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QUARTERLY

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# THE FED AND THE VALUE OF A DOLLAR

## Introduction

The lackluster US economic recovery and expansion since the end of the latest financial crisis is well documented and largely undisputed. In an effort to improve the economic and financial conditions in the United States, the Federal Reserve Bank (the Fed) has implemented policies that are more accommodative than any in US history. These policies include keeping short-term interest rates near zero for multiple years and pushing down long-term interest rates through large-scale purchases of government bonds and mortgage backed securities. Many investors fear that the Fed's aggressive policies will have the effect of devaluing the US Dollar and ultimately lead to much higher inflation.

In this *Quarterly*, we discuss the broad objectives of the Fed and the impact that monetary policies have on the value of the US Dollar. We also examine the effects that foreign exchange rates have on the domestic economy, and review our framework for estimating the fair value of the Dollar versus other currencies.

## Monetary Policy Objectives

Although the Fed monitors foreign currency markets and has an interest in how exchange rates impact the US economy, official policies relating to the Dollar actually fall under the jurisdiction of the Department of the Treasury. The Fed's primary policy objectives are focused on maintaining price stability and maximizing long-term employment within the United States.

Although their policy objectives remain the same, in recent years the Fed has become much more transparent in their communication of the rationale behind policy decisions and how these decisions are likely to evolve over time. To some extent, this communication serves as a policy tool in-and-of itself because guiding market expectations of inflation and short-term interest rates can influence both consumer behavior and longer-term interest rates. Transparency

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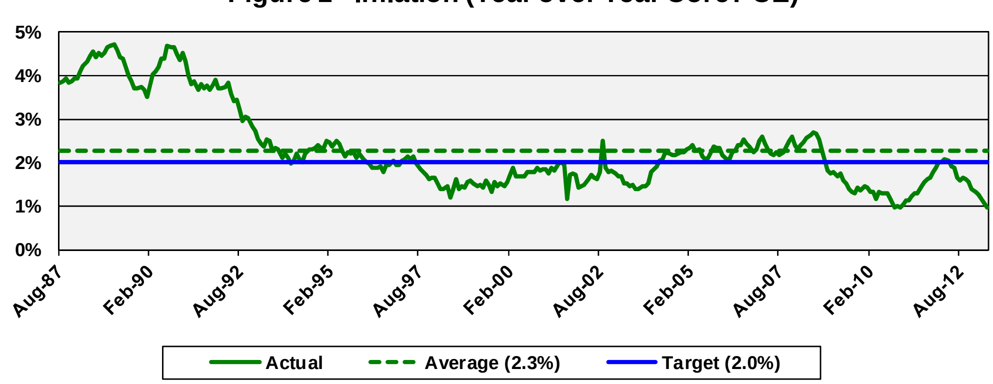
**"THIS LOW LEVEL OF INFLATION IS ONE JUSTIFICATION FOR THE FED'S CURRENT ACCOMODATIVE POLICIES"**

**Figure 1 - Inflation (Year over Year Core PCE)**




Sources: Bureau of Labor Statistics, Stairway Partners

## CURRENT TOPIC

***The Fed and the Value of a Dollar***

- *Introduction*
- *Monetary Policy Objectives*
- *The Dollar and the Economy*
- *Currency Valuation*
- *Conclusion*

***Strategy***

- *We reduced our exposure to US equity markets to neutral on the last trading day of the first quarter.*
- *Portfolios remain overweight foreign equity exposure and underweight investment grade bond exposure.*

***This publication takes the place of the Monthly newsletter that was discontinued after February of this year.***

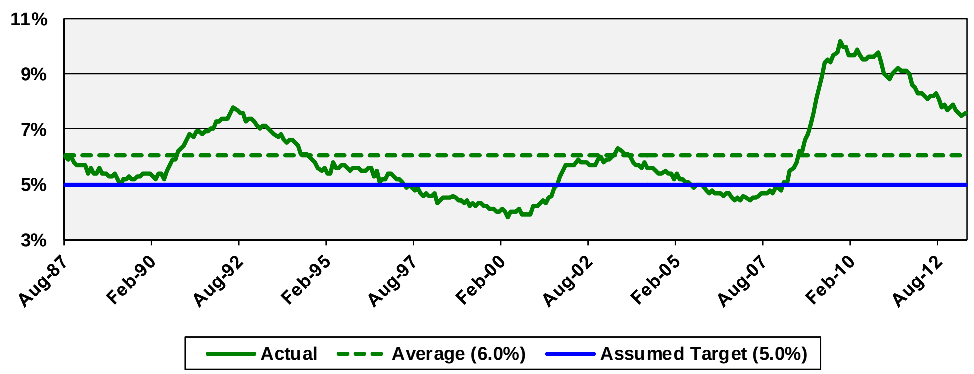
# THE FED AND THE VALUE OF A DOLLAR - CONT'D

also allows the Fed to demonstrate to US citizens and global investors that their actions are in alignment with their stated policy objectives.

