

WHAT A STRONG U.S. DOLLAR MEANS FOR CANADIAN INVESTORS

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EXECUTIVE SUMMARY

The U.S. dollar has been on its longest consecutive rally in nearly two decades. It began to rise relative to other major currencies after hitting a record low in August 2011. There are likely two reasons for this new strength. First, the U.S. economy is now growing faster than most other developed countries. Secondly, the Federal Reserve appears closer to making a long-anticipated interest rate increase, possibly ahead of other central banks around the world, many of which continue to cut rates in an effort to stimulate their lackluster economies. If this happens, the resulting interest rate differential could spur additional demand for the U.S. dollar.

What does a stronger U.S. dollar mean for Canadian investors? We believe it can provide an opportunity to enhance returns by selectively holding certain U.S. dollar-denominated assets. In this paper, we examine the types of investments that stand to benefit most from a stronger U.S. dollar.

THE U.S. DOLLAR'S RISE

1.1 The U.S. Dollar Index

The U.S. Dollar Index measures the dollar's performance against a basket of other major currencies, including the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc. After falling to its lowest point in late 2011, it began to climb again, rising above its 2006 levels in the longest consecutive run in 17 years.

With U.S. dollar cycles historically tending to last between six and 10 years, the current uptrend could persist for some time.

The U.S. dollar has experienced two bull runs since the Bretton Woods system dissolved in 1971. The first was triggered by a high U.S. interest rate policy in the 1980s designed to control inflation. The second started in the mid-1990s when U.S. information technology firms began to attract large global investment flows. These previous two bull runs saw rallies of 56% and 39%, respectively.

SINCE LATE 2011 THE U.S. DOLLAR HAS STRENGTHENED AGAINST MOST OTHER MAJOR GLOBAL CURRENCIES



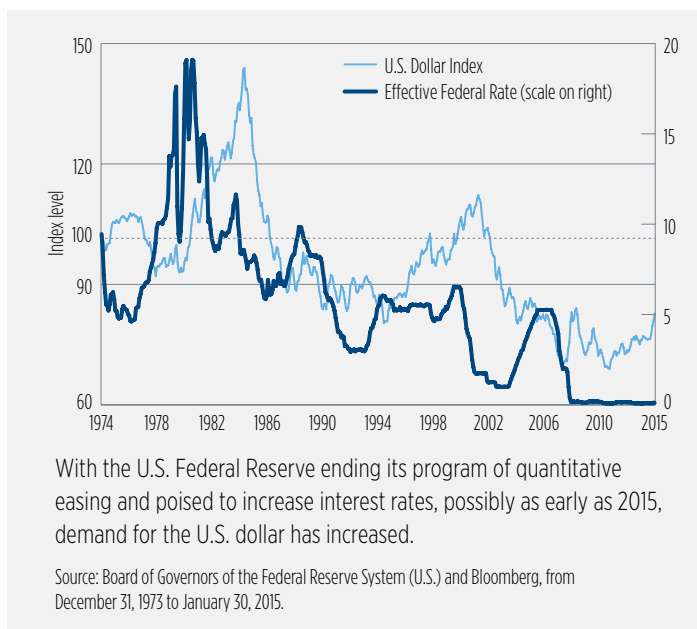
Source: Bloomberg, from December 31, 1973, to January 30, 2015.

1.2 Why is the U.S. Dollar Rising?

Investors around the world tend to gravitate to countries with faster growing economies, higher interest rates, or safer financial systems. As they invest in those countries, they have to buy their currencies, driving up their value in the process.

It has been more than six years since the 2008 financial crisis and the U.S. economy is once again showing signs of strengthening. While still lagging behind expectations, it is now in better shape than most other advanced countries. It is expanding at its fastest pace in more than a decade, and U.S. unemployment has dropped below 6% and its 50-year average.

Moreover, the Federal Reserve has ended its program of quantitative easing (its rapid expansion of the money supply, intended to stimulate economic activity). With inflation under control, the Fed now seems ready to raise interest rates, possibly as early as 2015. The near-zero rates of recent years, which have driven investors to look outside the United States for higher-yielding assets, could be about to reverse course.

