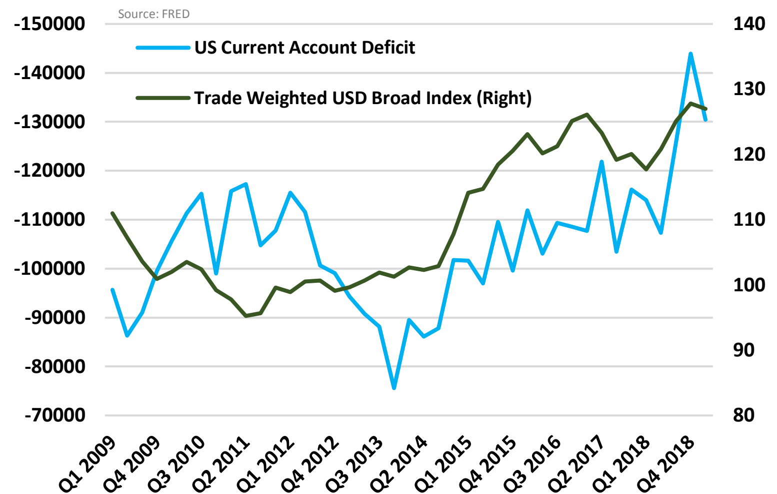
The Booming Buck

Market Viewpoint: August 30, 2019

Summary: The Dollar has continued its powerful run-up throughout 2019, even in the face of possible rate cuts and rising US inflation. While the greenback's strength has racked corporate earnings and US exports, our analysis of US and Eurozone real rates and PPPs shows that current Dollar strength is likely unsustainable. Vulnerability to intervention from the Fed and Treasury Dept. also looms large in the coming months.

The US Dollar has soared 12% since early last year, causing significant effects on trade, corporate earnings, and asset prices. The gain comes on the heels of a year-long respite following a six-year rise. Cumulatively, the buck is up almost 40% from its 2011 low. Perhaps it is time for an "Intervention"!



The impact on trade is apparent in the current account deficit, depicted to the right. To the chagrin of the Administration, and notwithstanding all the focus on improving trade balances, things have only gotten worse; a strong Dollar, makes exports more expensive and imports cheaper.

Then there is the dampening effect on profits growth for US companies with large international activities. In September 2019, MRP highlighted how a rising Dollar, combined with 80% of global currencies in decline, would affect corporate earnings through 2019. We also forecast that the Dollar's strength would subside in 2019, especially relative to the Euro.

Fast forward nearly a year, and the currency translation effect was heavily cited amongst US companies as a major negative issue for profitability in both first and second quarter earnings calls. According to Barron's, Apple blamed adverse exchange rates for shaving its fourth-quarter sales growth by 2 percentage points, while Honeywell International and 3M said the negative impact on their revenues was 1 percentage point and 2.7 points, respectively. This was the case for most companies as a FactSet analysis of the earnings of S&P 500 companies with more international exposure fell an average of 12% in the second quarter compared with a year earlier, while those with more domestic revenue posted growth of more than 4%.

While the Dollar has maintained its upward momentum, breaking through the USD Broad Index's 2016 high, the Fed has begun to set the stage for a weaker greenback going forward. Back in September 2018, the Fed was charting a path toward four rate hikes through the end of 2018 and into 2019. In reality, one hike, and then a subsequent cut just last month, have cancelled each other out and left the Fed right back where it was. Although the Fed's 25bps "insurance cut" wasn't enough to dissuade Dollar bulls, who ended up pushing the Dollar to new highs following the FOMC announcement, Fed Funds futures are now pricing in 75bps worth of further cuts by year end.