Like the European Central Bank, the Bank of England, and the Bank of Japan, the Fed has communicated a desired target of 2% for the broad rate of inflation. Figure 1 shows that the Fed's preferred inflation measure (the annual change in core prices for Personal Consumption Expenditures) is currently well below this 2% target. This low level of current inflation is one justification for the Fed's current accommodative policies.

The second policy justification relates to the health of the broad labor market. Figure 2 shows the Unemployment Rate, which the Fed uses as a gauge for the unused labor capacity in the United States. Although the Fed has not been as explicit about their exact target for the Unemployment Rate, we believe that they strive for a rate between 5% and the historical average of roughly 6%. This range is consistent with most economists' estimates of the Non-Accelerating Inflation Rate of Unemployment (NAIRU), which represents the level at which the maximum number of people will be employed without resulting in a rising rate of inflation. Although the employment situation has improved from the depths of the last recession, the current level of unemployment in the US, like current inflation, also justifies accommodative monetary policies.

**Figure 2 - Unemployment Rate**




### The Dollar and the Economy

Dollar exchange rates profoundly impacts the US economy because they effectively determine the relative value at which goods and services are traded with the rest of the world. The importance of trade to the overall economy can be seen in the total value of US imports and exports. On an annualized basis over the past eight quarters, the US produced roughly $15.5 trillion of goods and services, as measured by Gross Domestic Product (GDP). On an annualized basis over that period, we exported $2.2 trillion (14% of GDP) of American goods and services, and imported $2.7 trillion (17% of GDP) worth of foreign goods and services.

All other things being equal, an inexpensive currency makes a country's exports more attractive to foreign buyers and foreign imports less attractive to domestic consumers. As a result, a weaker currency will tend to boost economic growth. Unfortunately, the same weaker currency will increase the prices of imported goods, which is by definition inflationary. We believe that the best way to determine the impact that the US Dollar has on overall economic activity is through an analysis of its purchasing power relative to other currencies. This requires measuring the general level of prices between countries, which can be difficult due to the diversity of the goods and services that make up various domestic economies.

*The Economist* magazine publishes a rather light-hearted measure of currency value known as the "Big Mac Index". As the name implies, it is based on the price of a McDonald's Big Mac

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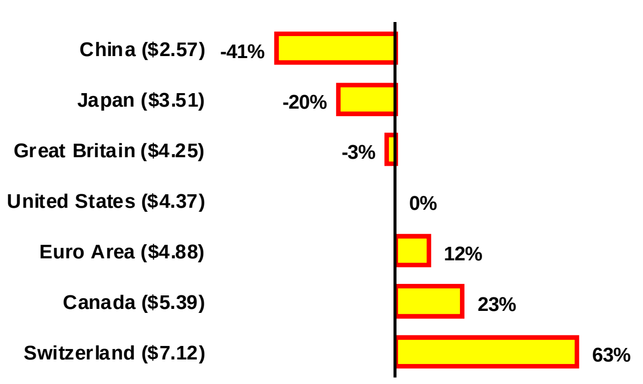
**Figure 3 - Big Mac Currency Index**




Sources: Bureau of Labor Statistics, *The Economist*, Stairway Partners

## About Stairway Partners, LLC

*Stairway Partners was formed to provide ourselves and our clients with an effective and comprehensive solution for managing wealth, over the long-term. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.*

*Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. All of our portfolios utilize customized investment policies to align portfolio objectives with our investment strategy utilizing the global capital markets.*

*(Continued from page 2)*

sandwich in various countries converted back into US Dollar terms. The index is widely quoted due to its simplicity and the fact that a Big Mac may actually be a reasonable representation of a broader basket of goods. After all, delivering a Big Mac to diners requires a multitude of raw material and labor inputs. The index values shown in Figure 3 indicate that the US Dollar is relatively cheap versus the currencies of some countries such as Switzerland and Canada, but expensive versus the currencies of other countries such as China and Japan. Taken together, these index values do not seem to indicate that the Dollar has been broadly devalued.

