Drivers for a multi-year decline in the US dollar into focus…
13 April 2020/10:40 a.m. EDT

Quotable
"Get your facts first, then you can distort them as you please."

--Mark Twain

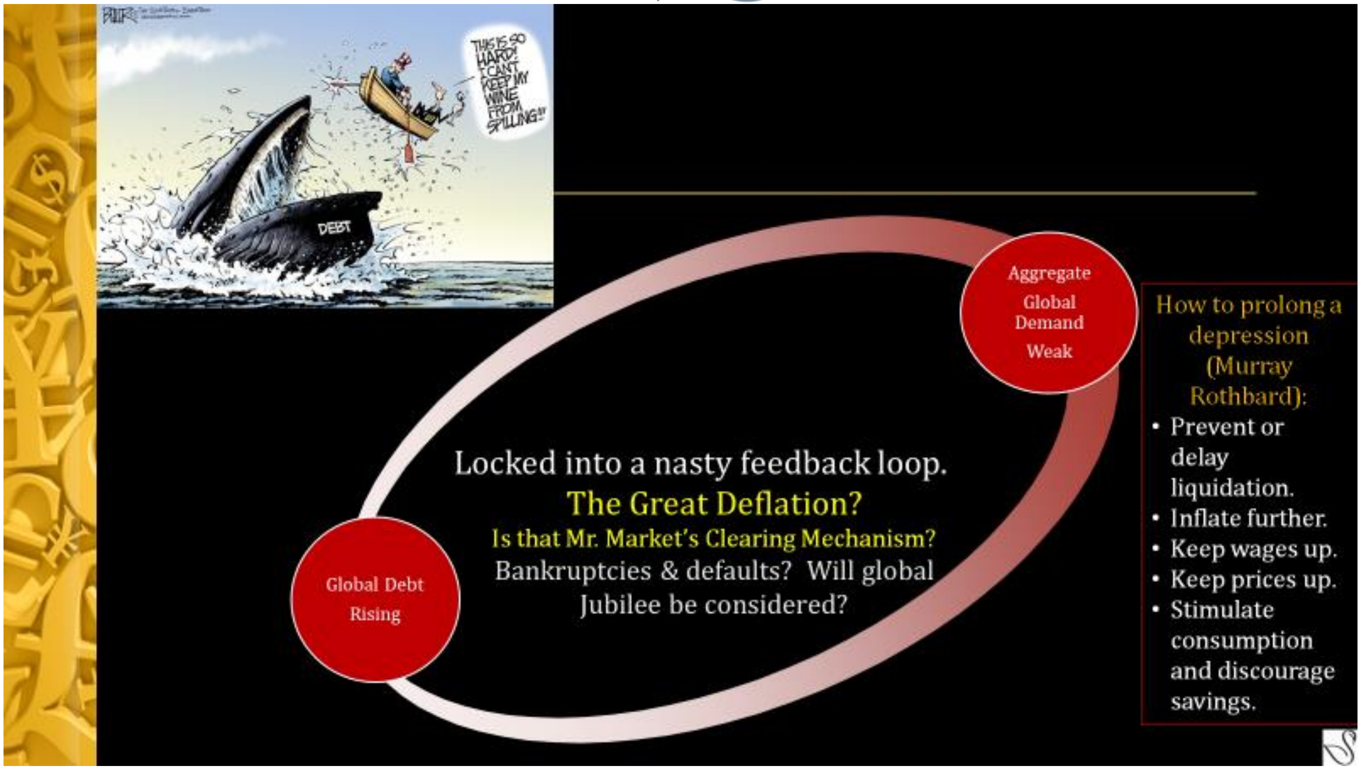
Comments
I just wanted to comment a bit more on our current macro theme as it relates to credit markets and its impact on the longer-term dollar path.

As you know I've been suggesting it is the credit market that is key to the US dollar's path at least intermediate-term (months) and is likely the trigger for a powerful leg down in the buck if key assumptions and guesses prove correct. In short, if credit markets muddle through, thanks to CB and government largess (morphed into "we will do whatever it takes" from the US Fed), the dollar most likely falls from here.

As much as Ludwig von Mises would shudder in pure horror of massive malinvestment, it seems we have entered the era of "do whatever it takes" from the Fed going forward, time indefinite but likely longer than we now expect. If so, it's also likely credit spreads will continue to shrink to somewhat *normalized* levels. (I realize the use of the word "normal" in this environment is an oxymoron.)

