tavistock WEALTH

REVOLUTIONARY THINKING

THIS TIME IT'S DIFFERENT

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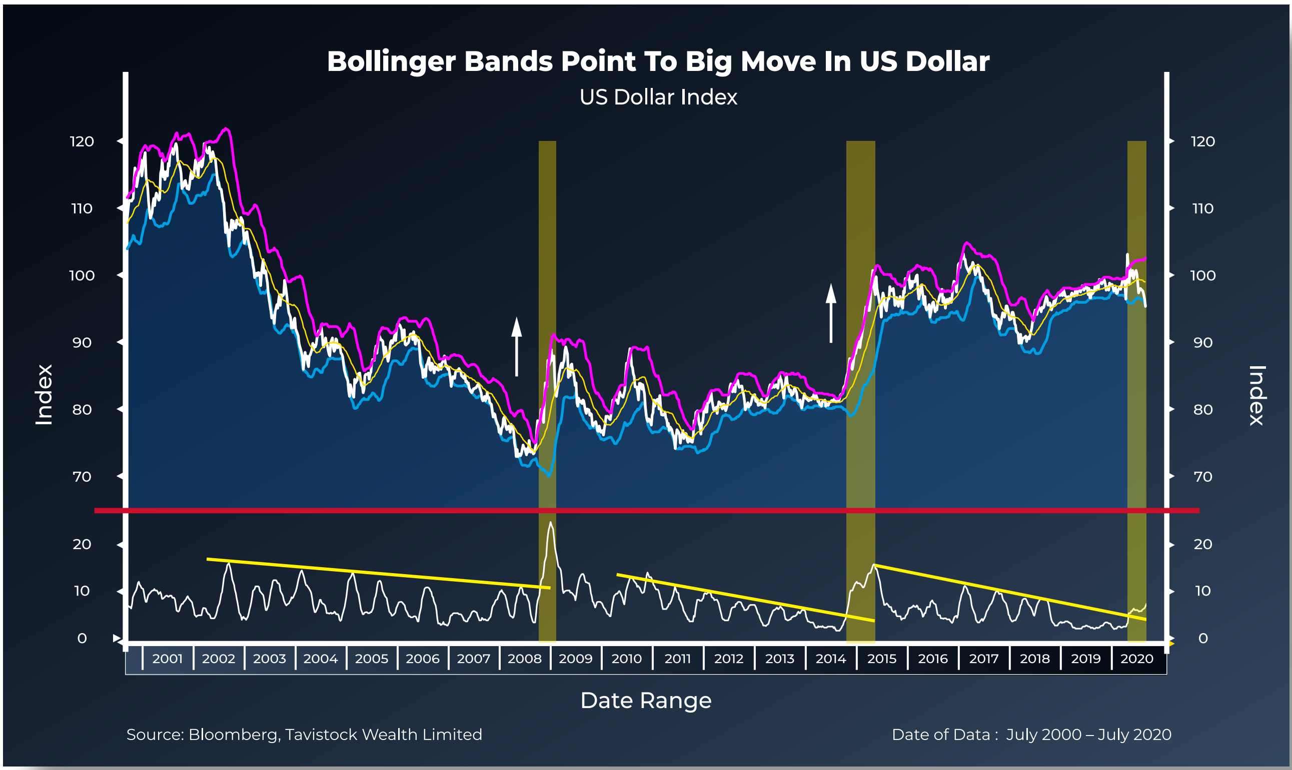
There are growing signs that the US dollar may finally roll over.

The chart below shows the US dollar index, in white, and two associated lines in blue and purple, known as Bollinger bands. Bollinger Bands are a technical indicator used in financial analysis.



They represent the price and associated volatility of an index, in this case defined as 2 standard deviations above and below the moving average price. During periods of low volatility, the bands narrow and the width between the lines gets smaller. During periods of heightened volatility, the lines diverge and the width between the Bollinger bands gets wider.