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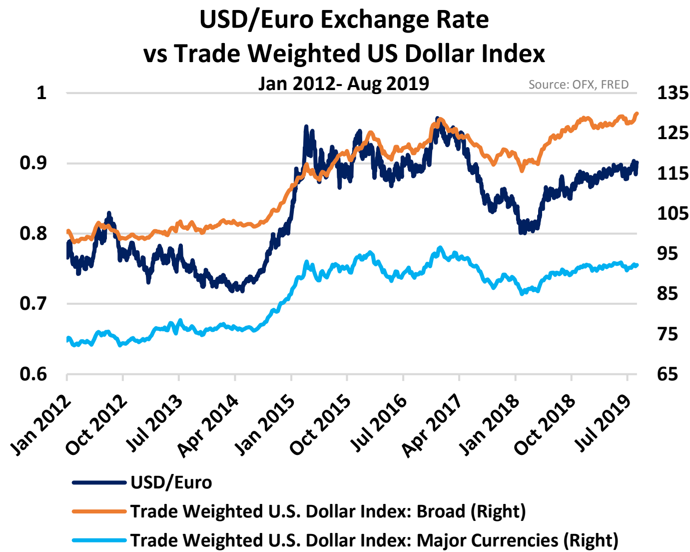
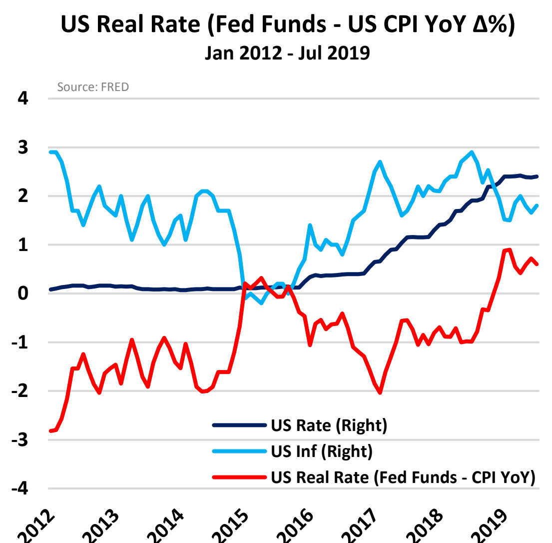
Although easing monetary policy would usually be enough to cause devaluation in the Dollar, the Fed is not alone in its desire to cut back their short-term rates. As we noted last month, central banks across Europe and Asia have already begun, or are preparing to begin, monetary easing.



It is significant, though, that while the Dollar has really beat up on smaller currencies, it has not made new highs against major currencies – the Euro chief among them. That brings us to our second point.

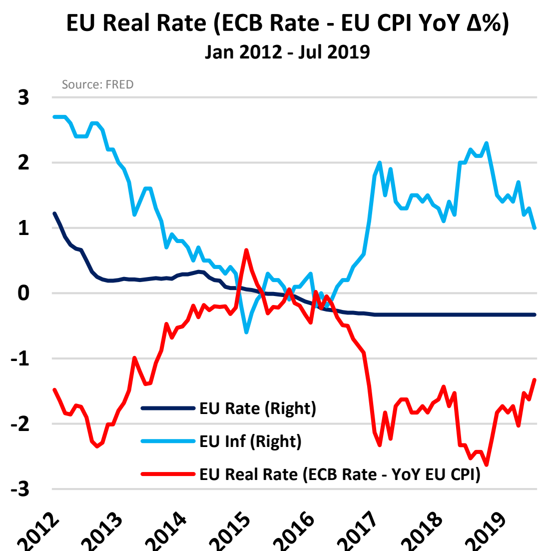
While the European Central Bank has already laid out plans to begin easing and boost stimulus alongside the Fed in the coming months, it may already be stuck behind the curve. The ECB's short-term rates are already in negative territory. They can only cut rates a certain amount before they begin causing even more serious damage to Eurozone banks, which are already being bled dry by monetary policy. According to CNBC, European banks have transferred 21.4 billion euros ($24.2 billion) in revenues to the European Central Bank (ECB) in the five years since these negative interest rates were introduced.

Adding to the many challenges European banks are staring down, oncoming Basel III standards, a set of international banking regulations developed by the Bank for International Settlements, will require European banks to raise their capital requirements by at least 24.4%. According to the EBA, major European Union banks currently face a collective shortfall of 135 billion euros ($153 billion) to meet Basel III's requirements by 2027. This need to raise capital reserves, on top of the rapidly increasing amounts of vault cash at European banks, which is up 50% since the introduction of negative rates, according to Bloomberg, could begin constraining the circulating supply of Euros, pushing up exchange rates. Vault cash has become popular among major depositors because it avoids incurring negative interest rates.

