, receive approximately 46% of their revenue base and 50% of their overall profit from activities outside the U.S.* In contrast, small- and mid-cap companies have less foreign revenue exposure with approximately only 20% of small-cap company revenues coming from abroad.**

Sector Matters: We believe that certain sectors will also feel the impact of the strengthening dollar, to a greater or lesser extent, depending on their foreign revenue exposure. Large-cap companies in the Technology, Energy, Materials and Healthcare sectors that typically derive over half their revenue from foreign sales may be negatively impacted by a strengthening dollar as their exports become pricier than their less expensive foreign competitors. Sectors that have a predominately U.S. centric revenue base, such as Financials, will be less impacted by a stronger dollar.

FIGURE 2 **S&P 500 Foreign Revenue as a Percentage of Total Revenue** (2013)

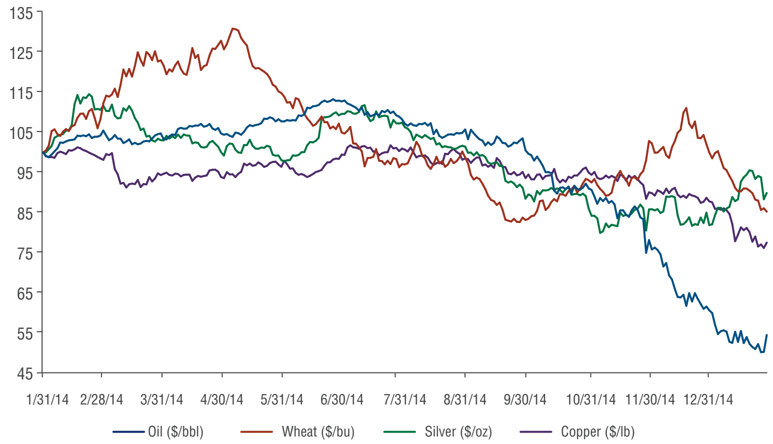


Source: Strategas Research Partners

2. *Be Cautious of Excessive Commodity Exposure*

Commodities tend to have an inverse relationship with the dollar. We suggest that investors exercise caution regarding their direct long commodity exposure or holding a larger allocation to companies that derive a meaningful percentage of their revenue base from commodity extraction or production.

FIGURE 3 **1-Year Commodity Movements**



Source: Bloomberg

3. *Tread Lightly in Emerging Markets*

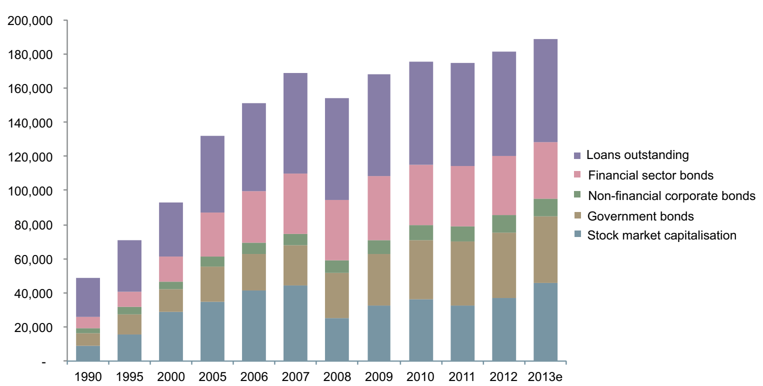
While investing in fast growing emerging markets has appeal, a stronger dollar often has negative implications for these dynamic economies. We believe that investors should consider the following three factors when allocating capital to these regions:

"The company expects that year-over-year currency translation will unfavorably impact sales"

- PPG Industries 1/15/15

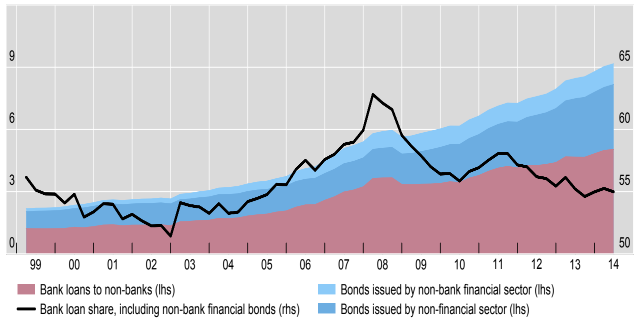
Growing Debt: During periods of low U.S. interest rates, emerging market countries, such as Brazil, Turkey, Ukraine, and Russia, tend to issue low-coupon dollar-denominated debt to fund investment in their faster growing economies. Years of easy U.S. monetary policy and Quantitative Easing has fueled a dollar-based borrowing boom in the emerging markets. As a result, emerging market financial assets in dollar terms have nearly doubled since 2008.

