Trend Macro

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MACROCOSM

Dollar Strength: A Crude Connection

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Two quarters of earnings-wrecking dollar strength is all about oil -- so it's about over.

Yesterday's earnings report from Coca Cola, and this morning's from Procter and Gamble, would seem to highlight the disruptive effects of the considerable recent strength of the US dollar. For the global soft drink giant, in a quarter in which unit case volume grew by 1% and concentrate sales rose 5%, Coke reported a 6% currency "headwind" on EPS.

- We are constantly asked by clients whether we are worried about this, and other effects of dollar strength.
- With the dollar having strengthened 5% in Q4-14 and another 9% in Q1-15, the cumulative effect on the consumer staples sector has been a decline in consensus forward earnings of 3% since the end of Q3-14.
- Currency translation effects like the ones that beset Coke have been a big part of the rollover in aggregate S&P 500 forward earnings -- which, historically, has been a harbinger of recession (see "Houston, You're the Problem" March 9, 2015).
- *That said, the decline in earnings -- at least for multinationals with significant non-dollar income from overseas operations -- is to a large extent an accounting artifact with little economic reality*.
- For example, if a company earns euros from its European subsidiaries, those euros still have the same purchasing power -- in euros -- that they always had. And thanks to the US corporate tax code that taxes overseas earnings upon repatriation, the company will never actually convert those euros into dollars and take a real FX loss. *Thus accounting rules that require translation of retained foreign profits into dollars are based on a fallacy -- the presumption of a loss-making transaction that almost never actually takes place.*
- To be sure, goods of US exporters become effectively more expensive overseas -- at least in the short run, until relative inflation in the cheaper-currency nations equilibrates prices in real terms.
- And to be sure, overseas companies that borrowed in weak dollars and have to repay their debt in strong dollars -- perhaps especially in emerging markets -- will face difficulties (again, at least until real prices equilibrate).
- *All in all, then, we are not terribly worried. We are more interested in understanding why the dollar strength has materialized in the first place, and then reasoning from first principles whether its causes might have other worrisome effects.*

Update to strategic view

FX, US STOCKS, OIL: The dollar hit to earnings of multinationals is just an accounting fiction, and other dollar effects will eventually equilibrate away. The real question is what has caused recent dollar strength. There's little evidence that it's central bank policy. Instead, it seems to be connected to the drop in oil prices, a connection that can be observed over more than 40 years. If oil has stabilized for the year, as we predicted, then the dollar's strengthening should be over.

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Here we must confess a certain amount of ignorance. We've been in the business of trying to understand the governing dynamics of the global economy and global markets for many decades. Over all this time there are some aspects of [the system of the world]() that we feel we have never come to understand. Unfortunately, currencies are one of them.

- *<u>But we do have some observations that we think have some salience, and these lead us to speculate that the dollar's strength has probably pretty much run its course.</u>*
- The dominant narrative seems to be about widely disparate central bank policies -- that is, the Fed is tightening while the ECB and the BOJ are easing.
- This is an appealing narrative. At least loosely, it seems to fit recent history. And it seems to go to very simple and persuasive core notions about supply and demand. All else equal, the unit price of a currency being made relatively abundant (or costly to hold) should decline, while that of a currency being made relatively scarce (or cheap to hold) should rise.
- But in our view this theory just isn't really supported by the facts. Over the very long term, there is virtually no statistical correlation between dollar strength and either (a) changes in the fed funds rate, or (b) relative changes between Fed and ECB policy rates.
- In recent years, in an event-study framework, dollar strength does not have a consistent relation to central bank policy announcements (please see the chart below). To be sure, one's eye immediately picks out seeming matches -- but the majority of events are misses.

