forest for the trees

MACROVOICES PODCAST JUNE 20, 2018

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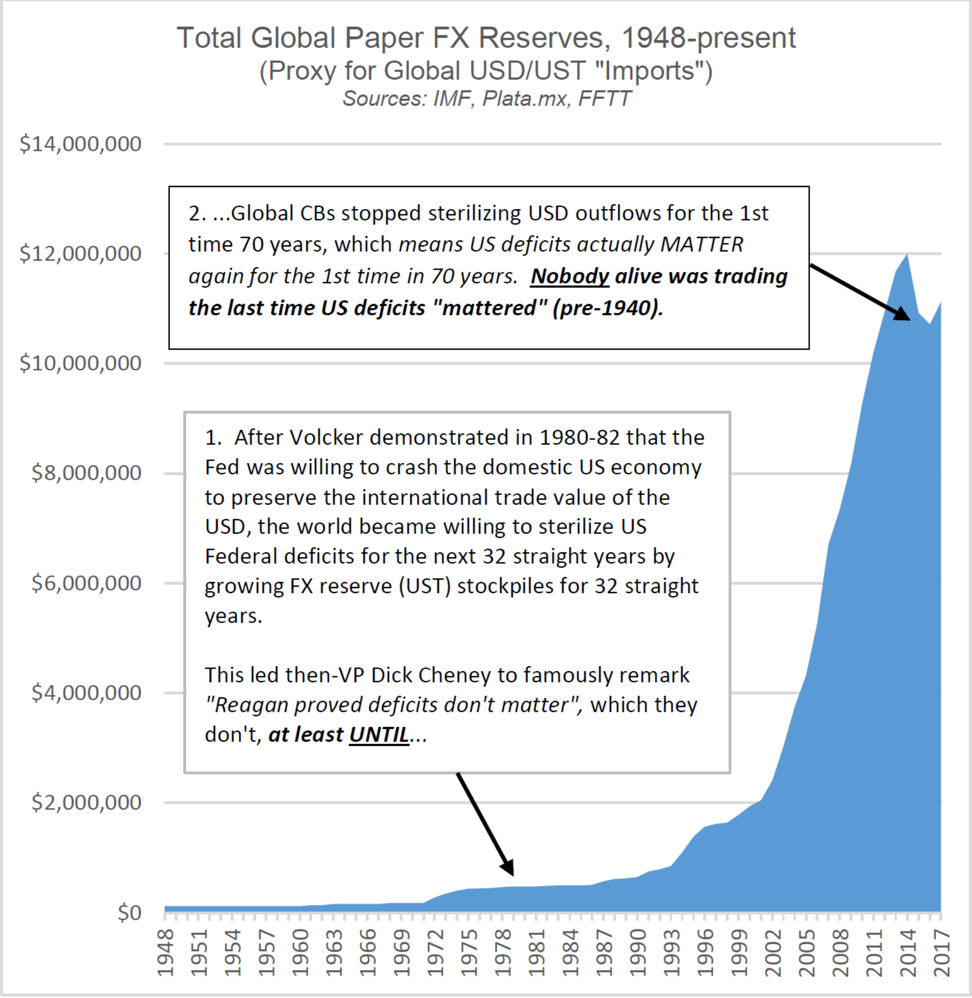
2H18E: “A Tale of Two USD Trades”?

USD Trade #1: Near term USD short squeeze as Fed hawkishness despite softening EM currencies.

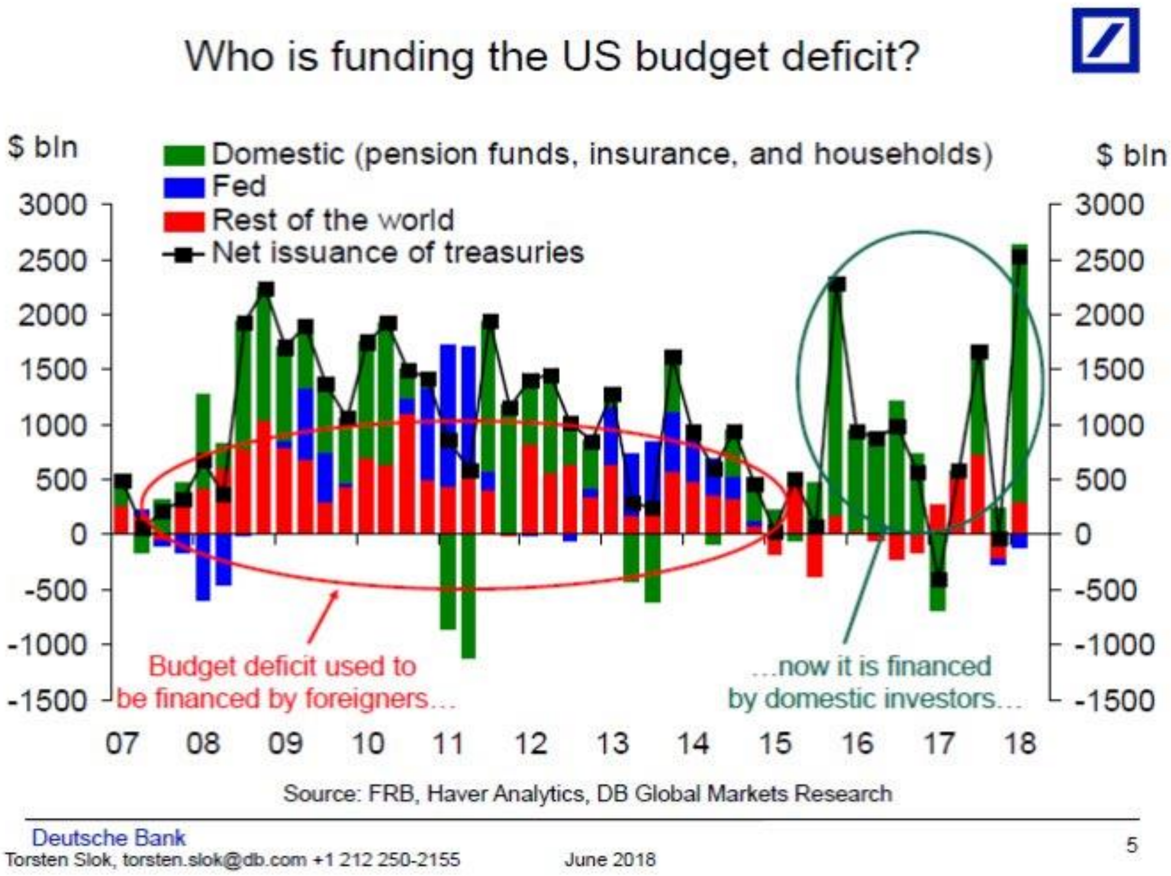
- “Shooting the Hostage”
- “Burning down the world.”

USD Trade #2: Structural USD Trade that makes “Long USD” look like perhaps the biggest “picking up nickels in front of a steamroller” trade since AIG was minting money selling subprime mortgage insurance in the mid-2000’s.

3q14: Global FX reserves fall for the 1st time in 70 years = *US deficits "matter" again for the 1st time in 70 years.*

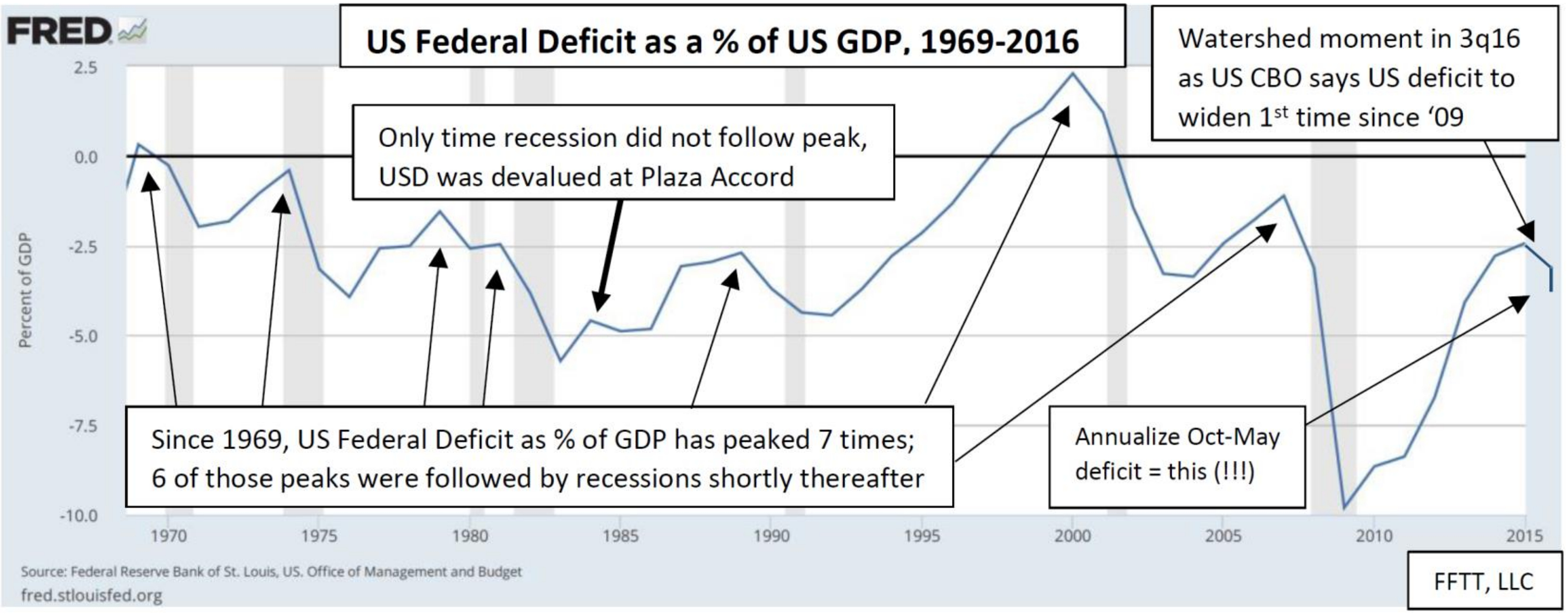


Deficits funded by foreign CB's for 70 yrs; since 3q14 by domestic US investors *("encouraged" by ACA, Bank HQLA, MMF Reforms & now Tax Reform.)*

