Investment Views

August 2020

Dollar Doldrums?

Since rallying sharply on the pandemic news, the US dollar has been on the slide. After its weakest month in a decade, the trade-weighted dollar (or DXY) ended July 3% lower for the year-to-date.

A soft dollar is often associated with a 'risk on' period, as cheaper dollar debts and dollar priced commodities stimulate growth. Liquidity seeks out opportunity beyond American shores, often bidding up more cyclical, developing regions. The message from current dollar weakness seems more nuanced.

The DXY is comprised of 58% euro, 14% yen and 12% sterling (the balance is spilt between Canadian dollars, Swedish krona and Swiss francs). The recent DXY drop has been driven by a rally in the euro and, to a lesser extent, sterling and the yen. With tentative signs that the pandemic may birth collective liability sharing via EU-backed 'crisis bonds', the single currency is 10% off its March lows and 5% higher this year. However, over the same period, the JPMorgan Asia and Emerging Market dollar indices have fared less well, failing to recover their pandemic losses; they ended 2% and 9% lower.

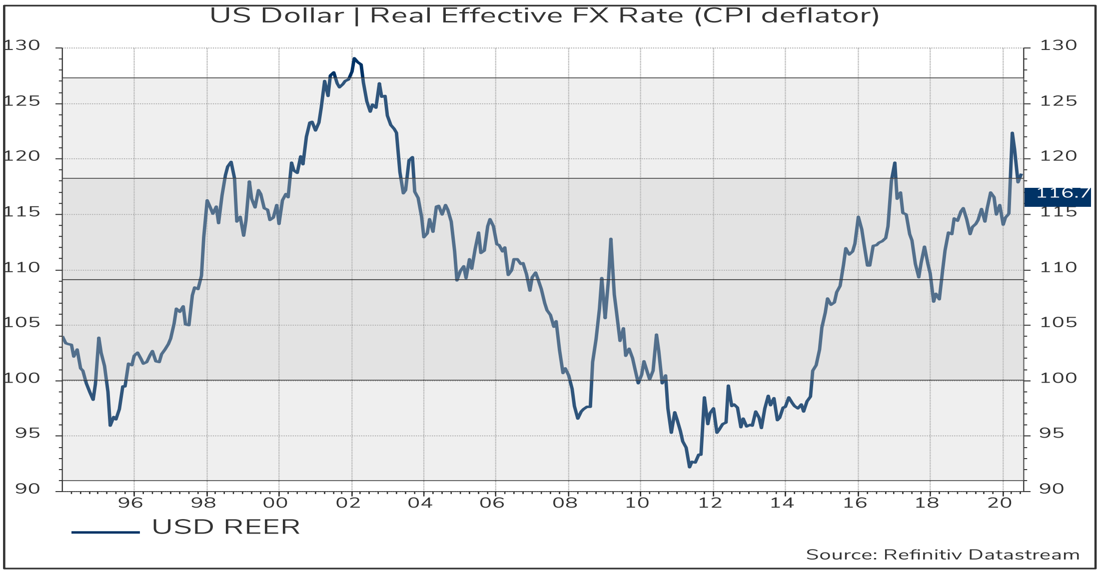
On the face of it, there are several reasons for dollar weakness. Firstly, currency markets are starting to price in the November US Presidential election with neither candidate seen as dollar positive. Whilst Trump favours zero (or negative) interest rates ad infinitum, a growing cohort of senior Democrats support 'modern monetary theory', where aggressive fiscal spending is funded by unlimited money printing.

Secondly, during June and July, the US has seen infection rates rise, as the rest of the world exhibited a degree of corona control. In a world where virus cases correlate to economic damage, pandemic hotspots can expect to see commensurate currency weakness.

