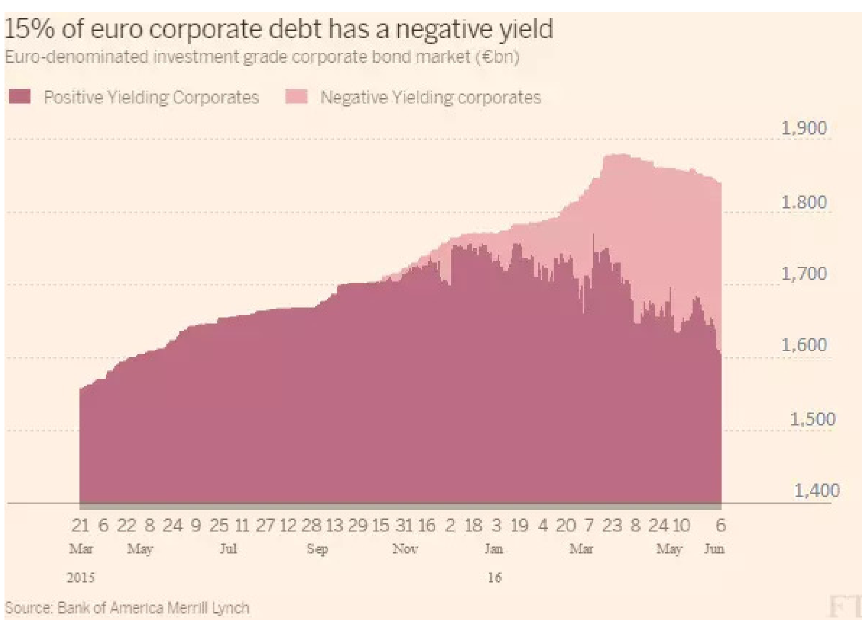
DOLLAR DOLDRUMS

The author is a Partner at Pureheart Capital. Opinions expressed are personal.

The language used is intentionally colorful because the world already has more than enough bloodless annual reports to wallow in. Those objecting need to get out in the sun more often.

WELL BEGUN IS HALF DONE

The last time we put pen to paper was exactly a year back, to make the case for a bottom in the commodities cycle and a peak in the bond bull market. Things played out nicely, with Brexit ushering in the final blow-off top in the bond markets and the "black swan" of Trump election accelerating its decline. Now, the jury is out on if it was A top or THE top. For us old-fashioned capitalistic Neanderthals, negative yielding corporate paper was a bridge too far. We could not get on with the new meme of "bonds for capital gains and stocks for the yield". Hence we dug in our heels and remain firmly in the latter camp.



Source: Financial Times

Trump election was no black swan. We were banging the table for Trump victory many moons before the election. Having been unwillingly dragged through many an electoral dog-and-pony-show as a part of growing up in the world's biggest, noisiest democracy, you can't help but develop a knack for identifying political momentum. And as the old saying goes: Momentum maketh electoral mandates.

So it was clear to us that while Hillary supporters were busy virtue-signaling and screaming into echo-chambers, Trump MAGA rallies were attracting committed followers, many of whom *incurred the wrath of their near and dear ones*. Hence, when rubber met the road, it soon became clear that no one was with her.

We happily note that Democracy has finally been exposed as an Extreme Realty TV fad. We are all for C-CPAN reincarnated as a pay-per-view free-for-all WWE style. We find it amusingly ironic that, in the midst of the post-election risk melt-up orgasm, the recent Reality TV Star-in-Chief was being compared to the previous Greatest President, Movie Star-in-Chief. But worry not dear readers, evidence is overwhelming that the latest iteration of the revolution will also be extinguished by the swamp. And the only certainty is that the Vox Populi will to crush the individual voices, and more civil liberties will be sacrificed for "greater good", as has been our tradition for some time now.