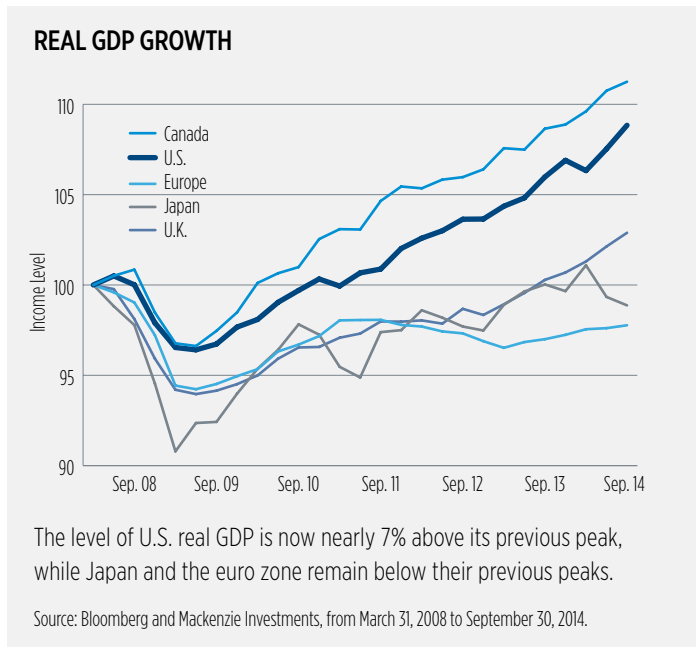


As a result, global investment flows have turned back to the United States. This is increasing demand for the U.S. dollar, the world's primary reserve currency, and lifting its value to the highest level since the Great Recession.

Meanwhile, other major currencies around the world remain weak. The euro, the largest single component in the U.S. dollar index, slumped against the dollar in the second half of 2014. The euro zone continues to struggle, with its unemployment rate above 11% and GDP growth in 2014 below 1%. This has caused the European Central Bank (ECB) to drive interest rates close to zero. As the ECB embarks on a new round of monetary easing, which could widen yield differentials and make U.S. debt more attractive than European debt, the euro could fall further against the U.S. dollar.

Japan's economy, meanwhile, is still sluggish and has experienced only one quarter of real GDP growth above 2% in the past five years. The Bank of Japan's unprecedented quantitative easing has led to a worrisome government debt-to-GDP ratio that is well above 200%. Investment flows to emerging markets have slowed somewhat in a flight to quality caused by ongoing concerns over shaky economic and financial conditions overseas.

Moreover, the Canadian dollar drifted lower in January 2015 after the Bank of Canada announced a surprise quarter-point cut in its key short-term lending rate, intended to offset the negative impact of falling oil prices on the Canadian economy.



THE IMPACT OF A STRONGER U.S. DOLLAR

2.1 U.S. Economy

A stronger U.S. dollar has many advantages for the U.S. economy. For one, it allows the government to pay down the national deficit, making U.S. debt more attractive to foreign investors. In 2014 this contributed to the largest annual rally in U.S. government debt in three years.

The dollar's rise also gives Americans more buying power, translating into cheaper imported goods and oil, which helps to keep consumer inflation in check. Crude oil prices have fallen significantly over the past year while the dollar has risen. That translates into a lower price for gasoline, which increases the real disposable income of the average American household. Less pressure on consumer inflation could help to delay (or at least slow the pace of) the Fed's long-anticipated interest rate hikes.

On the other hand, strength in the U.S. dollar can weigh on U.S. firms that export goods and services, or that generate a large portion of their revenues abroad. American exports become more expensive for consumers in countries whose currencies have depreciated relative to the U.S. dollar. As a result, foreign consumers tend to buy fewer American products. A strong U.S. dollar thus impacts the U.S. foreign trade deficit. It tips the balance negatively by reducing U.S. exports while increasing cheaper imports from other countries.

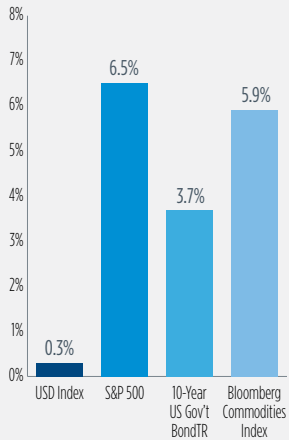
2.2 Canadian Economy

A weaker Canadian dollar can be beneficial for Canadian firms that source sales in the U.S. dollar but incur their costs in local currency. Generally, a weaker Canadian dollar boosts Canadian exports.

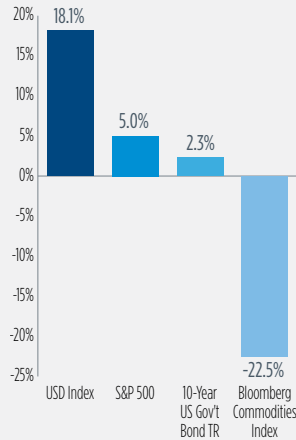
However, Canada is a major resource exporting country. A strengthening U.S. dollar hurts global commodity prices that are denominated in U.S.

dollars. When the value of the U.S. dollar increases, it takes fewer U.S. dollars to purchase these commodities and their prices tend to come down in the global marketplace. This is a disadvantage for the Canadian currency as well as for the Canadian economy. A large portion of corporate revenues and jobs in Canada depend, directly or indirectly, on resources such as oil and gold. The recent fall in oil prices, for example, has “significantly dampened the outlook for firms tied to the energy sector” (Bank of Canada, *Business Outlook Survey – Winter 2014-2015*).