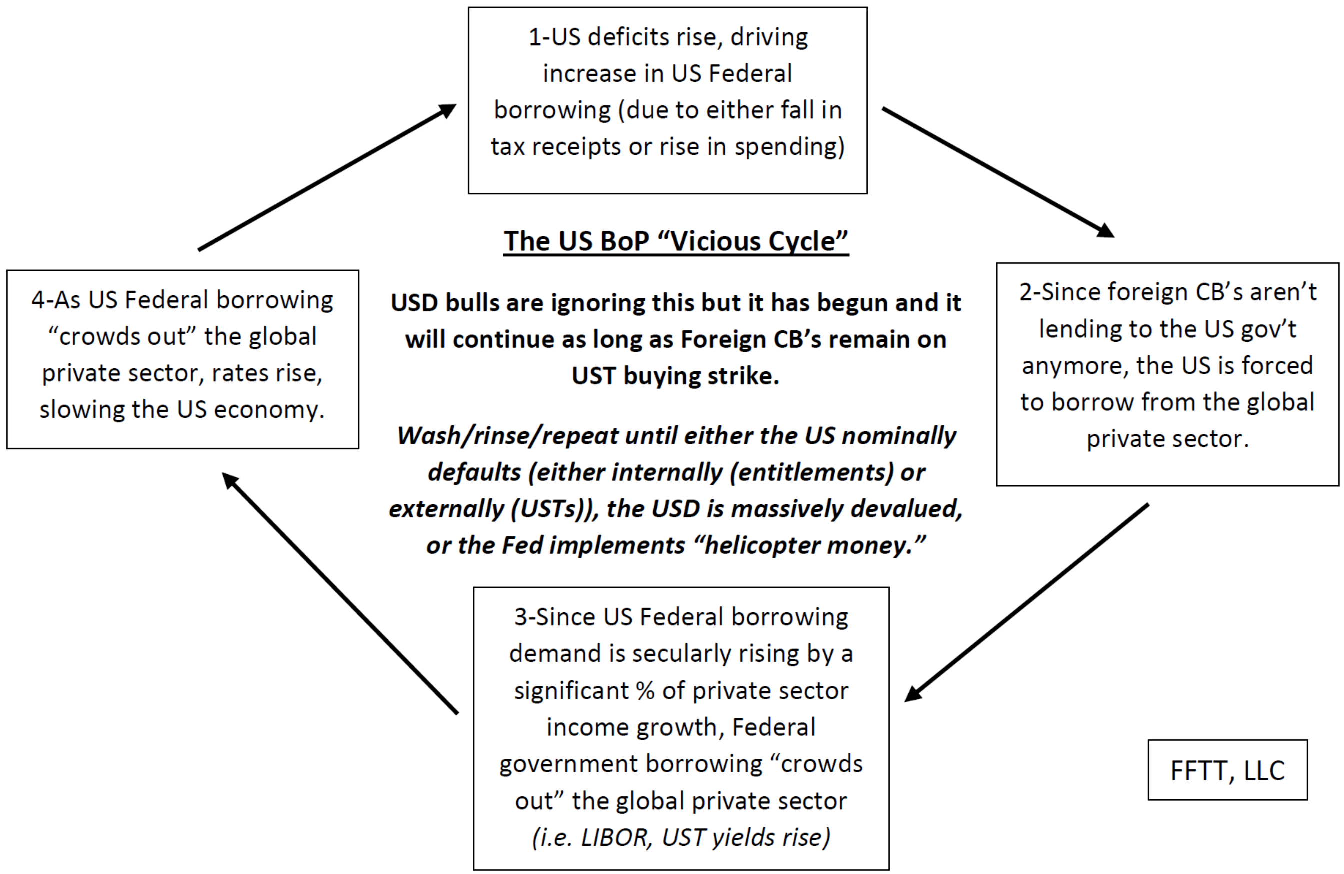


When Global CB's stopped sterilizing US deficits for first time in 70 years, US had to tap global private sector to fund US deficits. First "USD crowding out" (higher rates, higher USD, higher ACA premiums) in 70 years hit a critical tipping in 3q16:

US Federal deficit as a % of GDP bottomed, rose for only the 8th time in 50 years; 6 of 7 prior times saw US in recession within 14 months; the other time saw USD significantly at the Plaza Accord in mid-80s.



Prior two charts mean this “vicious cycle” is now engaged:



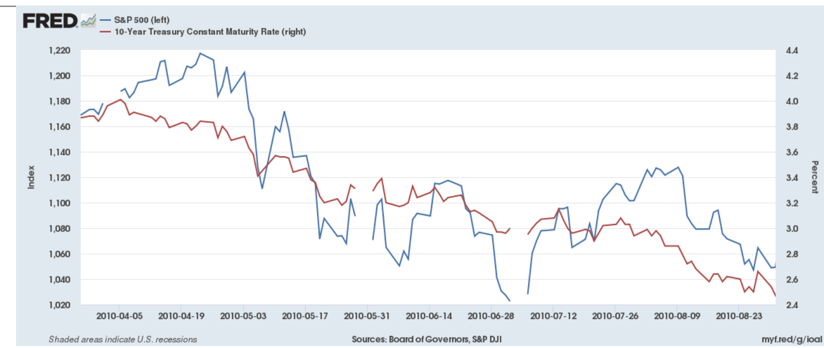
US Deficits “mattering” again = US subject to its own “Impossible Trilemma” *(h/t Louis Curran)*

Near term: US Federal Deficits “mattering” again = US now subject to its own “Impossible Trilemma.” Fed/US can have only 2 of the following 3:

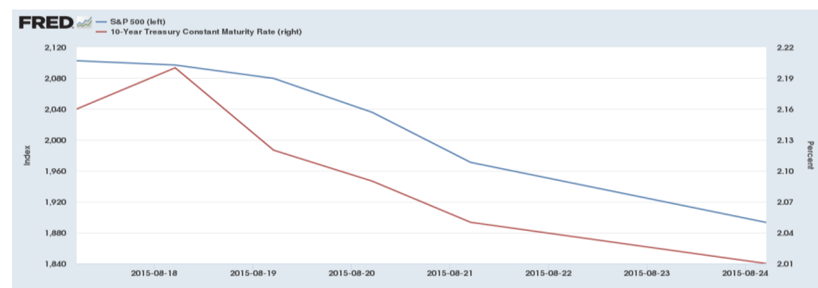
1. Rising Fed Funds rates.
2. Stable/Rising USD.
3. Rising Stock prices.

In 2017, the US saw a falling USD & rising stock prices, & we came into 2018 thinking this combo of the "US Impossible Trilemma" would continue…*UNTIL the long end of UST curve sold off in February's equity market sell-off = we think this spooked the Fed.*

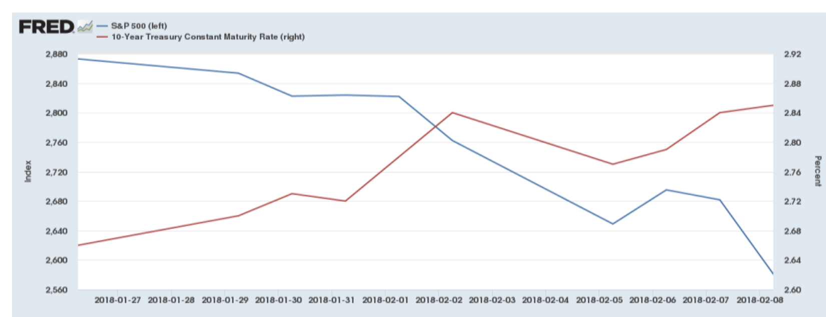
Apr-10 thru Aug-10: SPX (in blue) down, 10y UST yields down.



Aug 17, 2015 thru Aug 24, 2015: SPX (in blue) down, 10y UST yields down.

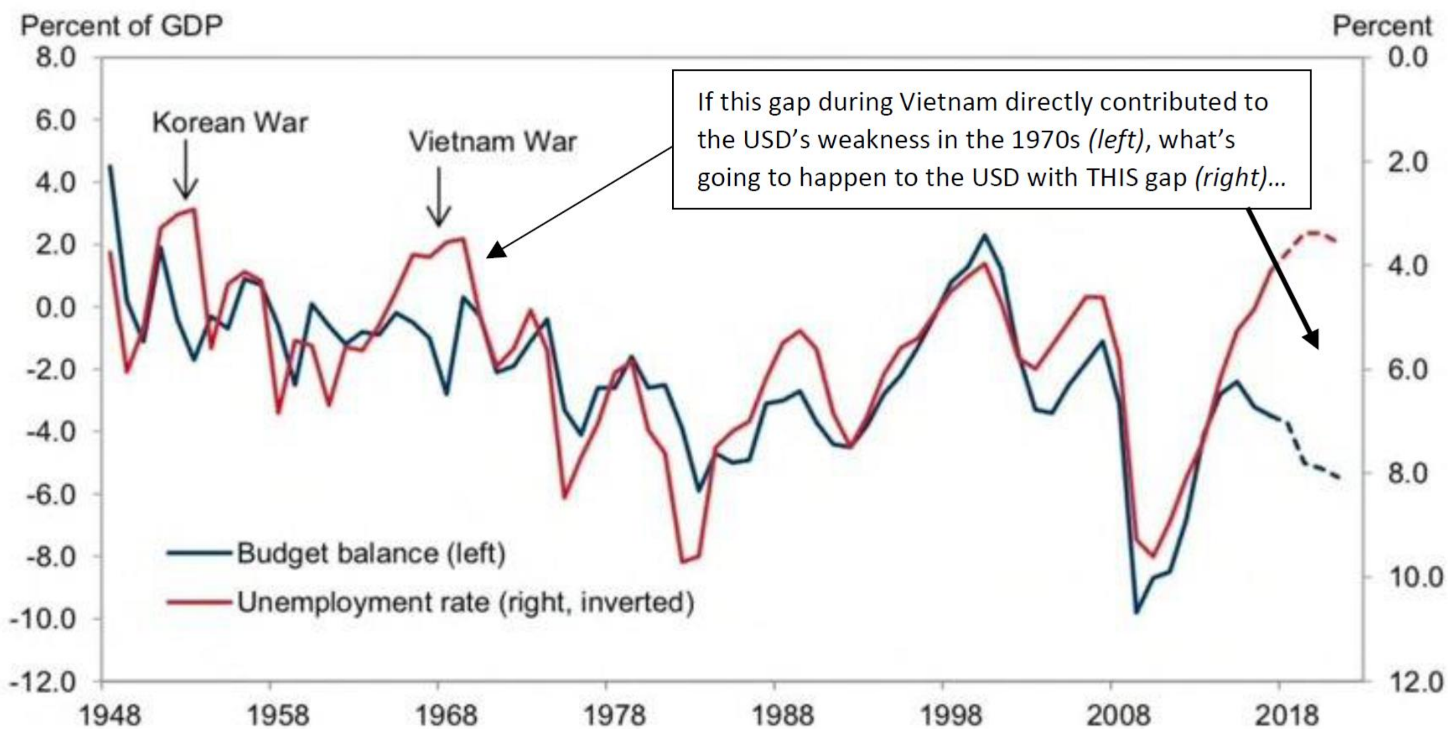


Jan 26, 2018 – Feb 8, 2018: SPX (in blue) down, <u>*10y UST yields…UP.*</u>



Why did UST's trade "like a risky asset" in early 2018?

