The dollar could lose some of its shine

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After appreciating steadily over a several-year period, the US dollar is facing a growing number of factors that might just tip the scales in the opposite direction. Market movements over the last eight weeks underscore the need to examine that eventuality.

> The dollar itself is highly sensitive to changes in risk appetite and, due to its global role, it is a particularly complex instrument

Desynchronised global growth

Disparities in how governments have handled the Covid-19 pandemic and in their fiscal policies suggest that the various economic blocs will recover at differing paces.

The United States stands out on all counts. No less than 60% of the adult population has been vaccinated to date, the economy has snapped back and fiscal and monetary policy stimulus is impressively large. Yet since the end of the first quarter, nominal interest rates have held fairly steady, the equity-market rally has slowed and the dollar has depreciated to the point that it now stands roughly where it was at the start of the year. This paradox is less surprising than it looks at first blush, however.

Plans to drive federal spending and national debt to record heights

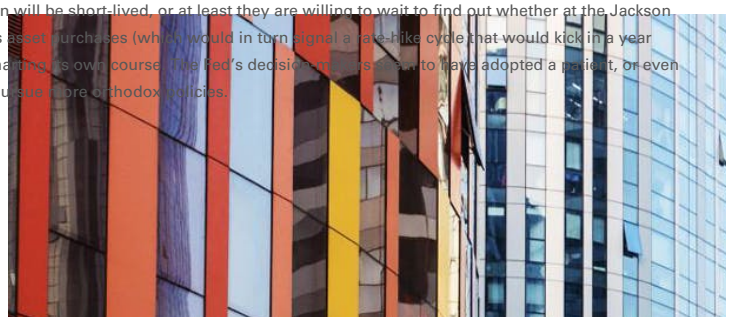
Both macroeconomic data and corporate earnings releases in the country bear witness to a sharp economic upswing[1]. Moreover, the Biden administration's proposed budget – with spending plans to the tune of $6 trillion dollars in 2022 – suggests the US economy will still be growing at a solid pace beyond this year of recovery.

Though such high economic growth, both in absolute terms and relative to the rest of the world, typically goes hand in hand with a rising currency, the greenback has already surrendered most of its first-quarter gains.

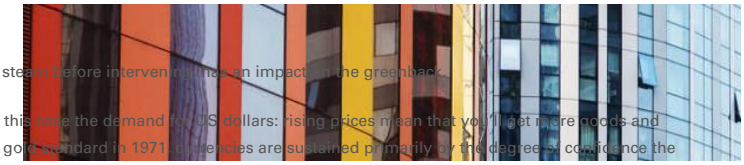
This is partly down to the problem that how Congress ultimately votes is often at odds with what the President wants[2]. But more importantly, Biden's leaning towards transfer payments, which would tend to support consumer spending rather than capital expenditure leads us to believe that the return on investment will likely be lower than in the past. And that will make dollar-denominated assets less attractive.

How well is central-bank credibility holding up?

Federal Reserve officials have in recent weeks reiterated their intention to maintain an accommodative policy. In doing so, they have outmanoeuvred financial-market participants who thought they could force the Fed to tighten[3] . A clear sign of this renewed credibility is that fixed-income markets have barely reacted to the latest inflation readings[4]. Investors have apparently bought into the Fed's narrative that the current bout of inflation will be short-lived, or at least they are willing to wait to find out whether at the Jackson Hole symposium this summer the Fed might discuss a possible slowing of the pace of its asset purchases (which would in turn signal a rate-hike cycle that would kick in a year later). A further implication of the current state of play is that each central bank will be charting its own course. The Fed's decision appears [illegible] to have adopted a patient, or even wait-and-see stance, leaving it to their British, Canadian, Norwegian and other peers to pursue more orthodox policies.



A dollar will be worth less tomorrow than it is today



This changed reaction function at the Fed, which boils down to letting inflation pick up steam before intervening, makes an impact on the greenback.

It should be recalled that inflation erodes the time value of a currency, and therefore in this case the demand for US dollars: rising prices mean that you'll get more goods and services for one dollar today than you will tomorrow. And ever since the US exited the gold standard in 1971, currencies are sustained primarily by the degree of confidence the corresponding central bank commands. Janet Yellen's appointment at the head of the Treasury thus heightens the existing doubts as to how fully independent the Fed actually is. The US central bank's plan to finance a sizeable share of the country's record fiscal deficit may raise some eyebrows[5] . To make matters worse, part of the shortfall will have to be paid for with higher taxes. And the deteriorating current account will likely fuel consumer spending rather than capital investment. That is bound to undermine a currency already weakened by a combination of fiscal and trade deficits and by the pandemic-induced erosion of an interest-rate differential that has worked to the advantage of the United States for so long.

