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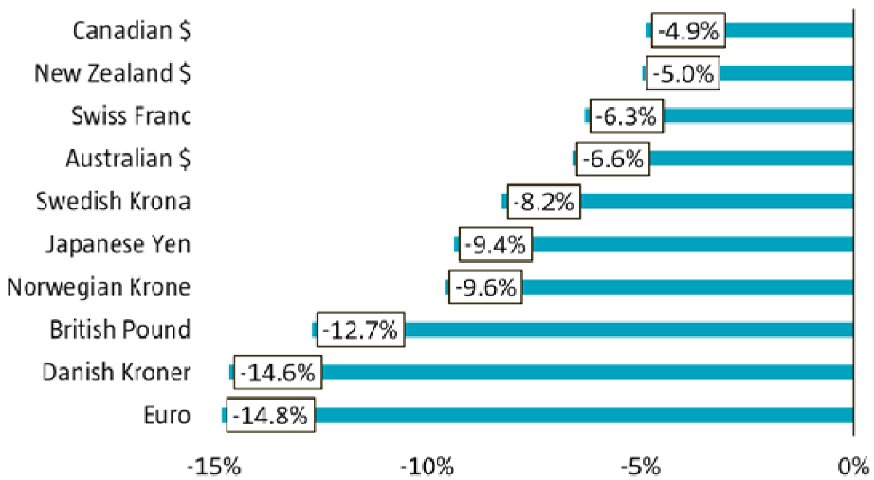
Market comment: On that weak greenback

April 2018

Riddle me this...

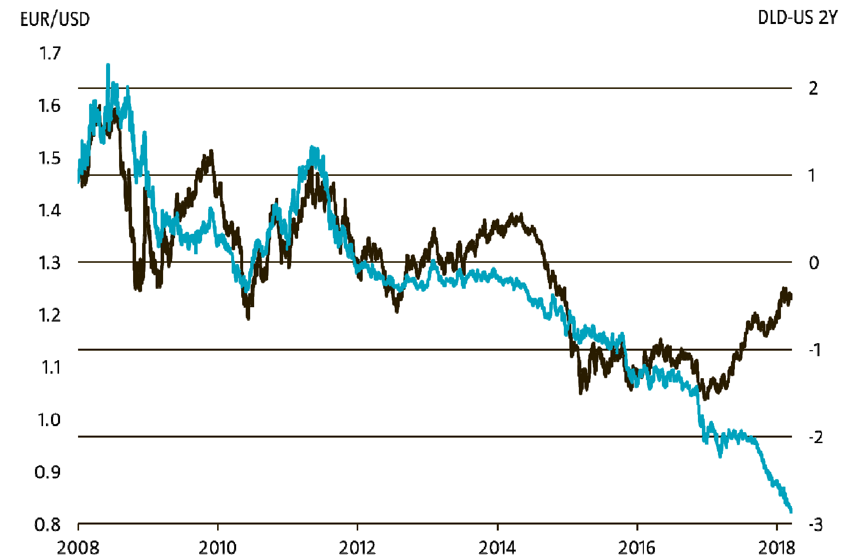
If we asked an economist to write a novel about the year 2017, it would probably feature two as-of-yet unresolved mysteries. The first would be the Curious Case of the Missing Inflation. Despite extremely accommodative monetary policy, the rebound in the price of oil and ever-tighter labor markets in leading countries like the US and Germany, inflation has refused to make a noteworthy comeback, leaving many wondering whether we can proclaim inflation to be dead. We discussed the subject back in September, and since that time inflation has still been mostly muted. Case not solved. The second mystery – and the one we are about to discuss here – is the Riddle of the Weak Greenback. If we take the start of 2017 as a reference point, the US dollar has weakened between 5% and 15% against all of the major developed market currencies. With momentum of the US economy picking up in 2017 and the Federal Reserve hiking interest rates by a full percentage point – practically the only central bank that is in proper tightening mode – this was not supposed to happen. So let's take a look at the underlying mechanisms and what it might mean for financial markets

The US dollar has been the weakest currency over the past five quarters



% change of the US dollar since January 2017 Source: Robeco & Bloomberg

So much for interest rates driving currencies...

