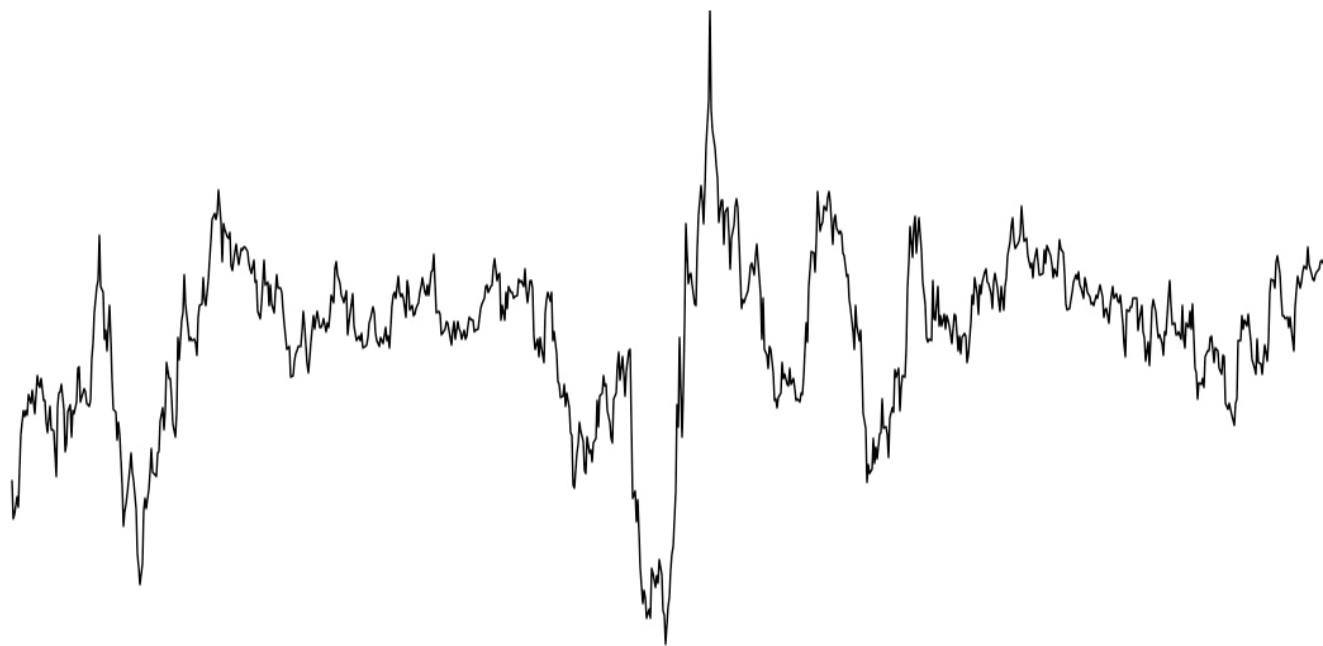


# ALPHA SOURCES

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FEBRUARY 19, 2018



## LET'S GET THE STORY RIGHT

I have [trampled around](#) in the [same weeds](#) recently, so I will keep it short this week. Equities are doing what they're supposed to, trying to complete a V-shaped recovery from the swoon earlier this month. Last week was a corker, even for the [portfolio](#), which benefitted from solid earnings reports. [Bloomberg's Joe Weisenthal had me one-on-one on Monday](#), where I duly warned that the S&P 500 remained overvalued relative to other asset classes. Even Gartman couldn't have done it better. On this occasion, though, I am happy to double down. A V-shaped rebound to a new bull run looks like wishful thinking to me.

Equities are the least of macro investors' problems, though. The puzzle of the day remains the link between rising U.S. yields, a firming cyclical outlook and a falling dollar. In my last post, I asked the question of whether foreign savings would come to aid of a U.S. economy at full employment—with a record low savings rate—about to be jolted by fiscal stimulus. [Open macro-economics suggest that such an economy should open up a large external deficit](#), and Japan and Europe have the savings to make it happen. Alternatively I suggested that perhaps the rest of the world doesn't fancy financing excess spending and investment in the U.S.



### A NEW EQUILIBRIUM IN THE MAKING?

My overview of this matter lacked a reconciliation between the two positions. [Bloomberg's Cameron Crise has offered just that](#); his explanation is elegant and simple. The combination of rising yields, a weaker dollar and a firming economic outlook reflects a rising financing premium for the U.S. The global savings glut is able and ready, but it won't finance the U.S. at any price. I am happy to accept this as the explanation for why the dollar is weakening as U.S. yields shoot higher.

It leads us to the million-dollar question for the macro-trading community.