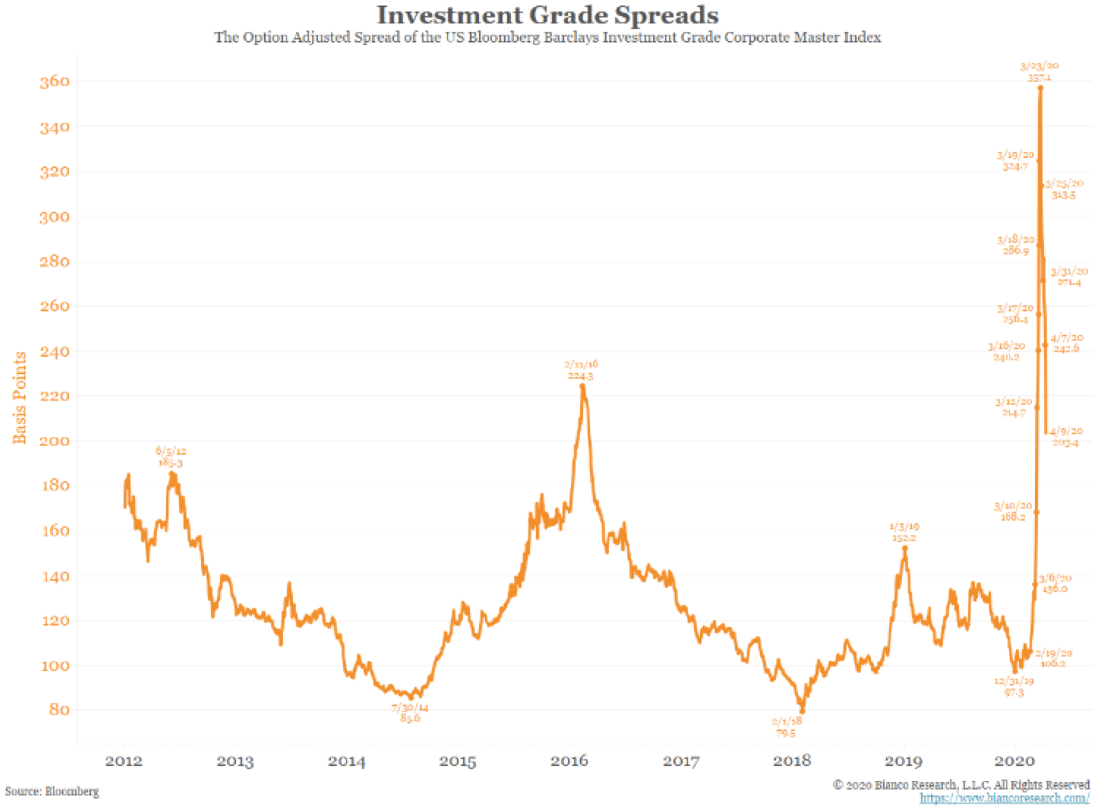
Below is a slide I shared at a presentation back in 2015 as the real economy was supposedly healing after the credit crunch. My point was we were indeed showing some progress, but from a macro standpoint we were still stuck in an ugly debt-demand feed-back loop; i.e. relying on increasing amounts of credit and leverage to supplement for a dearth of real demand. It is not going far out on a limb to suggest we are now much deeper locked into this dynamic and the great deflation is upon us. Note the box to the right in the slide (reprinted below), which is a summary description from Murray Rothbard's book, The Great Depression, showing how to prolong a depression. Sound familiar?

How to prolong a depression (Murray Rothbard):
- Prevent or delay liquidation.
- Inflate further.
- Keep wages up.
- Keep prices up.
- Stimulate consumption and discourage savings.



Usually the global reserve currency does well in the midst of global deflation, why is this time different? There seems a major credible push underway to find alternatives to the dollar as global reserve and funding currency (more on that below).