Then again, we could be in for something much worse: "stagflation". This portmanteau was coined when the golden age of Keynesian economic policy in the mid-1960s, based on fiscal largesse pursued in cahoots with central bankers, was on its way out. (Needless to say, any resemblance to recent events is "purely coincidental".) Those who harbour stagflation fears can indeed point to the latest US non-farm payroll reports, which surprised to the downside[6]. A probable explanation for this hiccup is that, flush with generous benefits, some of the unemployed seem to be in no hurry to look for a job at this stage. This could result in an upward drift in wages as companies struggle to attract workers – even though that struggle may not reflect a more robust economy. Rising pay levels are among the key possible drivers of more lasting inflation and could also rekindle fears of a wage-price spiral. Both monetary policy and fiscal policy are fairly ill-suited to overcoming such a predicament. What makes this a Catch-22 situation is that efforts to boost GDP growth tend to fuel inflation, whereas orthodox policies aimed at keeping inflation in check tend to stifle growth. The upshot is an unpalatable cocktail for a country's currency and economy.

These various forces are likely to weigh on the dollar in the medium term.

US DOLLAR INDEX EVOLUTION SINCE 2008

Source: Bloomberg, 07/06/2021. The US dollar Index to measure the value of the dollar against a basket of major world currencies

When it comes to investing, what distinguishes foreign exchange strategies is that they revolve by definition round a currency pair, and identifying the right counter currency is always a tough call.

Europe is still in the running

Although Europe has been more severely affected by the Covid-induced downturn and has less impressive stimulus policies than the US, the region has become more attractive to international investors, not only because political cooperation has strengthened, but also because a large number of issuers here are poised to cash in on an economic recovery[7]. This is the first time in quite a while that European equities have outperformed their US counterparts without being hindered by euro appreciation. Moreover, this trend stands a good chance of continuing. Eurozone inflation expectations have risen[8] but are still far below the ECB's target rate (contrary to the situation in the US), and they could be further buoyed by the region's comparatively more favourable growth momentum, as economic re-opening has only just begun.

Furthermore, European interest rates have been climbing noticeably this spring. In fact, investors even appear to be pricing in monetary policy tightening over the next two years and possible tapering of the ECB's extraordinary asset purchase programme. We feel these investors are jumping the gun, however. At this point, inflation is primarily a US issue, and we expect both the ECB's policy timetable and the future statements by its members to remain dovish. European interest rates can therefore be expected to stall.

Asia in the vanguard of the fourth industrial revolution

China has handled the pandemic much better than the United States. But the country is also rendered attractive by the improving long-term economic and technological outlook for the region as a whole. China has continued to invest in the technologies shaping the future. The yuan has risen significantly, reflecting both good macroeconomic news and the interest-rate oasis that China offers in an otherwise yield-starved desert. And for the time being, Beijing seems to have adopted a somewhat permissive stance on such movements – sensibly, as a stronger currency is an effective way to limit the extent to which the US inflation fuelled by Fed policy will be imported. Even so, the Chinese central bank is likely to stick with its dovish stance to prevent the currency from appreciating too sharply against the dollar, and that should keep the country's equity and bond markets humming. The simmering tensions with the United States are the main potential source of disorder.

The currencies of commodity-exporting countries are lagging behind

Commodity prices have returned to levels seen five years ago, leading some pundits to wager that another "supercycle" is in the offing. Now, we consider it risky to get direct exposure to that trend in this period of temporary supply disruptions, high inventory buffers and large-scale speculative positioning. Yet quite a few currencies of countries exporting commodities that are essential to the unfolding economic upturn and green infrastructure seem to be stalled.

Investors are likely still smarting from the "taper tantrum", when capital flowed massively out of what were still vulnerable emerging markets after the Fed signalled its intention to normalise monetary policy and interest rates went up in response.

But things are very different today. Central banks enjoy greater credibility and, contrary to the situation in 2013, many nations boast current-account surpluses today. We can therefore look forward to currency appreciation in countries with sound economic fundamentals and disciplined central banks. We have accordingly opted for a highly selective approach to our exposure to commodity-producing economies.

We are maintaining a balanced portfolio combining long-term and short-term convictions. Desynchronised growth has the advantage of allowing for more diversification.

