A.G. BISSET ASSOCIATES LLC

THE 15-YEAR DOLLAR CYCLE: WHAT DRIVES IT?

SYNOPSIS

A new 15-year cycle began in the dollar in January 2017. As the cycle unfolds into 2024, the dollar's coming decline will have a massive impact on investors and their net worth.

In the past three cycles, the dollar fell for an average of 8 years and its declines averaged 53% against the euro. That is equal to the euro rising 114% against the dollar.

Rising from $1.05 at the start of 2017, the euro may peak near $2.00 in 2024.

This paper explains why the dollar will fall sharply and what the forces are that drive its 15-year cycle and cause it to repeat.

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Winner "Currency Manager of the Year" in 2001, 2003, 2008 and 2010
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Registered Investment Advisor

Bisset's Approach

Our approach to research and currency management differs from that of other investment firms. With over 35 years of experience, we have seen and learned a lot.

At Bisset, we use the dollar as a lens to assess how trends will unfold in the dollar and in other markets since the dollar's value is the most important price of all prices. The dollar impacts the price of commodities and all other asset classes while its long-term cyclical trends cause investors, consumers, companies, and governments to change their investment and buying behaviors as the dollar becomes cheap or expensive.

The excess of the central banks in recent years has caused the world to be awash in dollars. Whether you are long dollars in a non-dollar based portfolio or use dollars to purchase goods or invest globally, you face serious risks in the coming years.

This paper discusses why the dollar will fall and what the forces are that drive its 15-year cycle and cause it to repeat. It concludes with a discussion of strategies that you can implement to protect investments and to preserve the global purchasing power of your assets.

We also discuss several aspects of this risky environment and show why it is urgent to address these risks now. Investors need to implement a strategic plan to avoid losses and to benefit from the dollar's coming large decline. It has become an urgent issue.

Dollar's 15-Year Cycle

A new 15-year cycle began in the dollar in January 2017. As this cycle unfolds into 2024, the dollar's coming decline will have a massive impact on investors and their net worth since the cycle can be projected to be as large as the prior three 15-year cycles.

In those cycles, the dollar fell for an average of 8 years and its declines averaged 53% against the euro. That's equal to the euro rising 114% against the dollar (Chart 1). The DM, which preceded the euro, rose 110% against the dollar in the first cycle; 145% in the second cycle, and the euro then rose 87% against the dollar in the third cycle.

Most investors are not aware of the 15-year cycle in the dollar and are not prepared for the massive impact the dollar's large decline will have on their investments and net worth in the next few years.

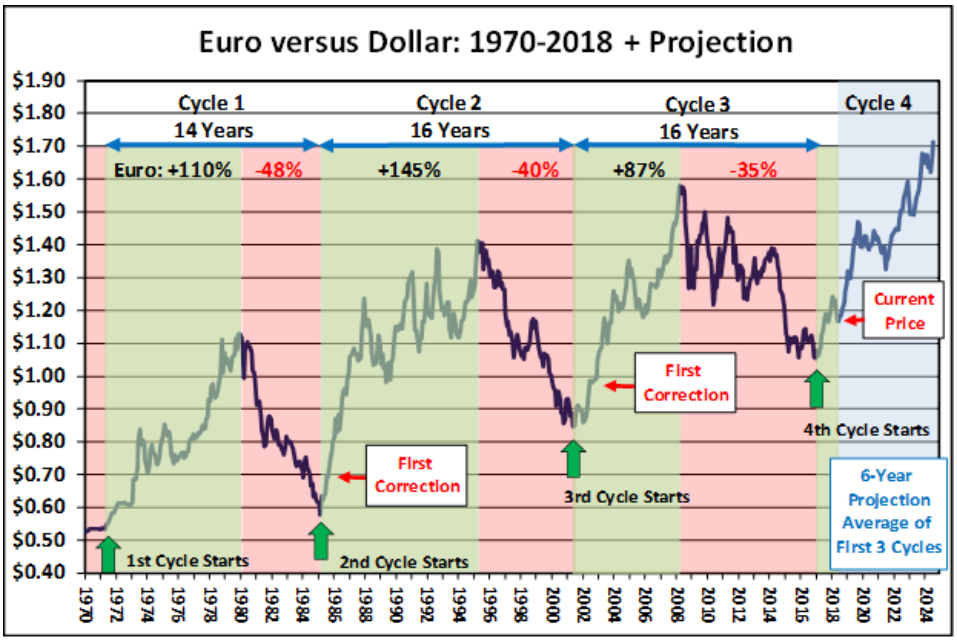

CHART 1: Three 15-year cycles have unfolded in the dollar in 1971-2016.

