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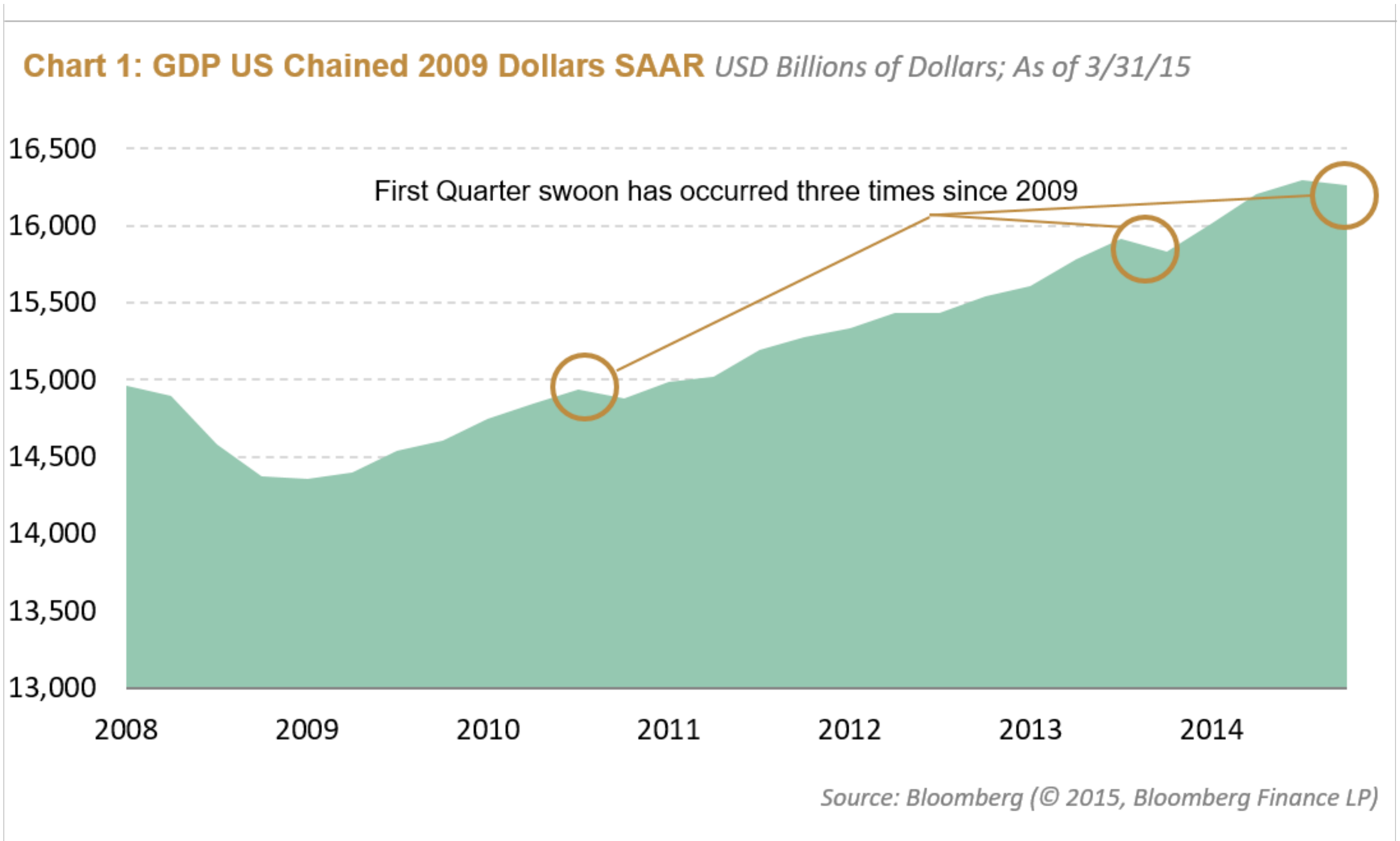
Featured G

Around the Curve

A Dollar for Your Thoughts?