JANUARY TO JUNE 2014



JULY TO DECEMBER 2014



Strength in the U.S. dollar typically has an adverse effect on commodity prices.

Falling commodity prices drag on the Canadian economy as a large portion of jobs and corporate revenues depend, directly or indirectly, on resources such as oil and gold.

Source: Bloomberg, from December 31, 2013, to December 31, 2014.

INVESTMENT OPPORTUNITIES

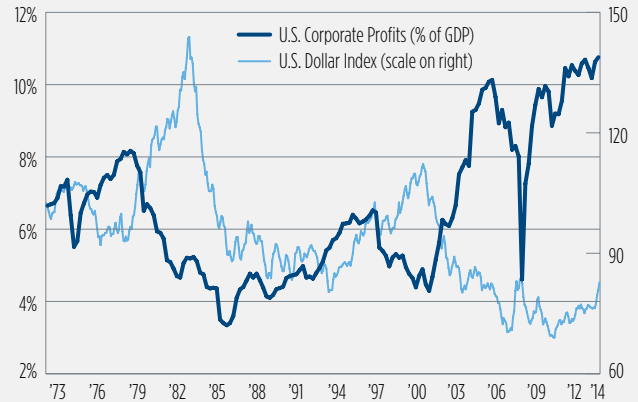
3.1 U.S. Equities

Historically, a strong U.S. dollar has been good for the U.S. economy. While a rising dollar can hinder U.S. export competitiveness, its impact on the equity market tends to be far less than many people assume. Currency fluctuations are just one of the factors affecting the U.S. stock market, but they are not as important as more fundamental economic factors, such as trends in corporate profitability and interest rate levels.

Many analysts anticipate that U.S. equity markets will continue their general upward trend as long as the U.S. economy slowly but surely becomes more robust. Corporate profits are now at a record high in the United States, the unemployment rate has fallen below its 50-year average and consumers have largely deleveraged, which all bode well for a sustained U.S. economic recovery. Moreover, a strengthening U.S. dollar helps to increase foreign demand for U.S. dollar-denominated assets, including U.S. equities.

What does all this mean for Canadian equity investors? It means that there are possible advantages to maintaining U.S. equity exposure in a portfolio, but only if investors buy U.S. companies selectively.

U.S. CORPORATE PROFITS AS A % OF GDP



Historically, a strong U.S. dollar has been good for the U.S. economy. Today, corporate profits are at record highs in the U.S.

Source: Federal Reserve Bank of St. Louis, from October 31, 1973, to March 31, 2014.

American companies that conduct a majority of their business domestically stand to benefit most from a rising U.S. dollar. Such companies sell their products and services into an economy that is now strengthening relative to many others around the world. They also sell in U.S. dollars, which makes them no more expensive for domestic consumers to buy even though the dollar is rising. In some cases, these companies import their products or components, and these imports become cheaper with a rising dollar. Moreover, such companies are largely untouched by the foreign-exchange risk that multinational companies face when repatriating profits from sales overseas.

U.S. companies with these characteristics can be found in sectors like Utilities, Consumer Staples, Healthcare and Telecommunications. An example would be Costco, which operates an international chain of membership warehouses that carry quality, brand name merchandise at substantially lower prices than are typically found at conventional wholesale or retail sources. Costco derives 71% of its revenue in the United States and benefits from cheaper imports made possible by a stronger U.S. dollar. While Costco is a large-cap company, investors might consider looking also amongst mid- and smaller-cap companies, which, on average, tend to generate more of their revenues at home than larger-cap companies. An example would be Spectranetics, a firm that develops and manufactures single-use medical devices used in minimally invasive procedures within the cardiovascular system. Its sales in the United States account for 82% of its revenues.

While the dollar's strength signals improving economic conditions in the United States, it is also a disadvantage for some companies. Especially affected are those companies headquartered in the United States that derive a large portion of their revenues from overseas operations where currencies are weakening. Not only does a rising U.S. dollar make their exports costlier and less competitive overseas, but currency losses can weigh on their profits. Large U.S.-domiciled multinational companies, such as Coca-Cola and Nike, which conduct sizable business abroad, end up suffering when they convert their foreign earnings back into a higher U.S. dollar.

Oracle and IBM are two such companies that both reported significant currency losses in 2014 due to a strong U.S. dollar. As a result, they have

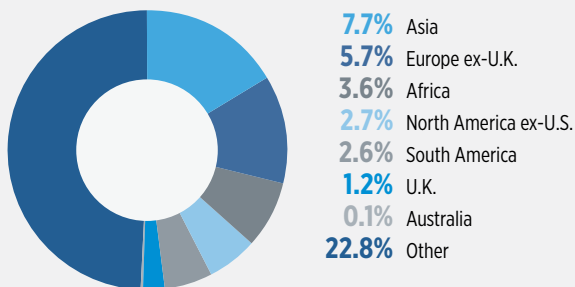
had to revise their 2015 profit projections downward. Oracle, for example, said that without the impact of the U.S. dollar strengthening relative to foreign currencies, its reported total revenues for fiscal 2015 Q2 would have been up 7% rather than only 3%.

