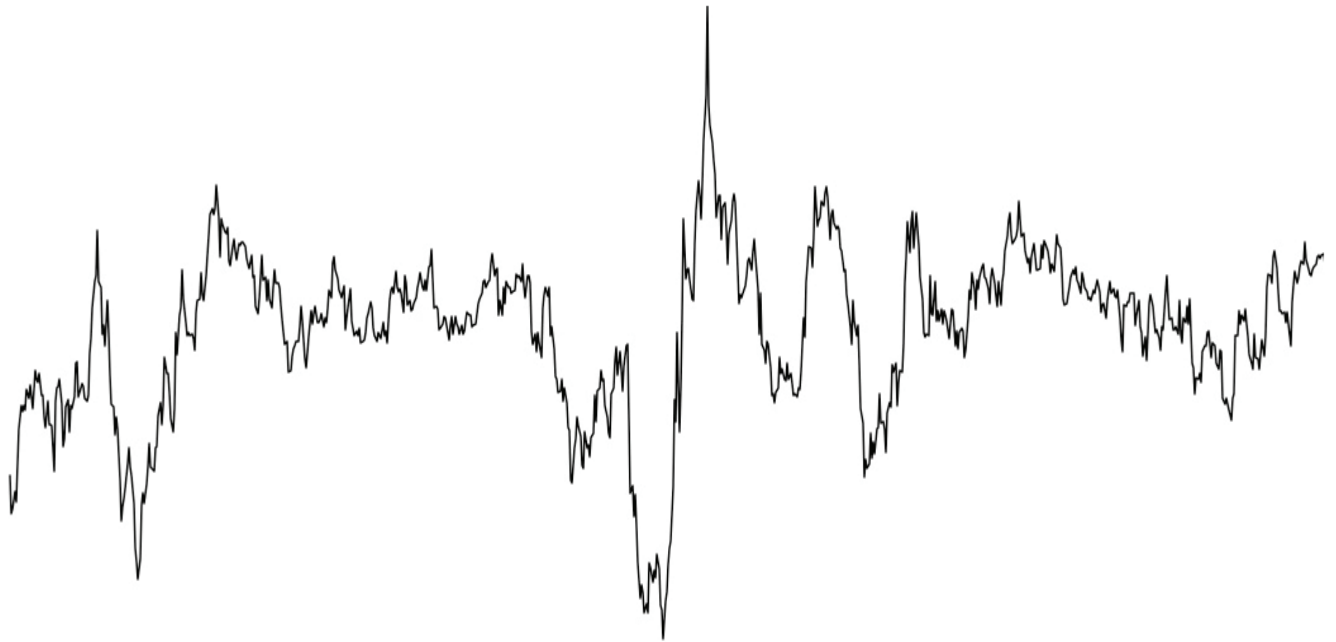
ALPHA SOURCES

APRIL 16, 2018



A RETURN OF THE USD CARRY TRADE?

A few weeks ago I provided a bird's eye view of most of the major asset classes, what they did in Q1, and what they're likely to do for the rest of the year. I neglected the most important one though; the dollar. **I am convinced that other markets eventually will take their cue from what happens to the greenback.**

The bull case is simple. The U.S. economy is about to get a jolt of fiscal stimulus, propelling growth to above 3%. The labour market has plenty of hidden slack, and productivity is rising, which mean that the Fed won't have to hike the economy into the stone age to quell inflation and wage growth.

Trade wars aren't a problem, and in the case of U.S. tariffs on imports, the dollar will appreciate offsetting a boost to competitiveness. If the shit hits the fan, the dollar will be the safe haven of choice as capital flees the more open and exposed economies in Europe and China. Mr. Trump might not get a lower trade deficit but he can "win" a trade war with the rest of the world.

The contrasting bear case is equally straightforward. The U.S. twin deficit is about to widen significantly, and foreign investors need compensation to finance the party. Higher bond yields and a weaker dollar are a necessary adjustment to reach a new equilibrium.

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WHAT MAKES THE DXY TICK?

At first glance, it would seem that the bears have already won the battle. The DXY is down just under 13% since the end of 2016, with the index hitting a multi-year low of 89 at the end of January. It has since been bobbing up and down around an average of 90. **A break out of this range would send an important signal to investors in all asset classes.**

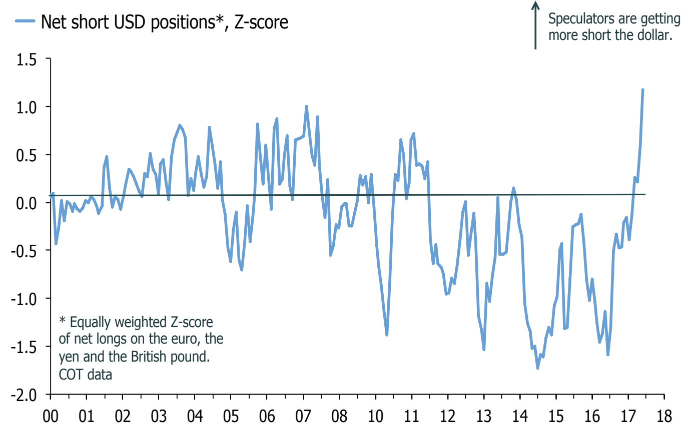
A big move in USDCNY would tell us a lot about where markets think the strength lies in the looming tit-for-tat trade conflict between the U.S. and China. The consensus appears to be that the dollar will strengthen if trade war breaks out, as capital outflows from China accelerated. But that requires investors to agree on what a trade war looks like, and what constitutes victory. Judging by the debate about this topic, I doubt that they do.

