



# Our On The Dollar

*? There are benefits of where the dollar is and there are costs of where the dollar is,? Mnuchin said during a panel discussion at the World Economic Forum in Davos, Switzerland. ?It's not a shift in my position on the dollar at all. It is perhaps slightly different from previous Treasury secretaries.? ?We do support free and floating currencies reflective of the market? courtesy: Bloomberg 1/25/2018*

The market's interpretation of the quote above from U.S. Treasury Secretary Steven Mnuchin is on par with the title of the Bloomberg article: *Mnuchin Defends Weaker Dollar Comments as ?Clear, ?Consistent.?* Despite the recent uptick, the dollar has been steadily declining since the presidential inauguration, and the positive and negative implications of the trend are becoming more evident to politicians, economists and investors. Many dynamics affect the value of the U.S. dollar, and libraries of books have been written on the topic. While we solidly grasp the traditional factors that affect the value of the dollar, we must also appreciate the aims and goals of central banks. These tend to receive less attention despite central banks' direct and, at times, massive

interventions in the currency markets. In this piece, we review the traditional influences on the dollar to gain an understanding of why it has generally trended lower for the past year and a half. Further, we present our two cents as to what the biggest explanation of dollar weakness may be. The relative value of the dollar has major implications for all investments. A clearer understanding of what is influencing it can yield insight that many investors tend to overlook and enhance decision-making.

## Factors Supporting Dollar Appreciation

Currently, the Fed Funds rate, as set by the Federal Reserve (Fed), stands at 1.75%. For many years after the financial crisis (December 2008 through December 2015), the target range was 0%-0.25%. In comparison, the targeted monetary policy rates in Japan and Europe, the currencies against which the dollar is most heavily weighted, are pinned below zero. The Fed Funds rate is expected to rise to at least 2.25% by year-end, with the Federal Open Market Committee (FOMC) telegraphing two more rate hikes this year. The Fed is also actively reducing their balance sheet with the pace of the reduction increasing throughout 2018. By the end of 2018, the Fed's balance sheet is expected to fall 10%, or about \$400 billion, from the peak reached in 2015. In comparison, the balance sheets of the central banks of Europe (ECB) and Japan (BOJ) are still on the rise, although the pace of growth is diminishing in both instances. The Fed has been more aggressive than Europe and Japan in normalizing monetary policy due to a more resilient economy and higher inflation levels over the last few years. Comparatively higher interest rates in the U.S. should attract

dollar. Consider the table below of which argue for dollar strength.

Comparative Economic and Rate Analysis			
	U.S.	Europe	Japan
Real GDP*	2.85	2.55	1.52
Inflation*	2.30	1.38	1.15
10yr Yield**	2.92	0.38	0.05
Central Bank Rate***	1.75	-0.40	-0.10
* Average last four quarters			
** German Bund			
*** Fed Funds, Euro Deposit Facility, and Japan Policy Balance Rate			

Data Courtesy Bloomberg and St.

*Louis Federal Reserve* Another factor that should benefit the dollar is that global growth appears to be running at its strongest level since the 2008 financial crisis. Given that the dollar is the world's reserve currency and most international trade is conducted in U.S. dollars, more economic activity naturally creates greater demand for dollars versus other currencies. The dollar should be appreciating versus the euro and the yen based on the domestic and global economic data, comparative interest rates and respective monetary policies. Before presenting some of the important factors that are weighing on dollar strength, consider that the euro has appreciated 11% and the yen 7% versus the dollar since 2017.

## Factors Supporting Dollar Depreciation

Despite the fundamentals supportive of a stronger dollar, there are a few factors working against dollar strength. The newly passed tax reform is expected to add approximately \$1.5 trillion to the deficit, and the continuing budget resolution (CR) will add \$300 billion. These amounts are on top of rising Treasury debt forecasted to grow over \$1.0 trillion annually for the foreseeable future. To put that in context, \$1.0 trillion is on par with the emergency deficits of the financial crisis and two to