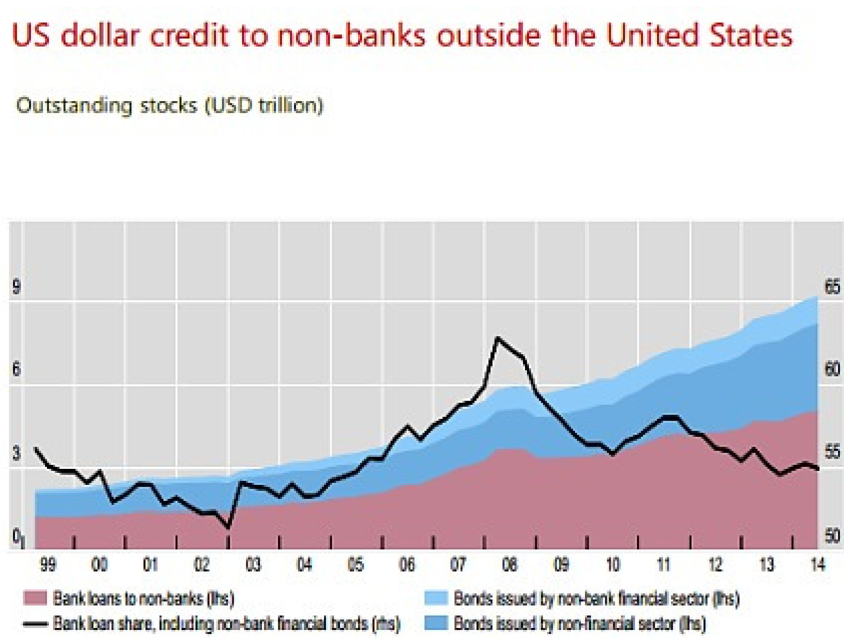
THE NEXT GREATEST TRADE

We have the privilege of speaking up only when we see something in the market that is worth commenting on. These days, the market hive-mind has convinced itself that the "US Dollar is going higher, much much higher". The force has been so strong in this one that many of the seasoned (unwashed?) gold-bugs have flipped from "Gold is the Anti-dollar" thesis to "Both Gold and USD will Trend Higher" thesis.

Whenever the seasoned gold-bugs reach out in unison, it first activates our gag-reflex and then triggers a fight-or-flight response. Once a hard-fought mile or two of margin of safety has been established, we dare to let our guard down, gaze into the horizon and analyze their arguments.

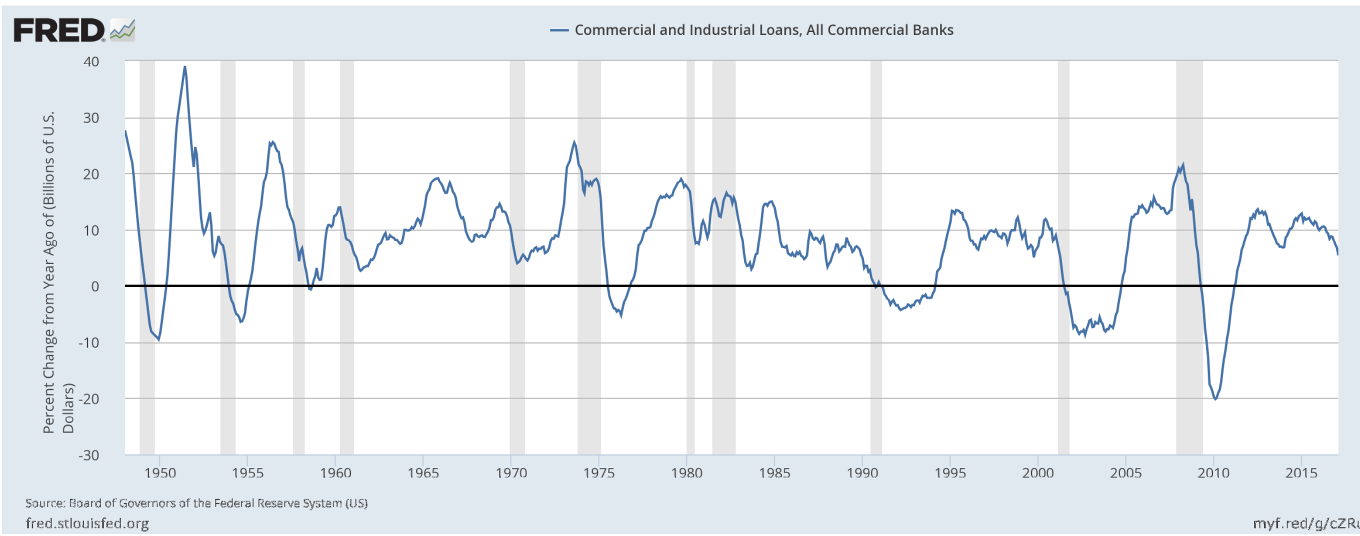
There is some truth to them. Here they are:

- US Economy is strong and inflation is rising
- FED is hawkish and moving to normalize rates
- The rate differential with the world (especially Europe) should lead to capital flight into USD
- Euro is a flawed currency and will disintegrate soon
- Trump's Trade and Taxation policy would respectively limit outflow of USDs and incentivize bringing USDs back into America to "create jobs"
- The Eurodollar money market is shrinking due to regulatory changes, so there is an international scarcity of dollars
- All the USD denominated foreign borrowing is an implicit dollar short which eventually needs to be covered. Bank of International Settlements estimates that there is approximately nine trillion worth of such debt outstanding. This is the Emerging Market Funding crisis that the wonks keep droning on about.



