CURRENCY CURRENTS

Global macro ruminations

Tuesday 12 June 2018

Quotable

"Only those who will risk going too far can possibly find out how far one can go."

--T. S. Eliot

Commentary & Analysis

Donald's Dollar Dilemma

President Trump has made it clear he wants to see the US trade deficit decline and appears willing to use all means necessary to achieve his goal.

Global macro analysis has shown there is truth to the idea a weaker currency may be the best single policy tool to help alleviate a trade deficit; with lag time of course. But herein lies the dilemma for President Trump—a trade war, some type of global risk-off event, and implementations of policies that lead to relative US growth are likely factors what will lead to a stronger dollar; at least over the near-term—and thus delaying any likely improvement in the trade deficit; thus, potentially leading to more trade concerns, more risk, etc.

Historically, strong relative economic growth and yield, driving capital flow, have corresponded in a powerful feed-back loop to push said local currency higher against competitors.

The diagram below I have shared in the past; it is here again to support the point about US relative yield, growth and capital flow connected in a feedback loop with a corresponding impact on the currency. I penned a piece on this comparison for *Currency Currents* back on November 23rd, 2016:

> As you well know, markets have reacted very favorably to the recent election of Donald Trump to be the next US President, despite the continued obsessive sniping among the mainstream press and assorted metrosexuals (defined as hubris-filled big city dwellers). Market players are betting on the benefits that might flow to the US economy from the set of tax, regulatory, and fiscal policies Donald Trump has outlined. Interestingly, history at least rhymes here, as we saw an economic boom in America triggered by a very similar set of policies enacted during President Ronald Reagan's first term in office. The core of Reagan's economic policy agenda was lower taxes, fewer regulations, and increased defense spending; surprising similar to Mr. Trump's proposals, albeit articulated differently.

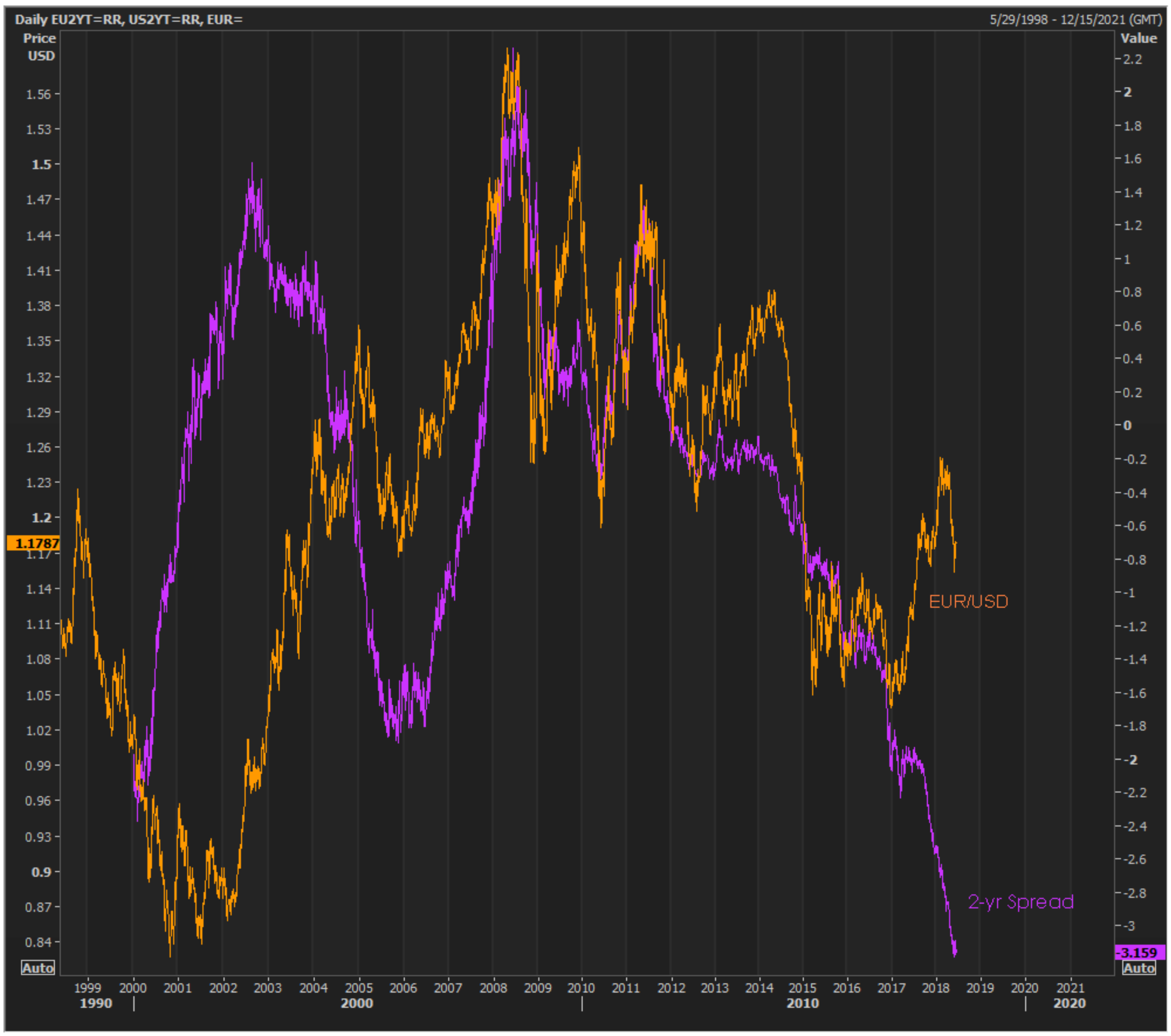
The Reagan Era led to a Virtuous Circle of money flow into America at the time, and it triggered a huge rally in the US dollar and launched the US economy into a real growth trajectory following the inflation prone morbidity of the 70's. There is a very good chance we could see a repeat under the tutelage of a President Donald Trump.