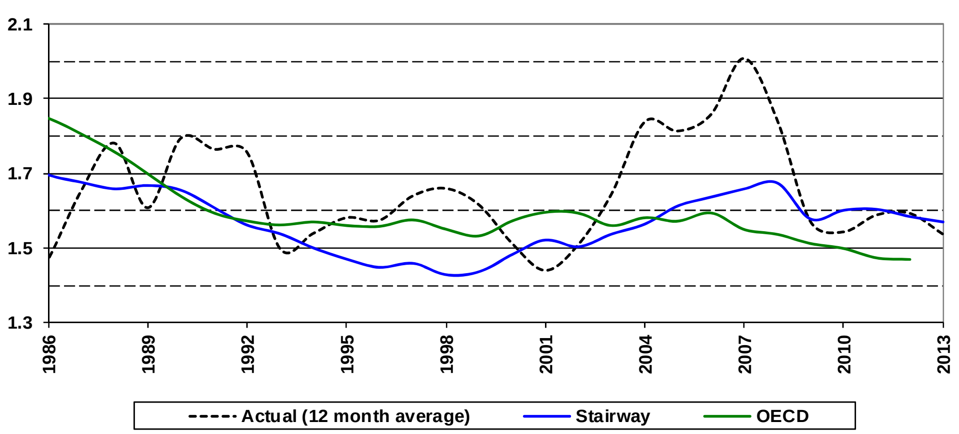
### Currency Valuation

Like the Big Mac Index, the Stairway Partners' currency valuation model is based on the concept of Purchasing Power Parity (PPP). Unlike the Big Mac Index, our model uses a broad basket of goods and services as a gauge of relative inflation. The concept behind all PPP models is that in the long run exchange rate movements are driven by relative price changes between countries. The currencies of countries with relatively high inflation should weaken against the currencies of countries with lower inflation. Although PPP models have a poor track record for predicting short-term currency movements, we believe that they are very useful for identifying longer-term trends in foreign exchange markets. As an example, Figure 4 illustrates how our model and the Organization for Economic Co-operation and Development's (OECD) PPP model compare to the actual movement of the British Pound's exchange rate versus the US Dollar. The figure shows that over time, actual exchange rates have reverted back to levels that are consistent with those implied by relative price movements. The results are similar for all of the currencies that we track versus the US Dollar. Because inflation has not accelerated in the US and current exchange rates do not meaningfully deviate from fundamental PPP indicators such as these, we believe that there is little evidence that Fed policies are negatively impacting the value of the Dollar.

### Conclusion

The magnitude and duration of the Fed's accommodative policies have caused many investors to question the Fed's motives and the potentially negative effects of their actions. Specifically, there is a fear that inflation and a loss of investor confidence will undermine the long-term value of the Dollar. On the contrary, we believe that the Fed's actions can be fully explained by relatively weak domestic labor conditions and extraordinarily low current inflation. Independent of our analysis of specific Fed policies, we look to fundamentally based PPP models to estimate the value of the US Dollar relative to other major currencies. These models do not show any compelling evidence that the value of the Dollar is being materially distorted by central bank policy here or abroad.

**Figure 4 - British Pound Sterling ($/£) Exchange Rate History**




Sources: The Organization for Economic Co-operation and Development, Bloomberg, Stairway Partners