US dollar index versus central bank policy announcements

Source: Bloomberg, Federal Reserve, ECB, BOJ, TrendMacro calculations

- On the other hand, the same event-study framework reveals an absolutely perfect match -- over and over again, to the exact day -- with four key non-monetary events: (1) the all-time peak in oil prices, (2) the bottom of the bear market in stocks associated with

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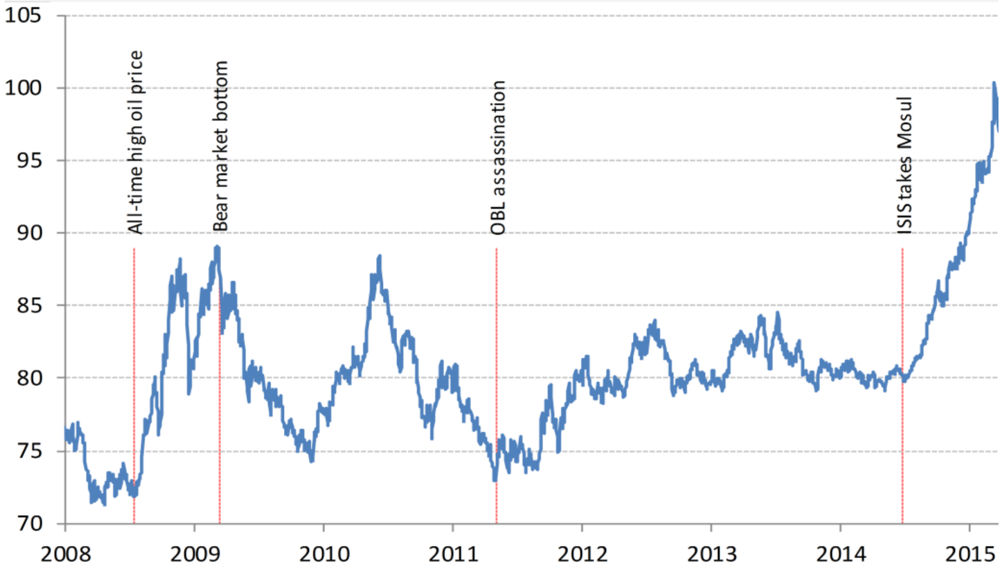
the Great Recession, (3) the death of Osama bin Laden, which was the secondary peak in oil prices, and (4) the capture of Mosul by the Islamic State, which was the tertiary peak in oil prices that preceded last year's collapse (please see the chart below).

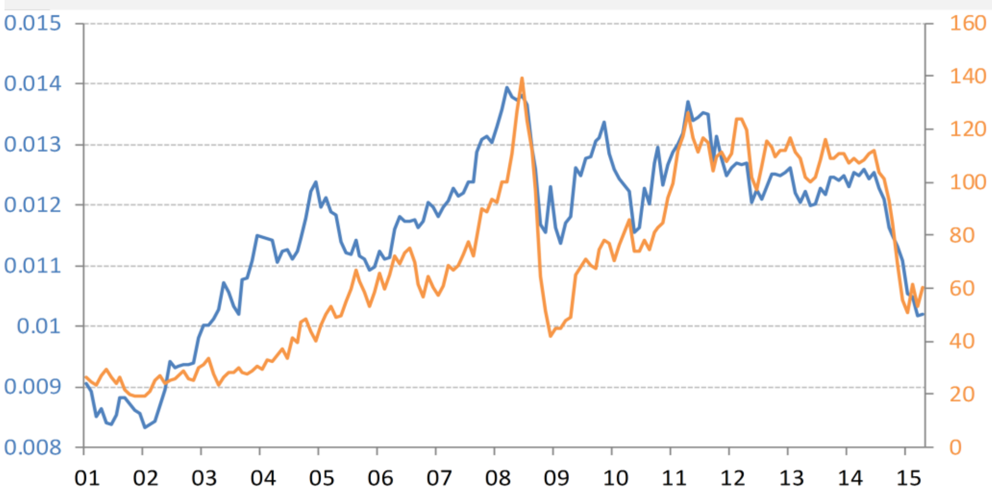
US dollar index versus key non-monetary events