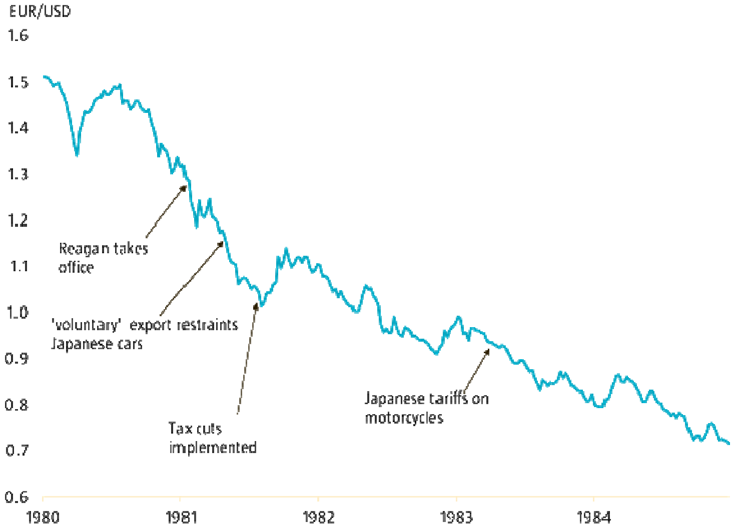


Source: Robeco & Bloomberg

This was not supposed to happen, was it?

The simplest way to show how unlikely the move in the greenback has been is by showing the relationship between the two-year interest rate differential (Germany/US) and the EUR/USD exchange rate. In theory, one would expect that a country with a higher short-term interest rate to attract more capital flows, thereby boosting its own currency. Although this is certainly not the only driver of a currency (trade, geopolitics, tax changes, trade wars can all play a role as well), the chart clearly shows that this has been a pretty reliable factor behind the currency moves over the past 10 years. Until the start of 2017, that is.

The dollar went flying when Reagan was president



Source: Bloomberg & Robeco

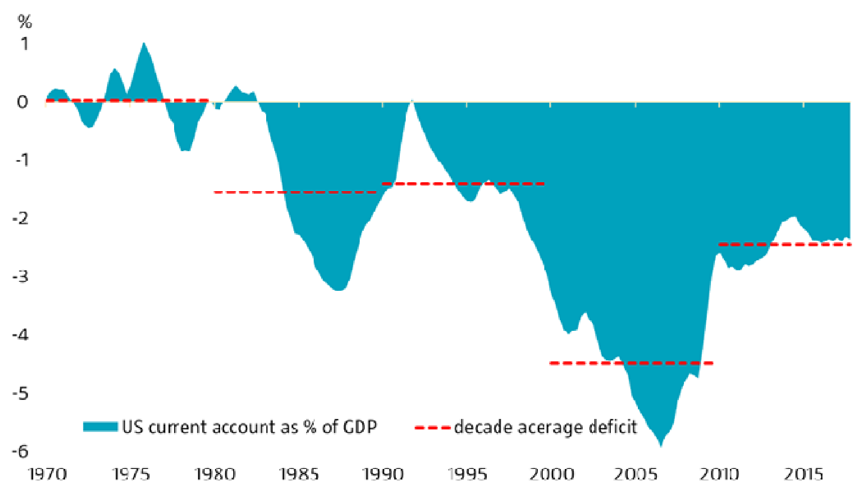
But there are more reasons why the dollar should have risen. In theory, the weird macroeconomic policy mix that President Trump has adopted since he took office at the start of 2017 should have sent the dollar flying. The combination of major tax cuts, monetary tightening by the central bank and trade restrictions is a policy mix that has a clear resonance with the policy pursued by President Reagan back in the 1980s (see chart). During Reagan's first year in office, the US dollar strengthened by 20% and had almost doubled in value by the time his first term was finished. Textbook economics would indeed conclude that tightening monetary policy, expansionary fiscal policy and trade restrictions call for a higher, not a lower, currency. Unlike what happened under Reagan, the dollar has weakened under Trump, thereby clearly ignoring this supposedly textbook outcome.

Some possible explanations

So how can the weak dollar be explained? There are a number of potential – although not always convincing – explanations doing the rounds, which we will discuss below.