"Rising from $1.05 at the start of 2017, the euro may peak near $2.00 in 2024."

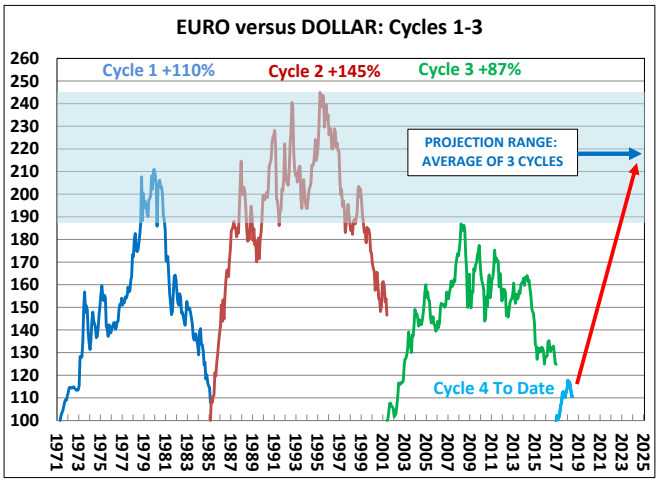

CHART 2: Three 15-year cycles have unfolded in the dollar.

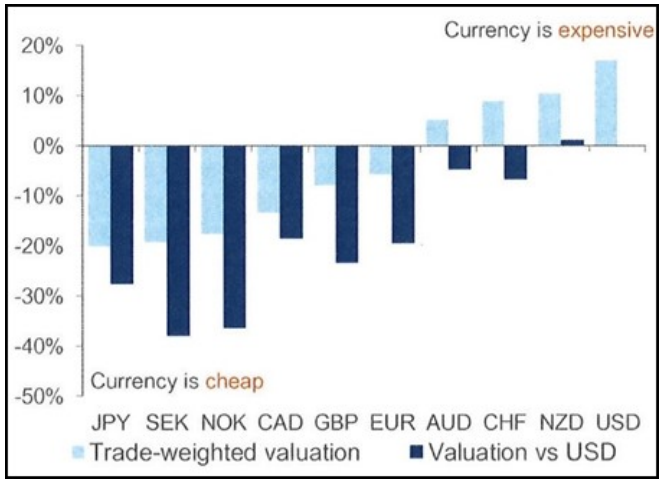

CHART 4: Purchasing Power Valuations 1Q 2018 (Citibank).

Cycles Exist and Repeat

Investors learning about the cycle are initially skeptical and doubt that it exists and that it is as large as it is. However, it became clear in 2017 that three 15-year cycles had completed over the past 45 years. The euro had started to rise from $1.05 and 16 years had passed since the prior cycle started in 2001.

It should not be a surprise that cycles exist and repeat in the dollar. Investors accept the business cycle and they recognize that cycles exist and repeat in interest rates, equities, and many economic variables such as unemployment. These cycles are driven by economic fundamentals and investor behavior that cause the cycles to repeat. Those that drive the dollar include purchasing power parity, mean reversion, and global commodity production.

A new cycle has just begun as shown in Chart 2, in which the start of each cycle is indexed at 100. The cycle that began in 2017 can be projected to peak in the area shaded blue. Rising from $1.05 at the start of 2017, it means the euro could peak near $2.00 in 2024.

Dollar is Overvalued

Currencies repeatedly become over and undervalued when measured by purchasing power parity against the dollar. As they become expensive or cheap, investors, companies and governments change their behavior to profit from and to counter the effects of high and low valuations, just as they change how they behave when interest rates rise and fall cyclically. Purchasing power parity is like a P/E for equities. When it is high, it is time to sell. When it is low, it is time to buy.