For the first time in 70 years, the US Federal deficit is widening as a % of GDP during a peacetime economic expansion…this should be a structural negative for the USD, cet par



Source: Department of Commerce, Congressional Budget Office

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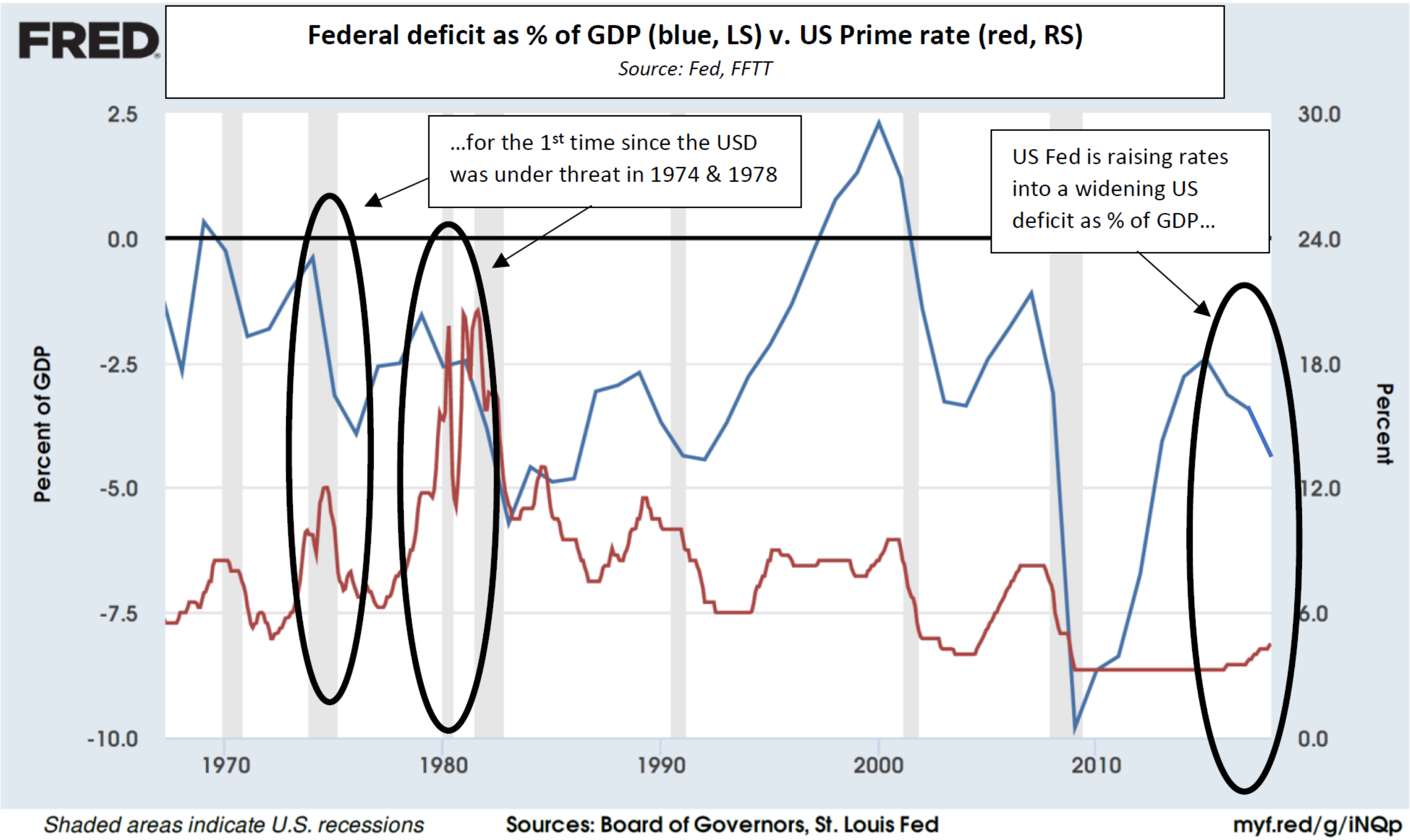
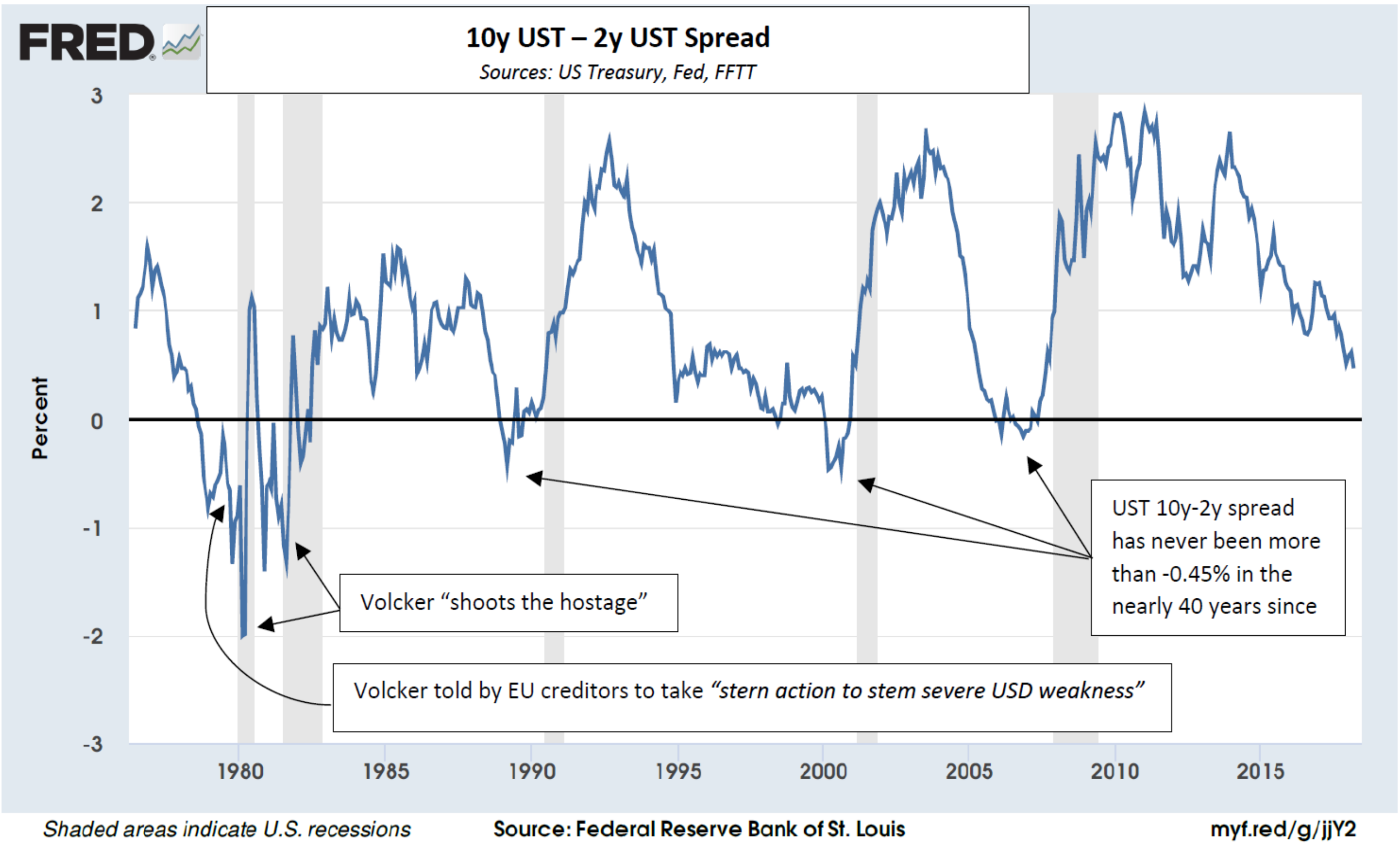
And so post-Feb, Fed strategy appears to have shifted within the "US Trilemma" from "USD down, stocks up" to "get more hawkish to support USD to support long end of UST curve"…aka *"Shooting the Hostage"*



Key question on USD Trade #1: How far will Fed take "Shooting the Hostage" – as far as Volcker did?

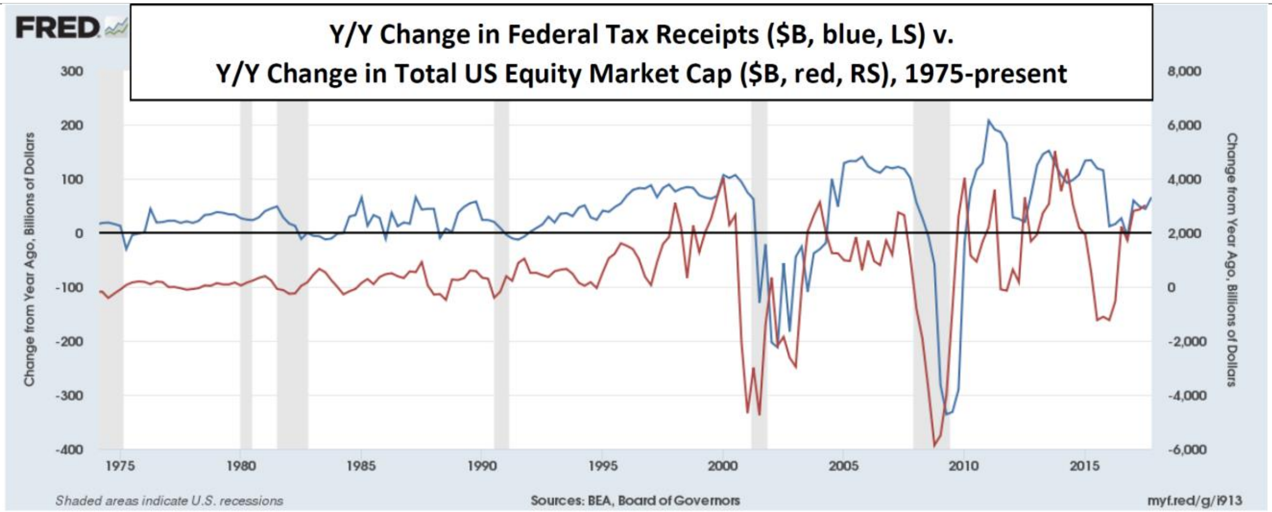
No one thinks this is possible, but might it be necessary?