1) US current accounts deficit. As we stated previously, currencies can be driven by a multitude of factors. One of the more traditional drivers has been (cumulative) current account imbalances. If a country is running a current account deficit, i.e. importing more goods and services than it exports, it de facto means that the rest of the world is building up a claim in that currency. In the short run, this will not necessarily have much of an impact on the currency, as foreigners may either hold on to these currencies (if we are looking at an international reserve currency for example), use them in the domestic economy (e.g. Zimbabwe) or use them to invest or buy assets in the country (capital account). The latter element in particular has become more and more dominant in recent years, with non-US residents buying US stocks and Treasuries, and investing directly. Still, at times, the underlying mismatches in trade do surface as a driver in the currency market. With the US running a structural and large deficit, it is clear that this would call for a weaker dollar over time.

Since the 1970s, the US has had a structural current account deficit



Source: Bloomberg & Robeco

2) Valuation. Another more structural factor that at times surfaces as a driver for currencies is relative valuation based on purchasing power parity. As long as there is free trade, the idea is that a basket of goods – in the long run – should be equally valued across countries. If not, this would trigger arbitrage opportunities, which would either lead to an adjustment in the price of goods, or in the exchange rate. Looking at the Real Effective Exchange Rate (REER) calculated by the IMF, at the beginning of 2017 the dollar was the most overvalued of the major currencies (see chart).

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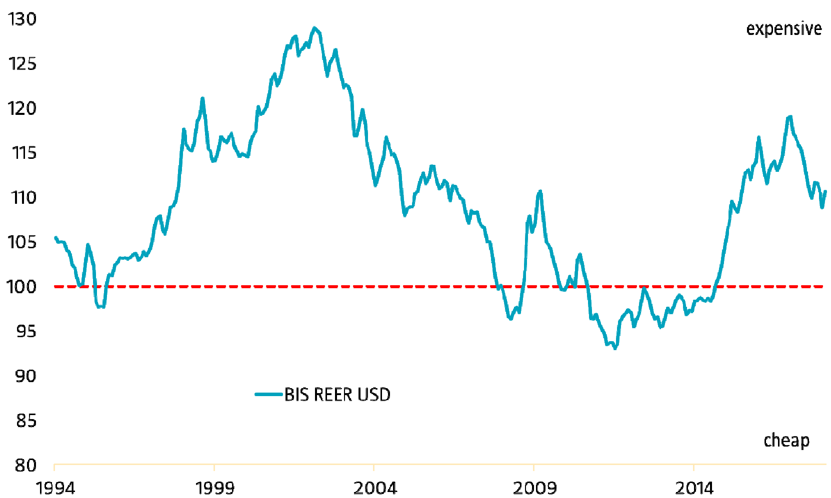
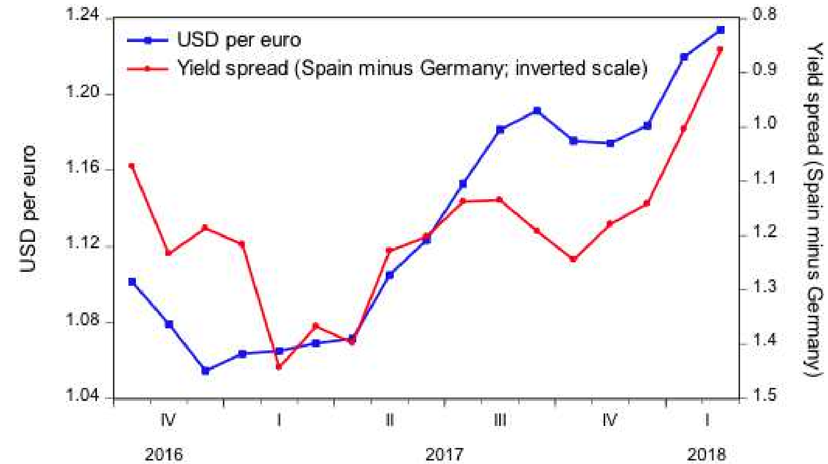


Source: Bloomberg & Robeco

The main problem with using trade and effective exchange rate considerations is that although they are both fundamentally sound, they normally exert only a weak pull on currencies, and may be disregarded for years. There are a couple of shorter-term considerations that may have played a role:

3) Declining political concerns in Europe. Following the Brexit and Trump votes, it was feared that three key European elections in 2017 would lead to more populist victories. Dutch, German and French elections were scheduled to take place, which raised fears of a populist anti-euro party winning. To say that the