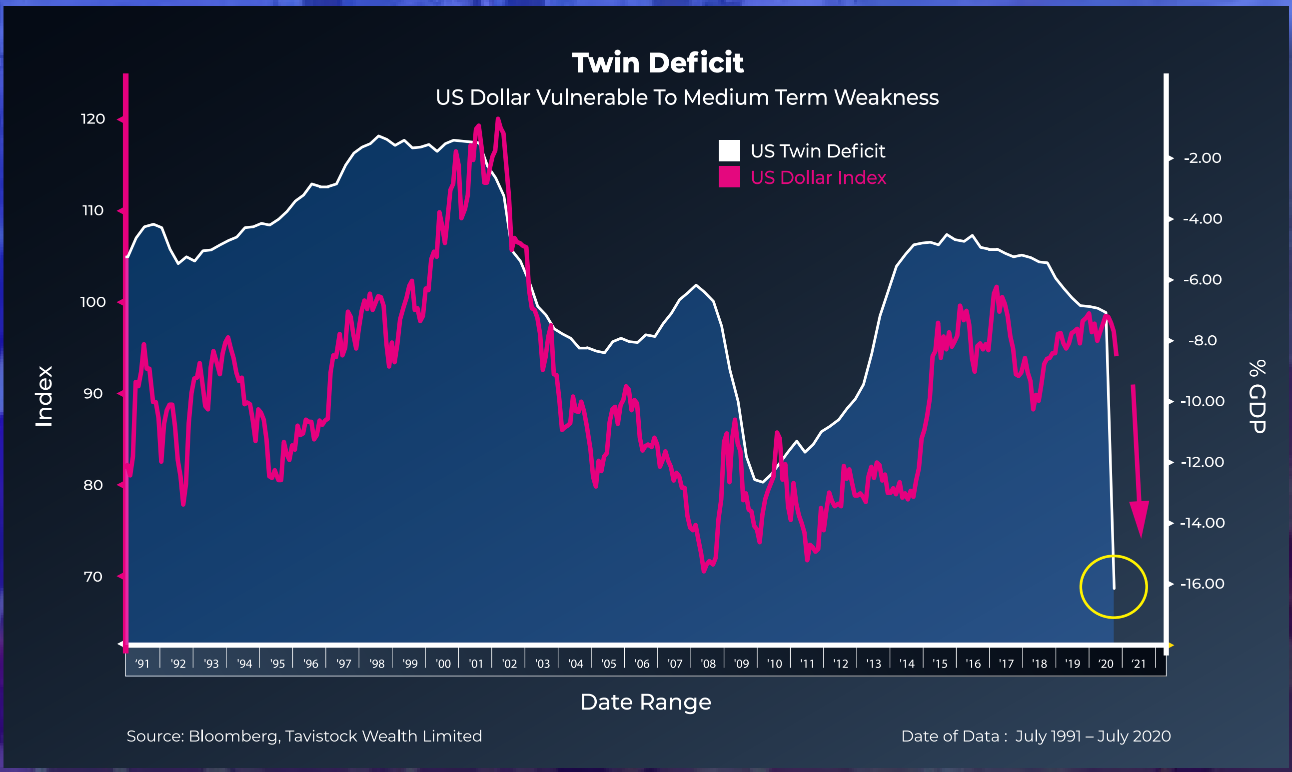
Over the last two decades there have been just three occasions where Bollinger band width has broken out of its prior narrowing trend. The first two times this happened, during the subprime mortgage crisis and eurozone growth slowdown, the US dollar appreciated noticeably. We are currently in the midst of a third breakout, only this time the US dollar seems to be weakening.

I first raised the possibility of a weaker US dollar in One Currency To Rule Them All... (And In A Crisis Bind Them) dated 20th April. Since then the US Dollar index has fallen -5%.

