The Near Term Direction Of The US Dollar

Louis-Vincent Gave
lgave@gavekal.com

The US dollar is trading bang on its 50-day moving average, and roughly where it was a year ago. Hence, it is tempting to conclude that it has not done much over the past 12 months. That would, of course, be wrong for the post-April rebound in the dollar explains the summer meltdown in emerging markets. And every investor today stands ready to increase or decrease risk in their portfolios depending on the next tick in the US dollar.

There are good reasons to be bullish on the US dollar but also reasons to be bearish

There were good reasons to be bearish on the dollar over the past year: US government spending has been running away, the budget deficit is widening, as is the trade deficit, and inflation is rising. There have also been reasons to be dollar-bullish: the Federal Reserve has been the only major central bank to properly tighten monetary policy, oil prices have risen (implying more demand for dollars), a new eurozone crisis, based on Italy, looks possible and Trump's tax cuts have caused dollars to be repatriated, thereby reducing the offshore pool and squeezing EMs like Turkey, Argentina and South Africa.

I see four reasons that may explain the fading of the US dollar rally

What the US dollar's one-year sideways move tells us is that these forces have largely canceled each other out (see left hand chart overleaf). It is noteworthy that in August the trade-weighted dollar rose only slightly, despite solid US equity outperformance (MSCI US was up 3.5%; MSCI World (ex-US) was down -2%). Thus even as capital pours into the US to buy equities, the currency is no longer benefiting. It is notable that these moves have occurred despite poor European news-flow with weak industrial data, bad poll numbers for Emmanuel Macron and worsening Italian political fissures. In Asia, China is slowing and Japan is putting consumption tax hikes back on the table. Given all of this, I see four obvious explanations for the fading US dollar rally.

First, the language of the Federal Reserve has softened

1. **Fewer Fed rate hikes**: The easiest explanation for the dollar's momentum change is that at the recent Jackson Hole confab Fed Chairman Jay Powell did not sound as hawkish as the market expected. After all, the US dollar peaked in the days before the central bankers' off-site. Since then the market seems to have focused on the renminbi's -10% devaluation

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US PPI rose 2.8% YoY in Aug, from 3.3% in Jul; ex food & energy rose 2.3%, from 2.7%	Both lower than 3.2% and 2.7% expected respectively	Upward trend intact; expect US inflation to only rise gradually
Eurozone industrial production fell -0.8% MoM in Jul, from -0.8% in Jun	Worse than -0.5% exp.; YoY, IP fell -0.1%, from 2.3%; Italian IP fell -1.8% MoM, -1.3% YoY	No sign of pickup; weak Ita IP makes budget commitments more difficult to achieve
China's aggregate social financing rose by RMB1.52trn in Aug, from RMB1.04trn in Jul	Better than expected; new Yuan loans rose by RMB1.28trn, from RMB1.45trn	Total money supply slows steadily; slight shadow finance boost due to loosening regs
India CPI slowed to 3.7% YoY in Aug, from 4.2% in Jul	Below 3.8% expected; easing of food price inflation outweighed rise in imported inflation	Rising oil prices and weak INR will likely exert upward pressure on inflation ahead

© Gavekal Ltd. Redistribution prohibited without prior consent. This report has been prepared by Gavekal mainly for distribution to market professionals and institutional investors. It should not be considered as investment advice or a recommendation to purchase any particular security, strategy or investment product. References to specific securities and issuers are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

and EM-currency car crash and decided that this situation does pose a real deflationary threat (such a shock may become visible through disappointing producer price and consumer price releases). To keep it simple, big EM currency devaluations mean that US inflationary pressure will be checked, lessening pressure on the Fed to tighten. Such a scenario is supported by the US auto and housing markets seemingly rolling over (see **The Signaling From US Autos** and **US Housing Gets Vertiginous**).

Second, the flood of dollars being brought back into the US by corporates may have slowed or stopped

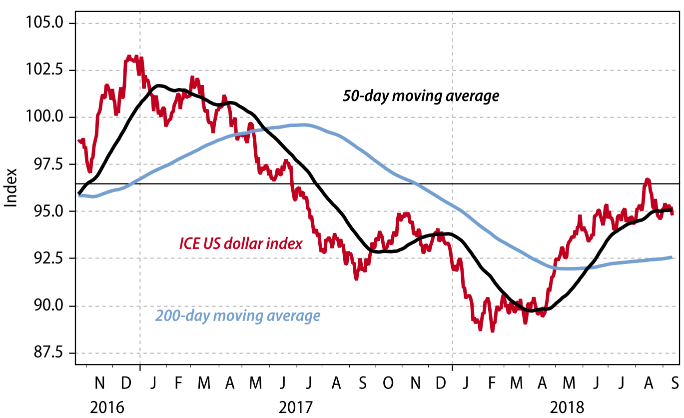
2. **Tax-cut induced US dollar repatriation may be ending**: Last year's tax cuts allowed US firms with dollars stacked abroad to repatriate earnings often built up over many years. As they did, offshore dollars became scarce (see **Don't Fret About Libor**) and the ensuing scramble for US currency caused the likes of Argentina and Turkey to be cut off. However, such a big repatriation should be a one-off event to which markets have adjusted (though not the weakest EM links). Thus, as the flow of offshore dollars back into the US abates, the dollar squeeze may ease up.