The relative aggression of the policy response is also a factor. As Cov19 spread, the US Federal Reserve cut the Fed Funds rate by 1.5% to 0-0.25% p.a. and flooded the world with dollars; US money supply (as measured by M2) rose at an annualised rate of 63% in the 3 months to end May (Source:

Datastream). At the same time, the nominal yield on the 10-year Treasury slumped from 1.9% to 0.5%; with CPI inflation of 0.6%, the real yield turned negative. With the US money supply rising faster than its peers and with nominal and real yields falling faster in the US than elsewhere, the greenback became (relatively) less attractive.

Finally, this all unfolded against the backdrop of an historically expensive dollar. The chart below plots the dollar real effective exchange rate (REER) over the last quarter century. The REER measures the value of a currency against its major counterparts, taking into account relative prices (i.e. the currencies relative spending power). The higher the reading, the more expensive the currency.



So why the disparity? Given the dollar headwinds, why have developing nation currencies struggled to match the gains of the euro, yen and sterling?

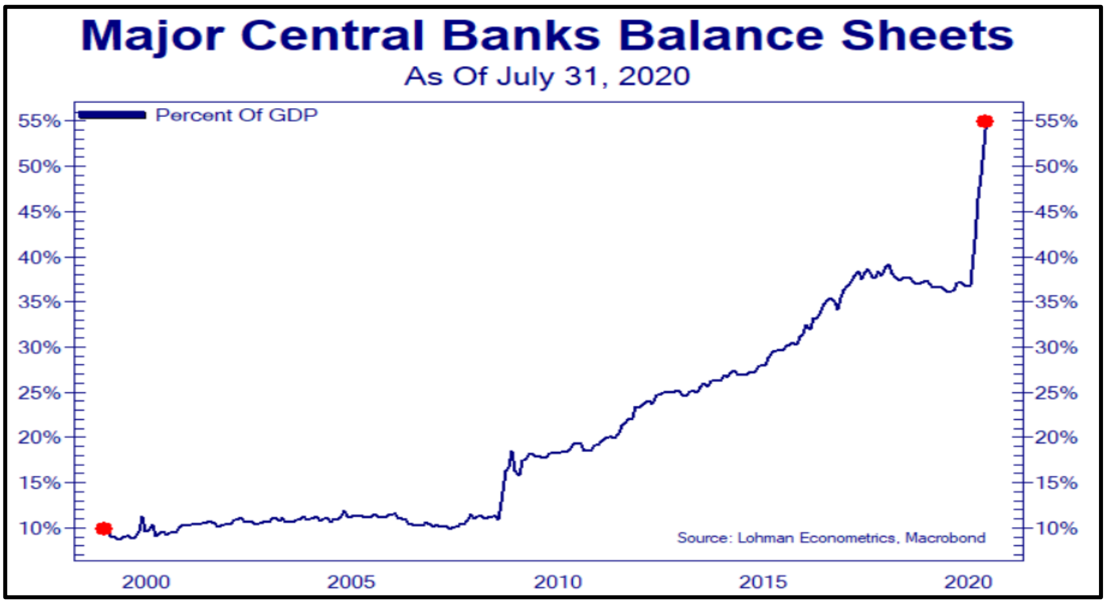
Firstly, investors have lacked the courage to allocate to emerging markets (EM), with net outflows from EM equity ETFs and EM debt markets this year (source: State Street, Schroders). As many of the EM currency and equity markets are not particularly cheap (relative to history or other markets), there has not been a compelling reason to embrace these more cyclical regions; they remain acutely vulnerable if the virus flares and the nascent global recovery stalls. They are also exposed to any renewed 'safe haven' dollar bid, given record dollar indebtedness; at the end of 2019, dollar credit to non-bank borrowers outside the US touched $12.2 trillion (source: BIS).

Following on, the Fed's intervention has encouraged foreign institutional investors to diversify their reserves away from the dollar; with the collapse in yields, Treasuries no longer offer a meaningful yield pick-up; Bunds, Gilts and JGB's are the obvious alternative. Having peaked at $7.1 trillion in February, foreigners held $6.9trn of Treasuries by end May.