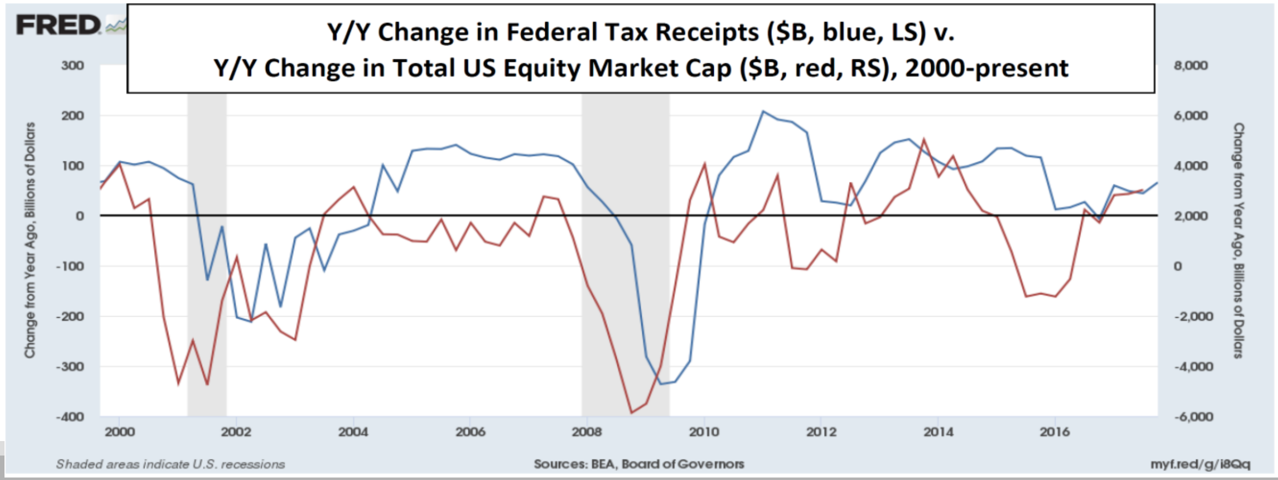


And so we shifted our NT view on USD, risk markets in early March…with the view that the "governor" on the Fed "shooting the hostage" (defending USD w/hawkish rate hikes) would be US risk asset performance:

A big NT shift in our thinking: The Fed's trying to stabilize the USD - *Take the "under" on 4 Fed hikes this year & the "over" on rate & equity volatility.*

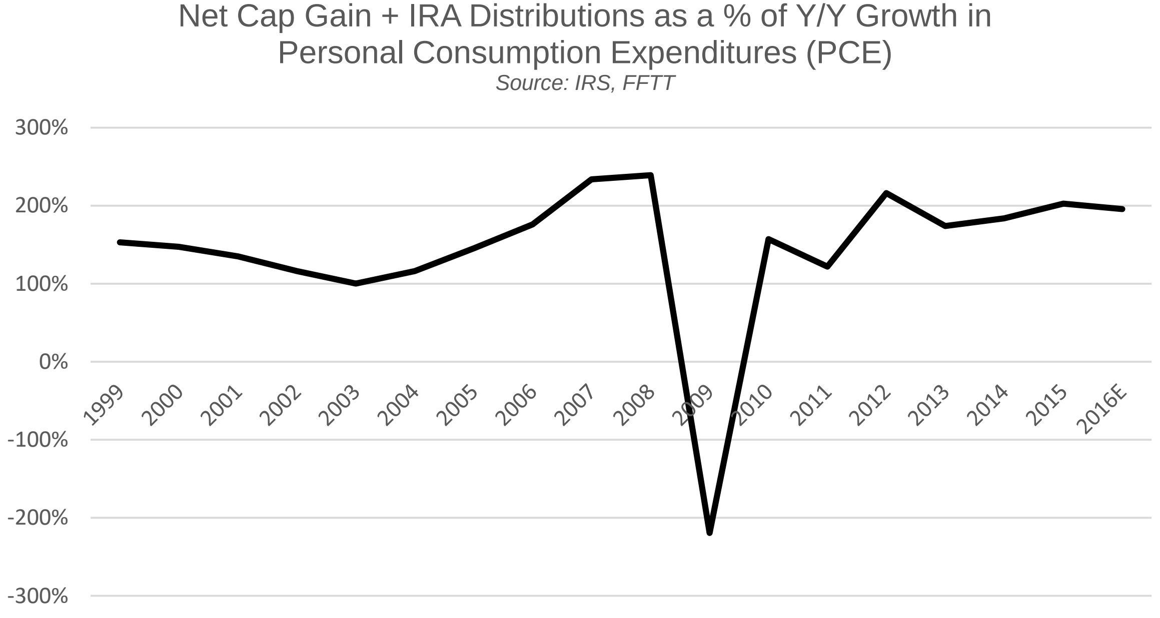
"US Impossible Trilemma" a function of US policymakers establishing a system over past 25 years that has tied US tax receipts to rising equity prices (thru consumer spending via options, restricted, IRAs, etc)…





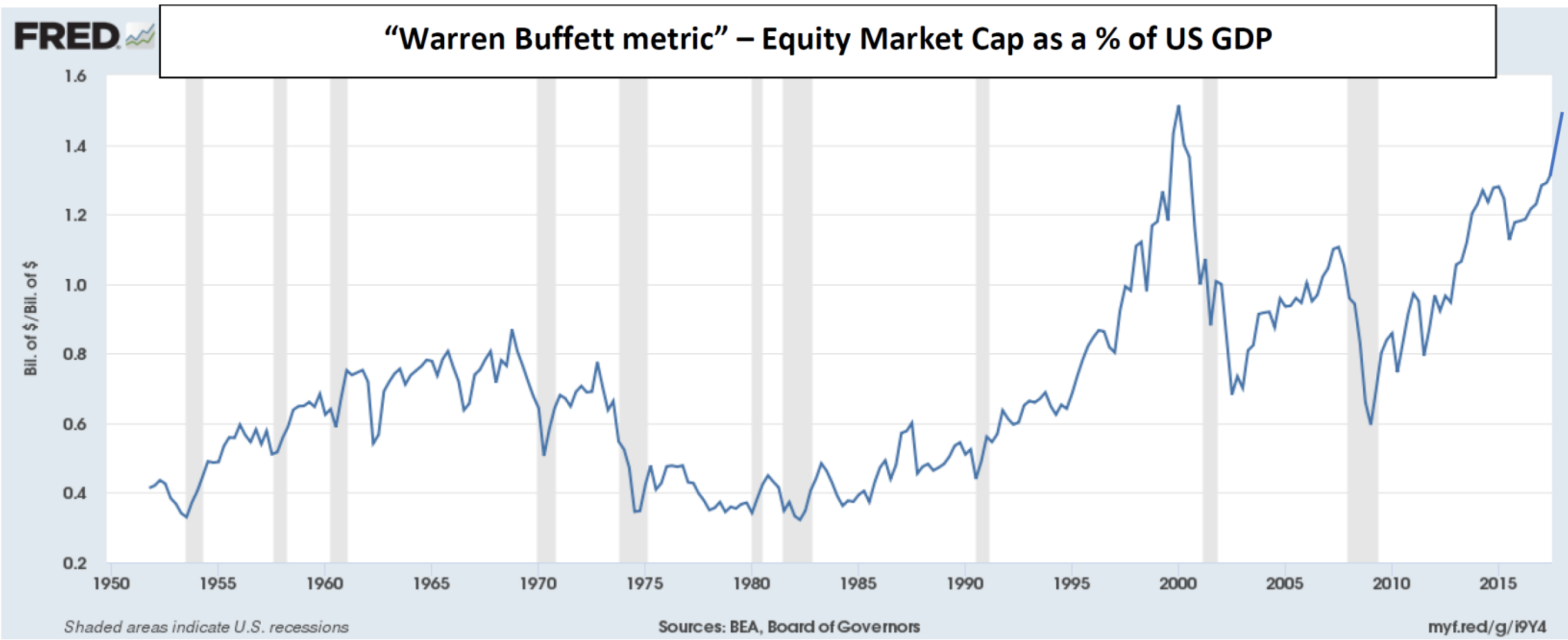
“US Impossible Trilemma” a function of US policymakers establishing a system over past 25 years that has tied US tax receipts to rising equity prices (through consumer spending via options, restricted, IRAs, etc)…

“A surprisingly large % of US income tax receipts are tied to a rise in US stock prices. When the US stock market just stops rising…not falls, but just stops rising, that will put pressure on the receipt side of the US fiscal picture, which no one is talking about.” -Alan Greenspan, 5/19/15

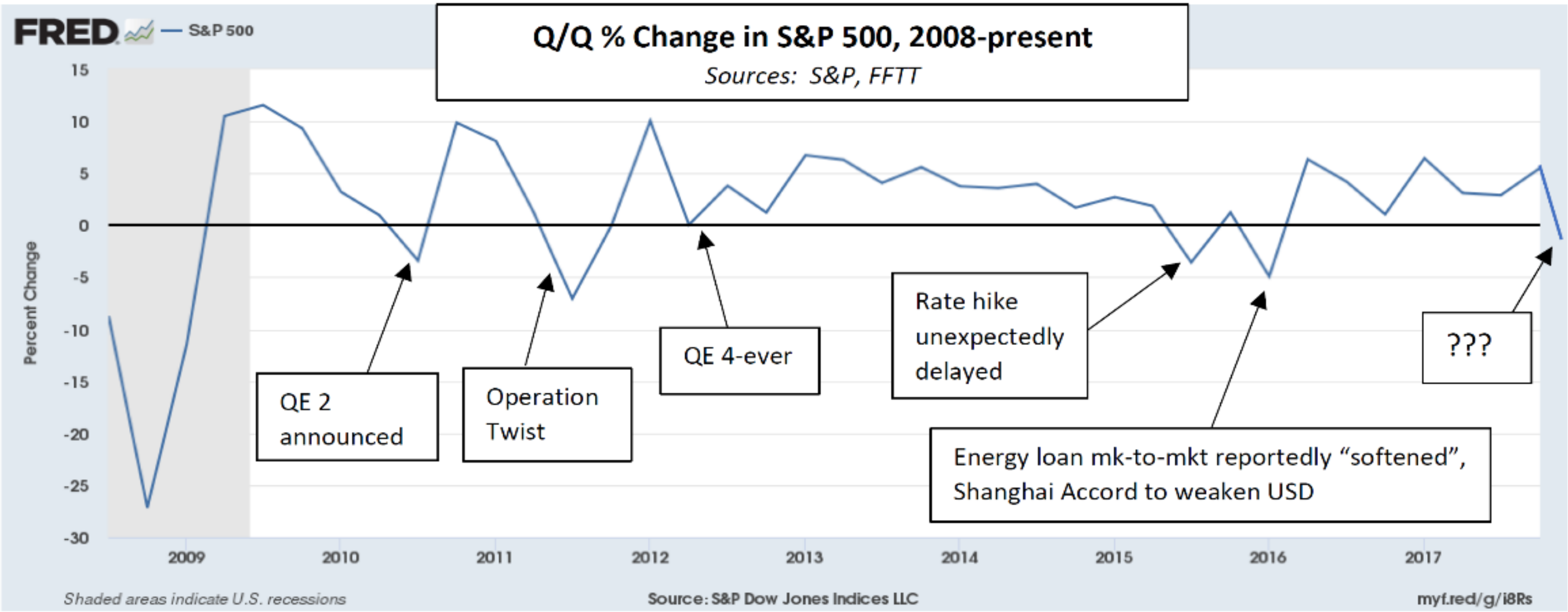


This is a function of a rarely-discussed corollary to the oft-cited observation that US Total Equity Market Cap is ~150% of GDP:

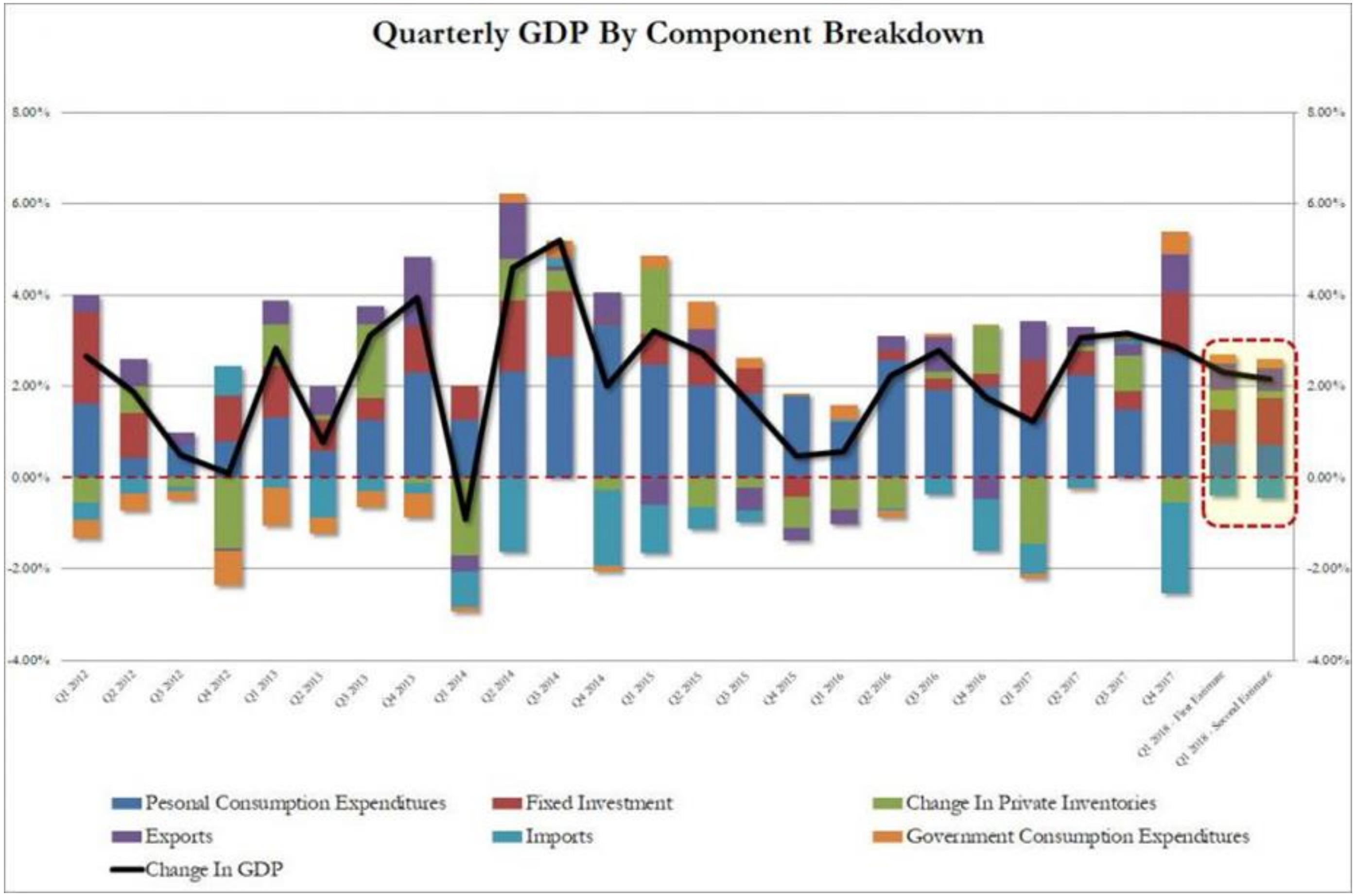
The US Stock Market increasingly IS the US economy.



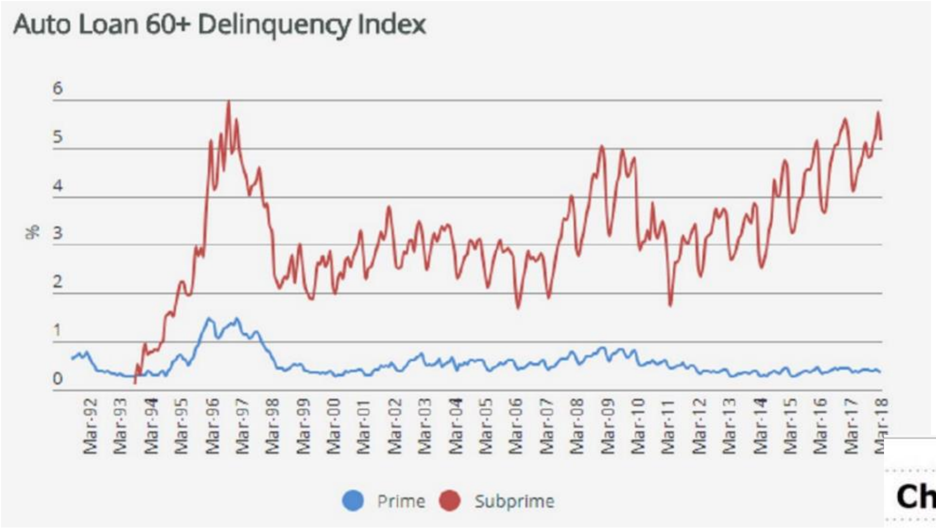
Right on cue, in 1q18 USD stopped falling for the 1st time in 18 months & stocks fell Q/Q for the 1st time in 2 years…



…& Personal Consumption Expenditures posted its weakest growth in 5+ years (per US BEA):



…as the weakest consumer trends appear to be emanating primarily from the part of the US consumer that looks most like an EM (subprime):



Charts via BBG

Bottom line on “USD Trade #1”:

1. Should work until higher US rates, strong USD weigh on US economic trends, with US equity markets the likely transmission mechanism.

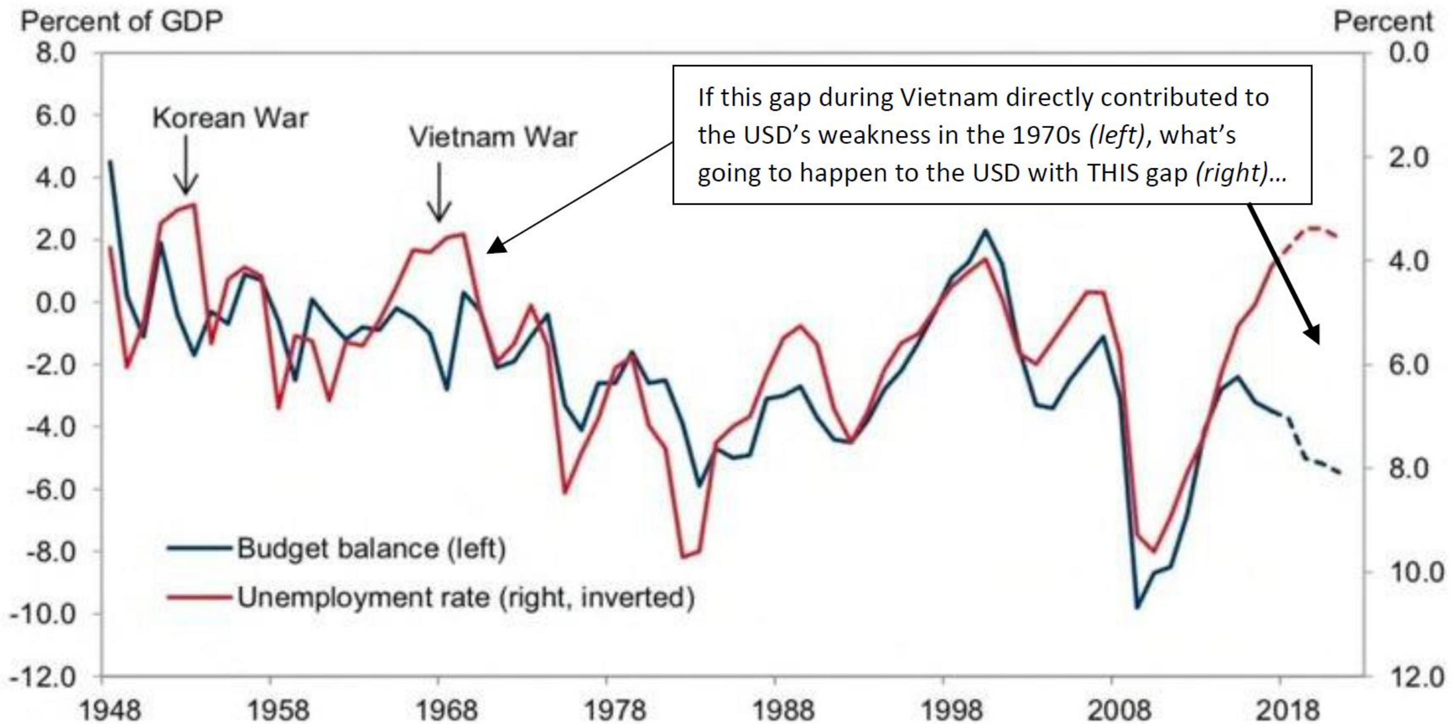
2. If we’re right, should become more obvious by late 3q18 & possibly force the Fed to revisit rate hike plans.

To date, US economic data & lack of broad equity market performance makes us feel comfortable with this outlook.

- Remember Alan Greenspan’s point: “If stocks just stop going up…” – and stocks haven’t risen in nearly 6 months now.

Brings us to "**USD Trade #2":** Last time a gap much smaller than the current one emerged, it forced the US to unilaterally end the Bretton Woods system, go off the gold standard, & brought us 1970s inflation & USD weakness.

This gap is bigger, & now we have signs Trump is trying to unilaterally end the USD's primary reserve role in global trade? (Selmayr quote.)