The poor performance of the U.S. economy in the first quarter largely reflects the "redistributive" nature of recent foreign exchange adjustments—the dollar's surge since June 2014 has significantly brought down manufacturing activity in the U.S. Similarly, the large drop in both the euro and the yen has helped Europe and Japan, respectively.

Of course, bad weather and the West Coast port strike also put a dent in first-quarter growth. The "first quarter contraction" conundrum has actually been a recurring phenomenon since 2009, occurring in 2011, 2014, and again this year. In previous instances, the contraction was followed by a rebound; currently, the Federal Reserve (Fed) is betting on a similar rebound.



Two important, yet outstanding, issues stand out in Chart 1: has the dollar exhausted its upside potential? And what are the odds the world economy will stay subdued rather than swing to the upside?

It is very tempting to think that the dollar's upward climb is over, given the economy's poor first quarter performance, deteriorating corporate profit growth, and increasing trade deficit. Generally, most market participants are also very long the dollar, which could imply the greenback's buying power is near exhaustion.

The U.S. dollar is considered overbought and expensive, and yet most market participants have accepted the

bullish view on the currency. From a contrarian viewpoint, these factors instead seem to suggest a possible U.S. dollar top.

Nevertheless, my inclination is the dollar bull market has only traveled two-thirds of its distance and has therefore not yet reached its final stage, based on three factors under consideration.

First Factor

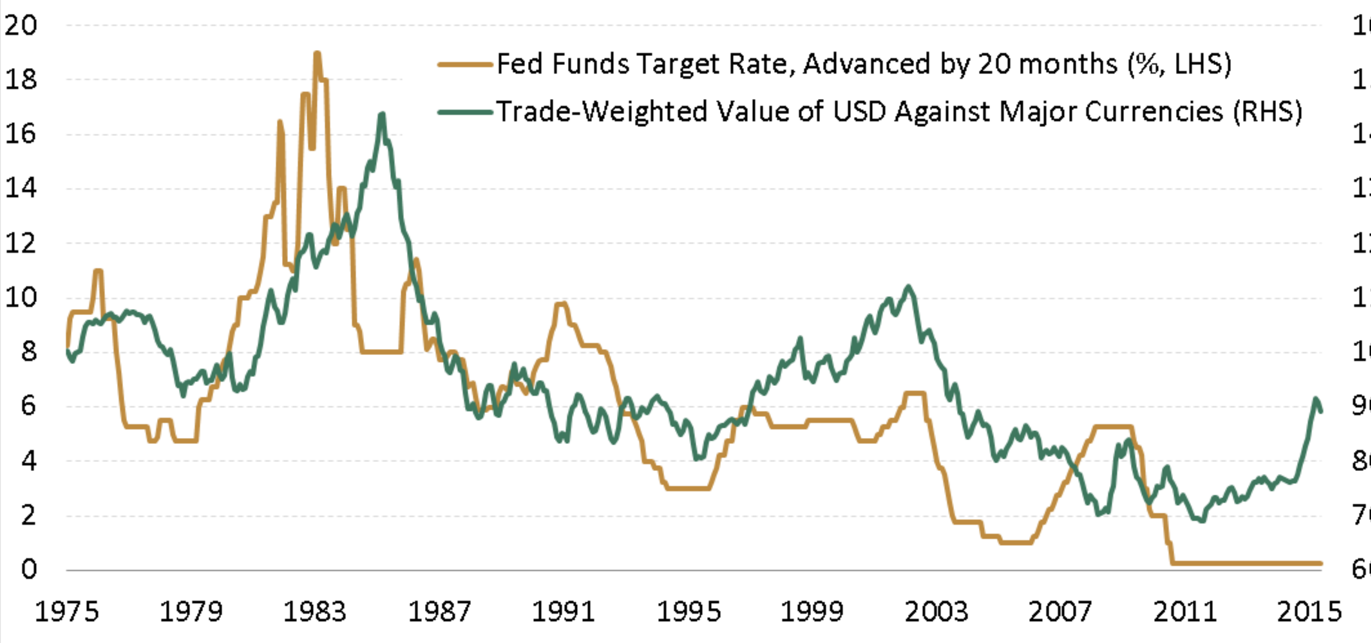
A dollar bull market has historically occurred at times the Fed was raising rates and/or the rest of the world was easing. The dollar bull market during the first half of the 1980s was set off by the combination of expansionary fiscal policy (Reaganomics) and then-Fed Chairman Paul Volker's draconian monetary tightening.