Given that market players now seem to have made many one-way bets: long the dollar, long stocks, and long interest rates, my favored scenario is a little shakeout here by Mr. Market, reversing all those trades to some degree, during the **transitionary phase** where by expectations are realigned with reality and <u>the time it takes for said policy changes to flow into increased corporate profitability and consumer income</u>.

For instance, during the transitionary phase: Policy changes will not be enacted immediately. Fiscal stimulus will not be a growth multiplier immediately. The huge debt burden facing developed world nations will not subside immediately and in fact the problem has grown more severe with the run up in the US dollar and surge in interest rates. Friction may develop on the trade policy agenda. And the left will do their best to derail as much of Trump's legislation as possible. Rising rates and an emboldened Fed will likely reduce liquidity at the margin.

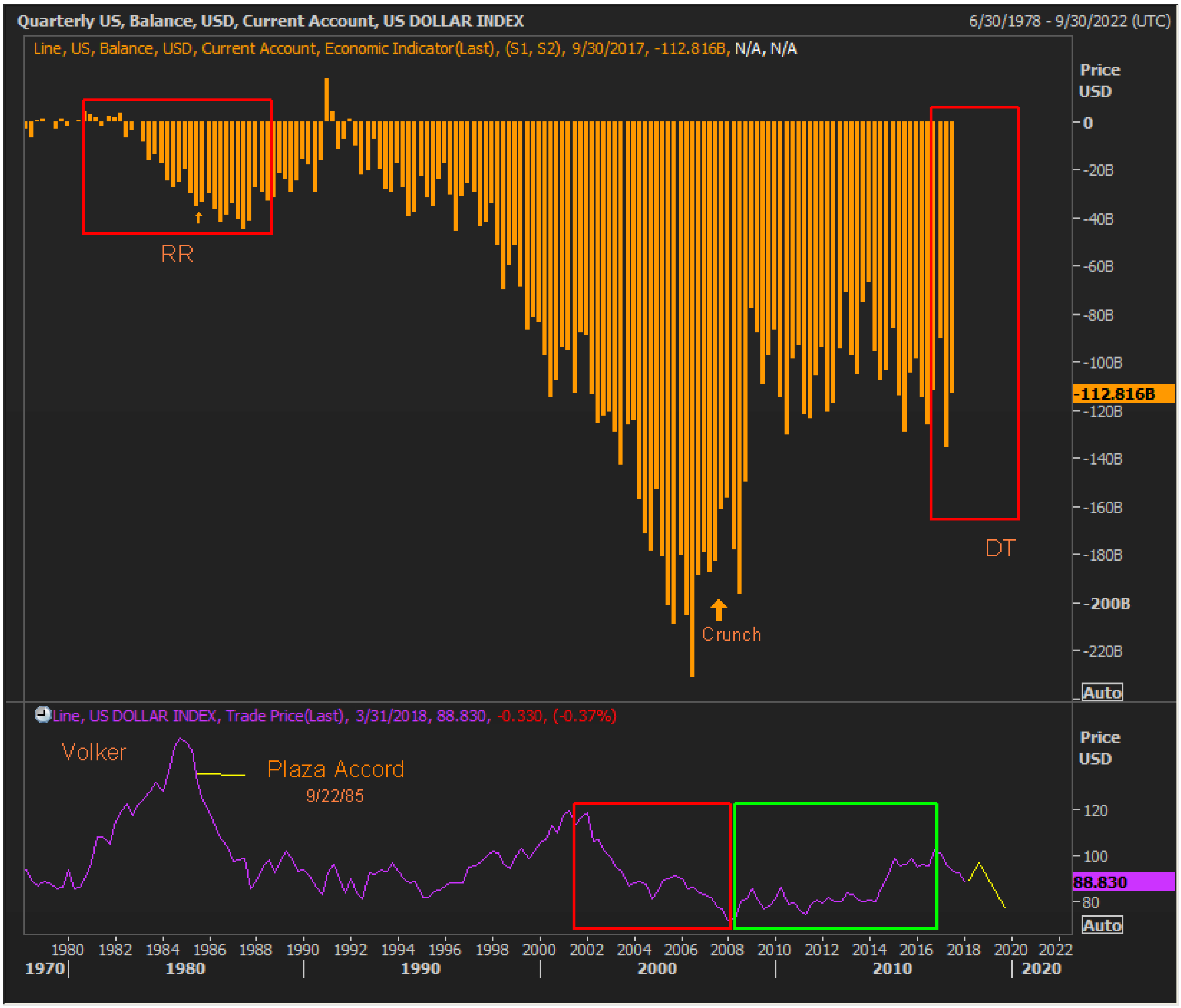
Interestingly, we have witnessed a transitionary phase since I November 2016 with some economic friction, and lots of the political/cultural variety (which is part and parcel to my view Asia *is* the future and the West is toast). Stocks have sailed through it nicely so far; thanks to gifts from central banks; which might be about to change. Job growth was suspect—not any more. Rising interest rates were suspect—not any more. Inflation expectations were suspect—the next shoe to drop?

But despite the rising yield spread (see **EUR/USD vs 2-yr EU-US spread** chart below), relative growth in the US economy, and capital flow away from emerging markets and Europe (to a lesser degree) and into the US, the US dollar hasn't exploded upward as it did during the Reagan Administration. And though one might suspect it to do so on these grounds alone, <u>I think the key difference now is the fact the US economy is no longer as dominant as it once was</u>; i.e. it is no longer the only game in town for major capital flow now that China has found its footing.