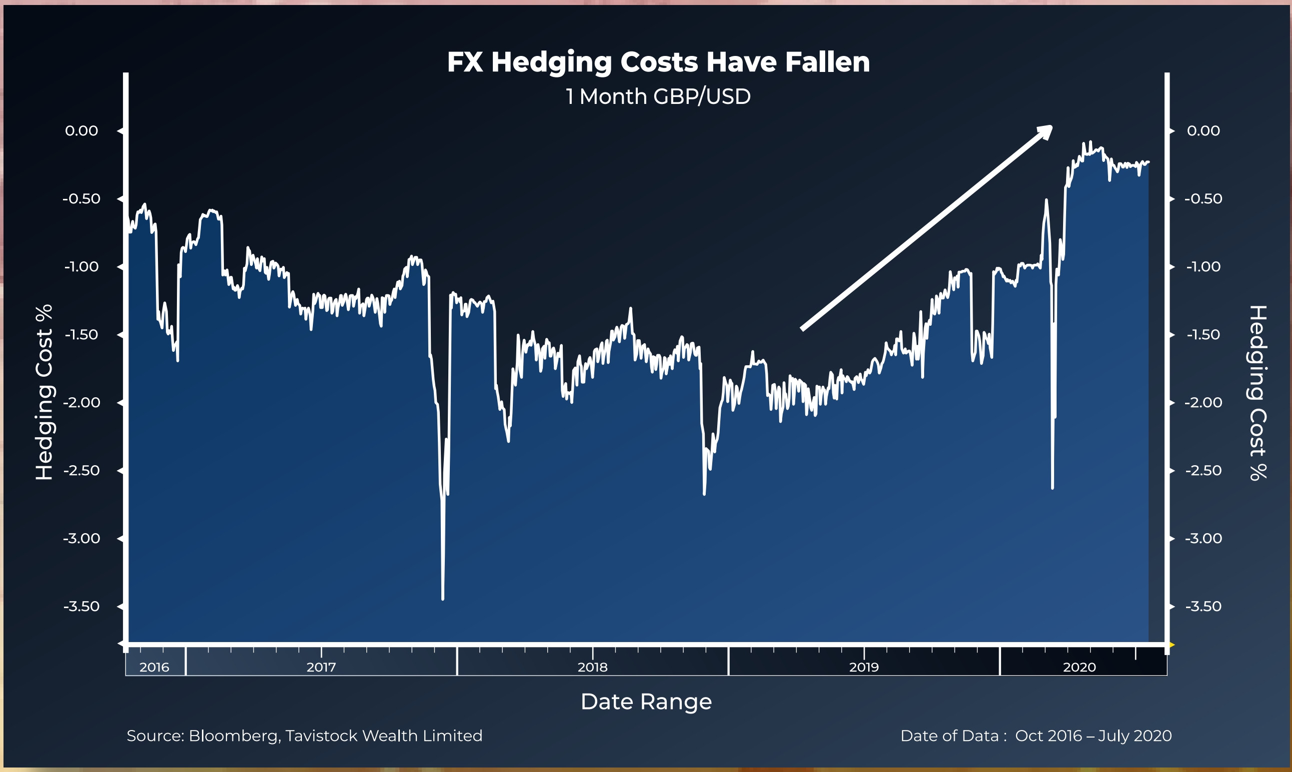
There are many reasons to believe the greenback is more likely to depreciate than appreciate over the coming months. Chief among them is the euro. The EU's relative success in tackling the coronavirus and recently agreed stimulus package points to renewed optimism in the region. Whilst a dysfunctional eurozone has long proved bearish for the common currency, recent progress means the euro is once again a credible alternative to the US dollar.

The stark contrast in policy response to the virus between China and the US is also dollar bearish. Whilst the Fed is likely to continue to ease monetary policy, the People's Bank of China is moving in the other direction. Tighter relative monetary policy has resulted in record yield differentials which will likely push the yuan higher against the dollar going forward.