Similarly, monetary tightening on the back of a booming U.S. economy also led the bull market in the second half of the 1990s. At the time, the Bundesbank and Bank of Japan slashed rates concurrently, creating the first policy divergence in post-war history, and causing the dollar to soar. My colleague Francis Scotland has correctly observed that financial or economic crises often erupt in the wake of a dollar surge, usually near its top. This correlation is largely reflective of Fed monetary tightening, which typically jacks up the dollar—and pegged exchange rates—which then transmits U.S. monetary policy to the emerging market world. As a result, a rising dollar has often coincided with financial crises.

In Chart 2 below it is clear that although rising interest rates may not always lead to a bull market in the dollar (e.g. 2006-07), a major cyclical top in the dollar always requires Fed monetary easing.

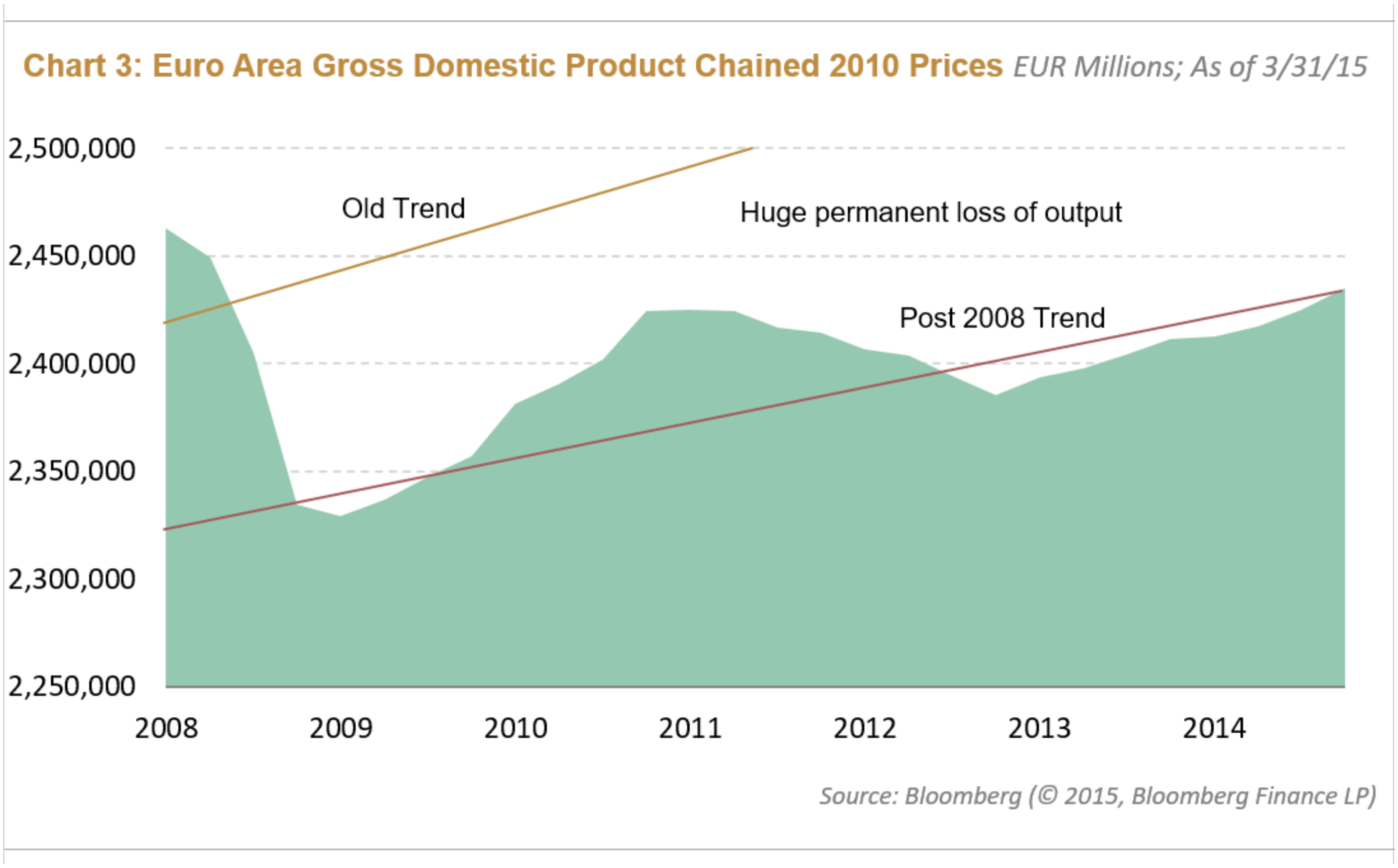
Currently, the Fed is just beginning to move onto the path of raising rates, while the rest of the world is only half way through a monetary easing cycle. Therefore, it seems way too premature to call a new bear phase in the dollar.