So the slide in the dollar does not (as yet) reflect a warm embrace of the reflation narrative; indeed, that would be a jarring counter to the message from sovereign bond markets, where the collapse in yields speaks to a rolling recession with little or no inflation. Rather it points to a diversification of low risk reserves, as the greenback's relative attraction wanes.

So what next? Will the dollar enter a precipitous downtrend, undermining its role as the world's reserve currency? Possible, but we doubt this plays out anytime soon.

Firstly, the behaviour of the Fed and Trump's Treasury is not unique. Directly or indirectly, most Central Banks are now financing local government policies, printing new money to buy up the resultant debt. Starting in 1999, the chart below shows the combined balance sheet value of key Central Banks in the US, UK, Europe, Japan and Switzerland. It has swollen to c. 55% of combined GDP or $22 trillion. Currency debasement has gone global.



Furthermore, we do not believe that the reserve status of the US dollar is threatened in the foreseeable future. Over 60% of national forex reserves are USD-denominated, parked (mainly) in Treasuries and T-bills. No other currency has the bond market depth to accommodate that quantum of assets. The Europeans are taking baby steps to address this with the tentative agreement to issue collectively backed 'crisis bonds' and the Chinese may well offer a viable alternative in the future; but not until they forsake control of their capital account, a key policy lever.

Finally, we still see the dollar as the default safe haven currency, with any flight to dollar safety amplified by the panicked bid of dollar debtors. Admittedly, the decision by the Federal Reserve to extend emergency swap lines to end March 2021 potentially reduces the latter dynamic. The Fed facility provides dollar liquidity to both US banks and some foreign Central Banks "easing the strains in global dollar funding...(and) on the supply of credit both domestically and abroad" (quote: the US Federal Reserve).

So what next? In the near term, having seen the dollar slide on a period of relatively poor virus news and an aggressive monetary/fiscal response, our sense is that it now drifts with risks to the downside. The relative impact of the virus on key nations will heavily influence the strength of currencies; in this regard, it is interesting to note rising infection rates in Europe, South America and parts of Asia, just as US numbers start to flatten out. We also sense that the dollar's downside will be limited for now, as the prospect of a flight to safety (and a firmer greenback) will intensify whenever the virus flares. Traders will not want to be too short given the prevailing uncertainty. Finally, with unfunded fiscal spending becoming the global norm and the spread between sovereign yields compressed to negligible levels, these policies and the path of relative rates is arguably priced in.

Further out, we have sympathy for the idea of a weaker dollar; it is relatively expensive and faces an extended period of low real growth, as accumulated debts weigh upon productivity. Many high growth/low-debt Asian economies stand in stark contrast. The last decade has also seen an unprecedented investor concentration in US dollar assets. As we noted above, foreign holdings of US Treasuries hit a record in February, whilst the S&P500 has outperformed 'Global ex-US' stocks fourfold over the last decade. The US stock market now accounts for c. 60% of global equity indices.

We share the above thoughts with the caveat that currencies have rarely been so unpredictable, even if volatility has collapsed. With every nation racing to debase their domestic currency, it is a question of trying to identify the least bad option. This speaks to our core holding in physical gold and the related mining stocks. With the real yield on sovereign bonds turning negative and the amount of negative yielding debt doubling to $16trn dollars between March and July, the zero yield on gold is no longer a detractor; quite the opposite. Furthermore, the supply of major currencies will continue to rise inexorably, with Central Banks committed to printing money in support of increasingly desperate and expensive reflationary policies. If this eventually engenders inflation, we see gold as a store of purchasing power, akin to the 1970s. If inflation does not appear, the ongoing debasement of fiat/paper currencies will accelerate, making the limited supply of gold and its history as a means of exchange ever more attractive.