Another example is Mondelez International, Inc., one of the world's largest snacks companies and the maker of Oreo cookies and Cadbury chocolate, which reported lower earnings in the last quarter of 2014 as a result of the rising U.S. dollar. Mondelez generates 80% of its revenue in foreign markets whose currencies have fallen relative to the dollar.

Some U.S. companies can also see their market position eroded in other countries by a strong U.S. dollar. General Motors, for example, had to temporarily halt delivery of vehicles to its Russian dealers because the ruble declined so precipitously against the U.S. dollar in 2014.

S&P 500 companies do not hedge a significant portion of their foreign earnings. The S&P 500 companies that provide details on foreign sales reported in 2013 that 46.3% of all sales were produced outside of the United States, with companies in the Information Technology sector registering the highest level at 56.6%.

S&P 500 FOREIGN SALES AS A PERCENTAGE OF TOTAL SALES – BY REGION (2013)



S&P 500 FOREIGN SALES AS A PERCENTAGE OF TOTAL SALES – ANNUAL BREAKDOWN

2013	2012	2011	2010	2009	2008
46.3%	46.6%	46.1%	46.3%	46.6%	47.9%
2007	2006	2005	2004	2003	
45.8%	43.6%	43.3%	43.8%	41.8%	

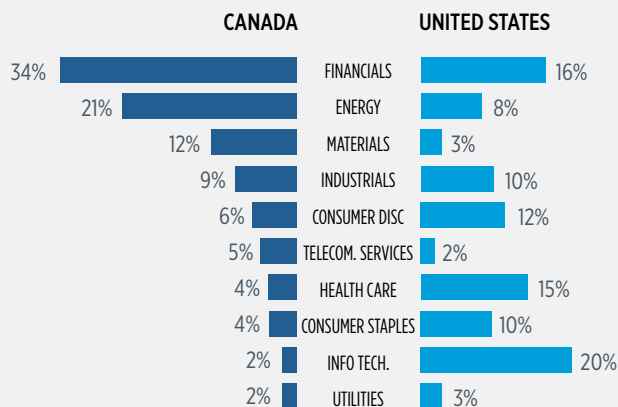
Source: S&P Dow Jones Indices LLC, S&P 500® 2013: Global Sales Year in Review. Data as of July 31, 2014.

3.2 Diversification Benefits

For Canadian investors, U.S. assets can be an effective diversification tool. In times when the U.S. dollar strengthens, Canadian investors will see their returns enhanced beyond whatever their underlying assets are returning when converted back into Canadian dollars. While it is very difficult to forecast the direction of the exchange rate, it is sensible to diversify a long-term portfolio's currency exposure to carry it through different market conditions with reduced volatility.

Another advantage to investing in U.S. equity markets is the opportunity for greater sector diversification. The Canadian market is dominated by just a few economic sectors, with 33% of large, publically traded companies concentrated in Energy and Basic Materials. These sectors tend to weaken with strength in the U.S. dollar. U.S. equity markets have more companies spread across the various

industry sectors, particularly those sectors under-represented in Canada, such as Information Technology, Consumer Discretionary and Health Care. For example, in the United States there are 335 listed companies in Information Technology alone, but only seven in Canada. Also, U.S. stocks are generally more widely spread out over the capitalization spectrum, from small to medium and large cap companies.



Exposure only to Canadian stocks could lead to currency risk as well as concentration risk, since over 70% of the Canadian equity market is in only three sectors: Financials, Energy and Materials.

Source: Standard and Poor's, as at January 30, 2015. Canada is represented by the S&P/TSX Composite Index; U.S. is represented by the S&P 500 Index.

CONCLUSION

Exposure to a strengthening U.S. dollar can have benefits for long-term Canadian investors. It can offer an opportunity to enhance returns and diversify their currency exposure. With the U.S. economy slowly but surely recovering and corporate profits in the United States generally at record highs, Canadian investors might want to consider U.S. stocks, at least on a selective basis. The U.S. companies that stand to benefit most from a strong U.S. dollar include those that generate a large portion of their earnings domestically.

While it is very difficult for investors to "time the market" on exchange rate movements, it is prudent to diversify a portfolio's currency exposure to reduce the impact of short-term movements in one currency against another. And while an improving U.S. economy and the prospect of higher interest rates suggest continuing strength in the U.S. dollar into the foreseeable future, Canadian investors should keep in mind that the tide will not continue rising forever.

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