The dearth of US dollars

London – June 6, 2018

Investors are rightly used to seeing the US dollar follow a downward trend. Indeed, most business cycles are reasonably synchronised, which means that in general the USD funding rate, which is set by the Fed for the US economy, is broadly consistent with the needs of the outer-world that is funded in US dollars. As these countries tend to exhibit higher paces of growth, their assets end up offering more attractive returns relative than those on USD ones for most of the lifetime of the business cycle. This is the reason why whenever the sky gets clearer for the world economy, the US dollar usually heads South, and assets outside the US tend to outperform their US peers. If one adds the fact that the US economy has been structurally weak since the burst of the "New Economy" bubble in 2001-2003, **the experience of most market participants over the past 15 years was that of a consistently weak greenback.**

In our view, this might explain the current reluctance of most investors to look at the US dollar from the radically different perspective we are in today. First, the balance sheet excesses of the US private sector, generated during the "New Economy" bubble by companies and extended to households during the "housing bubble", have finally been cleansed. From that metric, the period of structural headwinds to US growth is behind us. This means that US trend growth is finally allowed to flourish. The poor productivity trend of the recent past is being replaced by capital deepening through a genuine investment cycle. The fiscal impulse currently in place until mid-2019 together with the loosening of regulations that should support banking credit supply in 2019 are expected to further affirm US growth over the next two years**. The cyclical supremacy of US growth of late is highly likely to continue into 2019, while the seeds for a structural outperformance have also been planted.** Strong growth and higher inflation are natural outcomes of the business cycle phase the US finds itself in. Expect a full policy normalisation from the Fed towards an equilibrium real rate, which itself will normalise to higher levels than generally believed.

Another particular feature of today's situation is that regions are fully desynchronised in terms of their respective positions in the business cycle. Japan is close to the US, while EMU countries follow the US path with a longer-than-usual delay of two to three years due to the euro crisis of 2011. This group though shares clean private sector balance sheets and sizeable pent-up domestic demands, which puts their next recession at a distant future. This is the group where a full investment cycle is still to be experienced and where the private sector has plenty of room to express its optimism through more leverage. Initial conditions for future growth are extremely sound for these countries, from both a cyclical and structural point of view.

Since 2003 the rest of the world has experienced very contrasting dynamics of ever growing leverage of private balance sheets, with no pause during the 2008 recession[1], putting it in quite an unsafe position with regards to future growth. The collapse in commodity prices from mid-2014 to early 2016 has already revealed such macroeconomic vulnerability, plunging commodity-producing countries into one of the deepest recessions of their history. As private leverage now comes to a halt, these countries find themselves stuck in a long period of slow growth, balance sheet repair and poor investment dynamics. The largest countries in this group are **Brazil, Argentina and Russia**. In 2017, they have exited two years of very deep recession. However, do not expect too

[1] *Similar to Asia's unabated private leverage from 1985 to 1997 without a pause even during the recessions of the developed countries in the early 90s.*

much from them. Argentina suffers from twin deficits generated by years of monetary financing of the public deficit. Brazil is plagued with an unsustainable public debt dynamic that a very favourable external position has put on the background until recently. Slow growth, higher rates and a very uncertain electoral year should soon reveal in plain sight how close Brazil is to a sovereign debt crisis. Russia's fate is balanced between international sanctions and higher oil price, with not much bearing on the world economy. These countries have been the first to suffer from the passing of the peak in global USD liquidity in 2013-14.

As USD global liquidity is now being drained down further by higher policy rates and the decrease in the Fed's balance sheet, the pressure is expected to continue to grow slowly but surely, eventually reaching those USD-funded countries where, contrary to commodity producing ones, private leverage grew without interruption up to now. This sub-group is mostly made of **Asian countries**. This is the region where a huge macroeconomic risk is concentrated in the world today. Excessive leverage comes out of a good run gone too far. QEs in US, Japan and Europe, lower commodities prices, and stronger domestic demand in G3 countries proved a succession of positive shocks for Asia over the last decade. This incredibly long run has led to extremely stretched balance sheets, which makes this region awfully sensitive to higher interest rates today. **From a balance sheet perspective, Asia is over-extending into the final stage of its business cycle, while the US has just past its mid-point. These two regions are on a collision course, replicating exactly the same situation as in 1996 before the Asian crisis.** Eventually, what would look like a benign hike by the Fed is going to matter for the marginal borrower in Asia, subsequently exposing the whole balance sheet to a turn around. Bear in mind that private-sector-driven balance sheet adjustments are extremely convex. What initially looks like a local slowdown tends to degenerate into a deep recession when balance sheet dynamics are at play.

As during the Summer 2015 when the attention of investors was monopolised by a remote Grexit risk, soon to be followed by the real risk that was China's devaluation, **markets are today overly concerned with an even more remote tail event in Italy, while the big risk lies with the consequences of an upward US dollar trend in the context of out-of-phase business cycles between the developed and the rest-of-the-world markets.** As in 2015, the attractive risk premiums offered by the recent panic on EMU assets (GIPS bonds, EMU bank equities and bonds in particular) present a great opportunity not only to generate future returns, but also to balance portfolios with an eye on the real looming risk that comes with a stronger US dollar. The macro framework is clear: prefer assets in G3 countries where the business cycle has a lot more to go, especially when they are cheap for transitory reasons as are EMU assets today; at the same time, go short assets exposed to continuous USD strength. The more that can be done of the former, the more protection can be accumulated on the latter. **This is the true opportunity provided by the Italian drama these days: to be able to build a portfolio that can perform in the future by making the most of over-estimated EMU risks, while protecting it from the underestimated US dollar risk.**

Edited by H2O AM in London on June 6, 2018

Additional notes