Source: Bank of International Settlements

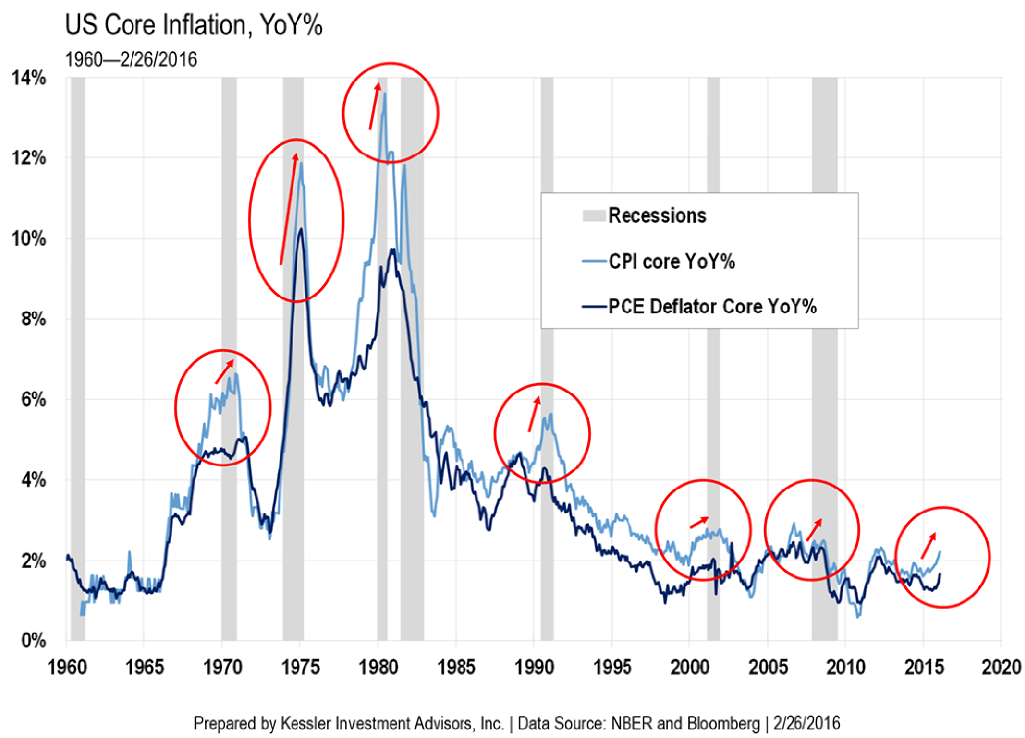
Most of the arguments listed are sort of true, except the first one. US economy is not strong, even the overtly optimistic official GDP data suggests that this has been the weakest post-war economic recovery. Business cycle expansion is long in the tooth and showing signs of fatigue. The most reliable "Brad Pitt" of economic cycles: The credit cycle is turning down, which usually precedes a recession.



Source: Federal Reserve Bank of St. Louis (Y/Y %change in Commercial & Industrial Loans)

In the yonder days of innocence, we had had been force-fed the idea that positive inflation differentials usually drive the inflating currency lower compared to the one with more stable inflation. So apparently this theory works while analyzing USD against INR but completely breaks down when applied to the EUR/USD pair. Such are the joys of QE induced madness! Counterintuitively, inflation actually picks up going into a recession.

Inflation tends to rise into and during a recession.