Source: Bloomberg, Federal Reserve, ECB, BOJ, TrendMacro calculations

- The dollar peak that coincided with the bear market bottom in March 2009 -- its strongest level in the time-frame viewed until the last two quarters -- suggests a unique moment in history in which the dollar was a safe haven asset in a global financial panic.
- *But the other three events associated with peaks in the oil price -- after each of which, to the day, the dollar substantively strengthened -- suggests a recurring relationship in which dollar strength correlates to oil weakness.*

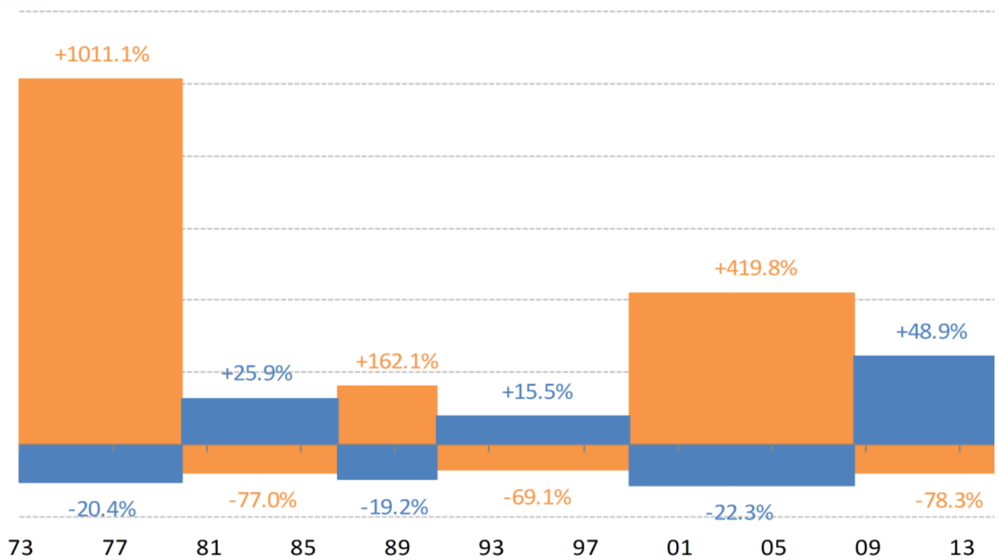
US dollar index Reciprocal **Brent crude**



Source: Bloomberg, TrendMacro calculations

- Indeed, this relationship has borne out over many years. For example, since 2001, from the onset of the most recent episode of rising oil prices -- the greatest such episode in history -- the relationship between oil and the reciprocal of the trade-weighted dollar has been quite close, becoming a near lock-step since 2010 (please see the chart on the previous page).
- Over a deeper history, the relationship is not so exact, but it is quite strong cyclically. During every major *bull* market in oil since 1973, the dollar *weakened*. During every major *bear* market in oil since 1973, the dollar *strengthened* (please see the chart below).

Over major cycles in crude oil ■ **US dollar index** ■ **WTI crude**



Source: Bloomberg, TrendMacro calculations

- *These empirical observations are, to a large extent, theory-free. We have no single unifying explanation for why this relationship between oil and the dollar exists.*
- *But we think this relationship can be useful -- because it demonstrably exists. We prefer it to the idea that relative central bank policies are determining dollar strength -- that idea has a theory behind it, there is very poor evidence in support of it.*
- *If the relationship between oil and the dollar is real -- and if it continues to be as tight as it has been for the last five years -- then we can expect dollar strength to peter out here, because we believe we have seen the end of the price cascade in oil that began last June, and the onset since January of the price stabilization that we predicted* (see "Oilmageddon: The Sequel" January 15, 2015).

Bottom line

The dollar hit to earnings of multinationals is just an accounting fiction, and other dollar effects will eventually equilibrate away. The real question is what has caused recent dollar strength. There's little evidence that it's central bank policy. Instead, it seems to be connected to the drop in oil prices, a connection that can be observed over more than 40 years. If oil has stabilized for the year, as we predicted, then the dollar's strengthening should be over.