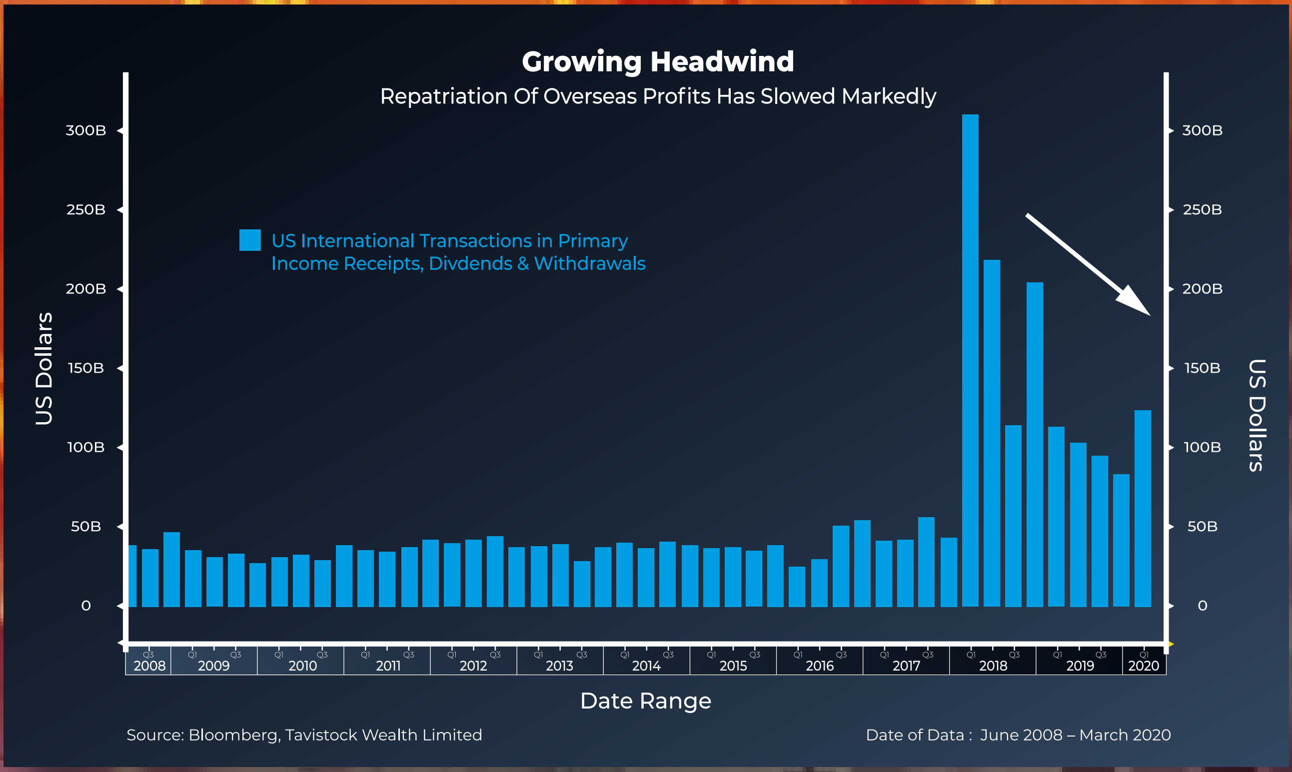
Fundamentally, the US twin deficit, which refers to both a trade and budget deficit, has now reached 17% of GDP (right hand axis inverted). This is a large number and typically not good news. Once economic growth recovers, and central banks taper asset purchase programs this underlying deterioration points to dollar weakness.



