Asset allocation update

Cut US-dollar overweight as near-term risk/reward ratio looks less attractive

Summary

- We are reducing our US-dollar overweight in euro and Swiss-franc portfolios
- In US-dollar portfolios, we are decreasing the extent of the aggregate foreign-currency underweight by unhedging our Swiss-franc exposure
- We still believe the greenback may appreciate a bit further in 2016 before topping out
- Short-term risks stemming from weaker US economic data may undermine sentiment for the currency in the period ahead

The Investment Committee has decided to reduce the current US-dollar overweight (from +7.5 percent to +2.5 percent in euro and Swiss-franc portfolios). The remaining 2.5 percent overweight reflects the recently purchased gold exposure. At the same time, we unhedge our Swiss-franc exposure in the US-dollar portfolio.

Since the spring of 2014, the US-dollar has rallied from 1.40 to a level of just below 1.10 to the euro. We believe that the greenback is in the final stage of appreciation versus the European and the Swiss currencies. According to our main economic scenario, this year’s expected three interest-rate increases in the United States will propel the US dollar towards 1.02 to the euro and 1.08 to the Swiss franc in 2016. However, sluggish US manufacturing poses short-term risks for the greenback.

“Only moderate” dollar upside seen …

We continue to anticipate US GDP economic growth to hit around 2.5 percent this year and headline inflation to gradually rise to 1.6 percent in 2016 and 2.5 percent in 2017. In such a scenario, we believe the U.S. Federal Reserve (Fed) will lift interest rates in three steps by a cumulated 75 basis points this year. Given the widening gap between the monetary policies in the euro zone and the US, we expect the dollar to rise towards 1.02 to the euro and 1.08 to the Swiss franc in 2016. The greenback’s potential to move beyond these marks seems limited except in the unlikely event of breakup of the European Monetary Union. A level below parity to the euro would indicate that the dollar is extremely overvalued.

... amid short-term risks

The overall outlook for the US economy remains solid with the labour market close to full employment and robust economic data coming from the consumer and services sector. The manufacturing sector, though, has been in a downward trend in the past few months and may continue to struggle given that the ISM manufacturing new orders index remains below a level of 50. The recent reading of the regional New York Empire new orders index was particularly bleak, pointing to further downside risk (see chart 1).

The sector’s overall significance to the US economy has significantly decreased over the past decade. Nevertheless, weak ISM manufacturing new orders data (especially readings below 50) have regularly dragged the dollar lower – which is why US manufacturing plays an important role in our currency “Scorecard” – an in-house tool designed to compare asset classes. Moreover, we see the possibility of the Fed deferring the next interest-rate hike to summer amid the dampening effect of the recent drop in the oil price on inflation.
Further potential disappointing US manufacturing data in combination with a significant overhang of speculative long positions in the US dollar (see chart 2) mean that the risk/reward ratio of a US-dollar overweight looks less attractive at this point.

Chart 1: Downward trend in US manufacturing

Chart 2: Investors are clearly “dollar-long”

Changes to our model portfolios

USD portfolio: Reduce our foreign-currency underweight from -10 to -7 percent by unhedging 3 percent of Swiss-franc exposure

EUR portfolio: Reduce our US-dollar overweight from 7.5 to 2.5 percent

CHF portfolio: Reduce our US-dollar overweight from 7.5 to 2.5 percent

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