Third, the market may finally be focusing on what huge deficits mean for the value of money in the US

3. **Growing US debt is becoming a problem**: If at the start of this year, I had been told that the Argentine peso and Turkish lira would be down 40-50% against the US dollar and China and India would see their currencies fall by -10%, I would have assumed that investors could not own enough long-dated US treasuries. Yet such treasuries are down for the year. So despite this turmoil, why has the global "safe" asset of choice not rallied? Is it because the US budget deficit is now set to rise *ad infinitum*? Given US policymakers' reluctance to tackle the issue, perhaps. Ahead of the November mid-term election, Republicans are running on a platform of more tax cuts, while Democrats are calling for more spending. No one is stopping to ask who will fund this largesse—except perhaps Mr. Market. Think of it this way: given the awful external picture, wouldn't you have expected the dollar to have sustained its rally and for treasuries to be in positive territory for the year? Imagine if Europe and emerging economies do eventually see improving growth, while the US continues to run huge deficits—the dollar and treasury market could then get properly smoked.

A stalling of the US dollar surge?

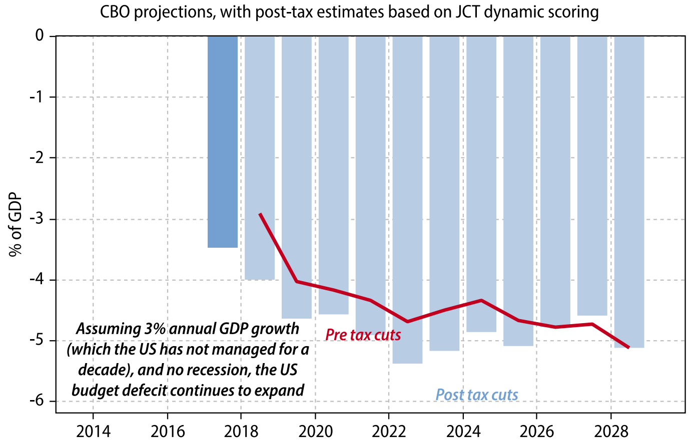
US$ DXY index



Gavekal Data/Macrobond

The US budget deficit will continue expanding in the coming years

CBO projections, with post-tax estimates based on JCT dynamic scoring



Gavekal Data/Macrobond

Fourth, the US looks to be softening its stance in the trade war it launched

4. **The US has lately backed away from a "trade war on all fronts"**: It is seeking a middle ground with the European Union, Mexico and perhaps even the evil Canucks living north of the 49th parallel. The question is whether these deals are just President Trump's way of working (see **The Bullish Logic Of Trump's U-Turns**), or whether they were done to tie up loose ends and, as Arthur argued yesterday, allow a full focus on China (see **An Irresistible Trade Policy Meets Immovable Interests**). If Anatole is right and the US backs down then the "safety bid" for the dollar and treasuries should disappear. But if Arthur is right and the end goal of US policy is to disentangle the integration of US-China supply chains, is that really so bullish for the dollar over the long run?

   It may not, as China's logical response to being cut off from earning US dollars will likely be to accelerate the de-dollarization of Asian trade, and the de-dollarization of the commodity trade (see **A National Security Imperative**). With this in mind, it is interesting that in the face of volatility among EM currencies and decent commodity price volatility, the price of gold denominated in renminbi has lately been as flat as a pancake. For all the talk of how the renminbi is now managed against a basket of currencies, it actually looks like it is managed against gold! And given the imperatives just outlined, perhaps that is not a bad strategy.

The question is if the dollar has stalled, is this enough for EMs and Europe to stage a recovery?

Yet, as argued at the start of this note, there are many reasons to think that the US dollar liquidity crisis is far from over. Oil prices are still rising, with Brent crude yesterday breaking US$80 a barrel (the effect will be to boost demand for dollars among oil importers). Italy remains a worry, especially as populist politicians across the block seem to be training their fury on Brussels. Major central banks in Europe and Japan do not seem to be in a hurry to raise interest rates. US equities are still outperforming, so the marginal dollar is likely to continue pouring into US stocks. Hence, given that the dollar's recent stall has happened against such a backdrop, the question must be whether it's enough for EMs, and even Europe, to bounce back.