### What combination of yields and dollar price is required for excess global savings to pile into U.S. debt?

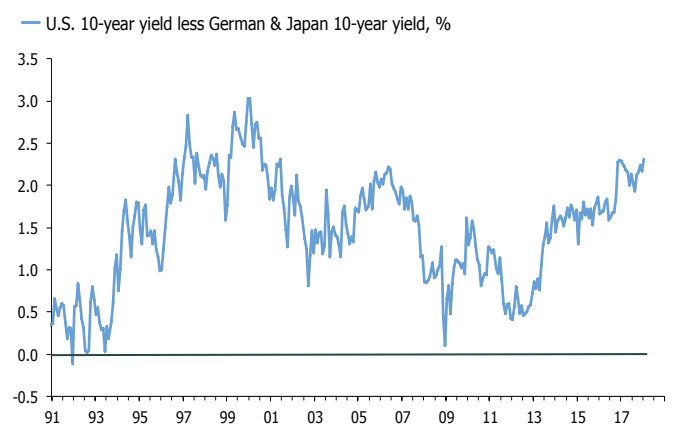
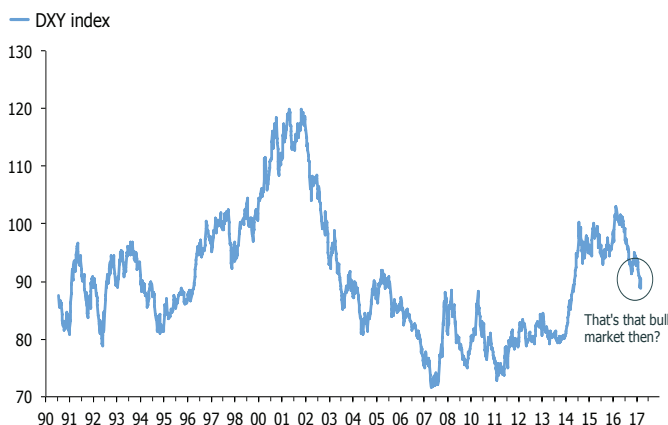
Cameron argues that foreign investors—mainly in Japan—are less likely to take naked currency risk even with a historically wide interest rate differential. He also contends that a flatter curve makes it more expensive to hedge FX risk. Put differently, it will take a much weaker dollar, and higher yields, to lure foreign savings back in.

From the perspective of Europe and Japan, the easiest explanation of the recent price action is that currency traders are front-running their colleagues on the fixed income desk. But we also have to think about the ECB's and the BOJ's reaction functions. **An increase in the euro and yen creates problems for Mr. Draghi and Mr. Kuroda.**

For starters, currency strength tends to curb EZ and Japanese equities' mojo, at least in local currency terms. We see signs of this already, especially in the Eurozone; the Eurostoxx 50 is now *falling* on a six-month basis. This is not hugely important for financial conditions in the euro area economy, but it doesn't fit the idea of a #euroboom.

The ECB and BOJ's problems are more fundamental, though. Despite decent growth, they are still struggling to reach their inflation targets. A stronger currency won't help, and both banks will be sensitive to a plunging dollar. Mr. Draghi has upped the rhetoric, and Mr. Kuroda assured markets that the BOJ has no intention of allowing 10-y JGB yields to follow U.S. yields higher.

fig. 01 / Don't look, but it's going lower — fig. 02 / Tempted into U.S. debt?





The dynamics are pretty simple after all. If investors in Europe and Japan are reluctant to take advantage of higher yields and a weaker dollar, the ECB and the BOJ can incentivise them by signaling that *their* rates will remain lower for longer. They wouldn't argue it as such of course, but it would be an (un)intended consequence of factoring in a stronger currency as a drag on the effort to reach their targets.

**In other words, the rapid fall in the dollar and rise in U.S. yields are sowing the seeds for a monstrous late-cycle USD carry trade.** The only assumption you need is that the Eurozone and Japan, as the most rapidly ageing economies in the world, can't shoulder rebalancing by which they become the consumers of last resort for the global economy. Even if that doesn't play out, [Brad Setser is on the ball](#) when he notes that foreign investors' reinvestments into US markets already are providing a windfall via a boost to their income balances due to the higher interest rate, an increased purchasing power via a weaker dollar.

### A TRUMPISH STING IN THE TAIL?

If you have made it this far, you will have a good grip on the story, even if you can't be certain which way the flows will go. After all, you never will.

But the U.S. government's trade policy also is playing a role. On the heels of announcing significant fiscal stimulus, Mr. Trump has upped the ante on tariffs. [Asian manufacturers of washing machines](#) and [foreign makers of steel](#) have been in the bull's eye so far. Let's summarize; a twin-deficit economy at full employment—issuing the global reserve currency—is getting a big injection of fiscal stimulus at the same time as the government is raising trade barriers.

**This policy combination, if sustained, equals a bloodbath in U.S. government bonds and the dollar.** It is almost as if Mr. Trump is *trying* to screw the U.S. economy's external creditors. That is fine, perhaps even politically expedient. But it is also a policy which comes with large costs for the domestic economy in the form of sharply higher interest rates and inflation in imported goods.

fig. 03 / Rents for financing the world — fig. 04 / The talking point in the next 12 months?