If we take Spanish spreads as a proxy…



Source: https://voxeu.org/article/dollar-euro-exchange-rate-2016-2018

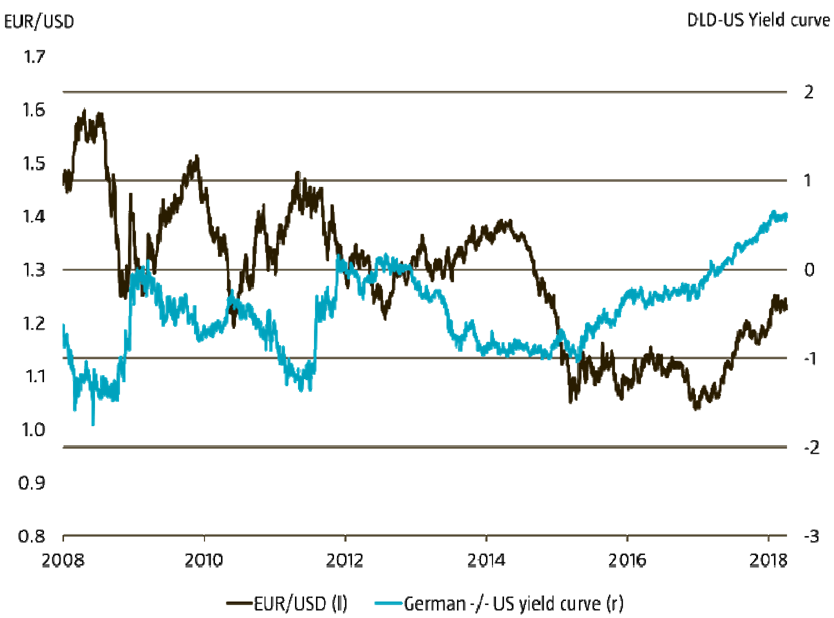
elections turned out to be smooth sailing for the ruling parties would be overdoing it, but once the dust had settled, it was clear that the populists did not manage to secure power. Political concerns eased, which helped to strengthen the euro. One way of showing this is by looking at the Spanish-German 10-year government bond spread, which tightened during most of the year. Although this may partially explain the strength of the euro, it does not help much in explaining the weakness of the US dollar vis-à-vis Norway or Japan.

4) Steepness of the yield curve. Some claim that it is not the level of interest rates that is the real driver behind the capital flows, but rather the steepness of the yield curve. This can probably be most easily explained by taking a European bond investor as an example. At face value, the US Treasury yield appears to offer a lot more value (2.8%) than the German equivalent (0.5%), but this is only the case if you are willing to accept the currency risk involved by buying US Treasuries. If, like almost all bond

investors, you are looking to hedge this currency risk, the US short rate enters the equation as a cost factor. With two-year yields in the US at 2.3% and those in Germany at -0.6%, it is clear that the German curve is currently steeper than the US curve. The flatter the US yield curve relative to the European yield curve, the less interesting it will be for European investors to actually invest in US bonds.

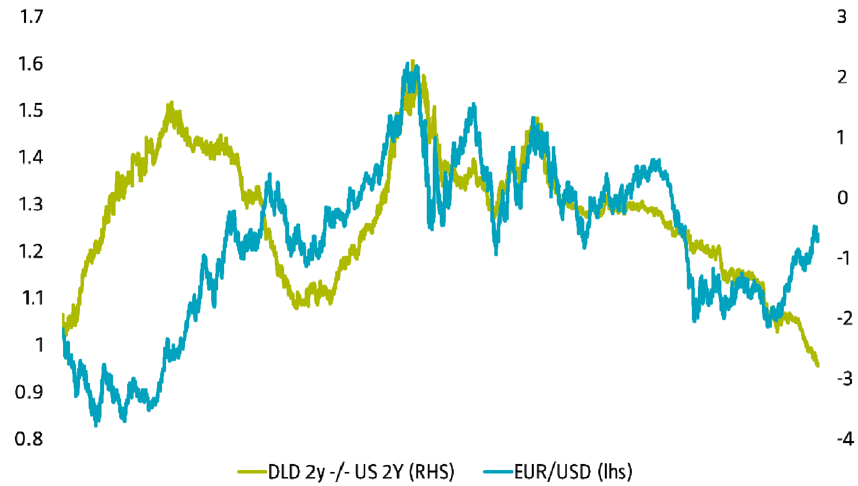
As the next chart shows, since 2015 the US yield curve has flattened relative to the European curve, which has led to a reduction in appetite of European bond investors to invest in (and hedge) the US bond market. The chart also clearly shows that the link between the relative steepness of the yield curve has almost no relationship with the exchange rate over a longer-term timeframe.