The euro was cheap and undervalued against the dollar on a purchasing power parity basis when new 15-year cycles started in 1985, 2001 and 2017 (Chart 3). It was overvalued when the cycles peaked in the 1990s and

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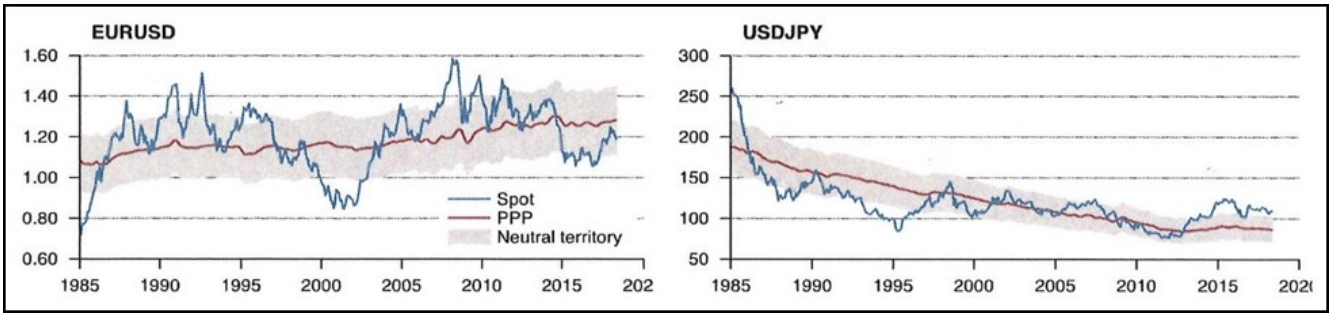

CHART 3: Currencies become cheap and expensive on a purchasing power parity basis as the cycle unfolds. (Source: FX Monthly.)

in 2008. It has been the same for the Japanese yen and other currencies. **A rising currency typically overshoots its fair value to a point that causes the cycle to peak. They will likely do so again.**

Today's undervaluation of the euro, sterling and the yen against the dollar (Chart 4) indicates that the 15-year cycle that started in 2017 will continue to unfold. These currencies must now rise significantly to eliminate their large under-valuation and to become expensive and over-valued. This process will take several years. The current 15-year cycle can therefore be projected to be similarly large as the prior three cycles.

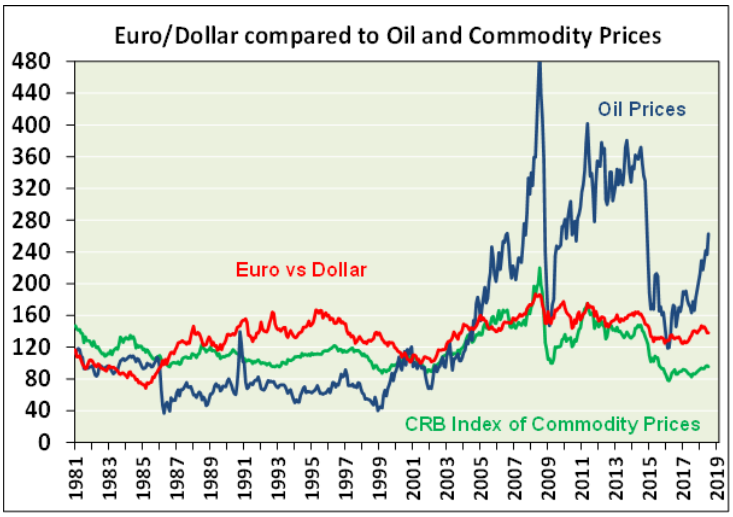

CHART 5: Trends in the euro/dollar and in commodity prices.

Mean Reversion is Powerful

Mean reversion is a strong and persistent force in the financial markets. It exists and persists because investors seek cheap assets to buy and expensive assets to sell. It is true for currencies as well.

When a currency becomes cheap or expensive, investors, consumers, companies and governments begin to change their behavior. Their actions eventually initiate a turn in the cycle and reversion toward the mean begins. Since purchasing power parity has stood the test of time and mean reversion is a recurring and powerful force, both will continue to drive the dollar's 15-year cycle. Simply put, a cork pushed under water will rise to the surface and pop above it.