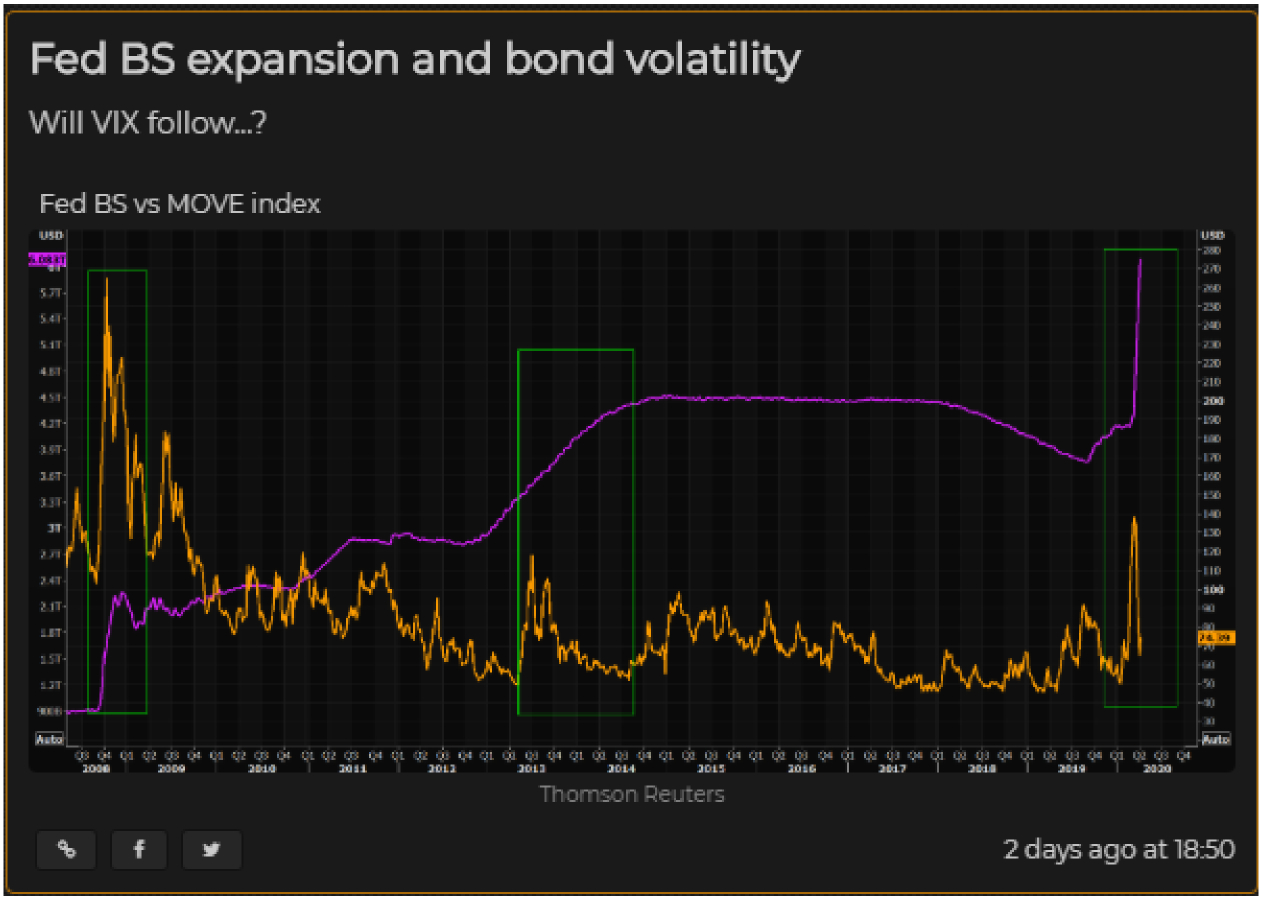
Below (next page) is a chart from Bloomberg showing the path of investment grade bond spread from 2012 to today. We saw a huge coronavirus triggered spike, then a sharp decline as the Empire stuck back with massive firepower. The Fed made it clear there it would do everything to keep the balls in the air.



Below is a chart of the US dollar index weekly; there seems a tacit relationship with spreads; i.e. the higher the spread in investment grade (denoting rising risk to the system) tend to be coincident (not perfect of course) to the movement in the US dollar index.


