GLOBAL MARKETS

The waning appeal of the US dollar

INVESTMENT CONCLUSION

The dollar's multi-year bull run might last a couple more months but its fundamental underpinnings are weakening. President Trump's unpredictability accounts for a lot, but fundamentals are shifting elsewhere and currency crosses are always a game of relatives. We think we're nearing a major turning point in currency markets.

The equity story is similar; they have further to run but not much. Current euphoria needs to be supported by fundamentals and we doubt that will be the case. The one trend that looks well entrenched is in bond markets. The reflationary backdrop continues to gain traction and the 'risks' that now surround these are equally inflationary. Bond yields will continue to rise.

ANALYSIS

The risks of holding large currency positions are growing. We may even be at a turning point for our longest and greatest US dollar call (which we first recommended back in December 2013) and its counterparties of short euro and yen. Our confidence in being short bonds is now much greater than for currencies.

In *The trouble with Trump*, 19 January 2017, we took issue with the notion that US protectionist measures (tariffs, or some form of border tax) would be good for the US dollar. Sure, they "improve" the US trade account and would heft inflation. So the Fed must tighten more. But Fed tightening (more than other central banks) is a tired story — even if the market still lags the dots.

Moreover, if the Fed were to use balance sheet shrinkage more than policy rates as a tightening tool, the impact on long-term rates would be greater than on the dollar. The reason is that the US dollar is more sensitive to short-term than long interest rates. By shrinking its balance sheet, the Fed would be selling long-term bonds it owns to mop up money, raising long-end rates, which of course will affect the mortgage market and housing, but less so the US dollar.

Protectionism may hurt the US capital account more than it helps the US trade account. On the capital account, there is risk of damage to the US dollar from second-order effects — principally retaliation by China, which could include reducing its USD1trn holdings of US Treasuries or a myriad of anti-US corporate measures in China. And that's before confrontation about the South China Sea kicks in.

Economically, the yen should be weak against the US dollar. After all, the BoJ is locking in a yawning yield gap by pegging 10-year JGB yields at around 0% and controlling the yield curve. But if things deteriorate between China and the US — geopolitically in the South China Sea or with a trade war — the Japanese will take their money home and the yen would be strong. It would also benefit from perceived "safe-haven" status.

Then there's the euro. The ECB is done easing. The ECB targets headline inflation adjusted for transient effects. Headline CPI is likely to end the year closer to the ECB's 2% target than anyone thinks. As important, the Germans want no more of this QE thing for a good reason; their inflation rates are ramping up. Indeed, Germany headline inflation was at its highest in 41 months in December and core hit a 20-month high. The European economy is doing fine and the German economy is on fire. The ECB's persistent reluctance to buy bonds below the deposit rate (despite granting itself permission to do so) means it will still have trouble buying the volume of bonds it needs in 2017. Rather than change the allocations under the capital key, it will declare victory in achieving its mandate and stop QE.

The domino theory of populism may be about to fail the reality test too (Table 1). Italy dodged a banking crisis bullet and a failed referendum almost unscathed. And the Constitutional Court has ruled out a referendum on most of Renzi's labour market reforms. It also seems early elections are less likely after the Constitutional Court ruled out some aspects of the electoral reform law (Italicum). Although the "majority premium" for the party that gets 40% or more of the vote (which would give it 55% of the seats)

2017 European political calendar

January	February	March	April	May	June
31st - UK Article 50 bill to be submitted to parliament	12th - **German Presidential election**	2nd - Northern Ireland Assembly election 15th - Dutch general election	23rd - **France Presidential election first round**	4th - UK local elections 7th - **French Presidential second round**	11th & 18th - **French Legislative elections**
July	**August**	**September**	**October**	**November**	**December**
7-8th - G20		**German parliamentary election** (between 27th August and 22nd October) 11th - Norway parliamentary election	Czech legislative elections (expected)		

Table 1. *Source: Independent Strategy*

was upheld, the idea that there could be a second round run-off if no party hit that marker was deemed unconstitutional. No party is close to gaining 40% of the popular vote, so this effectively consigns Italy to more weak government. And this ruling has made it harder for the populist Five Star Movement to get to power. Given that the economy is also doing a bit better, the decision plays vaguely into the hands of the government and might even provide Renzi with a platform to get his job back.

France looks very likely to give the populists (the awful Marine Le Pen and her Front National) a bloody nose. She could even fail to make the second round of the presidential election, which could well turn out to be the classic run-off between the traditional right and left.

If that were to happen, it would be helpful to Merkel in her own federal election in the autumn. This is much more likely to end up in a weak and messy Merkel-led coalition rather than a populist (AfD) upset.

In Holland, Geert Wilders' far-right (PVV) will become the largest party but will still fall well short of the number of seats to get a majority in parliament. And none of the other 11 or so parties that will end up in the legislature will have anything to do with them.

So beyond 2017, the populist shoe will have failed to fall in Europe (at least for a while). Together with an EU economy doing better and an ECB done with easing, that could change perceptions of the euro a lot. Equities would also benefit and bonds suffer.

Current real effective exchange rates (standard deviations from 10-year average)

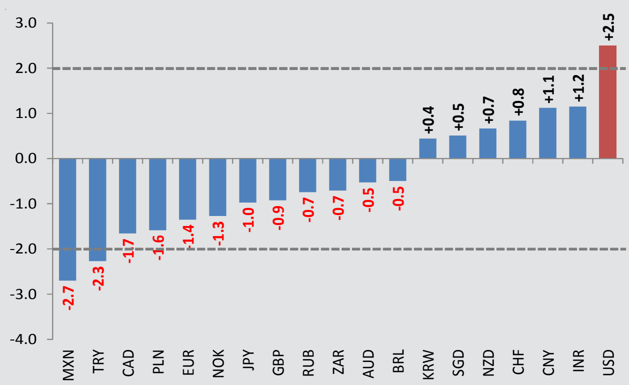

Figure 1. *Source: BIS, Independent Strategy*

The market effect would be amplified if this coincided with Trump damaging the dollar in the global arena, or failing to deliver fiscally all the good news anticipated by US equity investors.

All that would matter less if the US dollar were cheap. But it is not (Figure 1). Sure, there are things out there which could push it to a greater extreme — like profit repatriation. The flow effect of this is largely psychological given that most 'profits' retained are already denominated in dollars. Where the risk is real is for equities, because the proceeds will be used for buybacks and M&A, so altering supply and demand. There could also be a knee-jerk reaction in the dollar to protectionism or a border tax.

But the US administration doesn't want a super-strong currency and may act to prevent it. And given the maverick nature of the President, he is as likely to act in ways that weaken the currency rather than strengthen it. So even if you believe all this makes the US dollar just mark time, the risks of holding long US dollar positions are growing. That means holding less of them. Trying to time Trump's temper is harder than it sounds. The US dollar could have a few months more to run if no-one pokes him. But we are strategists not market timers and the writing about the ultimate outcome is on the wall.

The same can't be said for short bond positions. Almost all the policy measures proposed by Trump will boost inflation. Protectionism, border taxes, fiscal deficit spending in a full employment economy and disrupting efficient global supply chains all act in this way. And, of course, the President's antagonistic and unpredictable foreign policy agenda has the potential to make the US look much less of a safe-haven for capital flows to the world's largest international debtor!

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