## 3 Year Annualized Return Estimates for Global Markets

| 7/30/2013 | Total Returns | | | After-Tax Total Returns | | |
|---|---|---|---|---|---|---|
| | Expected | Hurdle | Excess | Expected | Hurdle | Excess |
| **Equities** | | | | | | |
| **United States** | **2.7%** | **4.5%** | **-1.8%** | **2.1%** | **4.2%** | **-2.1%** |
| **Large & Mid Cap** | **3.3%** | **4.4%** | **-1.1%** | **2.5%** | **4.1%** | **-1.6%** |
| Growth | 3.4% | 4.7% | -1.3% | 2.6% | 4.3% | -1.8% |
| Value | 3.2% | 4.2% | -1.0% | 2.5% | 3.9% | -1.4% |
| **Small Cap** | **-1.1%** | **5.1%** | **-6.2%** | **-0.8%** | **4.8%** | **-5.6%** |
| Growth | -2.1% | 5.6% | -7.6% | -1.6% | 5.2% | -6.8% |
| Value | -0.2% | 4.7% | -4.8% | -0.1% | 4.3% | -4.5% |
| **Foreign Developed Markets** | **13.1%** | **5.0%** | **8.2%** | **10.0%** | **4.6%** | **5.4%** |
| EMU | 20.3% | 5.3% | 15.0% | 15.5% | 5.0% | 10.5% |
| UK | 20.7% | 5.3% | 15.5% | 15.7% | 4.9% | 10.8% |
| Japan | 1.3% | 5.4% | -4.1% | 1.0% | 5.1% | -4.0% |
| Canada | -1.7% | 4.7% | -6.5% | -1.3% | 4.4% | -5.7% |
| **Emerging Markets** | **24.5%** | **6.2%** | **18.3%** | **18.3%** | **5.9%** | **12.4%** |
| **Fixed Income** | | | | | | |
| **US Aggregate** | **-1.0%** | **2.5%** | **-3.5%** | **-1.4%** | **2.2%** | **-3.5%** |
| **US Treasuries** | | | | | | |
| 2 Year | -0.2% | 1.3% | -1.5% | -0.6% | 0.9% | -1.5% |
| 5 Year | -2.2% | 1.7% | -3.9% | -2.1% | 1.4% | -3.6% |
| 10 Year | -3.6% | 2.3% | -5.9% | -3.3% | 1.9% | -5.2% |
| 30 Year | -5.4% | 2.4% | -7.8% | -4.6% | 2.1% | -6.7% |
| **TIPS** | | | | | | |
| 5 Year | -1.5% | 1.8% | -3.3% | -1.6% | 1.5% | -3.1% |
| 10 Year | -3.3% | 2.3% | -5.6% | -3.1% | 2.0% | -5.0% |
| 30 Year | -8.5% | 2.6% | -11.1% | -6.8% | 2.3% | -9.1% |
| **Municipal** | **2.0%** | **1.8%** | **0.2%** | **2.3%** | **1.5%** | **0.9%** |
| 2 Year | 0.1% | 1.2% | -1.0% | 0.5% | 0.8% | -0.3% |
| 5 Year | -0.9% | 1.5% | -2.4% | -0.1% | 1.2% | -1.3% |
| 10 Year | -0.1% | 1.9% | -2.1% | 0.8% | 1.6% | -0.9% |
| 20 Year | 4.9% | 2.1% | 2.8% | 4.8% | 1.8% | 3.0% |
| **High Yield** | **0.1%** | **3.4%** | **-3.3%** | **-1.1%** | **3.0%** | **-4.2%** |
| High Quality High Yield | 0.4% | 2.6% | -2.2% | -0.8% | 2.2% | -3.0% |
| **Emerging Market ($ demonimnated)** | **-0.1%** | **3.6%** | **-3.7%** | **-1.1%** | **3.3%** | **-4.4%** |
| **Foreign Aggregate** | **-2.5%** | **3.9%** | **-6.4%** | **-2.3%** | **3.6%** | **-5.8%** |
| Foreign Aggregate (hedged) | -2.9% | 2.2% | -5.0% | -2.5% | 1.9% | -4.3% |
| **Foreign Treasury** | **-2.1%** | **3.4%** | **-5.5%** | **-1.9%** | **3.1%** | **-5.0%** |
| Foreign Treasury (hedged) | -3.1% | 1.8% | -4.9% | -2.5% | 1.4% | -3.9% |
| **Cash** | **0.9%** | **0.9%** | **0.0%** | **0.6%** | **0.6%** | **0.0%** |
| **Foreign Currency (versus US$)** | | | | | | |
| Euro | -2.9% | 2.3% | -5.2% | | | |
| British Pound | 0.0% | 2.2% | -2.2% | | | |
| Japanese Yen | 5.0% | 2.4% | 2.6% | | | |
| Canadian Dollar | -0.5% | 1.4% | -2.0% | | | |

Notes
1. Foreign market returns assume US dollar as the base currency and are unhedged unless otherwise indicated.
2. All hurdle returns are based on long-term asset volatility. Equity and fixed income hurdle rates include expected cash returns.
3. After-tax total returns assume that all gains and losses are long-term and realized within the investment horizon.
4. After-tax total returns only take into account Federal taxes based on the following tax rates:
    • 43.4% Ordinary Income, 23.8% Qualified Income, 0% Exempt Income, and 23.8% Capital Gains/(Losses)