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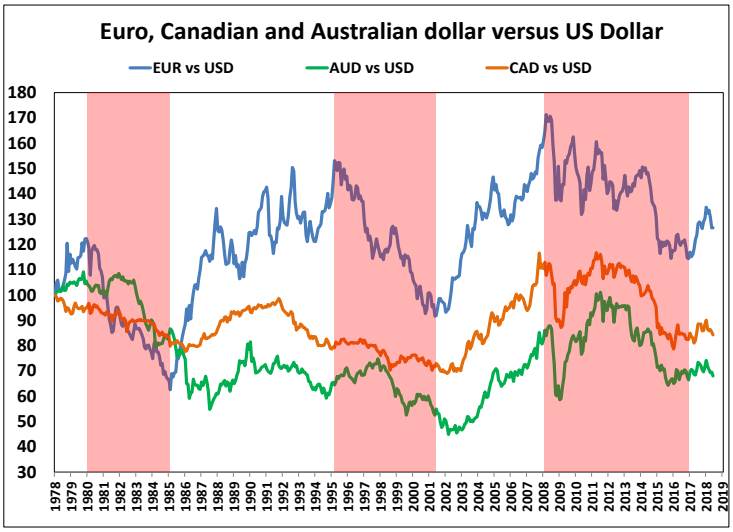

CHART 6: Trends in the Euro, Canadian & Australian dollars.

Short-Term Obscures Big Picture

The daily flow of economic statistics and politics impact currencies; they create trends that unfold over a few days or several months and that can be large from time to time. However, these fluctuations have little influence on mean reversion. Once a cycle has turned and a currency that is cheap has started to rise, its initial purchasing power valuation will determine the duration of the long-term cyclical trend.

Short-term trends are important for traders, but less so for investors. Investors need a strategic plan that will protect assets and their net worth against large losses and that can help them profit from the seldom seen opportunity that the start of a new 15-year cycle represents. Too much focus on short-term currency trends distracts and causes investors to overlook the Big Picture and miss opportunities.

For example, in the past three years, investors have expected that each hike in U.S. interest rates would drive the dollar higher. It has not. As interest rates rose from 0% in 2015 to near 2% in 2018, the dollar fell and currencies rose. The euro moved from $1.05 in January 2017 to $1.25 in the first half of 2018. The euro began to rise because it was cheap.

Currencies and Commodities

Trends in commodity and oil prices have correlated strongly with trends in the euro against the dollar in the past 45 years. The correlation was particularly strong in Cycle 3 and has remained strong (Chart 5). It proves there is a strong connection between cycles in the dollar and in commodities.

It also demonstrates that the currency cycle is driven by the global economy and global forces that a single government has limited powers to change. Billions of people around the world working to better their lives cause economic growth that generates an increasing demand for commodities and energy.

Terms-of-trade measures relative export prices over import prices and links the dollar to trends in oil and commodities since they are traded in dollars. As oil and commodity prices rise on increased demand, commodity exporting countries receive more dollars, as do sovereign wealth funds. They sell dollars for other currencies to import goods from around the world while wealth funds sell dollars to diversify their investments globally. As commodity prices and oil prices rise, foreign currencies rise with them.

Commodity prices are also pushed up as the dollar falls to compensate for its weakness. It adds cyclical downward pressure on the dollar. As commodity and oil prices rise, producers invest in more production. It takes time to develop these new sources but when they come on stream, supply is increased, prices stabilize and then begin to fall; the commodity and dollar cycles peak and go into reverse.

The dollar's close link to the commodity cycle is also evidenced by a high correlation between trends in the euro against the dollar and price trends in "commodity-driven" currencies like the Australian and Canadian dollars (Chart 6).

Risky Investment Climate

The dollar's multi-year decline that began in 2017 has a long way to go. **The investment climate has become even more risky since the dollar's decline will have a larger impact on investment portfolios in this cycle than in the prior three.**

When the first 15-year cycle began in the dollar in 1971, institutional investors had not diversified globally. Diversification began in the second dollar cycle (1985-2001) when U.S. pension funds achieved portfolio allocations in excess of 10%. In the third cycle (2001-2016), investors worldwide diversified aggressively.

Institutions and most family offices now have investments outside their home currency that often exceeded one third of their assets. When the dollar falls in this cycle it will therefore have a proportionally much larger impact on returns and the net worth of investors.

The euro rose rapidly in the first three years of each of the past cycles (Chart 2). When a new major trend begins, investors first see it as a correction. However, as the new trend becomes recognized, more and more investors begin to adjust their behavior to profit from or to avoid the losses it creates. Their actions accelerate the trend and prices begin to move rapidly. As investors know, equity prices move up fast when a new bull market starts. It's the same for currencies.

