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THE DOVE, THE FED AND THE TANKER

Since the Federal Reserve raised its borrowing rate by 25 basis points (bps) this past December, the U.S. dollar keeps dropping to lower and lower levels relative to other currencies. The tanking dollar is the exact opposite of the predictions of economists' models. Here's what most economists say: if rates are higher and rising in the U.S. versus Japan, people want U.S. bonds, so they sell yen to buy dollars. This should push up the value of the dollar versus the yen. In fact, the opposite has occurred.

As April trading came to a close, the greenback continued its months-long downward trek versus the euro, the yen, the Australian dollar and most other currencies. In response, broad sentiment for the dollar is deteriorating as market players increasingly recognize the strength of the trend, even if they can't explain it. Regardless of your views on interest rate differentials, the U.S. Federal Reserve, or the U.S. economy, the weakness in the dollar is undeniable.

Looking more closely, the Japanese yen has surged more than 10% in 2016, reaching a fresh 18-month high this week, despite the negative interest rate policy (NIRP) environment in the Land of the Rising Sun. Again, economists say the lower (negative) interest rates should weaken the yen relative to the dollar; yet again, this has not been the case.

One reason may be that while Europe and Japan race for lower and lower interest rates, the data on the American economy released last Thursday shows that growth here is even more listless than had been expected. Housing figures, while mixed, have mostly muffed expectations. Consumer confidence, while at good levels, has turned to the downside. As Warren Buffett quipped, the American economy "is certainly not accelerating....(but) it's not declining." Adding to the picture, the U.S. Federal Reserve's recent press conference offered little color for investors, left the door open for a rate hike, but failed to give insight into a date for that hike. Many, including ourselves, expect another worthless meeting in June.

Interestingly, this confluence of events is creating opportunity. Financial markets are like a water bed: push down on one part and another part goes up.

Since bottoming in January, emerging market debt has staged one of its largest rallies in years with external debt up over 7% and local debt stacking up a 15% gain.[1] In our view, the largest driver of the rally is a dovish Federal Reserve that keeps getting more dovish; keeping a lid on rates in the U.S. is one of the most fundamental reasons for the strong global debt markets. The aggressively easy money and a falling dollar have combined to put money into the beat-up emerging debt category.

Pessimism toward emerging markets reached levels last seen during the global financial crisis. This proved a buying opportunity for value investors who believed that the markets were moderating, but not collapsing. These buyers started an upward trend for emerging market debt. Now, even the biggest naysayers in emerging markets debt are slowly throwing in the towel, pushing emerging markets stocks, bonds and currencies to further gains.

As we wrote last month, some of our best ideas right now are in the emerging markets bond space. Spreads widened to over 500 basis points, well above historical averages. Even through spreads have recently narrowed, boosting prices of these bonds, we still see room to run. Emerging markets bonds can be volatile, but pay a substantially higher yield than developed bonds with the same exact credit rating. The higher yield offered in emerging markets debt means investors need to hold the bonds for shorter time periods to neutralize for volatility.

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April 29, 2016

[1] Countries outside of the U.S. can issue debt in dollars, called external debt, or in their own currency, called local currency debt.

7311-NLD-5/4/2016