Source: Department of Commerce, Congressional Budget Office

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China, et al accelerating efforts to de-dollarize global commodity markets takes on a new tone in context of foreign CB's not buying UST's: *They're slowly backing away from UST's and hoping US banks, retail investors & public pensions don't notice.*

China oil futures launch may threaten primacy of USD: UBS – 3/26/18
https://www.reuters.com/article/us-china-oil-futures-dollar/china-oil-futures-launch-may-threaten-primacy-of-u-s-dollar-ubs-idUSKBN1H227E

- *Already on Monday, Unipec, the trading arm of Asia's largest refiner Sinopec, has inked a deal with a western oil major to buy Middle East crude priced against the newly-launched Shanghai crude futures contract.*

China taking first steps to pay for oil in CNY this year: sources – 3/29/18
https://www.reuters.com/article/us-china-oil-yuan-exclusive/exclusive-china-taking-first-steps-to-pay-for-oil-in-yuan-this-year-sources-idUSKBN1H51FA

- *Shifting just part of global oil trade into the yuan is potentially huge. Oil is the world's most traded commodity, with an annual trade value of around $14 trillion, roughly equivalent to China's gross domestic product last year. A pilot program for yuan payment could be launched as early as the second half of this year, two of the people said.Regulators have informally asked a handful of financial institutions to prepare for pricing China's crude imports in the yuan, said the three sources at some of the financial firms. "Being the biggest buyer of oil, it's only natural for China to push for the usage of yuan for payment settlement. This will also improve the yuan liquidity in the global market," said one of the people briefed on the matter by Chinese authorities. Under the plan being discussed, Beijing could possibly start with purchases from Russia and Angola, one of the people said, although the source had no details of anything in the works.If successful, it could also trigger shifting other product payments to CNY, including metals and mining raw materials.*

PBOC improves cross-border CNY payment system CIPS, to now operate 24 hours/day up from 12 hours – 5/2/18
https://www.wsj.com/articles/pboc-makes-improvements-to-cross-border-yuan-payment-system-1525251799?mod=e2twcb

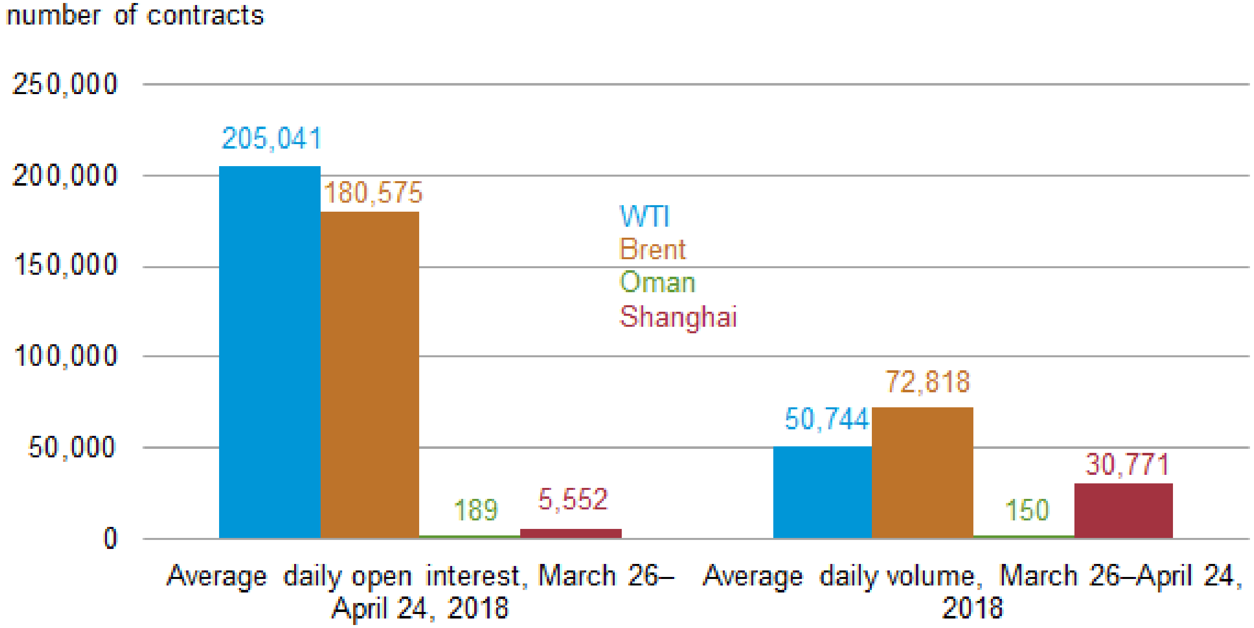
Russia increases grip on Chinese oil market by opening 2nd ESPO pipeline doubling capacity to 600k bpd– 1/1/18
https://www.bloomberg.com/news/articles/2018-01-01/second-chinese-crude-oil-pipeline-linked-to-russia-s-espo-opens

Iran exports 784k bpd of oil to China in September, up 59% y/y [FFTT: All in CNY] – 10/25/17
http://www.presstv.com/Detail/2017/10/25/539830/Irans-oil-exports-to-China-up-59

Saudis may seek funding in CNY – 8/24/17
https://www.reuters.com/article/us-saudi-china/saudis-may-seek-funding-in-chinese-yuan-idUSKCN1B413R

China, et al accelerating efforts to de-dollarize global commodity markets takes on a new tone in context of foreign CB's not buying UST's: *They're slowly backing away from UST's and hoping US banks, retail investors & public pensions don't notice.*

Figure 3. Trading data for various crude oil futures contracts for September 2018 delivery

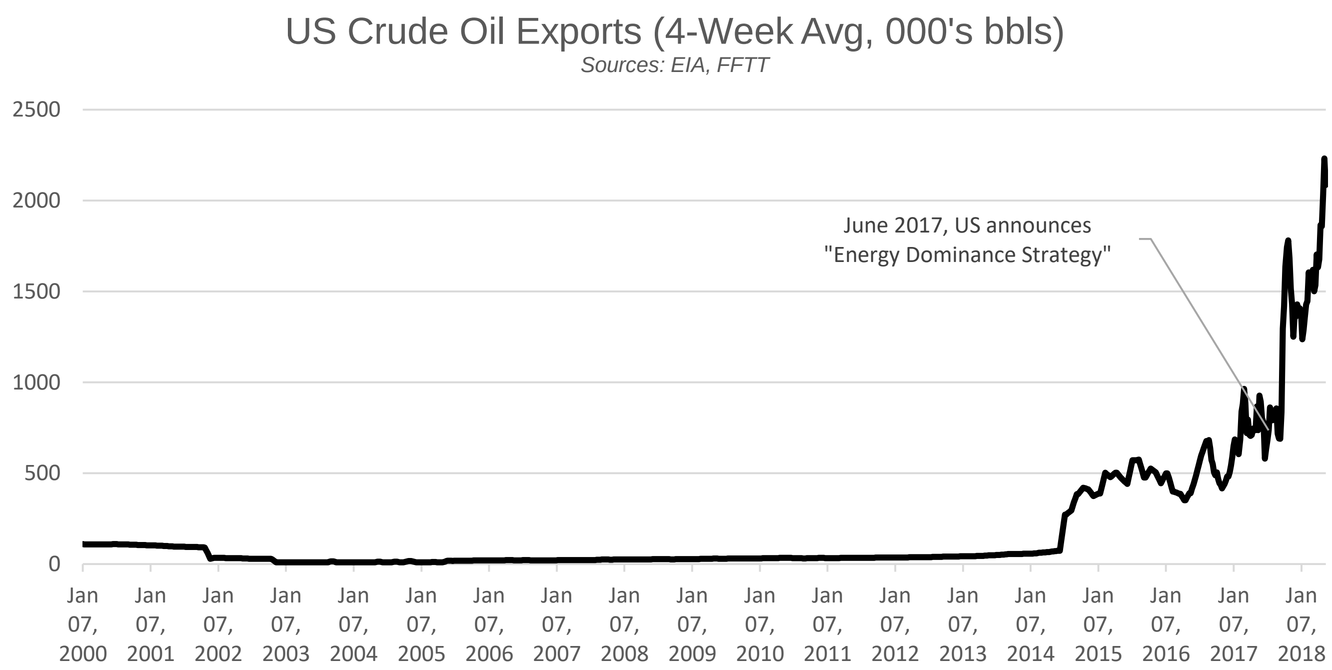


Source: CME Group, Intercontinental Exchange, Dubai Mercantile Exchange, Shanghai International Energy Exchange, Bloomberg, L.P.
Note: Because the Shanghai International Energy Exchange counts both long and short sides of a transaction, Shanghai's open interest and volume are halved to compare with the others.

The US appears to have responded by the Fed & US government effectively weaponizing the USD & oil against Russia & Iran (& by extension, China & the EU):

***"We will be dominant.** We will export American energy all over the world, but this full potential can only be realized when government promotes energy development...The golden era of American energy is now underway."*

Trump heralds US energy dominance at "Unleashing American Energy Event" – 6/29/17
https://seekingalpha.com/news/3276434-trump-heralds-u-s-energy-dominance-pledges-end-obama-curbs?ifp=1



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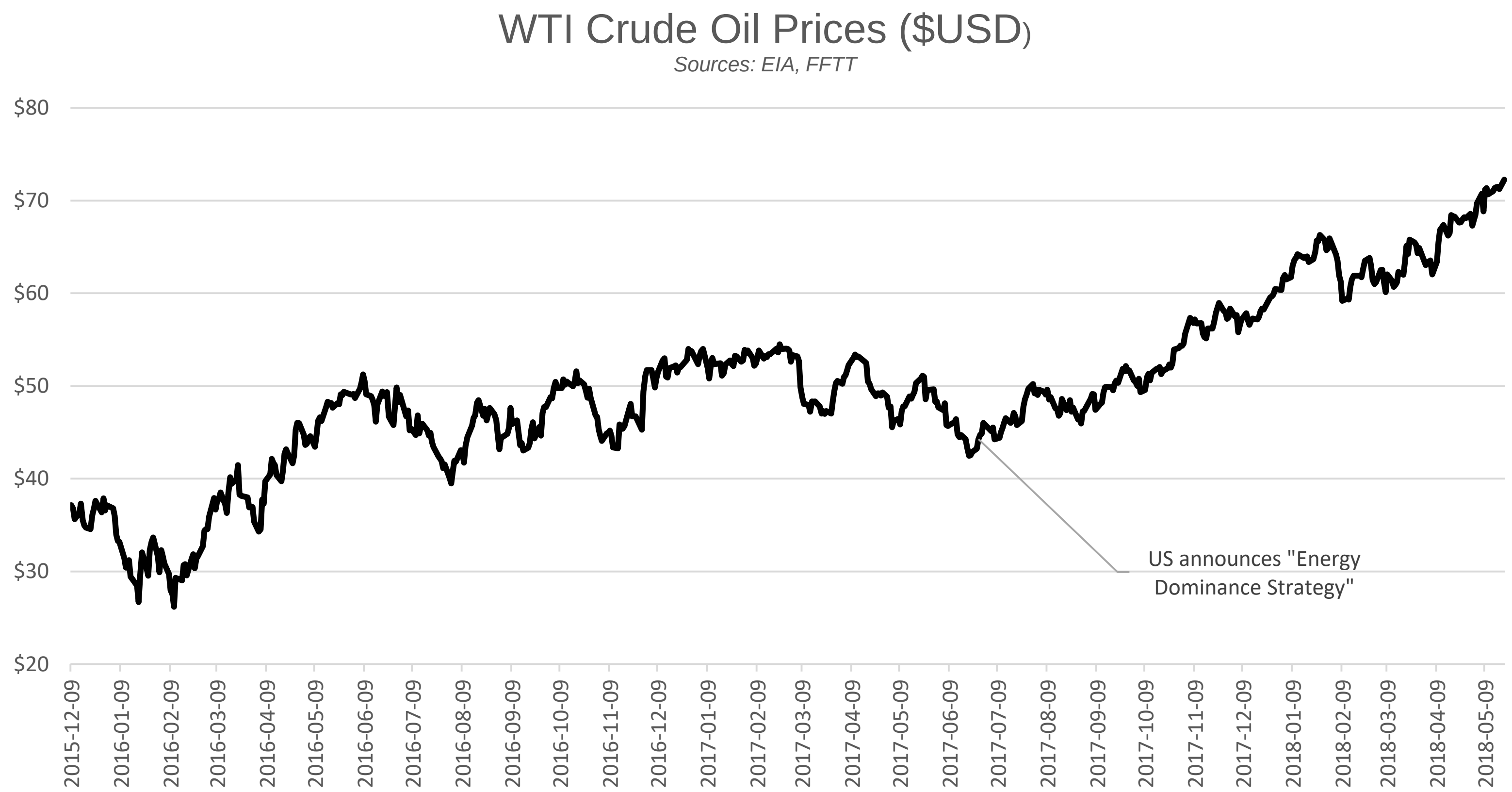