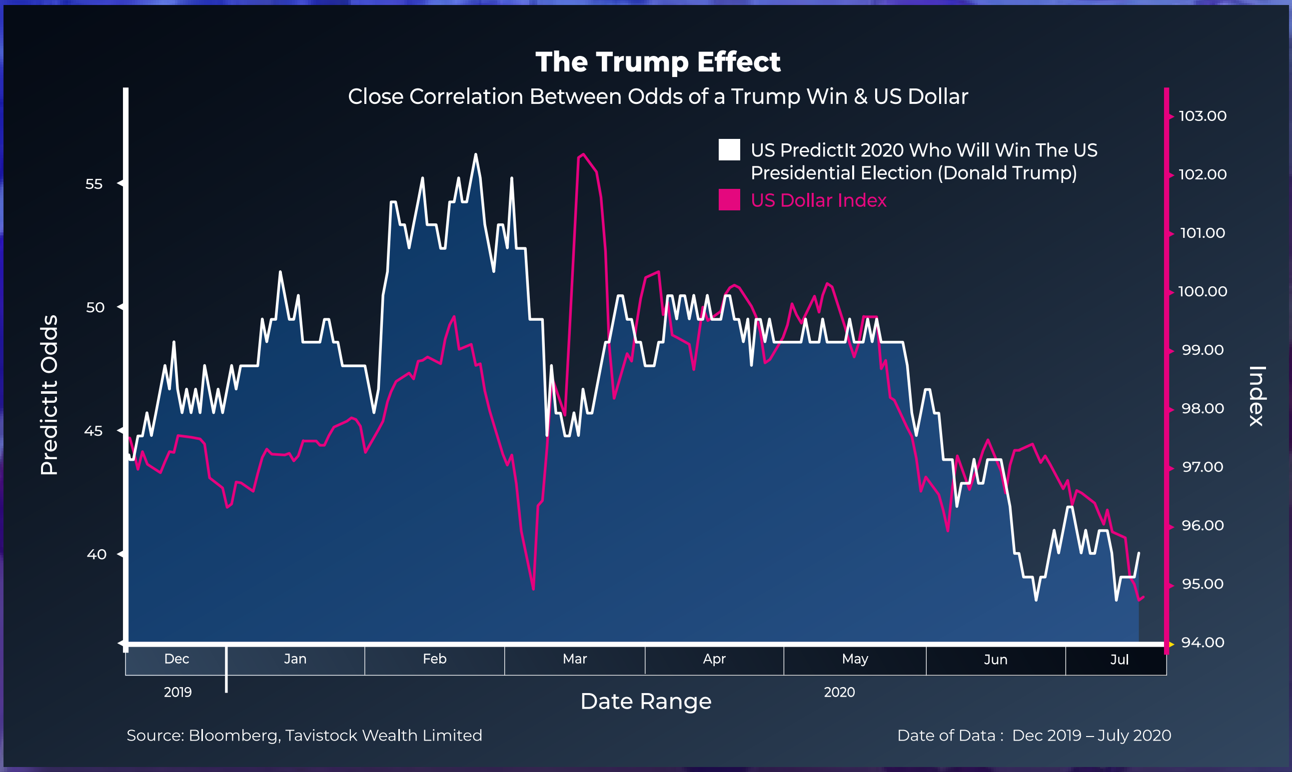
Further, the cost of hedging USD assets has fallen notably over the last year. As a result, investors buying USD assets are more likely to hedge the currency than might have been the case previously, thereby weighing on the currency.



Finally, US companies have dramatically slowed the pace at which they are repatriating offshore profits to the US. Following tax cuts in 2017, companies brought back approximately $850 billion in 2018 but this fell to under $400 billion in 2019 with the trend look set to continue into 2020.



US dollar weakness is also consistent with the growing probability that Trump does not win the next election as currently implied by PredictIt. However, it is still far too early to call the election one way or the other and as Harold Wilson once said, “a week is a long time in politics” (in my humble opinion a week is even longer in markets).



As such, it would be unwise to give up on the dollar entirely. Time and time again the US has reasserted itself on the global stage. Should the medium-term economic outlook deteriorate markedly or geopolitical tensions rise then we could see safe-haven flows back into the dollar.

Indeed, that is what happened back in March. During the early stages of the corona crisis the US dollar weakened to current levels (dotted white line) just prior to the subsequent, and significant, dollar rally. Back then, investors were desperate for liquidity and the dash-for-cash into USD, against a global shortage of dollars, sent the currency rocketing. Since then, however, the Fed has dramatically increased the money supply, with M2 (which is a broad measure of money including cash, checking/savings deposits and money market funds) up 25% year-on-year. The Fed also increased the global supply of dollars via fx swap lines to foreign central banks.

In this new, liquid world, there may well be cause to believe “this time it’s different”.

Source: Bloomberg, Tavistock Wealth Limited

Date of Data : July 2010– July 2020

Despite recent weakness, the US dollar remains its long-term uptrend. Where the dollar goes next is key and the direction of travel will have implications for the global economy and our investment strategy. Should the dollar move lower, through long term support, then we are likely to see a rotation into pro cyclical risk assets, whereas a bounce higher is more consistent with a renewed bout of risk aversion later this summer.

Whilst we retain a cautious bias, we are positioned for a weaker US dollar via our commodity carve-out and overweight allocation to emerging markets.

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