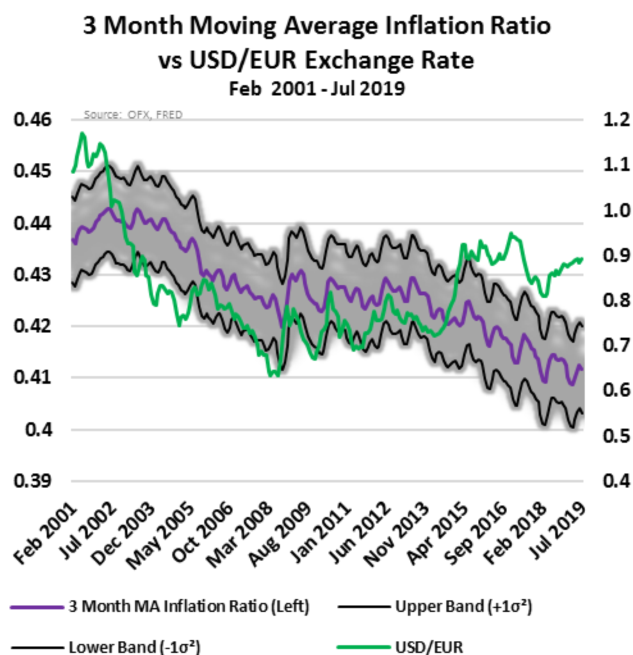


The Euro was one of the few currencies that strengthened after China's move to allow the Yuan's depreciation past the 7 mark, and if action isn't taken, it's now very possible that relative strength in the Euro could prevail throughout the rest of the year.

As MRP has highlighted before, the most obvious determinant of where the money goes is short-term interest rates and their differences from other currency regimes. Other things equal, it makes more sense to keep cash in a currency that has a higher rate of interest. Still, there is another key consideration: inflation-adjusted or "real rates". However enticing a short-term yield may be, it doesn't buy much if the purchasing power of the currency diminishes by more than the interest earned; or it can buy even more if purchasing power improves. This point is often omitted in much of the FX narrative we see in the media every day. When overnight bank rates are adjusted for inflation, the swing in "real" rates is sometimes even more pronounced. International money flows usually chase "real" yield, however small the differentials may sometimes be.

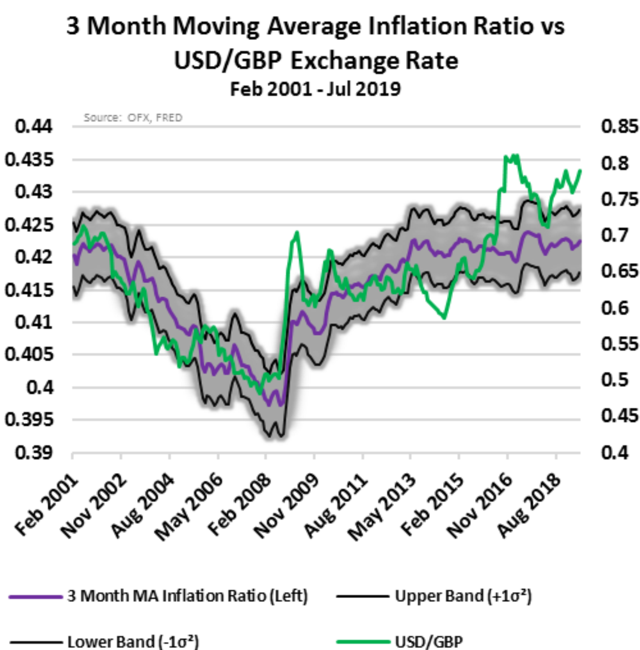


Last year, we noted that a rising Fed Funds rate would bolster real rates in the US, while negative short-term rates and flat inflation would pull down real rates in the Eurozone. This is exactly what played out, but this balance could now begin shifting, albeit a bit later than we thought.



US inflation was mostly stable for the past few months, but jumped back to its highest level since April in July. August should see prices rise even more following the Fed's rate cut, putting downward pressure on real rates. In Europe, however, inflation continues to fall, reaching only 1.0%, the weakest reading since 2016. While the ECB is set to cut rates later this month, it's likely to be a smaller cut than the US and should not stimulate inflation as much. This points to stronger EU real rates, relative to the US.

Over the very long run, exchange rates are primarily determined by the relative changes in the cost of living between countries. That is what economists call Purchasing Power Parity (PPP); it is the central tendency to which exchange rates eventually mean-revert. A simple PPP, using a ratio of the EU to US consumer price indexes (CPI), shows that moves in exchange rates often follow trends in inflation. While a simple PPP model would suggest an eventual decline to around €0.67 per Dollar, a level not seen since 2011, the Dollar continues to diverge, likely due to global monetary easing and little action from Fed to respond.