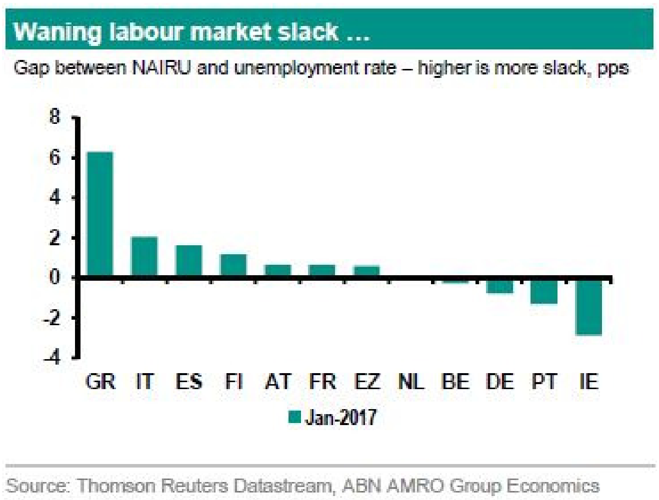


Source: Kessler Companies

One of the possible explanations is that the tightening by the FED is what creates a recession. The FED is now hiking into weakness. It only makes sense if they want a buffer to cut rates again when the inevitable recession finally strikes. Ironically, it is this misguided tightening that will most likely cause the recession that scares the living daylights out of them.

Our “modern” monetary system is built on an exponential function (the compounding interest rates). To match the previous effectiveness, the stimulus this time has to be exponentially higher than previously. In plain language: say hello to QE4 in tens of trillions, then QE 5 in hundreds of trillions. Some experts have noted that, of late, Gold has been responding positively to “deflationary signals”. The gold market is probably just “seeing through” the intermediate crisis and starting to discount the “Shock and Awe” FED reaction function.

On the other hand, Inflation and wage growth has been picking up in the Eurozone. If it continues, Germany will have to drag Super Mario kicking and screaming into a rate hike cycle. Same holds true for UK, they will need to hike to save the pound. Ether ways the best days of the famous rate differential seem to be behind us.



Source: ABN AMRO

There is a strange blindness that befalls the investment community while talking about the Euro. They say, in a strange and a distant voice, “The Euro is doomed”. Then their eyes glaze over and the thinking stops exactly at the point at which the Eurozone disintegrates right in front of their eyes. This is, apparently, the financial event horizon beyond which no reality exists.

Obviously Euro is flawed and presumably it will fail one day, though it might drag on longer than most imagine, owing to our near-infinite capacity for self-delusion. Just ask the lame duck Syriza Government in Greece, who realize that they need to drop the Euro for any shot at recovery, but are hamstrung by the bizarre popularity of the Euro currency among its population a la. Stockholm syndrome.

The European countries would, presumably, still exist. Each will still need a currency. The most likely scenario is that the German/Norther European Deutschemark, unleashed from all the peripheral deadweight, would go on such a supersonic tear that it would most certainly cause a massive rip in the space-time continuum and a recession in the host economies. The actual break-up of the Euro would undoubtedly be hugely dollar negative as a superior alternative would have been summoned into existence.

Having dealt with the simple arguments, we will need to meditate on the nature of markets next. But before that (stick with us here)…

NOW FOR SOMETHING COMPLETELY DIFFERENT

It is 2003, you have been promoted as the CFO of a Noodle making company in Indonesia. You started out in the late 90s and painfully remember how the Rupiah crashed while you were minding your ***own*** business and wiped out nearly all your wealth. Ever careful, you always hedge out all your risk, all USD exposure always, without exception.

As a part of your 2005 audit, you realize that the company has simply been hemorrhaging cash on the hedging operations. Bold leader that you are, you make the brave choice of borrowing in USD without the hedge. The company profits increase as the cost of debt keeps falling with the USD. You are a hero!

By 2007, you ARE the King. You have so much confidence in your proprietary Fx concepts that you have started taking on “complex and uncorrelated exposure” if “the bid-ask is sufficiently compensatory”. Corporate Finance department which was all costs, is now the biggest profit center for the company. Bankers are in awe of your acumen, employee morale is high. You read the news that Supermodel Gisele Bundchen is now demanding to be paid exclusively in Euros. You nod in approval, she is such a smart girl. Good looking too.

It is 2009 and the last year was brutal. Many years’ worth of accumulated profits wiped away in months! And all positions turned out to be correlated shorts on the USD, all of them! Blasphemy! You had to ask for a bailout from the actual noodle makers. What a disgrace! Your fledging hedge fund was curtailed but you survived. You are back to plain vanilla corporate finance. It is a setback, but you survived!

You have been rolling over your USD debt and accumulating funds in EUR when suddenly Greece punches you in the face (It is 2011). You dump your Euro exposure and that's that. But you notice that USD is showing signs of life for first time since the financial crisis.

The next 4 years are slow water torture. USD starts to rise and all your debts are denominated in USD. Tic by tic, day by day, month by month consistently. First you neglect it, expecting it to "retrace". Then you devise a clever strategy which would kick in once there is a dip in price, but there zilch. By 2015 you are in blind panic, partially hedging but the costs have now skyrocketed. So you start swapping USD exposure for EUR, it is a dead currency anyways. By early 2016, you have swapped all your liabilities from USD to EUR and managed to make some meager profits along they way. Phew. That was close.