My take on this affair is the following: Butting heads with China to reduce its bilateral surplus with the U.S. is *not* the same as inciting China to play fair on inward investment and intellectual property protection. In the case of the latter, it is perfectly possible that Mr. Trump's aggressive actions will force China into concessions. That is probably a good thing. That said, I am pretty sure that it wouldn't make any difference whatsoever to the U.S. trade deficit with China. I suspect the main loser in all this will be Peter Navarro. He will have to come on TV and announce "victory" at the same time as the trade deficit is blowing out. I can't wait.

In the case of the Eurozone and Japan, investors are warming to the idea that the ECB and the BOJ will attempt to normalise policy over the next 12-to-18 months. Given how important these two are for global liquidity, it would be a significant shift if they do.

A further sharp increase in the euro and yen against the dollar, though, probably would prompt Mr. Draghi and Mr. Kuroda to think twice. At least, I suspect bond markets would discount it as such. *A stronger dollar would give the ECB and the BOJ cover to slowly reduce stimulus. The alternative likely would force them to stand pat, at least.*

fig. 01 / It would decide a lot — fig. 02 / Dollar bears are out in style



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The proposition I am getting at here consists of two hypotheses. **Firstly**, a weaker dollar would hurt global markets more than a stronger dollar. **Secondly**, the dollar is not a safe haven. It is now a carry-trade play with the euro and the yen as the funders, and therefore *they* are the "safe havens".

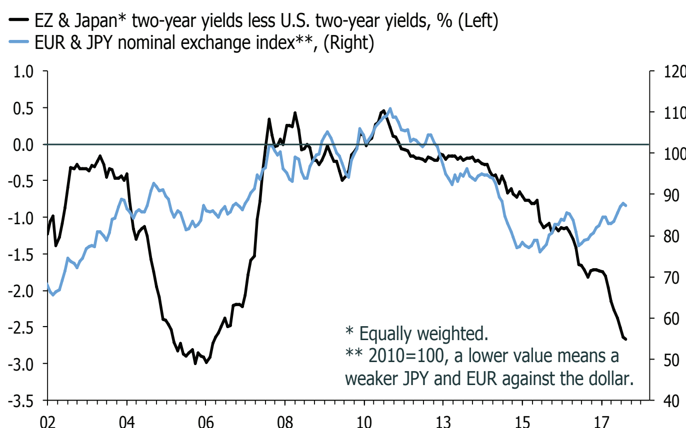
With regards the first point, speculative positioning doesn't exactly support my argument. The COT data shows that punters are now net *short* the dollar looking at data for the euro, pound and yen. Though, this comes on the back of a long period where speculators were uniformly long the greenback. At face value, however, it suggests that for FX punters, a weaker dollar would do just fine, at least in aggregate.

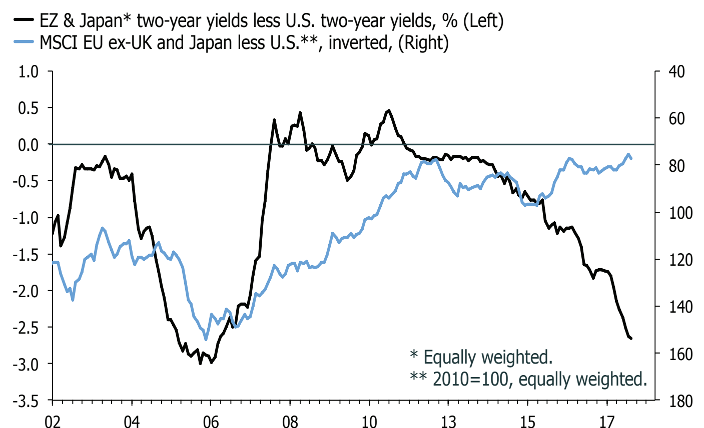
For markest as a whole, though, I think it is the other way around. The idea that a weaker dollar is the pain trade makes sense if you accept the second part of the argument above: the dollar is now the long leg of a global carry trade. This fits the direction of capital flows since 2012, with large external surpluses in the Eurozone and Japan recycled into the U.S., and to some extent also the U.K. If things go wrong, the money would come home to Japan and Europe pushing up the value of the yen and the euro.

This does not chime with the notion that markets will seek shelter in the global FX reserve currency—and its debt market—in a global crisis and panic. The answer probably depends on the kind of crisis. A dollar crunch by definition leads to a stronger DXY, but if punters are unwinding long dollar trades, it doesn't, at least not initially.

Meanwhile, the combination of a wider twin deficit in the U.S. and plenty of excess savings in Europe and Japan is a recipe for a monster global carry trade in the USD. If it gets going, it would lead to a stronger dollar, a rally in risk assets and almost surely extend the global cycle. Alternatively, markets could decide not to take the bait, instead seeking shelter in the excess savings currencies by selling the dollar. Whatever direction the dollar decides to go, I suspect it will determine it a lot for other asset markets.

fig. 03 / Baiting to go long the dollar... — fig. 04 / ...and to buy global equities





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