FIGURE 4 **Composition of Financial Assets, Emerging Markets, U.S. $ Billion**



Source: McKinsey Global Institute.

FIGURE 5 **U.S. Dollar Credit to Non-banks Outside the U.S.**
(Crossborder loans US$ billions left; Percent on right)



Source: Bank for International Settlement

"It goes without saying the strong U.S. dollar has negative impact on our international business."

-Apple
2/19/15

Borrowers Squeezed: When the dollar strengthens, repaying dollar denominated debt suddenly becomes expensive, stressing Emerging Market debtors by increasing their effective cost of funds. In addition, to the negative currency translation impact, falling commodity prices can deliver a double-whammy to those resource exporters.

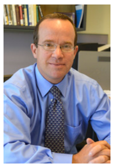
FIGURE 6 **Rising Dollar, Falling Emerging Markets**

Source: Bloomberg

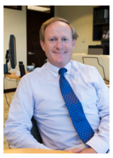
Crisis Management: Be cautious of emerging markets as they begin to unwind their massive dollar-denominated debts. Historically, unwinding dollar denominated debt of this nature has resulted in crisis. In 1998, the culmination of the credit boom in Southeast Asia led to a Russian default and the collapse of Long Term Capital Management. More recently, the Yen-funded carry trade leading up to the 2008 crisis resulted in a collapse in emerging market credit conditions and a sharp increase in the Yen.

Barrow Street Advisors Leadership

Nicholas Chermayeff
Principal
- 22 years of industry experience
- BA Harvard College



Robert F. Greenhill, Jr.
Principal
- 23 years of industry experience
- BA Harvard College
- MBA Harvard Business School



David R. Bechtel
Principal
- 23 years of industry experience
- BA Yale University
- JD Stanford Law School

About Barrow Street

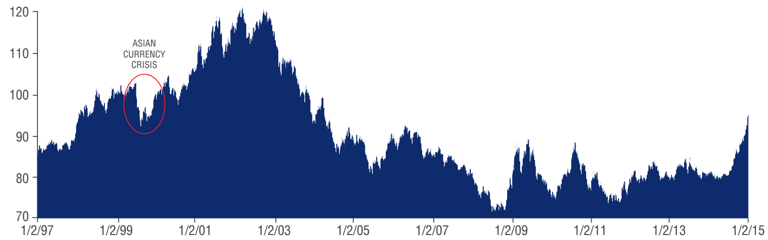
Barrow Street Advisors LLC is a registered investment advisor and is an affiliate of Barrow Street Capital LLC which is an investment management firm that manages value-oriented private and public equity strategies.

Headquartered in Stamford, CT the firm serves pension funds, sovereign funds, endowments, foundations, family offices and high net worth individuals. Since its inception, Barrow Street Advisors LLC and Barrow Street Capital LLC have invested approximately $550 million, cumulatively, of equity in private and public equity strategies.

For More Information

(203) 391-6100

FIGURE 7 **Dollar Movements 1997-2015**



Source: Mauldin Economics, Bloomberg

FIGURE 8 **Yen Movements 2005-2011**

Source: Mauldin Economics, Bloomberg

Conclusion

In this increasingly complex environment, we understand that it can be challenging to keep track of these ever-changing dynamics while anticipating the potential impact they may have on a portfolio. With the U.S. dollar strengthening we believe that large-cap companies, commodities and emerging markets could face challenges. This may present an opportunity to evaluate and re-assess your current portfolio allocation.

*Source: Mauldin Economics, large-caps as represented by the S&P 500

** Source WSJ, small-caps as represented by the Russell 2000