BELLEVIEW RESEARCH

Belleview Report 2017-09-29

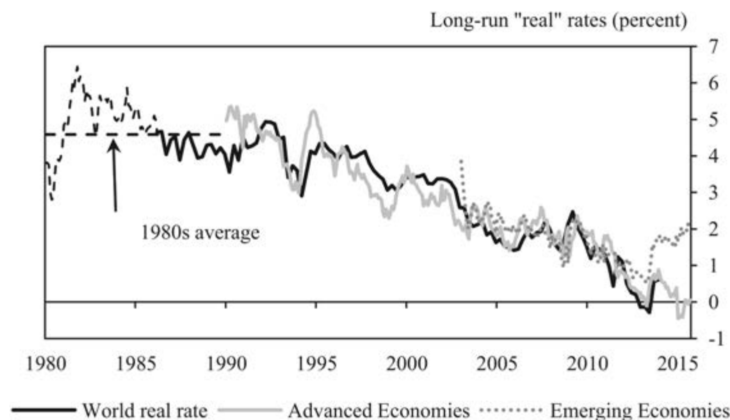
Has The Dollar Bottomed? (Cont')

As we discussed in July, the US economic surprise index has become extremely depressed and the lowest within the G10. We believe US data may start to improve, and the USD may find a floor.

Market consensus of low growth low inflation looks complacent

The post-crisis environment plays a part with expectations of growth inevitably lower and the lower net supply of safe assets due to central bank QE putting downward pressure on yields.

Long term real interest rates have fallen by about 450 bps in the past 30 years (see chart below).



Source: King and Low (2014); Bank of England's calculations

An analysis in the International Journal of Central Banking identifies some key underlying drivers for low long term real interest rates, which include 1) lower labor force growth

impacting the desired level of savings, 2) the impact of higher inequality within countries, and 3) increased precautionary saving by EM governments since the Asian crisis. However, ***the key question is whether central banks should stick to a simplistic inflation targeting framework or pre-emptively target excesses in asset markets that threaten instability in this low inflation/yield environment***.

Examples of excesses in asset markets:

- In the US bond market, net leverage approaches a 25-year high at 1.87x.
- In investment grade (IG) bond market alone, over 50% of debt was sub-2x levered at end 2012. Now only 23% is; while 30% is 3-4x and 13% 5-6x and up.
- Year-to-date issuance of high grade US corporate bonds surged past $1 trillion in September.
- On EPFR data, more than $218 billion has flowed into funds investing in IG US corporate bonds this year.
- EM debt markets are just as frothy, when coup prone African countries like Ivory Coast and Senegal can issue 16-year paper at just over 6%, as both have done recently.

What do the above excesses mean?

Asset allocation decisions are reflecting the following strongly held views:

- ***disinflationary forces are entrenched;***
- ***US growth won't accelerate materially via fiscal stimulus; and***
- ***energy prices are set to stay flattish indefinitely***.

With job openings at a record high amid a scarcity of experienced workers, odds on a tax deal shortening and Brent crude back at $58 per barrel, that extrapolation of "Goldilocks" looks both self-serving and complacent.

Asian central banks are intervening against the weak dollar

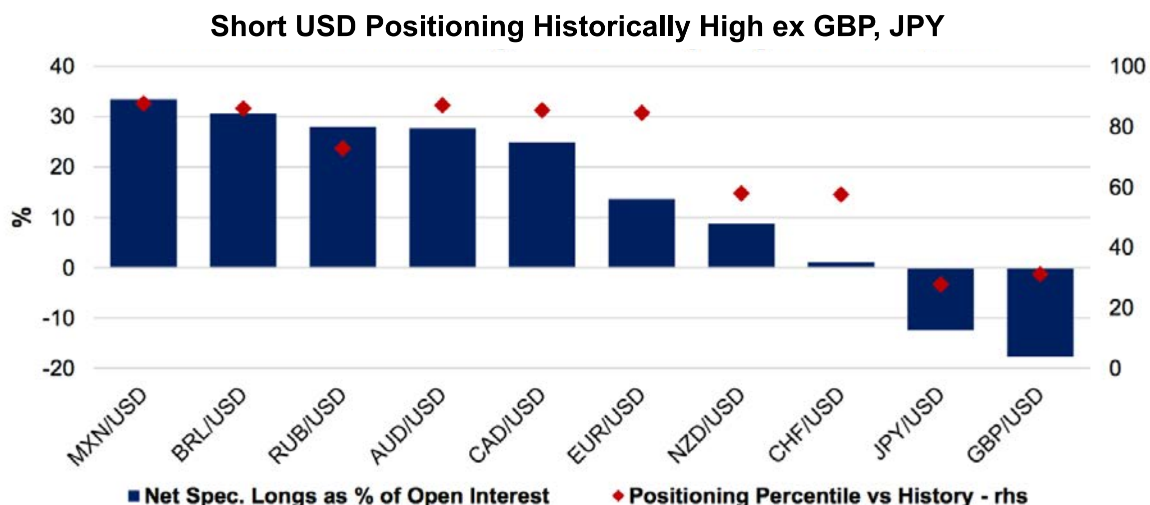
Back in Q4 2016, the strong dollar was causing an EM angst. However, many Asian governments are now becoming concerned by persistent USD weakness. Central banks' FX intervention has quietly resumed:

- The PBoC is trying to cap the RMB rally – it has reversed a rule enacted in October 2015 that required banks to set aside reserves with the central bank when dealing in currency forwards. The RMB has more than recouped all of its 6.6% decline against the dollar last year.
- Thailand's reserves are up $10 billion since the end of June; it is now intervening at about 33 THB to the dollar.
- Singapore looks to be intervening again by more than is evident on the balance sheet of the MAS by transferring a large share of the assets it buys to its sovereign wealth fund.

- Taiwan seems to be back in the market to keep the TWD from rising through 30 – it has been range bound near there all summer.
- Korea's forward book jumped by almost $1.5 billion in July as the BoK almost certainly intervened to keep the won from rising through 1100 until the North's nuclear stunts took the pressure off.

This renewed intervention is modest so far and is relatively discreet – outflows through sovereign wealth funds and other state-controlled balance sheets to stay under the radar of the US Treasury.

Market positioning on the dollar is now broadly bearish (at a time when relative US growth and rate expectations are bottoming). From Europe to Asia, if verbal and market intervention pressures continue to build up, there is a growing potential for a dollar short squeeze.



Source: CFTC

** Net Speculator Longs as % of Open Interest: the number of net long future contracts held by speculators, expressed as a % of total Open Interest*
*** Positioning percentile: calculated on data since 2010*

The Fed and the reappointment of Yellen imply higher rates

The Fed's dot plots suggest that it will take a year longer for the Fed funds to reach their estimated neutral rate, which it lowered to 2.75% from 3%. However, ***the odds of one more hike this year have jumped to about 60% with a median expectation that three hikes may be appropriate next year (a large fiscal stimulus would likely add a couple)***.

Meantime, it will not recycle the full amount of maturing bonds and MBS in its portfolio at a pace which will begin slowly at $10 billion per month from October and increase by $10 billion every quarter until reaching a $50 billion monthly pace.

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The reappointment of Yellen as Fed Chair now seems the path of least resistance for Trump (and she apparently gets Ivanka's vote). Some of the more rule-based approaches (and John Taylor's name has been mentioned as a candidate) would imply much higher rates.

Our contrarian stance on the dollar

Given the strong performance this year across EM carry trade strategies, a sustained burst of rate volatility into Q4 bears watching. The reflation trade has been apparent in global equities this year, but not on bond yields or the USD.

Most of the positive economic catalysts from the Trump presidency such as lower regulation have been priced out of the market. ***COT data shows that speculators have increased their exposure to US duration as well as the USD to a near-extreme level. This means reversion could be a good contrarian thought.***

The dollar's depreciation has been a function of relative growth in Asia and Europe and a reaction to low US inflation and falling expectations of large scale fiscal stimulus.

Both Chinese and Eurozone growth have surprised the consensus this year.

However, ***by Q1 2018, markets could be looking at US tax cuts, hurricane rebuilding underway and inflation expectations rising materially. In that backdrop, the dollar shall squeeze higher (in particular against the yen, underpinning our constructive stance on Japan)***.

Investment implications

Yield curve steepening proxies like financials should be added to global equity portfolios, as in H2 2016.

Energy looks likely to become the positive surprise while technology remains acutely vulnerable to both an underwhelming Apple launch and the bursting of the bitcoin bubble, which has dragged "cryptomining" GPU stocks like Nvidia in its wake.

We remain tactically bearish on MSCI growth versus value since end Q2 2017 (split equally between mining and energy).

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