Chart 2: Federal Funds Target Rate *Advanced by 20 months; As of 4/19/15*



Source: Thomson

The policy divergence between the U.S. and the rest of the world will probably remain in place for at least two-to-three years. While the gap in U.S. output has narrowed to almost nothing after six years of economic expansion, the euro-zone's economy is nowhere near clawing back to the level of output that was lost during the 2008 recession. The euro-zone economy's comparative weakness means that deflation will be a constant threat to the global economy. Chart 3 does not conjure up images of a strong euro.

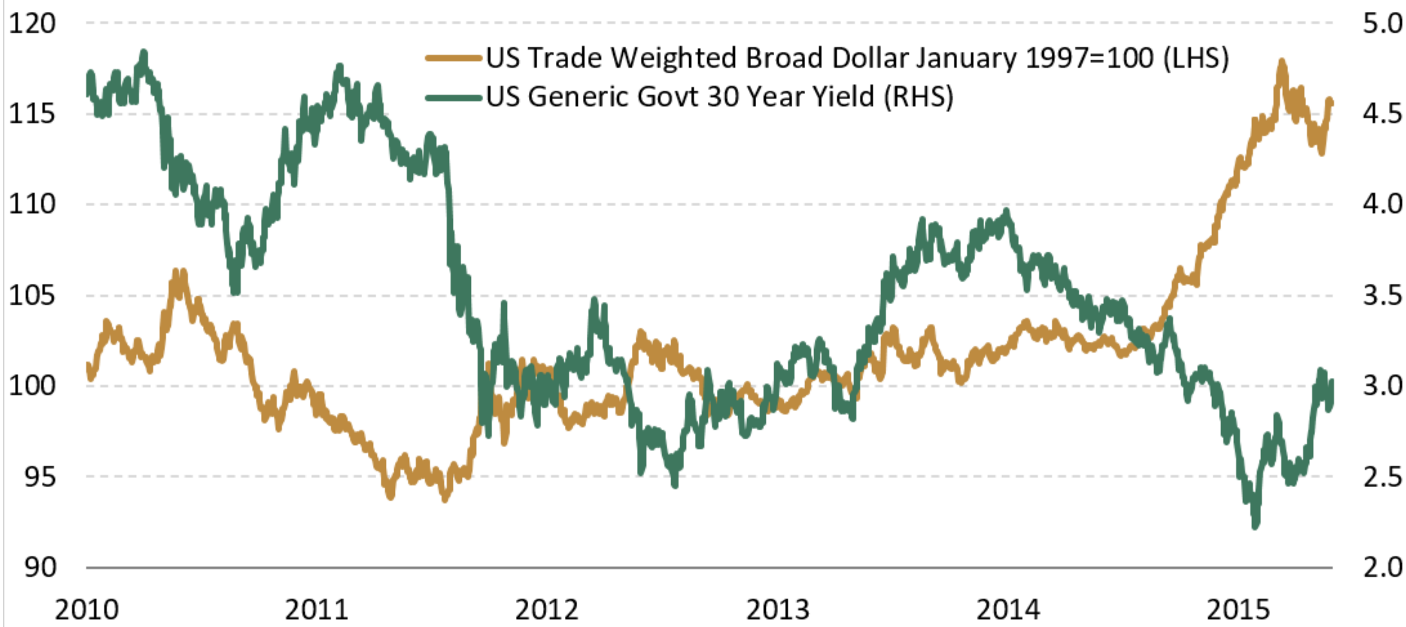


Second Factor

The U.S. export and manufacturing sector has been hit hard by the dollar's strength, which contributed to the U.S. economy's technical contraction in the first quarter. Nevertheless, we need to put the story in proper perspective: U.S. manufacturing as a share of gross domestic product (GDP) is 12%. Even if manufacturing activity were to decline by 5%, only 0.6% would be subtracted from GDP growth.