A weaker US dollar is not antithetical to higher interest rates

Those performance drivers are being supported by key strategic hedges. As described in our recent Notes, interest-rate risk is one key focus of that approach. And as we've hinted at in this paper, currency risk is the second. Though it may seem counterintuitive, a weaker US dollar is not antithetical to higher interest rates. And just as with interest-rate risk, managing currency risk calls for an active approach. The dollar itself is highly sensitive to changes in risk appetite (both upward and downward) and, due to its global role, it is a particularly complex instrument that is prone to short-term movements.

Investment strategy

Actions

European equities outperformed in the last two months as vaccination campaigns gathered pace. At the same time, the global economic recovery buoyed a region whose fortunes are to a large extent linked to the global economy and business cycle. In an unusual development, the rally wasn't hindered by appreciation of the euro, and banks and specific consumer-oriented market segments performed particularly well. Boosted by pent-up consumer demand, the European economic upturn is likely to continue. Companies such as Worldline (digital payments) and Inditex (apparel retail) as well as travel-related businesses like AENA (Spanish airports) stand to benefit.

In the United States, the more cyclical corners of the market are already banking on high growth and a possible paradigm shift. We have accordingly reduced our exposure to names that are most exposed to economic re-opening and put hedges in place. Despite the stimulus programmes in the offing and the substantial household savings, consumer-goods stocks have ranked among the poorest performers since the start of the year – a good reason for us to stay invested in that segment.

Chinese equities have likewise lagged the upturn due to profit-taking and an uncertain regulatory environment. But as China is further advanced in the business cycle, the names with predictable earnings growth in our portfolio seem poised to score gains. This desynchronisation among world regions has enabled us to diversify our holdings.

We have continued to favour convictions which we believe will outperform over the long term, while avoiding companies that are saddled with abiding challenges and whose growth prospects seem neither attractive nor reliable going forward. In fact, the recent underperformance by a number of growth stocks in our high-conviction themes has opened up opportunities. But we have also moved to offset our "growth" bias by investing in derivatives on cyclical indices, as we did by taking long positions over the past several weeks on inflation-sensitive indices such as bank indices.

Fixed Income

Desynchronisation among world regions has also affected fixed-income markets.

In "core" eurozone countries, the ramp-up in vaccination campaigns and forecasts of an economic upswing have pushed up inflation expectations, and with them interest rates – which have begun narrowing the gap with rates in the United States. Over the coming months, we wouldn't be surprised to see European governments taking further action, particularly with elections scheduled for the near term in Italy, France and Germany. Frugality is seldom high up on the list of campaign promises. At the same time, with only a remote prospect for inflation to gain lasting traction in Europe, the ECB is unlikely to tighten the screws in the short run. European interest rates could therefore hold steady, creating a favourable setting for carry strategies. We have accordingly taken profits on our sell positions on German interest rates and sparingly bought bonds from a few non-core eurozone countries.

US bond yields have levelled off in the past two months after surging powerfully in the first quarter. The economic upswing could lead to a more long-lasting rise in inflation than has been forecast by the consensus, particularly with so many supply bottlenecks still operating. We therefore plan to use a wide range of instruments such as sell positions on nominal yields and/or long positions on inflation breakevens.

We also have a cyclical bias in credit markets, where we have removed a portion of our hedges. As these tend to be pricey in the long term, they must be managed actively. We have also selectively added a few positions amid today's encouraging economic climate characterised by ongoing monetary policy easing and upbeat macroeconomic data.

Source : Carmignac, Bloomberg, 07/06/2021

[1]In the first quarter, US GDP growth came in at 6.4% on an annualised basis. Corporate earnings per share were up 50% year-on-year, overshooting what were already quite bullish forecasts.

[2]Given how slim the Democrats' majority in Congress is, getting laws passed will hardly be a stroll in the park for Biden.

[3]Chairman Powell and his Board of Governors have managed to convince investors that they won't be shifting gears any time soon, that the current price increases are transitory and that there is therefore no compelling reason to start tightening policy yet.

[4]At over 4% year-on-year, the inflation rate currently exceeds consensus forecasts and stands higher than at any time in the past decade.

[5]The Fed will be hoovering up some 25% of all new Treasury issuance this year.

[6]The April report showed 278,000 jobs created, versus a median estimate of over 1 million. The figure for May was 559,000, compared to an estimated 675,000.

[7]These issuers include consumer-goods and travel-related companies, along with "old economy" businesses in manufacturing, banking and commodities.

[8]Average expected inflation for the next 10 weeks is 1.4% for the eurozone, versus 2.4% for the United States (or one percentage-point higher for the next 10 weeks, year-on-year).

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