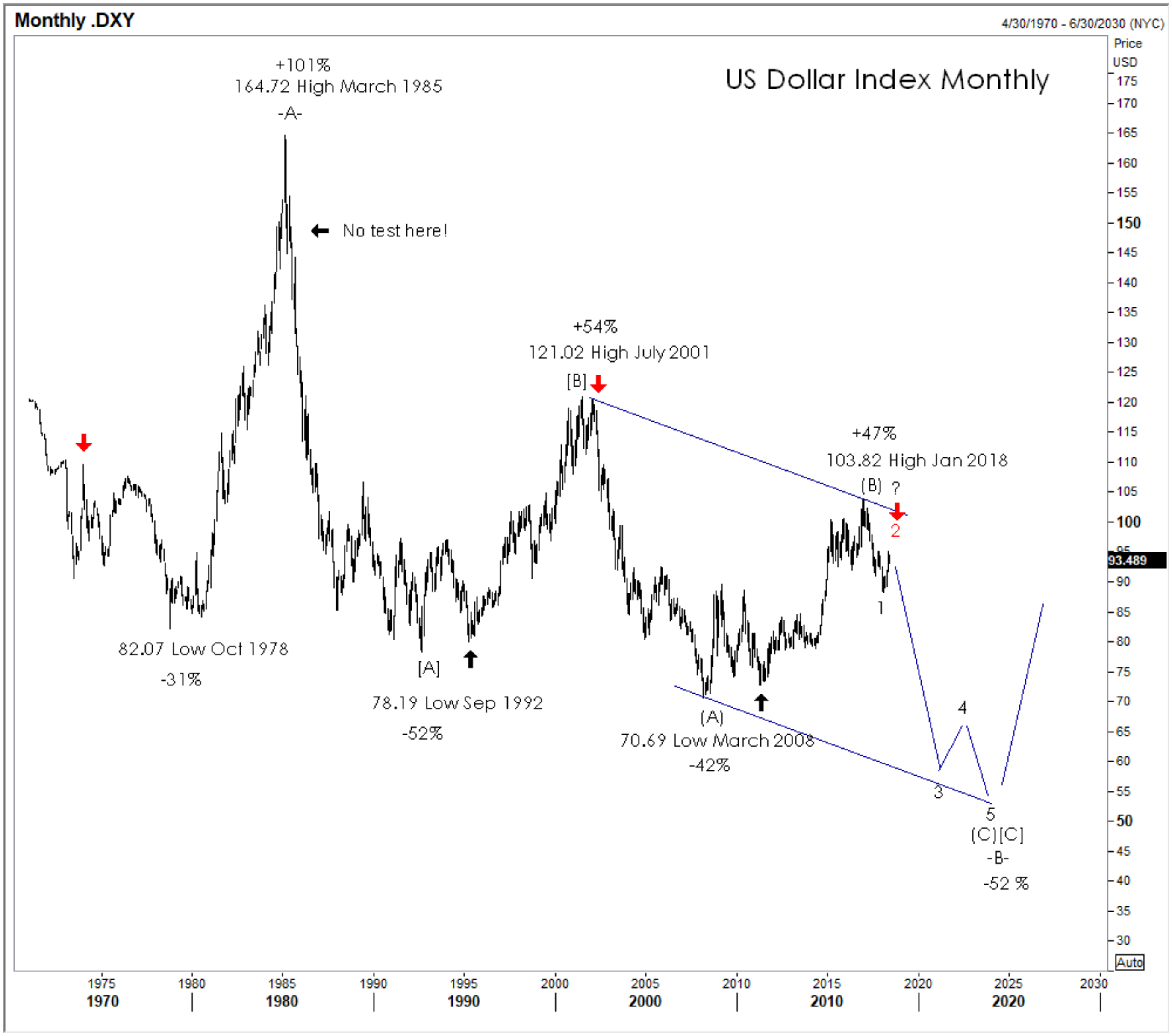
Below is a chart (circa February 2018) which is a bit difficult to understand, but there is much to discern from it. The top of the chart shows the **US current account deficit** (yellow/orange bars); while the bottom of the chart shows the path of the **US dollar index**.

The key point is this: President Reagan effectively devalued the US dollar via the Plaza Accord in order to reduce the blossoming US current account deficit (we should be so lucky now) as a result of Japan's awesome export prowess. Though the US current account has improved from its low thanks to the global credit crunch, it is increasing again, especially via China, which is running a record surplus with the United States (small chart to the right). I suspect, at some point there will be policy action from the US designed to devalue the US dollar in response to China's awesome export prowess; I am not sure how or when.