According to the 10-1 rule, every 10% in dollar appreciation is equal to a 1% interest-rate hike. However, it is extremely important to remember that the negative correlation between the dollar and bond yields ensures a steady monetary condition. Although the dollar has gained 12% since June 2014 in broad trade-weighted terms, yields on 10-year Treasury bonds have dropped by 100 basis points. The negative correlation is a near perfect offset, so there is good reason to believe that underlying monetary conditions in the U.S. remain largely unchanged from a year ago when the dollar surge just started.

Chart 4: US Generic Gov't 30 Year Yield and US Trade Weighted Broad Dollar *As of 6/2/15*



Source: Bloomberg (© 2015, Bloomberg Finance LP)

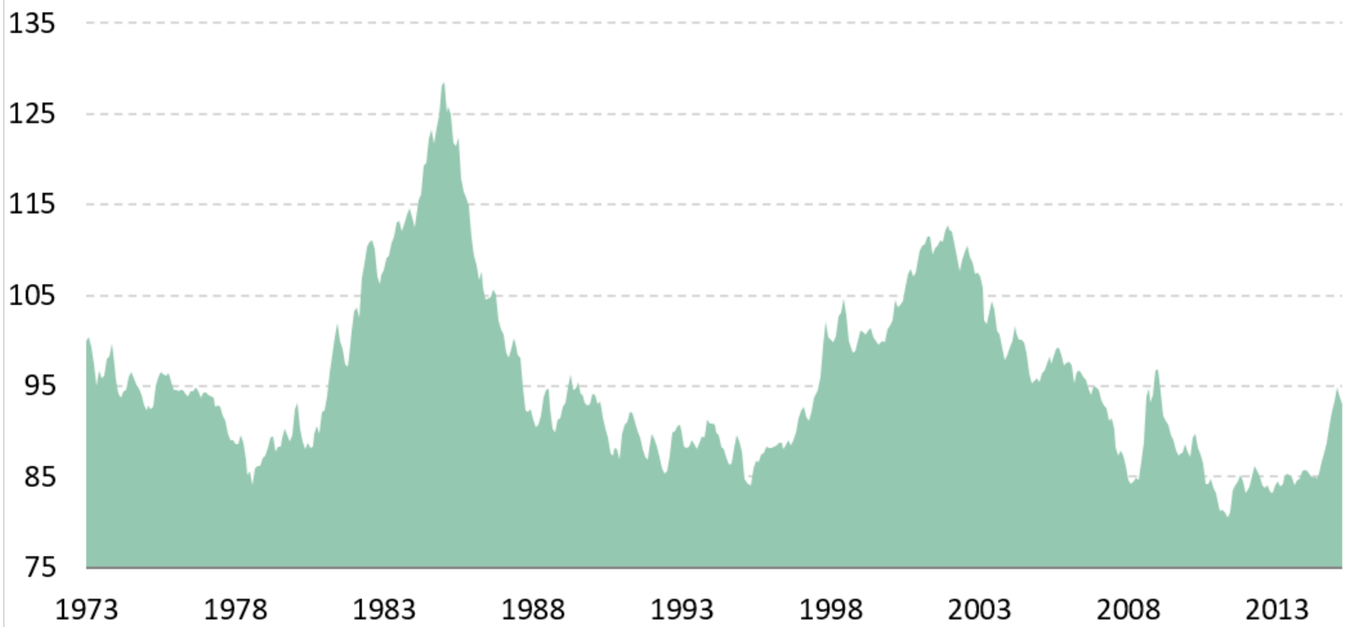
This happened during the second half of the 1990s when the dollar surge depressed exports, but also placed huge downward pressure on bond yields which, in turn, triggered a boom in consumer spending, and caused the U.S. current account deficit to soar.