We can observe a similar phenomenon in the Dollar versus the British pound Sterling (GBP) through July. It's likely the Dollar will continue strengthening further, however, as political turmoil from the ongoing soft/hard Brexit drama plays out over the coming months. In late August, for example, the GBP plunged following British Prime Minister Boris Johnson announcing the temporary suspension of parliament – a sign that a no deal, hard Brexit is on the way.

While the Yuan is a different story than the Euro, since it is not a completely free-floating currency. China has allowed the Yuan's midpoint reference (a guide for the daily fixing price) to slip past 7 CNY per 1 USD. This level was politically symbolic since China had long been preventing Yuan from slipping past this level, but in pursuit of alleviating the cost of tariffs on manufacturers, they've decided to end that policy. A weaker Yuan will help prices of Chinese goods become more competitive, following huge mark-ups on the country's exports to the US due to tariffs already levied.

Earlier this month, CNBC reported the People's Bank of China (PBOC) unveiled a key interest rate reform, revising the mechanism used to establish the loan prime rate (LPR) in pursuit of bringing down borrowing costs. The central bank recently set its new one-year LPR at 4.25%, down from the old lending benchmark rate of 4.35%. The Yuan responded by tumbling to an 11-year low versus the Dollar. The declining LPR, combined with further cuts to Chinese banks' reserve requirement ratio and the possibility of further stimulus from the PBOC, may well weaken the Yuan further.

Other emerging market currencies have also begun accelerating their depreciation versus the Dollar.

Bloomberg notes that rate cuts across Southeast Asian central banks, including India, Thailand, and the Philippines this month, have wiped out gains for the vast majority of emerging market currencies. MSCI's currency gauge fell into negative territory for the year in August. Among the most strongly affected are the Indian Rupee, which tumbled to an 8-month low versus the Dollar. The Indian currency is expected to fall further yet, however, due to the Reserve Bank of India (RBI) having now cut rates four meetings in a row.

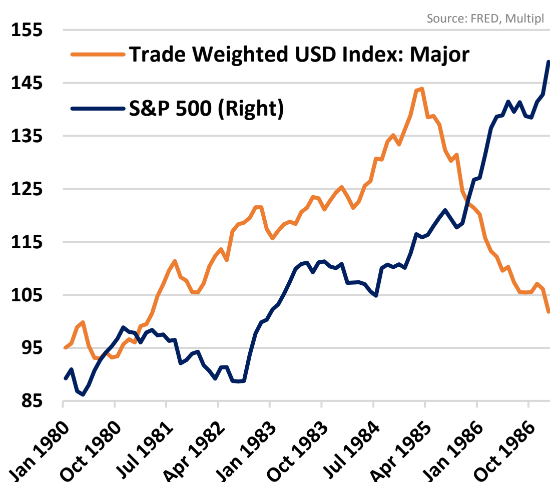
President Trump has previously advocated for a weaker Dollar and just recently chided the "highest Dollar in US history". While that is not factually correct, given the Dollar is well off of its all time peak in the mid-80s, Trump is certainly not afraid to criticize the rapid appreciation we've seen in the greenback this year, which threatens to stifle GDP growth by slowing manufacturing even more than it already has. No doubt, the strength of the Dollar has played a role in US manufacturing entering contraction territory for the first time in a decade. Just as China's weakening Yuan can strengthen the price competitiveness of Chinese exports, a strong Dollar makes American goods more expensive in foreign markets.

While some may criticize his brash approach, Trump is not alone in his belief that the Dollar has become overvalued. In the IMF's July External Sector Report, the fund said that its analysts had determined the Dollar's real effective exchange rate was between 6% to 12% too high. Since this report, the Dollar has only strengthened further. By contrast, the IMF report estimated the Euro to be undervalued by anywhere from 8% to 18% for the German economy.

Certainly, the White House has become desperate to weaken the Dollar with the 2020 Presidential Election approaching and the financial media almost incessantly ringing the recession alarm bells. Trump's verbal attacks on the Fed, its Chairman, Jerome Powell, and their perceived inaction in the eyes of the administration have become more frequent… and with desperate times, comes desperate measures.

