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MACROCOSM

Our Contrarian View on the Dollar

Thursday, January 5, 2017

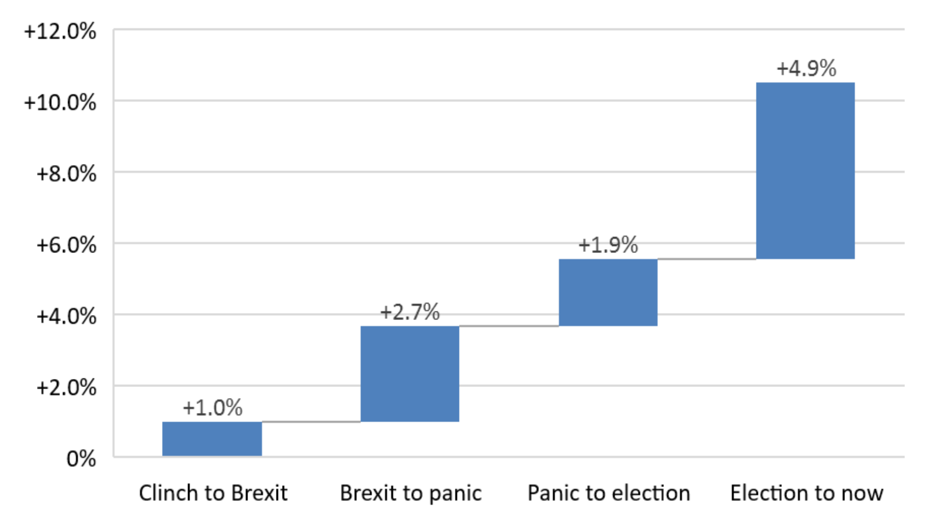
Donald Luskin

Neither arbitrage nor Trump can justify the rally. What shouldn't be up must come down.

Of all our views in our 2017 outlook report (see "2017: It's Bigger than The Donald" December 30, 2016), we've gotten the most pushback from clients on our out-of-consensus forecast that the dollar will weaken.

- *Our view is rooted in the belief that the 11.4% surge in the trade-weighted dollar – over just eight months from the low on May 2 to the high on Monday – is unjustified and overdone, and will be undone. None of the explanations for it that we hear make any real sense to us.*
- *We hear two narrative explanations. One is that it is due to flight from the euro in the face of overhanging Brexit risks. The other is that the election of Donald J. Trump portends a stronger economy, which implies a stronger currency.*
- The latter has some appeal in the event-study framework. We've never seen this pointed out, but it is a fascinating fact – that the present USD rally began precisely on the day that Trump clinched the GOP nomination. About half the rally was complete by election day, and the next half occurred after (please see the chart below).
- But US growth has been stronger than most of the rest of world for

Trade-weighted USD from 2016 low to present



Source: Bloomberg, TrendMacro calculations

Update to strategic view

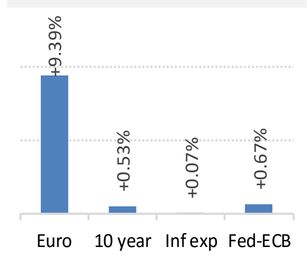
FX: We see no reason for the US dollar's extreme strength since its May bottom, and expect it to be reversed. The present rally began, to the day, when Trump clinch the GOP nomination, and reaccelerated after the election – but we don't see that connection as justifying the rally, especially as Trump's protectionist agenda calls for a weaker USD. Neither do we see a connection with post-Brexit flight from EUR, as USD has appreciated just as much against JPY. Arbitrage arguments about higher relative long-term yields, inflation expectations, and Fed rate hike expectations don't hold up – the magnitude of the USD rally is out of all proportion to any of those potential drivers. With oil having more than doubled since February, USD should by all historical precedent be weaker, not stronger.

[Strategy dashboard]

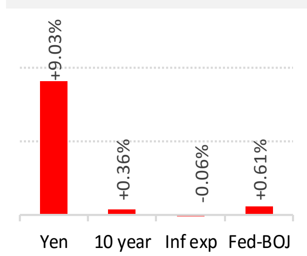
several years. We don't disagree that it will be stronger still under Trump, but we think non-US growth will be too – perhaps even stronger, to the extent that high-beta emerging economies get a stronger US customer. But more fundamentally, our research can't establish any verifiable connection between relative growth rates and exchange rates anyway.