It looks like the U.S. economy is currently making a similar transition, with GDP growth contracting in the first quarter, and U.S. consumer spending holding up reasonably well. Income growth has been steady and housing activity is picking up again. If the late 1990s is any guide, we should see domestic spending and interest rate sensitive sectors (e.g. financials and banking) pick up soon on lower bond yields. If so, the U.S. economy will demonstrate renewed strength, allowing the dollar to gain additional ground.

Third Factor

Although the U.S. Dollar Index has surged more than 20% within a very short period, the increase in the broad trade-weighted dollar has been much more muted. Chart 5 shows the real broad trade-weighted dollar has rallied slightly more than 10% since 2014; this rally is much smaller than the previous two big bull markets.

Chart 5: US Trade Weighted Real Broad Dollar *As of 5/31/15*



Source: Bloomberg (© 2015, Bloomberg Finance LP)

In fact, most of the emerging Asian currencies have remained steady or strong versus the U.S. dollar: the Chinese renminbi has stayed flat, the Korean won has appreciated over the last four years, and the Taiwanese dollar has also appreciated since June 2014. These countries are big trading partners of the U.S. and their steady currencies explain the muted appreciation in broad trade-weighted dollar terms.

Although the euro and Japanese yen have fallen sharply, the actual dollar appreciation is much more modest than what appears to be in the marketplace after taking my three factors into account. Therefore, we should not be exaggerating the damage the strong dollar may be having on U.S. trade, or underestimating the U.S. economy's ability to absorb a further rise in the dollar.

What does this mean for markets?

- It is possible the pause in the dollar bull market is over and the greenback will move into its last and perhaps over-shooting stage of the rally with an unknown duration, driven by the intensification of policy divergence on the back of an improving U.S. economy and possible Fed lift-off this year and softening growth throughout the rest of the world.
- China will not devalue its currency, which increases downward pressure on the Chinese economy and the urgency of more aggressive rate cuts to compensate the tightening by an overvalued Chinese yuan. So far the Chinese equity market is betting that Beijing will deliver, but we need to watch whether the authorities move quickly and aggressively.
- A rising dollar is negative for commodity prices. Moreover if the dollar retests its old highs or makes new highs, U.S. bond yields may retest their old lows. However, a rising dollar could be a negative for U.S. stocks, likely leading to a period of underperformance, but markets with cheaper currencies could outperform.

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