The US yield curve has flattened substantially versus the European yield curve



Source: Bloomberg & Robeco

The rising interest differential has not helped the dollar all that much



Source: Bloomberg & Robeco

5) <u>End of the rate hike cycle</u>. Another version on the interest-rates-can-still-explain-it-after-all scenario is the one that was put forward by PIMCO. It observed that each new rate hike by the Fed meant that we were one step closer to the terminal equilibrium level as projected in the famous Fed dot plot. Each rate hike reduces the potential of the remaining rate hikes, according to this line of thinking, making rate hikes de facto dollar-bearish. If the market truly believes in these terminal values (which is a big 'if'), then the ECB and BoJ have a lot more room to raise rates, acting as support for their currencies. The way that this is presented graphically is by looking at the one-year spot rates and their three-year forwards, as is done in the following chart. In line with the yield curve argument above, this explanation moves to a different maturity bucket of the yield curve to explain the currency movements.

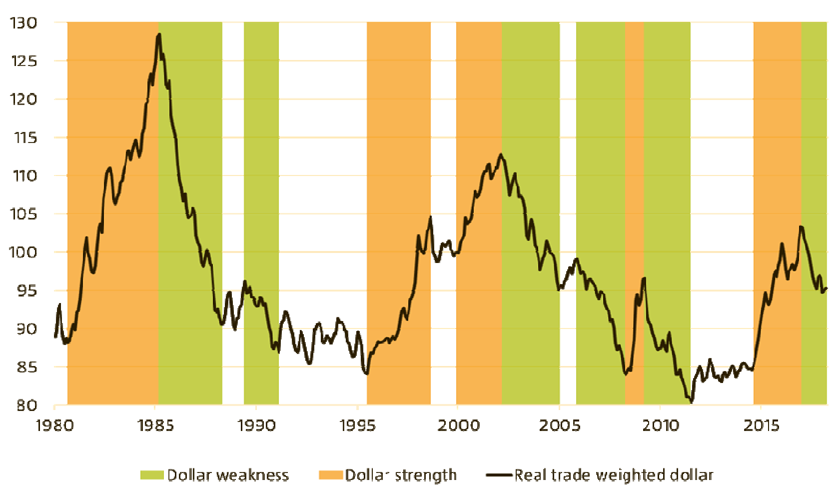
6) <u>Trump</u>. A loss in confidence in the US as a leading power has also been flagged as an option. This one comes with no further comments.

Is it important?

As is more often the case, all of these arguments probably have some merit, with a combination of them leading to the result that we have seen: a weaker dollar. Based on the arguments presented above, it should become clear that predicting where the dollar will go from here is a pretty difficult call to make. Trade, valuation, short rates, investment flows, politics, confidence: they can all be of secondary importance for years, largely ignored, only to all of a sudden take center stage. The erratic behavior of one of the lead characters (Trump) makes it even more difficult to come to a proper prediction. Not surprisingly, we currently do not have a very outspoken view on what the greenback will do from here onwards, although we do have a long position in the Japanese yen.

Is it important though? Does a weaker or stronger dollar have a predictable impact on the fate of the various asset classes, or on the relative regional performance within assets? The general feeling seems to be that a weaker dollar is good for equities and emerging markets, while a stronger dollar is a bit of a headwind, but is that true? In order to asses this, we have taken a look at the performance of the broader asset classes at times of two opposing regimes: periods of dollar strength and dollar weakness. The regimes have been determined by looking at the real trade-weighted dollar, using a cut-off of a 7.5% decline or rise over a timeframe of at least six months. The next chart shows the timing of the five periods of dollar strength and the six periods of dollar weakness seen since 1980, although the last period will be left out of this analysis as it is unclear whether it is finished already.

The ups and downs of the dollar



Source: Bloomberg & Robeco

In the tables that follow, we take a look at the annualized returns of the various asset classes during the previous periods, starting with equities. As a general word of warning: we only have a sample of 10 periods (five each), so any conclusion needs to be taken with a certain pinch of salt.