You get the news that Gisele now investing with a "barbell strategy" where half her wealth is invested in "the most disruptive new-economy stocks" like Tesla and the other half in super safe, long dated US treasuries. Having read the book "The Black Swan" by N. N. Taleb, you are in awe of her dazzling intellect and investment acumen. You finally work up the courage to move to Brazil and ask for her hand in marriage. Then you find out that she has been married to some Joe Six-pack called Tom Brady since 2009. Heartbroken, you make yourself a last drink and jump out of the window.

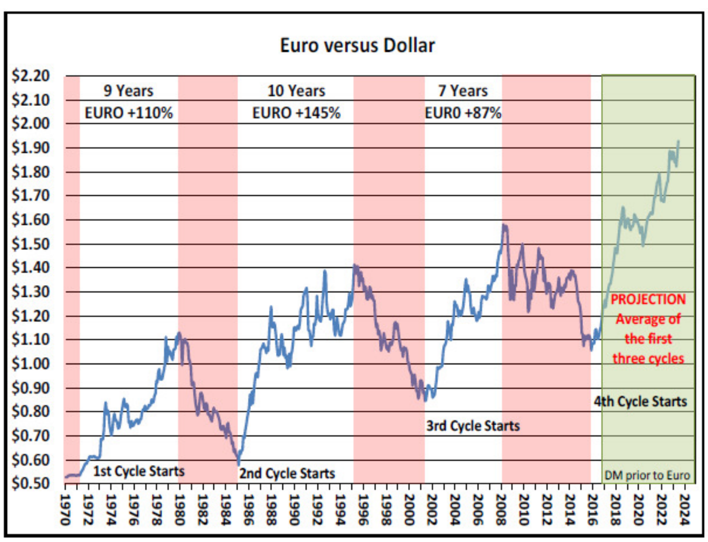
NO CHAOS, NO MOTION, NO MARKETS

Markets are forward looking by nature and are prone to heard behavior. In the parlance of chaos theory, markets are complex adaptive systems. A Swiss watch, however complicated, is a simple system with only one degree of freedom, forwards or backwards. The two hands can't even move independently of each-other. The weather is a complex system, lots of moving parts, each with a lot of latitude. A complex adaptive system is much like the weather, except that the clouds and the trees and the birds and the bees, have all become sentient and are conspiring to annihilate you. Or they could just be pulling a prank. The point is, that you can never say for sure which is which.

The markets are organic and hostile and usually try to price in all the relevant information at once, adjusting course wherever necessary. They are not like mechanical systems which can continuously be squeezed upwards, which implies that the market participants are being constantly surprised by their state of being.

As Auric Goldfinger told James Bond “Once is happenstance. Twice is coincidence. The third time its enemy action.” (We love the old movies about Gold being smuggled into India. Free-markets in action!) Or, the more plebeian “Fool me once shame on you, fool me twice shame on me”. The markets abhor surprises, and after a few shocks start extrapolating the new trend to infinity. Therefore, after sufficient time has passed allowing for the markets to trend, and for the participants to assimilate, hedge and speculate, events invariably get priced in before they happen. This is why old adage of “Buy the rumor, sell the news” works.

Like our alter-ego, the noodle maker CFO from Indonesia, who is based on a real life archetype described in Satyajit Das’s very entertaining book “Traders, Guns and Money”, a typical market participant is perennially perplexed by a change in trend, and fully commits to the prevailing paradigm only after the real meat of the move has passed. And then, he becomes the ultimate believer/advocate of the existing paradigm just as it is about to flip on its head. *Works every time 60% of the time*. No wonder more than 90% of the traders fail. This is also why EUR/USD seems to go around 15 year cycles.



Source: A.G. Bisset Associates

The last few points made by the dollar bulls cannot be factually refuted because they are indeed, correct. The Eurodollar market is shrinking due to regulatory changes and causing LIBOR to spike. And there are about 9 trillion USD borrowed by non-US entities from other non-US entities. But this is not exactly news to the market. We don't know how much of it is already hedged, how much is backed by USD collateral or contractual obligations priced in USDs. All the effects may not be precisely known but the market has taken them into account and they should already be fully discounted. A betting man would anticipate that a change of trend is at hand.

