Weekly Market Summary

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Time to Worry About a Weak US Dollar?? Depends Which Country You're Really From!!

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On January 12th, 2018 – following the release of data showing the underlying pace of US inflation accelerated in December – US 2-year treasury yields jumped above 2.0%, marking a rebound to a key psychological level that was last seen just as the U.S. sank into the depths of the financial crisis in September 2008 (the low for this cycle stands at 0.145%, traded on September 19th, 2011). In fact, the past 14 months have witnessed a remarkable reversal for the coupon maturity that is most sensitive to Federal Reserve expectations: After hovering around the 1.0% mark for most of 2016, the two-year yield surged following President Donald Trump's surprising election victory later that year, and kept climbing throughout 2017 as policy makers delivered on their promised three rate increases.

This morning, the Treasury 10-year rate joined the bull party, rising to the highest level in more than three years and extending the selloff that had marked the start of 2018 for the world's largest debt market. The yield climbed to a high of 2.64% on the prospects of more Federal Reserve rate hikes and increased government debt issuance to finance America's widening budget deficit. With President Donald Trump planning to release his infrastructure proposal as early as this month, and equity and oil prices continuing their relentless rally to new records (a three-year high for Brent prices), growth and inflation expectations remain very buoyant. The yield advance also comes as the House passed a spending bill to avoid a U.S. government shutdown, though Senate Democrats said they have the votes to block the measure in the Senate (the latter held a procedural vote, which did not pass the spending bill and has called a recess until Friday, when it will try to pass the bill before the shutdown kicks in at midnight!). As a refresher, a government shutdown in the US occurs whenever Congress and the President fail to pass appropriations legislation funding government operations and agencies. In case that happens, the current interpretation of the "Antideficiency Act" requires that the federal government begin a "*shutdown*" of the affected activities involving the temporary layoff of non-essential personnel and curtailment of agency activities and services.

And yet, the US Dollar index continuous to perform very poorly!!

US Dollar Index (USDX) – Daily Chart

Dollar weakness was one of the main market features of 2017, defying the predictions of many analysts and economists at the start of that year. And though it was held in check during the months of September and October, its downward path has resumed and resisted supportive factors such as a strengthening US economy, recent passage of major US tax reforms and surging US bond yields (the 10-year UST/German Bund yield differential currently sits at 205 bps, having been as tight as 165 bps a year back). When measured by the DXY index, the dollar's value against other currencies has dropped 10% in 2017! Its fall has now extended into the first few weeks of 2018 (another 2% drop), with the index measuring the currency against its leading peers touching a three-year low! "*In large part, the dollar's decline reflects the markets' perception that Europe is catching up with the US; that as the recovery gathers pace, the ECB will be able to follow the Federal Reserve and start normalising policy*," says Karen Ward, chief market strategist for the UK and Europe at JPMorgan Asset Management. "*But while the recovery is accelerating in the Eurozone, that doesn't mean the European Central Bank is on course to shift from accelerator to brake. There is little sign inflation is picking up and the most recent comments from the ECB recognise this."* Simon Derrick, of BNY Mellon, added that although a breakdown in correlations between the euro-dollar currency pair and two-year German/US differentials tended to occur around big shifts in monetary policy, "*the reach for yield as a driving force for EUR/USD appears to be dead for the moment*". The persistent weakness of the greenback is forcing global central bankers to step up their efforts in warning about the cost of currency appreciation on their economies. The decline in the global reserve currency matters greatly for other economies that have witnessed a rebound in growth thanks to stronger exports, such as Europe and Japan. The euro, which has risen by as much as 2.7% since the start of the year, dropped sharply from an intraday high of $1.2322 last Wednesday after Vítor Constâncio, European Central Bank vice-president, became the latest policymaker to take issue with the single currency's sharp rise against the dollar. "*I am concerned about sudden movements [in the euro] which don't reflect changes in fundamentals*," he said. Ewald Nowotny, fellow ECB member, added that the euro's rise was "*not helpful*". The yen appreciation was also held in check in past week on central bank "*jawboning*". Taro Aso, Japan's finance minister, said it was "*not a big deal*" if the yen's value was about $110.80, but added that rapid currency moves would be a problem.

With a US government shutdown looming large in the coming 24 hours, one fears that sentiment for the US currency could deteriorate further. Should it materialize, and depending on how long it lasts, a government shutdown would hurt US business and consumer confidence and thereby growth. This would in turn further weaken the USD against the EUR, JPY, CHF and GBP. Whether or not the USD would continue to weaken against the commodity currencies would depend on the reaction in equity and commodity markets.

But what if President Trump was the man to blame for the weak US Dollar?

In a 2017 paper, Barry Eichengreen of the University of California, Berkeley, and Arnaud Mehl and Livia Chitu of the European Central Bank developed a "*Mercury and Mars*" hypothesis about the value of reserve currencies. They wrote that there are two sides to a currency's appeal. The Mercury side is economic: It is all about safety, liquidity, network effects and economic connections. The Mars side is geopolitical: It reflects the issuing country's strategic, diplomatic and military power. Eichengreen and collaborators have argued that the dollar's "*security premium*" accounts for a significant part of its attractiveness as a reserve currency. Losing it would mean a 30% point reduction in the share of U.S. currency in nations' reserves. Isolationist "*America First*" policies would certainly seem to undermine the "security premium." As such, Einchengreen, Mehl and Chitu wrote the following: "*The dollar's dominance as an international unit is buttressed by the country's role as a global power guaranteeing the security of allied nations. If that role was seen as less sure and that security guarantee as less ironclad, because the U.S. was disengaging from global geopolitics in favour of more stand-alone, inward-looking policies, the security premium enjoyed by the U.S. dollar could diminish. Our estimates suggest, in this scenario, that $750 billion worth of official U.S. dollar-denominated assets – equivalent to 5 percent of US marketable public debt – would be liquidated and invested into other currencies such as the yen, the euro or the renminbi."*

All year, the Trump administration has blown hot and cold on its commitment to alliances, to the point that any assurances it makes today cannot be taken at face value. Trump's quick temper and his willingness to play the "*whose nuclear button is bigger*" game have not helped bolster the U.S. reputation as a security guarantor. The constant leaks pointing to Trump's incompetence, such as the new Michael Wolff book, appropriately titled "*Fire and Fury*," also detract from the dollar's reputation as a safe asset. Not to mention the latest ridiculous turn of event at the White House in relation to Donald Trump using the word shithole or shithouse during immigration discussions with lawmakers in an Oval Office meeting that took place last week!

No wonder – in this case – that the USD share of global foreign exchange reserves, as reported to the International Monetary Fund ("IMF"), stood by the end of the third quarter of 2017 at the lowest level since the middle of 2014 (though still at a high of 63.5%). It declined throughout the first three quarters of last year, and would surely have further to go, should Mr. Trump serve a full term in office!

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