Have US attempts to weaponize the USD/"burn down the world" hit a "UK Suez Moment"? *Even our staunchest allies are unhappy with Iran sanctions:*

US sanction power may be reaching its limit, "response to Iran decision shows global economy won't be bossed around forever" – 5/22/18
https://www.bloomberg.com/news/articles/2018-05-22/u-s-sanction-power-may-be-reaching-its-limit

- *"You f***ing Americans," the message read. "Who are you to tell us, the rest of the world, that we're not going to deal with Iranians?" -UK banker, in 2012.*

EU to start Iran sanctions blocking law process to ban EU companies from complying w/US sanctions – 5/17/18
https://www.reuters.com/article/us-iran-nuclear-eu-response/eu-to-start-iran-sanctions-blocking-law-process-on-friday-idUSKCN1II20A

India says it only follows UN sanctions, not unilateral US sanctions on Iran – 5/28/18
https://www.reuters.com/article/us-india-iran/india-says-it-only-follows-un-sanctions-not-unilateral-us-sanctions-on-iran-idUSKCN1IT0WJ?feedType=RSS&feedName=worldNews

Australia & Japan still support the Iran deal – 5/9/18
https://www.apnews.com/7769da33651a449196128dbdf1bcf48c

Russia stands by Iran, condemns US sanctions – 5/23/18
http://www.xinhuanet.com/english/2018-05/23/c_137201107.htm

China will continue to cooperate w/Iran w/out violating int'l obligations, foreign ministry spokeswoman says – 6/4/18
https://www.pakistantoday.com.pk/2018/06/04/china-to-cooperate-with-iran-without-violating-international-obligations-fm/

Merkel Warns of G-7 Summit Split Over Trump's 'America First', says world becoming 're-ordered' globally – 6/6/18
https://www.bloomberg.com/news/articles/2018-06-06/merkel-warns-of-g-7-summit-split-over-trump-s-america-first

Fascinatingly, global prestige financial media are suddenly warning about USD's reserve status over the US Iran sanctions:

US sanction power may be reaching its limit, "response to Iran decision shows global economy won't be bossed around forever" – 5/22/18
https://www.bloomberg.com/news/articles/2018-05-22/u-s-sanction-power-may-be-reaching-its-limit

- *"Europe & China have banks. One of these days, the US is going to talk the USD right out of its international role." -Jeff Sachs*

The long arm of the USD – how to escape a hegemonic currency – May 2018
https://www.economist.com/finance-and-economics/2018/05/17/the-long-arm-of-the-dollar

- *"The more we condition use of the dollar and our financial system on adherence to US foreign policy, the more the risk of migration to other currencies and other financial systems...grows"*

America beware: USD supremacy is not forever – under Trump, US increasingly seen as unreliable partner – 5/20/18
https://www.ft.com/content/3d4d1190-5931-11e8-806a-808d194ffb75

- *"China & South Korea are conducting trade using their own currencies rather than relying on the USD as a "vehicle currency". The logic for denominating in USD virtually all contracts for oil & other commodities is waning."*

Donald Trump is jeopardizing the dollar's supremacy – 5/31/18
https://www.ft.com/content/7cc729c2-6328-11e8-a39d-4df188287fff?emailId=5b0f23ba9954000004bb6d9c

- *The world could be entering an era of multiple reserve currencies, as Barry Eichengreen predicts. This has been typical through most of history. In between the world wars, the USD & GBP shared the stage with the French franc and the Deutschemark. Today, the rival contenders would be the CNY & EUR. The transition could even be a smooth one. But it is also possible that the US will have a massive debt shock, caused by a war, or another 2008-scale financial meltdown. A return to protectionism might do similar damage. At that point, the USD would cease to be king.*

"EU-US-Iran issue is existential for Swift as a global network": FT – 6/6/18
https://www.ft.com/content/9f082a96-63f4-11e8-90c2-9563a0613e56

- *Swift's very survival as a worldwide system for facilitating cross-border payments depends on it resisting such attempts to "weaponize" it for political ends, said Nicolas Véron, senior fellow at the Peterson Institute for International Economics." The Europe-US-Iran issue is existential for Swift as a global network," he said of the action against the company, which is owned by about 2,400 banks and other financial institutions.*

…or perhaps just reiterating Pres. Obama’s (& Secretary of State John Kerry’s) warning from August 2015?

We cannot dictate the foreign, economic and energy policies of every major power in the world. In order to even try to do that, we would have to sanction, for example, some of the world's largest banks. We'd have to cut off countries like China from the American financial system.

And since they happen to be major purchasers of our debt, such actions could trigger severe disruptions in our own economy, and, by the way, raise questions internationally about the dollar's role as the world's reserve currency. That's part of the reason why many of the previous unilateral sanctions were waived.

- **-Pres. Barack Obama, 8/5/15**

What's going on here?

GaveKal's Charles Gave recently gave an interesting interview on MacroVoices:

Charles: Okay, you are China. You want to de-dollarize the world. So you have to offer a credible alternative to the dollar. You want to de-dollarize not only trade between nations in Asia – if Korea was selling goods to Taiwan, they were settling their accounts, up to two or three years ago, in dollars. And the Chinese are saying, why on earth do we have to use the dollar to settle the account between us? So they are trying to do that.

They are also trying to de-dollarize the oil markets. That has started with Russia. Iran is now selling its oil in Euro. So you have a lot of movement saying that there is something happening also in the oil markets.

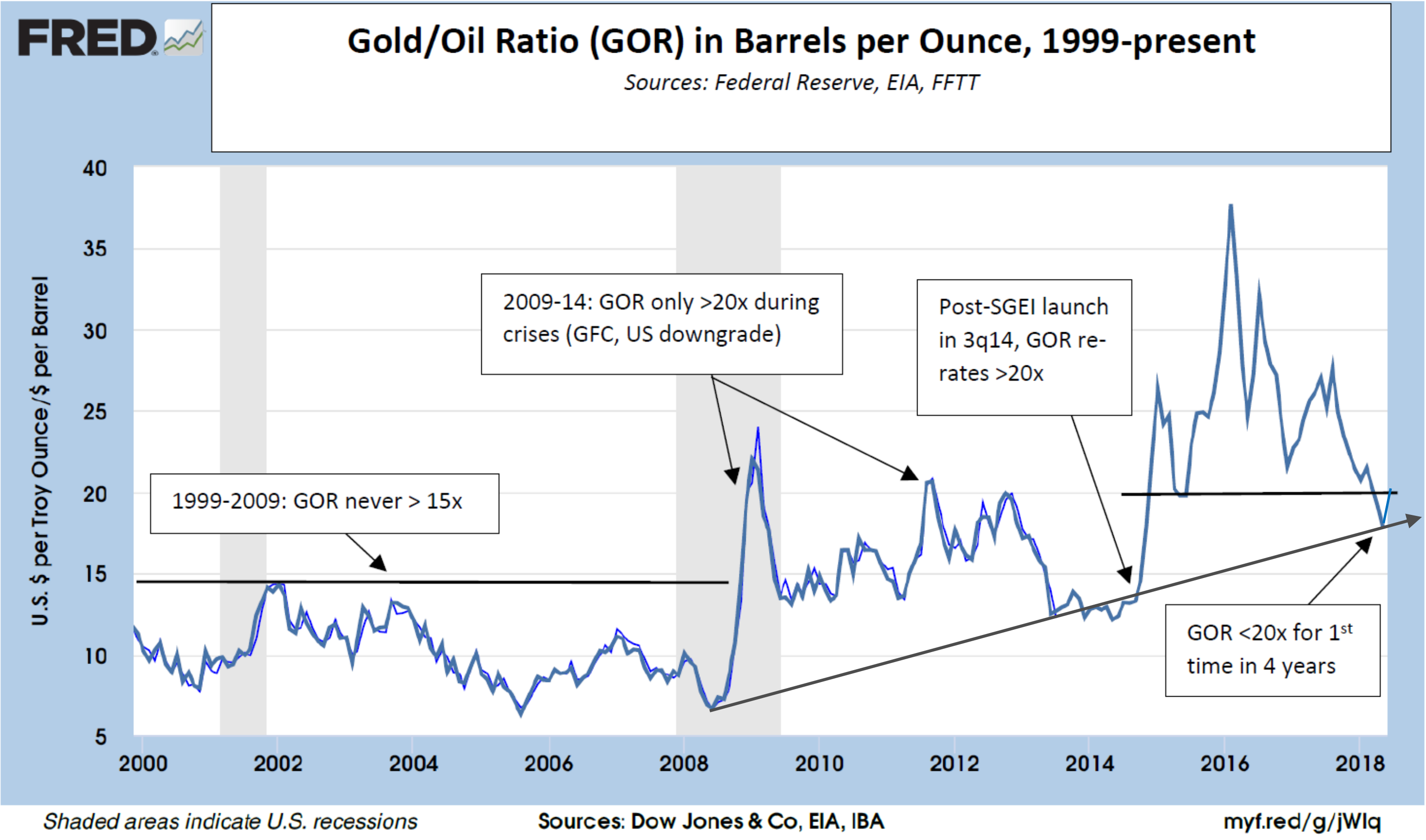
So the Chinese want to de-dollarize. But now the problem is that they want also to keep their capital account closed. In simple words, that means that they want to control the money that comes in and out of China. So it's difficult to tell people you should keep your reserves in renminbi if at the same time you prevent the guys from either investing in China or taking their money abroad. You see what I mean there.

There is a very astute solution that the Chinese have found: It has been to say, guys, look, if you have too many renminbi because you have been selling a lot of oil to China, or whatever, we will settle either in renminbi, you can keep your renminbi in your reserves, fine with us. Or we can give you gold instead of renminbi.

So you have to understand that the gold price is now a big play between the US and China. For the Chinese currency to be credible, a big rise in the price of gold would help them tremendously. Because they have been buying gold like crazy for the last six or seven years. So they have huge inventories of gold. And that is what will ultimately lend a lot of credibility to their currency.