Source: Federal Reserve Bank of St. Louis

Same with the Trump's plans. In a bout of hysteria, Mr. Market priced in the full effects of an effective Trump presidency right after his victory speech, and seems ponderous of late. The dollar market is now poised to move on Trump disappointment not Trump euphoria.

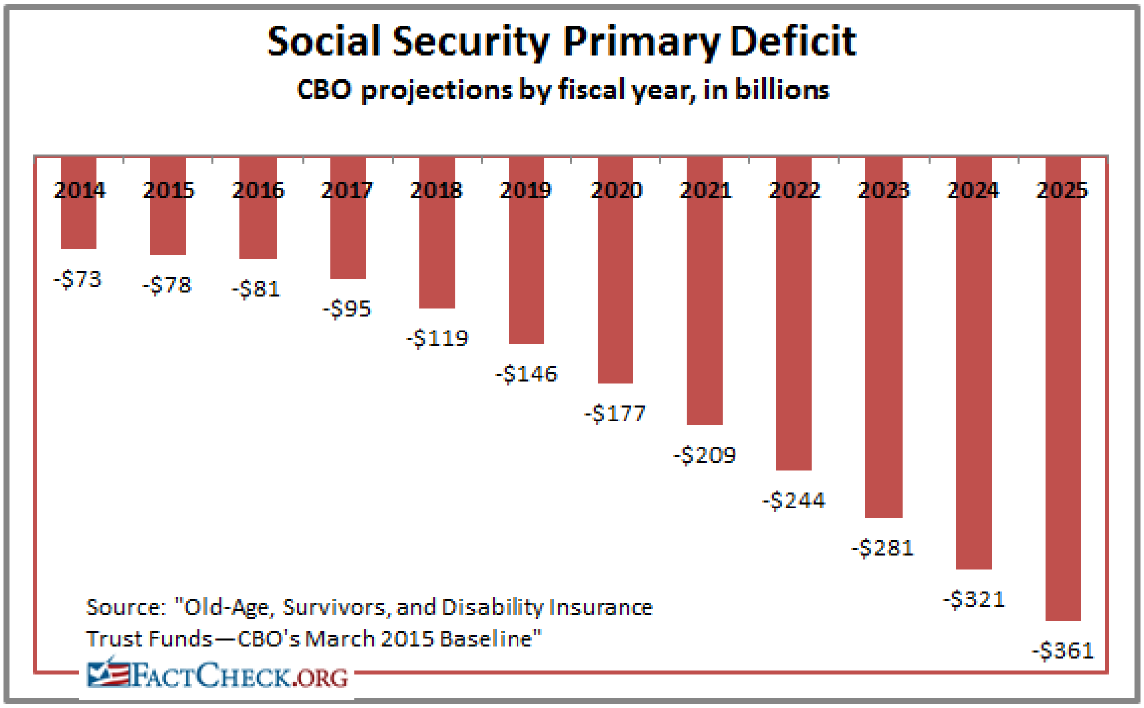
It is only April 2017, and Trump Presidency is already turning out to be as deliciously lame duck as it promised to be. If there is a dollar bullish Trump announcement, it will likely cause one more knee jerk reaction to the upside before resuming the descent. The uptrend has been in motion for many years, and unlikely to break the upper trend-line.

Source: Investing.com, Pureheart Capital

FINALLY, IN THE LONG RUN WE'RE ALL DEAD

It is historically accurate to say that all fiat currencies eventually revert back to their marginal cost of production, which is zero. It is clear that due to high leverage (on & off-balance sheet) the participants in the US economy seem incapable of absorbing even a minor drawdown in the asset markets.

It is painfully clear that all the legal obligations of the US government and related entities will be paid in full, in CPI adjusted nominal terms by creation of new currency units. This problem is not in the "near future", it is here and now. What this does mean for the value of the USD is anybody's guess. Will the other fiat currencies also be in the same boat or will Emerging Market currencies be different? Impossible to tell as of now.



Source: Factcheck.org

However, this will play out over many years and involve many down-legs along the way. Our concern, here and now, is to merely provide enough evidence that the next crisis in this great saga might be imminent.

It is relevant because a weak dollar is the fuel in the fire for commodities and Emerging Market Equities. In the last weak-dollar cycle, MSCI emerging markets index went up 5.2x in 6 years. A weak dollar usually starts the party somewhere, you just have to find it.

However, no cycle is exactly like any other. In this case, if the fire is lit under the gold market, the "long run, in which we would all be dead" would have finally arrived to finish us off.

The author can be reached at: shashwat.panda@gmail.com