Bullion has had a stellar year, rising 30% in dollar terms and touching new highs in all major currencies. Along with gold miners, this has been a key reason why our sterling mandates are breakeven over the last 12 months, with dollar ones showing 4-5% real (after inflation) gains. As speculative money flows into this relatively small asset class, bouts of weakness and volatility will inevitably increase. We understand this but choose to run our exposures in the belief that portfolios will be well rewarded for tolerating the risk. Adjusted for inflation, bullion remains 45% below its 1980 peak; given the policy backdrop, we see no reason why we should not revisit and exceed that level.

Don't Bank On It

A few months back we discussed the troubled state of global banks. Things have not got any better. As the pandemic triggered a second quarter depression, loans have soured. In the UK, the six biggest banks made loan loss provisions of £17.2bn during the first half; more than the value of RBS/NatWest and equivalent to the market capitalisation of Barclays. In the US, it's a similar story; in the second quarter alone, JPMorgan, Wells Fargo, BoA and Citi wrote off $33bn. More will follow.

A study by Accenture suggests that, if the world slips into a double dip recession, the top 100 US and EU banks will lose over $880bn on their loan books by 2022. This equates to c. 10% of US loan balances and 5% of the EU equivalents.

Unsurprisingly, bank share have cratered. Below is the 30-year chart for the Euro Stoxx Bank index. It is more than 20% below its 1987 low. Across the pond, the S&P US Bank index trades at 1997 levels. Finally, you could have bought HSBC at the current price back in 1996; the same year that Tiger Woods turned pro.

As bank struggle to contain loan losses, chronically low sovereign yields (the benchmark for lending rates) slash net interest margins; lending becomes less profitable. As we write, the average yield on 10-year sovereign bonds for the US, UK, Germany and Japan is 0.01%.

Our conclusion remains the same. As bank become increasingly politicised, forced to act as conduits for fiscal and monetary policy, they are taking on the guise of quasi-nationalised, regulated utilities. Eventually this will make them attractive, low risk yield stocks. But not yet.

Policy Matrix Summary

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intendd as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives Cash	Gold Miners China A Shares Sustainable yield Japan Energy sector	Inflation-linked, Emerging Market	Gold
–	Equities Bonds	European US Technology	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31 July 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3085	5.5%	3.9%	7.6%
CHF	1.0949	3.7%	5.7%	8.8%
AUD	0.7143	3.5%	9.7%	4.4%
JPY	105.8300	-1.9%	-1.3%	-2.7%
EUR	1.1778	4.8%	7.5%	6.3%
BOND YIELDS (10 yr)				
UK	0.10	-0.07	-0.13	-0.51
US	0.53	-0.13	-0.11	-1.49
Germany	-0.53	-0.07	0.06	-0.08
Australia	0.82	-0.06	-0.08	-0.37
Japan	0.01	-0.01	0.05	0.17
EQUITIES				
US. S&P 500 (USD)	3,271.12	5.5%	12.3%	9.8%
UK. FTSE 100 (GBP)	5,897.76	-4.4%	-0.1%	-22.3%
FTSE Europe Ex UK (local)	255.10	-0.9%	6.7%	-4.8%
Japan. Topix (JPY)	1,496.06	-4.0%	2.2%	-4.4%
China. Shanghai Comp (RMB)	3,310.01	10.9%	15.7%	12.9%
HK. Hang Seng (HKD)	24,595.35	0.7%	-0.2%	-11.5%
Australia. All Ords (AUD)	6,058.31	0.9%	8.2%	-12.2%
FTSE Asia Pac ex Japan	566.70	7.4%	15.6%	6.2%
FTSE World (USD)	645.08	4.8%	12.5%	4.9%
FTSE World (GBP)	728.67	-1.3%	8.1%	-2.1%
COMMODITIES				
Oil (WTI)	40.27	2.4%	52.7%	-28.0%
Gold	1975.86	10.9%	17.2%	39.8%

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