Dollar Strength	MSCI (local)	North America	Europe	Asia Pac	Emerging Markets
1980-'85	11%	2%	-7%	3%	
1995-'98	15%	8%	7%	-25%	-27%
1999-'02	-13%	3%	0%	-11%	0%
2008-'09	-52%	7%	-15%	9%	-19%
2014-'16	4%	4%	-7%	-2%	-10%
	-7%	5%	-5%	-5%	-14%

Dollar weakness	MSCI (local)	North America	Europe	Asia Pac	Emerging Markets
1985-'88	18%	-14%	1%	22%	
1989-'91	-2%	6%	12%	-11%	19%
2002-'04	0%	-3%	3%	7%	11%
2005-'08	2%	-3%	7%	-3%	16%
2009-'11	20%	1%	0%	-3%	9%
	8%	-3%	5%	2%	14%

Source: Robeco

In the first two tables we look at the MSCI World (local currencies) as well as the relative performance of the various regions during the different periods. Broadly speaking, the conclusions seem to support the idea that a weak dollar (8% average return) has on balance been better for equities than a period of strength (-7%). It is also clear that this conclusion is much influenced by the horrible performance of equities (-52%) during the 2008-09 sell-off, a market plunge that had little to do with the strength of the dollar. In fact, it can be easily claimed that it was the meltdown in the financial markets that led to the spike in the dollar, as everyone scrambled for safety. Causation would in that case run in the opposite direction, with the dollar the product of what happened in stocks. If we exclude this period, the average return rises to 4%, which is still below the 8% seen during dollar weakness.

As for the regional split, the results do not appear to be in line with expectations. In general one would expect European and Asian stocks to outperform in periods of dollar strength: it enhances local competitiveness to the cost of the US. According to the same logic, US stocks experience more headwinds with a stronger dollar. The opposite turns out to be true though: European stocks do better in relative terms in periods of dollar weakness. We see the same pattern for emerging markets, but here the outcome appears to be more logical: most emerging currencies are pegged to the dollar, which means that a weaker dollar helps their competitiveness relative to Europe and Asia.

Dollar Strength	US Treasuries	EURO Treasuries	Japan Treasuries	US High Yield	EURO High Yield
1980-'85	13%				
1995-'98	9%			9%	
1999-'02	10%	6%		-1%	-12%
2008-'09	9%	9%	4%	-29%	-32%
2014-'16	1%	3%	3%	4%	4%
	8%	6%	4%	-4%	-13%

Dollar weakness	US Treasuries	EURO Treasuries	Japan Treasuries	US High Yield	EURO High Yield
1985-'88	12%			16%	
1989-'91	9%			-1%	
2002-'04	7%	8%	1%	13%	15%
2005-'08	8%	2%	2%	5%	1%
2009-'11	3%	2%	2%	30%	37%
	8%	4%	2%	12%	18%

Source: Robeco

As for the other asset classes, the picture is mixed. The impact on the government bond market seems to have been negligible at best, which is not a very surprising outcome as the time period under investigation has been the 35-year-long bull market in bonds. As for the riskier part of the bond market (high yield), dollar weakness clearly has led to higher and more stable results.

All in all, it appears that risky assets, and especially emerging market equities, are helped by a prolonged period of dollar weakness, while the opposite scenario also holds true. Investing made easy: all you have to do is come up with a reliable long-term view on the dollar and superior results are there for the taking. The word of warning here is that many have tried to come up with the 'reliable long-term view' part and failed.

Changes in the portfolio

Over the month we made a number of changes to our portfolio in reaction to the trade war tensions, de facto de-risking. Our biggest position currently is our short position in the high yield bond market.

	Portfolio	BM	active	previous
Equities Developed Markets	26.5%	25.0%	1.5%	3.0%
Equities Emerging Markets	3.5%	5.0%	-1.5%	
Real Estate Equities	5.0%	5.0%		
Commodities	5.0%	5.0%		
Core Gov Bonds 1-10	17.5%	20.0%	-2.5%	-4.0%
Core Gov Bonds 10+	6.90%	7.5%	-0.6%	-0.6%
Investment Grade Corp Bonds	23.5%	20.0%	3.5%	0.0%
High Yield Corp Bonds	1.0%	5.0%	-4.0%	-4.0%
Emerging Market Bonds LC	7.0%	5.0%	2.0%	4.0%
Cash	4.10%	2.5%	1.6%	1.6%
EUR/USD	3.5%	0.0%	3.5%	2.0%
EUR/JPY	-2.5%	0.0%	-2.5%	
EUR/GBP	0.0%	0.0%		
EUR CASH	-1.0%	0.0%	-1.0%	-2.0%

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