Investors should prepare for the possibility that the US undertakes additional measures beyond waiting for the FOMC to adjust short-term rates or open up the balance sheet for more quantitative easing. Although the Fed is responsible for executing any FX intervention, Dollar policy is traditionally the purview of the Treasury Department. MarketWatch reported last month that the Treasury's Exchange Stabilization Fund has around just $22 billion in U.S. Dollars — and another $51 billion in IMF Special Drawing Rights, or SDRs, that could be converted — that could very well be injected into the FX market to put some ice on the continually swelling Dollar. While some have speculated about whether or not the Fed would go along with the Treasury if ordered by the President to take action on the Dollar, Goldman Sachs believes the Fed "would probably defer to the Treasury and go along even if it does not agree." Even if Trump doesn't go so far as to order the Treasury to pursue a weak Dollar policy, something that hasn't been done in decades, simply using the prospect as a bully pulpit and threatening to do so would likely move FX markets.

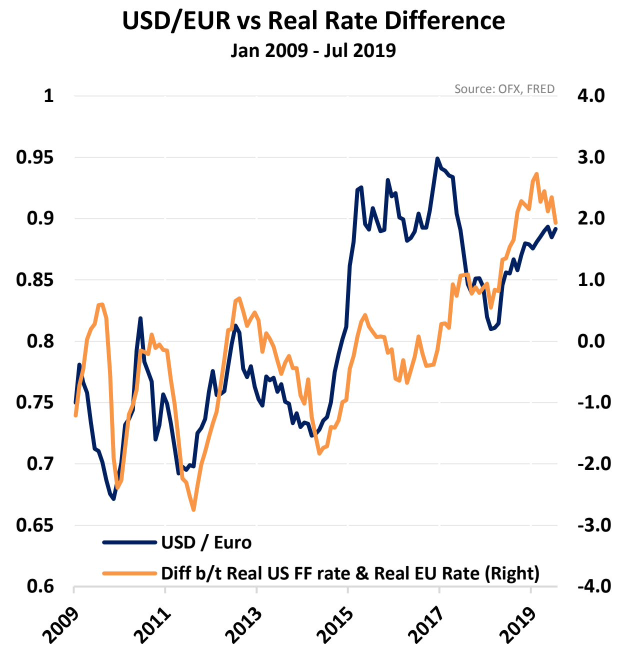
While some may be skeptical of the ability of less than $100 billion to materially influence a market that moves well over $5 trillion per day in forex trading, it has been done before. The Plaza Accord, an agreement between finance ministers from the US, West Germany, Japan, France, and the UK to simply talk their way into intervening in currency markets, is an event worth citing. As the New York Times wrote over 30 years ago, after the Dollar fell by more than 20% against a trade-weighted basket of currencies from the first quarter of 1985 through the third quarter of 1986, "jawboning by finance ministers and treasury secretaries is more significant either in heating this market up or in cooling it down than buying or selling by central banks." The previously booming buck fell by as much as 35% from its peak in the 2 years following the Plaza Accord.



Perhaps that is all its going to take now – officials acknowledging that the Dollar has grown too strong. As we've said, Trump has been signaling displeasure with the Dollar's current exchange rate, but the Fed has thus far remained tight lipped on anything Dollar-related, likely due to the fact they know the effect their words can have. ING notes that Jerome Powell could engage in a Dollar negative rhetoric blitz by dropping the "mid-cycle

adjustment" phrase that he began using in his post-FOMC press conference, hint at a possible reintroduction of unconventional monetary measures, or simply mention the strong Dollar as an obstacle to the effectiveness of monetary actions.

In the short-term, jawboning aside, the Dollar is likely to remain buoyant, but the rapid appreciation we've seen in 2019 is simply unsustainable. As discussed earlier, shifts in US monetary policy to counter easing measures abroad is likely to push down real rates through the rest of the year and into 2020. MRP maintains our assertion that the Euro is undervalued relative to the Dollar, and with inflation beginning to accelerate in the US while decreasing in Europe, we believe real rates will follow the same divergent path, driving investors toward the Euro. Because the US tightened much more stringently than nearly any other major economy over the last half-decade, the Fed is going to have much more room to ease without succumbing to zero or negative rates and diminishing returns on accommodative policy, already a reality the Eurozone is struggling to deal with.



As seen in the chart to the right, the path of the USD/Euro exchange rate usually correlates with the difference between US real rates and Eurozone real rates. In recent years. While the difference between rates had been heading north for some time, it has changed course sharply in recent months and MRP believes the Dollar is likely to follow it as real rates in the Eurozone climb higher.

Until we reach that point where the Dollar begins to roll over, which we expect to see in the next six months, trade numbers will not improve and corporate earnings will continue being hit hard by the currency translation effect – especially earnings of companies doing a sizable portion of their business overseas.

Joe Mac

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