- We'd add that Trump campaigned as a protectionist, and has brought into the White House an advisor, Peter Navarro, who has argued strongly that our trading partners, particularly China, artificially undervalue their currencies (see "Kudlow, Navarro, Uh Oh: Trump's First False Move" December 23, 2016). We don't see how a trade agenda aimed at strengthening other nation's currencies could lead to a stronger dollar at the same time.
- We don't buy as an explanation the potential under Trump's tax reform plans for corporations to repatriate tax-exiled cash, nor under Speaker Paul Ryan's plans to border-adjust corporate revenues. These are still highly speculative proposals with lots of moving parts that, we think, can't justify a rally as great as we have seen.
- The Brexit narrative doesn't stand up in the event-study framework. The present USD rally was underway before the surprise referendum result, continued during that panic after the surprise, and continued further when the panic subsided and reversed (again, please see the chart on the first page).
- Besides, if USD strength were due to flight from the euro, then why has USD strengthened in the present rally by about 9% versus *both* the euro *and* the Japanese yen?
- <u>*We also often hear various arbitrage arguments. These make sense conceptually, but the magnitudes involved are all wrong.*</u>
- Since the May bottom, USD has strengthened 9.39% versus EUR. This simply can't be explained by the small change in 10-year yields, US versus Germany, of only 53 basis points; nor by the change in long-term inflation expectations, US versus eurozone, of 7 basis points (that one actually points in the wrong direction); nor by the change in expectations for 3-year forward central bank policy rates, Fed versus ECB, of only 67 basis points (please see the top chart at right).
- Since the May bottom, USD has strengthened 9.03% versus JPY. This, too, can't be explained by the small change in 10-year yields, US versus Japan, of only 36 basis points; nor by the change in long-term inflation expectations, US versus Japan, of only 6 basis points; nor by the change in expectations for 3-year forward central bank policy rates, Fed versus BOJ, of only 61 basis points (please see the middle chart at right).
- Since the May bottom, USD has strengthened 19.12% versus GBP. This, too, can't be explained by the small change in 10-year yields, US versus UK, of only 79 basis points; nor by the change in long-term inflation expectations, US versus UK, of only 22 basis points; nor by the change in expectations for 3-year forward central bank policy rates, Fed versus BOE, of only 62 basis points (please see the bottom chart at right).
- These are *negative* arguments – in the sense that we are not

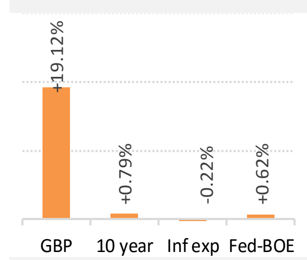
USD and EUR



USD and JPY



USD and GBP

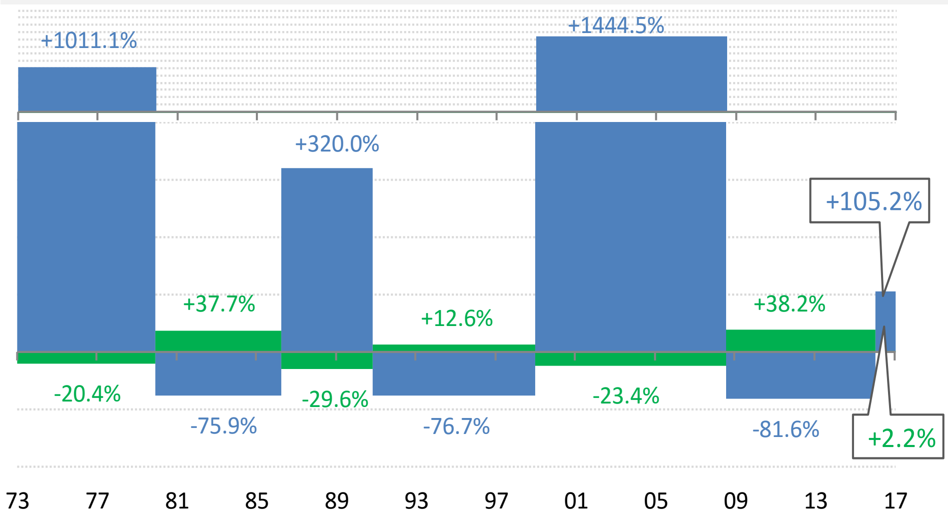


Source: TrendMacro calcs

offering our own theory, merely saying that the popular theories of others are wrong. *Our positive argument is that we believe that, over intermediate- to long-term timeframes, USD is reliably inversely correlated to the global oil price* (please see the chart below, and "Dollar Strength: A Crude Connection" April 23, 2015).

- Indeed, the great 25%-plus surge in USD that began in mid-2014 began practically to the day as oil topped out, and then underwent and historic crash.
- Starting from the February 11 bottom in what we believe is a new bull market for oil, in which oil has already more than doubled, USD has violated a pattern consistent since the mid-1970s by rallying 2.2% (again, please see the chart below).

Change during oil bull and bear markets ■ Oil ■ Trade-weighted dollar



Source: Bloomberg, TrendMacro calculations

- *With oil having rallied 18.9% since the USD bottom on May 2, since which USD rallied as much as 11.4%, we have to believe that this extremely strong violation of reliable historical relationships must soon be reversed. All the more so, as we believe the oil price is headed even higher* (see "2017: Making American Crude Again" December 29, 2016).

Bottom line

We see no reason for the US dollar's extreme strength since its May bottom, and expect it to be reversed. The present rally began, to the day, when Trump clinch the GOP nomination, and reaccelerated after the election – but we don't see that connection as justifying the rally, especially as Trump's protectionist agenda calls for a weaker USD. Neither do we see a connection with post-Brexit flight from EUR, as USD has appreciated just as much against JPY. Arbitrage arguments about higher relative long-term yields, inflation expectations, and Fed rate hike expectations don't hold up – the magnitude of the USD rally is out of all proportion to any of

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