Weekly .DXY
12/20/2013 - 8/14/2020 (NYC)
Price
USD
104
103
102
101
100
99.456
99
98
97
96
95
94
93
92
91
90
89
88
87
86
85
84
83
82
81
80
79
78
Auto
Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3
2014
2015
2016
2017
2018
2019
2020

And here is a chart (from Marketear.com showing the Fed's balance sheet (purple line exploding higher) versus the bond volatility index (yellow line that has tumbled since the Fed did its thing—the time frame captures 2008 credit crunch to now:



Two questions: 1) So, how is the Fed providing this much fire power; and 2) Does it mean the credit system will normalize over time?

Take from John Authers Bloomberg column this morning; Jim Bianca of Bianco Research explains how the Fed is providing all this firepower:

> *So how can they do this? The Fed will finance a special purpose vehicle (SPV) for each acronym to conduct these operations. The Treasury, using the Exchange Stabilization Fund, will make an equity investment in each SPV and be in a "first loss" position. What does this mean? In essence, the Treasury, not the Fed, is buying all these securities and backstopping of loans; the Fed is acting as banker and providing financing. The Fed hired BlackRock Inc. to purchase these securities and handle the administration of the SPVs on behalf of the owner, the Treasury.*

In other words, the federal government is nationalizing large swaths of the financial markets. The Fed is providing the money to do it. BlackRock will be doing the trades.

This scheme essentially merges the Fed and Treasury into one organization. So, meet your new Fed chairman, Donald J. Trump.

Given that arrangement, and knowing the new Fed Chairman (Donald Trump) isn't going to be worried about the US dollar falling and likely knows keeping the pedal to the metal in terms of stimulus will help achieve his secondary objective of pushing down lower against key trading competitors.

In addition to the wall of money from the Fed, the G-20 is now talking a debt deal to help relieve pressure on "lower income countries." As reported in the *FT* this morning:

The G20 group of nations is closing in on a deal to offer lower income countries a moratorium on bilateral government loan repayments as part of a plan to tackle the Covid-19 pandemic and avoid an emerging markets debt crisis.

According to a senior G20 official, the initiative is due to be finalised at a finance ministers' meeting this week and would see a freeze on sovereign debt repayments for at least six months —possibly through to 2021 — in line with an appeal last month from the IMF and the World Bank.

Wealthy nations and multilateral institutions would use the time to draw up "very clear criteria, country-by-country of what exactly is going to happen", such as debt relief or deferment, the official said.

"For debt relief to happen it would take time for it to be co-ordinated," said the official, who did not want to be named because of the sensitivity of the discussions. "But what is immediately needed is to give these people space so they don't need to worry about the cash flow and debt servicing going to other countries, and they can use that money for their immediate needs."

It seems, and we never want to expect success from an organization as convoluted as the G-20 is today, if this action is taken it will relieve dollar funding pressure in emerging market countries-- both a key driver of risk spreads and dollar strength so far during this crisis.

Given that we have known for years (see John Maynard Keynes bancor idea) the dilemma of relying on the US dollar for global funding, though efficient, it creates also sorts of imbalances and boom-bust problem for smaller countries lacking access to deep capital markets, as developed market nations withdraw money from the periphery at a time of global stress (as discussed above). The other imbalance for the US is the constant current account deficit, as forecasted and defined by Mr. Triffin's dilemma. Thus, it is likely the US dollar's position as a reserve currency will come under continuous to in the months and years to come.

China, Russia, and Europe are quite unhappy with the current system of international payments known as SWIFT. Because most international trade and capital flow is denominated in US dollars, the US dominates the SWIFT system. This domination of SWIFT effectively provides the US global sanctioning power with the flip of a switch.

Germany, France, and the UK have set up an alternative to SWIFT—it is known as Instex. The latest impetus for Instex is US strong arming on the Russian gas pipeline into Germany, and of course sanctions on Iran business dealings after the US abruptly withdrew from Iran nuclear agreement.

In fact, Europe successfully completed its first Instex transaction a few weeks ago:

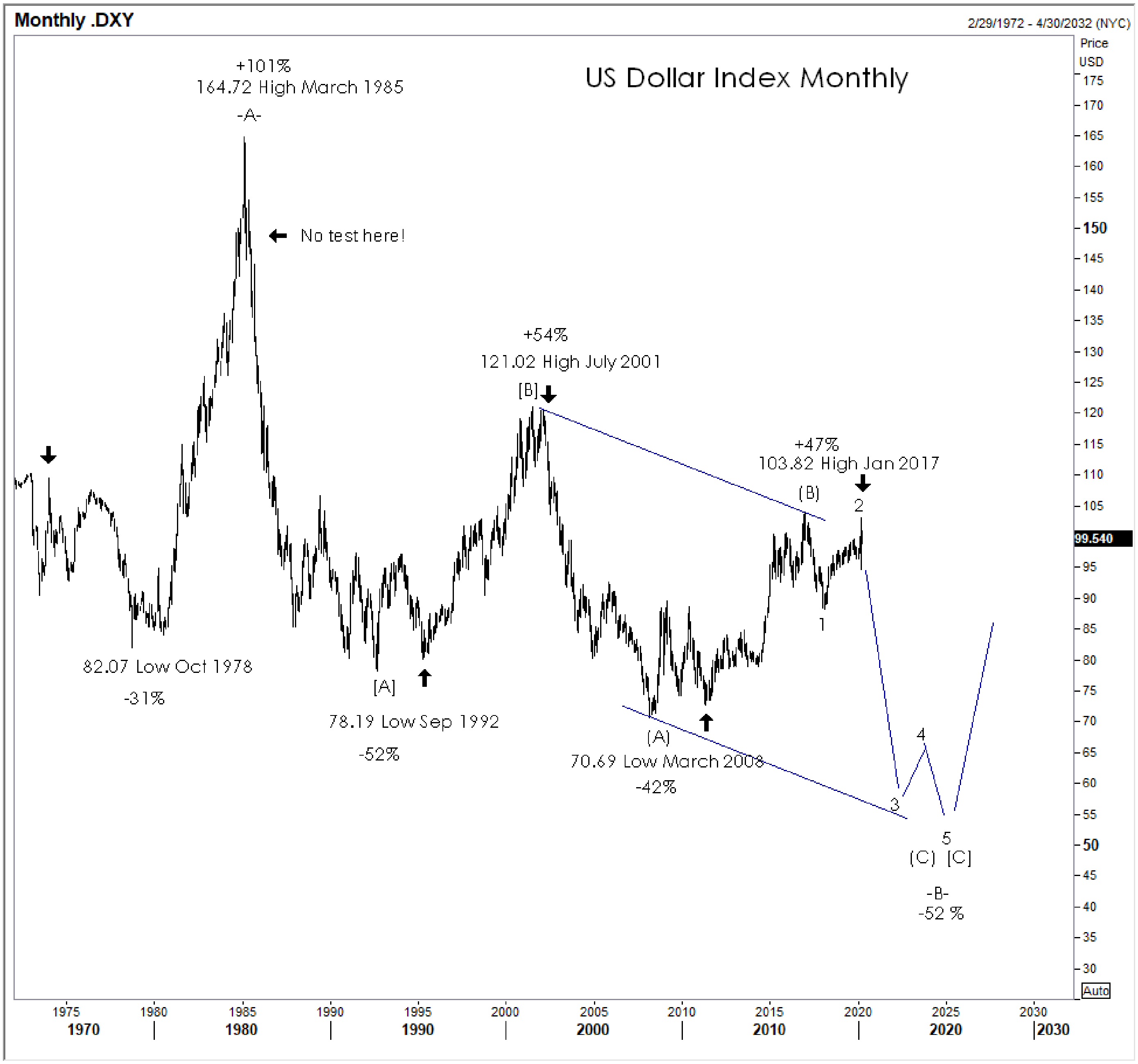
> *European nations have exported medical supplies to Iran as part of a mechanism set up to circumvent US sanctions on Tehran. The two sides have struggled over the past year to establish the INSTEX barter system. (DW.com)*

China and Russia are looking at their own ways to dethrone the dollar in time (more and more trade between the two countries is being settled in Yuan and Roubles). And China's Belt and Road strategy, despite its pitfalls, is a big start down that path of greater internationalization of the Chinese currency. Additionally, China is working on the E-Yuan as a payment's alternative for the interbank market. Though not there yet, this too could be a threat to dollar funding demand from Asia.

USD Index Monthly Chart Next Page

The major bull and bear markets in the dollar, duration, and return %, plush my expectations going forward can be seen in the USD Index chart below. (*Risk to this view: Major plausible risk, evidenced by a plunging stock market and rising credit spreads likely triggered by a crisis in China will lead to a fresh new high in the dollar*.)

Note the arrow's represent tests of the swing high before a major decline accelerates.



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