four times those witnessed during the remainder of the 2000's. Also potentially adding to the deficit are recent proposals for a trillion dollar infrastructure spending plan. For further insight on the arduous task of funding future deficits, we recommend reading [\*Deficits Do Matter\*](#). Deficits are inherently negative from a creditworthiness perspective, especially when they are rising quicker than economic growth. Therefore, a sharply rising deficit tends to be dollar negative. This presents the U.S. Treasury with a dilemma. On one hand, in order to cost-effectively fund the government's \$21 trillion of debt outstanding, the future growth of debt outstanding, and the outsized debt of corporations and individuals, Treasury officials will encourage the Fed to keep interest rates low. On the other hand, the amount of new supply of Treasury debt may require higher interest rates in order to attract buyers. Over the last few decades, as the debt burden has increased, the economic sensitivity to higher interest rates has increased markedly. The deterioration in the U.S. fiscal standing and the heightened probability of Fed intervention to manage rates either through traditional or unconventional policies seem likely to weigh negatively on the dollar. While impossible to pinpoint the level at which rising interest rates could cause economic difficulties and recession-inducing stress, we are confident that the Fed will use everything in its monetary policy arsenal to avoid that outcome. This not only entails lowering the Fed Funds rate back to zero and restarting quantitative easing (QE) but may also include targeting negative interest rates. These monetary policy tools, especially when used in the extreme as we have seen since 2008, greatly debase the value of the dollar. • To wit consider the following headline from April 13, 2018 ? (Fed Governor) ?*Rosengren sees risk of rates back at zero in future recessions.*? It is quite possible the currency markets are looking forward. In addition to the deteriorating fiscal situation and the likelihood that extreme monetary policy will be used to combat its consequences, it is increasingly apparent that President Trump, as echoed by the Treasury Secretary, appreciates the benefits of a weaker dollar. From an economic perspective, a weaker dollar makes U.S. manufactured goods cheaper to foreign buyers encouraging more production within the U.S. or, at a minimum, helps retain existing U.S. production. This helps to fulfill Trump's promise to restore the U.S. manufacturing sector. A weaker dollar along with tariffs and other adjustments to global trade is a powerful incentive aimed at fulfilling those popular political promises. Last April Trump made the following comments: ?*Look, there's some very good things about a strong dollar, but usually speaking the best thing about it is that it sounds good. . . . It's very, very hard to compete when you have a strong dollar and other countries are devaluing their currency.*? Need we remind you the midterm elections are right around the corner and holding the majority in Congress is vital if Trump is to have legislative success. Further in early 2019, Trump will begin campaigning for a possible second term and would no doubt like to have tangible evidence of progress in strengthening the manufacturing base and U.S. trade deficit reduction.

## Our Two Cents

**The logical conclusion would seem to be that dollar weakness stemming from concerns about increasing deficits and Trump's economic goals are overshadowing the positive economic and monetary policy factors that should be driving the dollar higher.** However, there is more to consider beyond these fundamental factors. Just as any currency may be influenced by internal dynamics, they are equally susceptible to external influence. Japanese and European central banks are taking baby steps towards reducing their balance sheets and normalizing monetary policy. While these moves are small and almost meaningless compared to the extreme policies of the last ten years, they will eventually tighten financial conditions in those countries. Japan and many European countries have been dealing •with anemic economic growth and tottering in and out of recession for at least the last ten years. Japan's malaise is now approaching 30 years. Based on the comments of their central bankers and politicians, they desperately want to foster current levels of growth and are apprehensive about any policy measure that may present a set-back. For instance, at the January 25<sup>th</sup> ECB policy meeting, ECB President

Mario Draghi spoke of deflation risks disappearing and promising economic growth. After the relatively rosy economic outlook he reminded us, *‘If the outlook becomes less favorable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase the asset purchase program in terms of size and/or duration.’* Bottom line, the ECB will quickly re-engage unconventional policies if they see any signs of slowing growth or deflation. **So the question becomes how to tighten monetary policy while maintaining accommodative monetary conditions.** Such a task seems nearly impossible until you consider the role of the U.S. dollar in foreign nations. Many foreign companies and some nations borrow in U.S. dollars. They effectively convert the dollars borrowed to their home currency, and when the debt matures they purchase dollars with their home currency to pay off the dollar-denominated debt. In other words, foreign borrowers of dollars are effectively short the U.S. dollar. The cost of borrowing is the dollar-denominated interest rate **plus** the change in the exchange rate between the dollar and their home currency. If the dollar weakens over the life of the transaction (i.e., the change in the exchange rate is negative), the foreign issuer’s real cost of borrowing declines. **It is quite possible that the central banks, notorious for intervening in currency markets, are tightening or threatening to tighten monetary policy while easing financial conditions behind the scenes via currency manipulation.** It is likely the Trump administration is on board with such a plan, as it can help make American exports more affordable and thus provide further impetus for the U.S. stock market. We also suspect that the Fed, given their desire to boost inflation, would not resist such a plan as a weaker dollar is inflationary as foreign goods become more expensive (often referred to as ‘imported inflation’). As it relates to the Treasury Secretary’s comments and the impact of a weaker dollar, Ray Dalio, of Bridgewater Associates recently stated: *‘Regarding Treasury Secretary Mnuchin’s comments about the administration’s weak dollar policy, I want to make sure that you understand what having currency weakness means - most importantly, it is a hidden tax on people who are holding dollar-denominated assets and a benefit to those who have dollar-denominated liabilities.’*

## Summary

We end with a word of caution: disorderly foreign exchange movements will change market conditions across many asset classes, mostly for the worse, but especially so if it occurs in the U.S. dollar.