"The investment climate has become very risky. The dollar's decline will have a much larger impact on investment portfolios in this cycle than in the prior three."

The start of the new cycle in 2017, the cycle's long duration, and the coming acceleration of the trend, coupled with the high level of investment assets diversified globally, have made the investment climate for the coming two to three years particularly risky.

In past cycles, when investors outside the U.S. had a lower exposure to the dollar, they could absorb large losses when it fell. That's no longer true. A euro-based investor who holds a third or more of its assets in dollar-denominated investments cannot afford to be idle as the dollar falls 40% to 50% over the next few years. They will begin to reduce allocations and increasingly hedge the dollar. That will add additional downward pressure on the dollar as it falls.

Some dollar-based investors hedge their currency exposure continuously. As currencies rise, these hedges will have losses that must be paid. As payments grow, these investors will begin to close their hedging programs to stem the outflow of cash.

When allocations were small, as in the past, passive hedging losses could be tolerated. But not today when allocations are 30% and in the billions of dollars. These terminations will add to the demand for currencies and the downward pressure on the dollar.

Dollar's Impact on Investments

At A.G. Bisset Associates we have developed a currency strategy that is cycle-based and designed to benefit from the unfolding of the 15-year cycle.

Dollar-based investors with investments in foreign equities, fixed income and other assets will gain when currencies rise. In an environment of still historically low interest rates, it has become favorable to increase the exposure to rising currencies to capture gains. Bisset's Cycle-Based Currency Strategy is designed to harvest currency gains as the dollar falls while allowing investors to keep investment allocations unchanged.

Dollar-based investors have currency risk that is hidden and needs to be mitigated. Their allocations to foreign assets will be beneficial. However, the global purchasing power of their dollar-based assets will shrink as the dollar falls. Family offices will wish to counter this loss to maintain their global purchasing power by increasing the exposure to rising currencies. Bisset's Cycle-Based Currency Strategy can assist investors to achieve this important objective.

Euro-based investors, and investors based in other currencies, will see increasing currency losses as the 15-year cycle unfolds and the dollar drops. In 2008 to 2016 the rising dollar boosted U.S. equity returns when measured in euro. That is no longer the case. The coming large drop in the dollar will reduce and even erase underlying equity returns in the years ahead.

Investors with dollar-denominated fixed income will see the value drop dramatically when the dollar declines against the euro. Treasuries are no longer a safe investment but one that will cause portfolio losses. Bisset's Active Currency Hedging Program can assist investors in mitigating currency losses as the dollar falls.

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Dollar and euro-based investors who wish to use currency as an "asset class" can invest with Bisset's Cycle-Based Currency Program, designed to harvest gains when currencies rise against the dollar. Using currency forward contracts, the return can be added on top of underlying portfolio returns to compensate for low returns associated with fixed income investments.

Strategic Decisions

Global investors have become excessively exposed to dollar-denominated assets. Allocations to U.S. assets have been driven higher by the superior performance of U.S. equities and bond yields that are higher than those in Europe and Asia. As the 15-year cycle unfolds and the dollar falls, these investors will begin to reduce allocations down to or below their benchmarks. They will also increase their hedging of the dollar. All of this will add to the downward pressure on the dollar.

"Dollar-based investors have a currency risk that is hidden. Investors need to mitigate this risk."

The behavior of investors will be driven by the unfolding of the 15-year cycle as the dollar falls steeply. This behavior is not incorporated in economic forecasting models. As a result, currency forecast made by banks and economists are unreliable and too short-term in their horizons to assist investors. They must make difficult but critically necessary strategic decisions about the dollar to profit from and to avoid losses from the falling dollar as the 15-year currency cycle unfolds.

Cycle-Based Currency Program

Bisset's Cycle-Based Currency Strategy has three key components that are combined to optimally harvest returns when currencies rise and decline cyclically.

The components are Bisset's research on cycles and trends, Bisset's systematic trend-following models and Bisset's disciplined and systematic risk management consistently applied.

The Cycle-Based Strategy is not an ordinary currency program. It is designed to optimally harvest returns from the cycle as it unfolds. Currency positions are aligned with where we are in the 15-year cycle. **This is where Bisset's research and strategy separates us from other currency managers.**

Our objective is to assist investors like you in making better strategic currency decisions and to help you avoid losses and to increase your returns.

We look forward to discuss the currency cycle with you and how we can help.