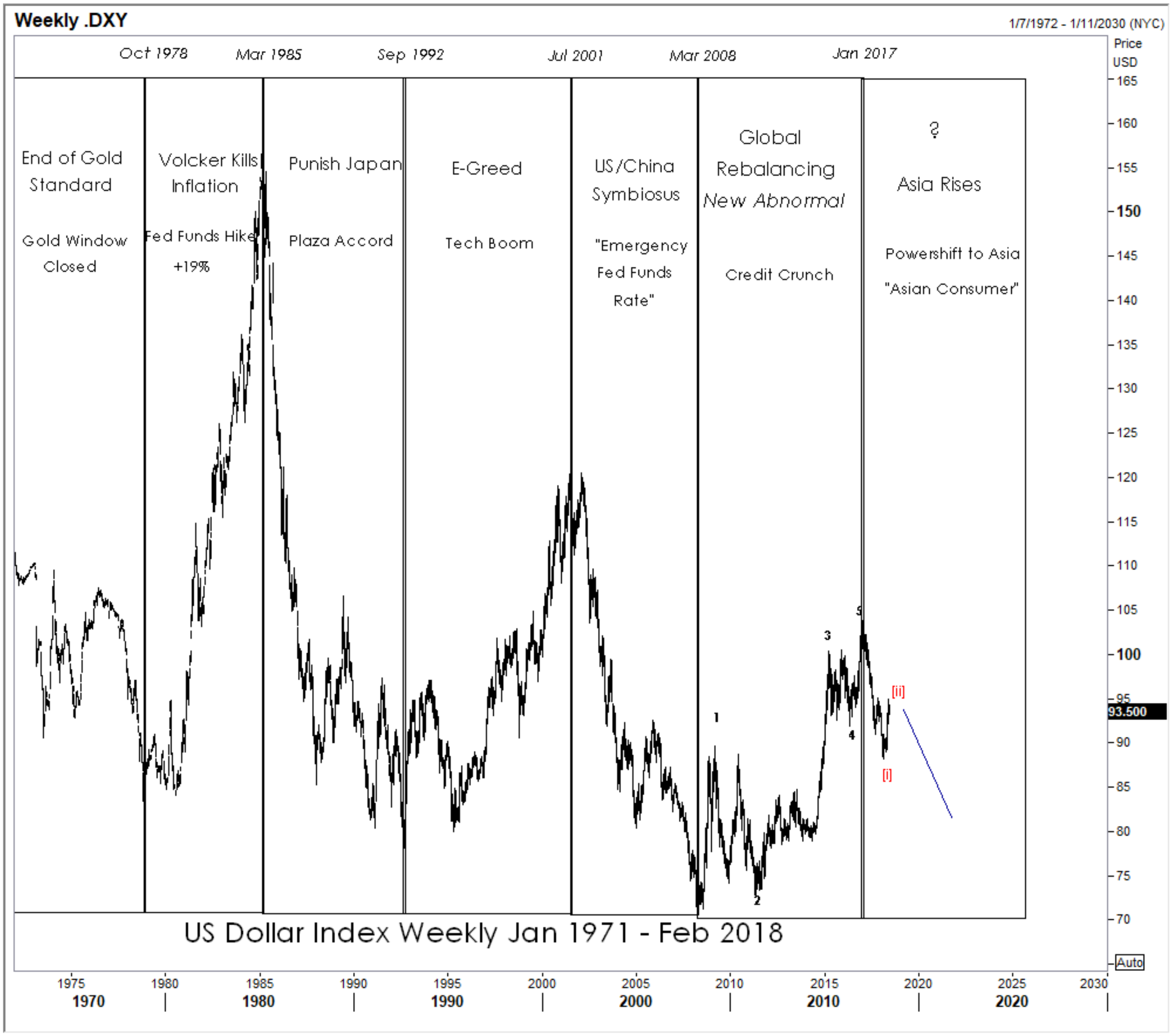


In the interim; possibly into 2019, I suspec the US dolalr runs higher given the relative growth dynamics discussed above. But the next major move in the dollar will likley by down if I am right about President Trump's attemp to trash the dollar as a polcy tool.

US Dollar Index View Monthly: Includes percentage gains and losses during bear and bull markets since 1971.



Corresponding US dollar index eras relative to major global macro triggers:



If you have an interest in our services, which can be found at our website as listed below, please send an email and I would be happy to provide a free trial.

Thank you.

Jack Crooks, President,
Black Swan Capital
jcrooks@blackswantrading.com
www.blackswantrading.com
772-349-6883