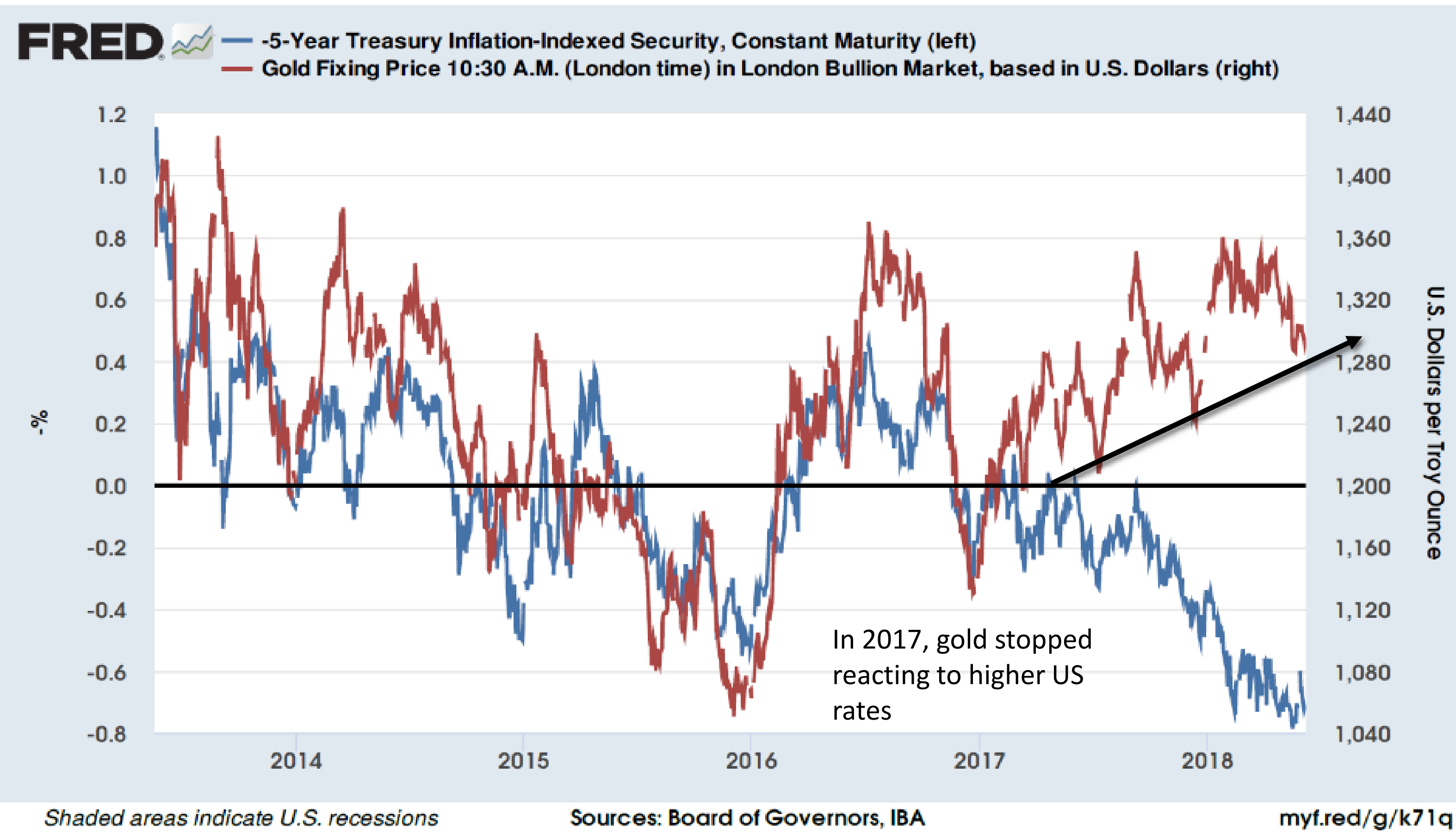
On the other hand, the Americans don't want that de-dollarization because that's part of their power. And so what they are trying to do is prevent gold from going up. So, to a certain extent, the price of gold is going to tell you who is going to win in that effort to de-dollarize Asia. If gold goes up, it's China. If gold goes down, it's the US.

“If gold goes up, China is winning; if gold goes down, the US is winning.” – Charles Gave, GaveKal



"If gold goes up, China is winning; if gold goes down, the US is winning." – Charles Gave, GaveKal

US 5y TIPS (inverted) v. Gold



So How Do We Make Money With This in 2H18E?

"Tale of Two USD Trades" framework:

- Near term, look for Fed to continue tightening to support USD; not a good outlook for risk assets broadly, esp EM, commodities, etc.
  - Governors = "Shoot the Hostage", "Burn down the world", & when do US equity markets not rising weigh enough on US GDP growth?
  - Can repealing Dodd-Frank bank balance sheet restrictions create more US domestic buying power for UST's to fund US deficits?

- Structural USD Trade: US creditors continue to de-dollarize global commodity trade at accelerating rate.
  - Alternative to USD-centric system nearly ready to go.
  - London Gold Pool II = binary risk as China, Russia, etc. buy ever more physical gold?
  - Trump tariffs pushing world away from USD-centric system, seemingly fighting the Fed on USD – "Machiavellian" or just "Mistaken"?

So How Do We Make Money With This in 2H18E?

Unless either…

- *Global CB's begin sterilizing massive (& growing) US deficits again*
- *The US is able to convince China/Russia to stop de-dollarization (up to and including going to war with China, Russia & others);*
- *The US is willing to nominally default on Entitlements, DoD, UST's (or all 3);*

…1 of 3 things likely must happen later this year:

- *The USD must weaken further (& possibly significantly), or;*
- *The Fed will have to back off their "3 rate hikes this year, next year" narrative.*
- *Risk assets are likely to have another risk-off stretch in 2H18E*

So How Do We Make Money With This in 2H18E? *Near Term v. Intermediate/Long Term*

Near term (next 2-3 months): *"US Impossible Trilemma".* Fed appears to be attempting to stabilize USD in attempt to grow private sector bid at long end of UST curve given the continued absence of a Central Bank bid for UST's = good for UST's, USD, but likely not for risk assets = volatility may elevate next 2-3 months, increased vol may be good for gold too.

Intermediate/Long Term: Long commodities, industrials, especially those exposed to vehicle electrification/infrastructure.

Long equities, especially EM & US multinationals that will benefit from a weaker USD.

Short UST's, but only as a pair to the above *(i.e. levered long risk assets).*

Short USD's.

Look for derivative trades that work if the Fed surprisingly reverses course on planned interest rate hikes ("steepener derivative trade"?).

Long gold.

Given that we are dealing with "Political Economy" outcomes, we must now consider "Political Economy" wildcards within our "risk frameworks":

All of the aforementioned in turn leads us to three big "pain trades" for 2H18E, situations where the majority of investors appear to be leaning notably in the possible "wrong" direction.

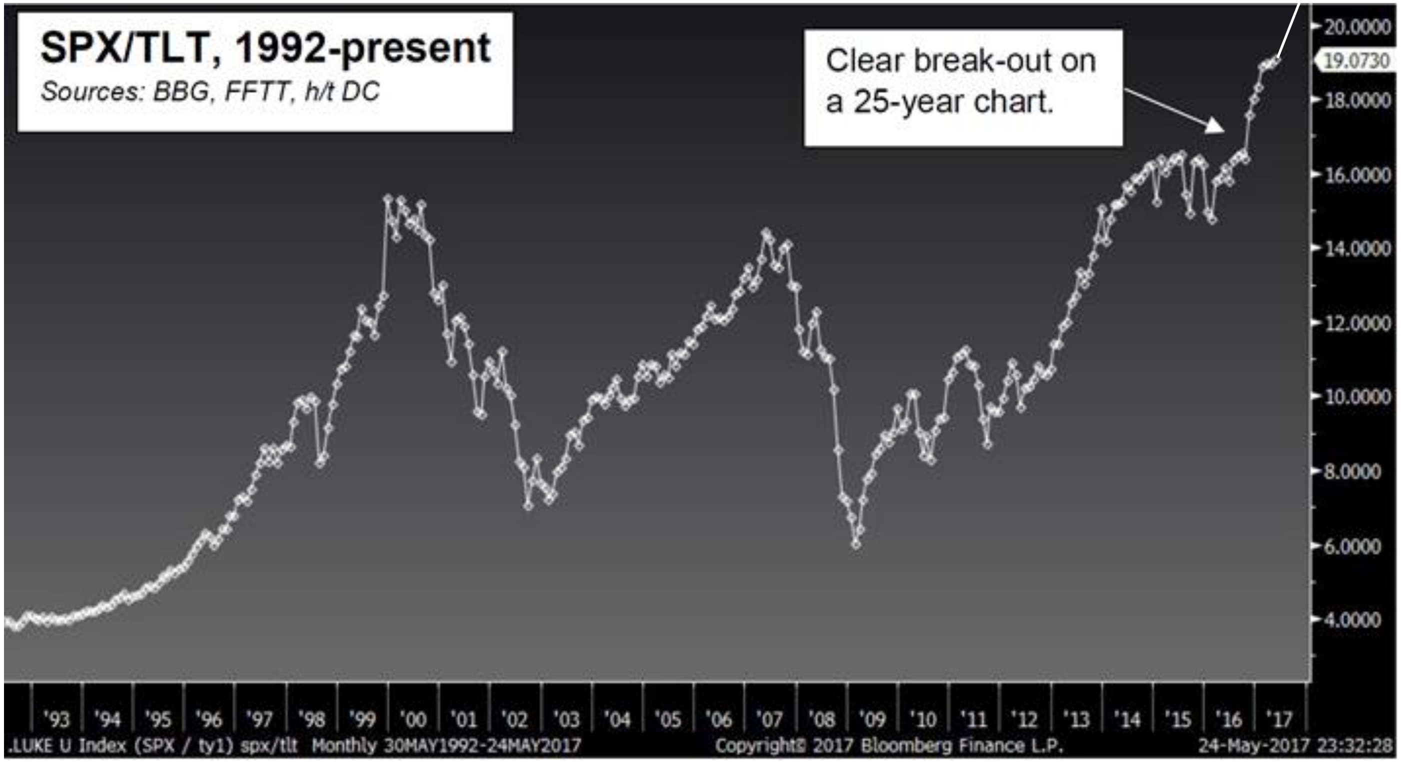
Pain trade #1: The US will not "burn down the world" to defend the USD (i.e. force the world to finance US deficits.) <*Bad for Risk assets, esp EM's & Commodities*>

Pain trade #2: China is going to play along with US sanctions on Iran like China did in 2012. <*Bad for oil, related names*>

Pain trade #3: The US economy will be the last economy to be hurt by higher rates & USD strength. <*Bad for USD v. EUR, CNY*>

Near term, the SPX/TLT breakout has paused; intermediate-term we continue to think this is a key metric/way to play trends we're describing – "short UST's", but only against risk assets:

"Long term bonds are a terrible investment at current rates…T-bonds haven't been attractive ever except in the early 1980s, when they briefly offered a 14% return." -Warren Buffett, 2018



DISCLOSURES:

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