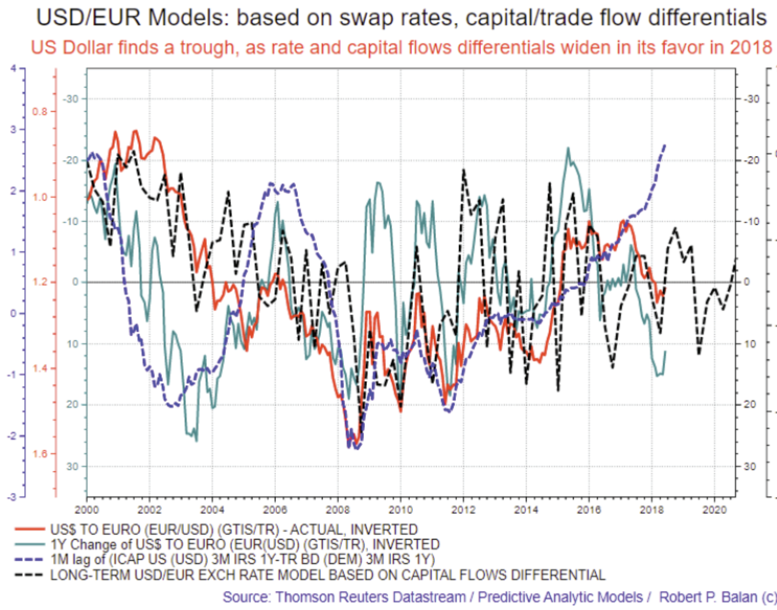
41 / The US Dollar pulls back at a resurgence of financial risk appetite in July, but the ongoing uptrend continues thereafter

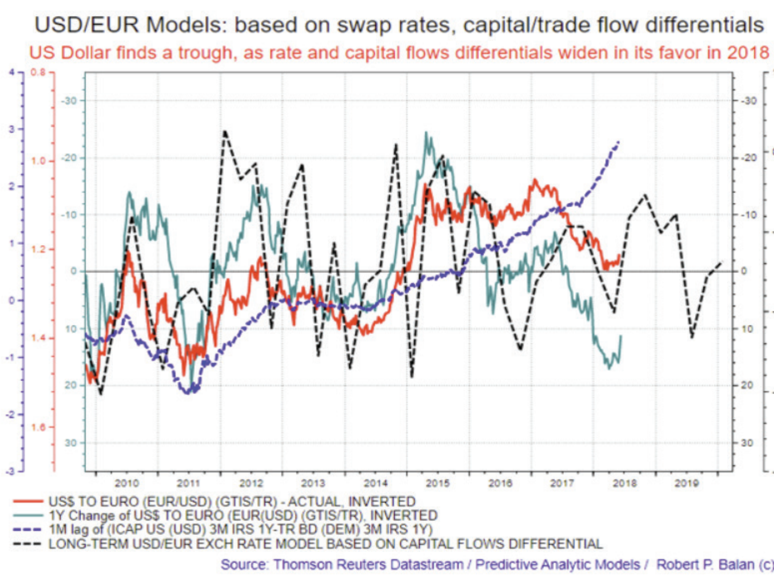
The US Dollar has been front and center of financial news after rising sharply in the past few weeks. This has been accompanied by fears that Emerging Markets will be in again for a lot of pain. Reason: **the US Dollar ascent was also accompanied by rising long-term rates, as well as short-term rates, due to the published intention of the Federal Reserve to raise policy rates three times this year. This triple whammy presents risks, not only to Emerging Markets, but to the US and global economies as well – a fear which we expressed at various issues of Capital Observer as early as February this year.**

In February, the almost-universal theme in FX has been that the US Dollar will continue to decline further. Our call that the US Dollar will turn around within Q1 2018 and strengthen for most of the year was very much a contrarian call. By March, the USD has plumbed bottom, and was getting set to breakout to the upside, and we did document the reasons why the greenback should continue to rise further. In last month's Capital Observer (June 2018 issue), we said:

"The US dollar is now winning the FX "beauty contest. Almost all the macro factors remain in favor of the US currency, especially those that matter in FX currency valuation. Against the EUR, the dollar's most stalwart rival, GDP growth spreads now lean favourably towards the U.S. With regards to the spread of the 2yr bond and 2yr bund (instruments closest to the official policy rates), it's almost no contest – the spread is massively in the U.S. dollar's favour *(see the two graphs on this page)*. The very recent EUR bounce against the US Dollar has been triggered by a relief that no Italexit is likely to happen soon. But the EUR rebound is unlikely to last very long."



Zoomed view



". . . the US dollar's continuing strength is, and will be, coming from the steady improvement of the US Capital Account Balance *(see 1st graph on next page)*. The capital account balance reflects net change in ownership of national assets and is one of the components of a country's Balance of Payments ledger, the other being the Current Account Balance. A surplus (or improvement) in the capital account balance means money is flowing into the country, the inbound flows represent non-resident borrowings or purchases of assets. A deficit (or deterioration) in the capital account means resident capital is flowing out of the country, in the pursuit of ownership of foreign assets."

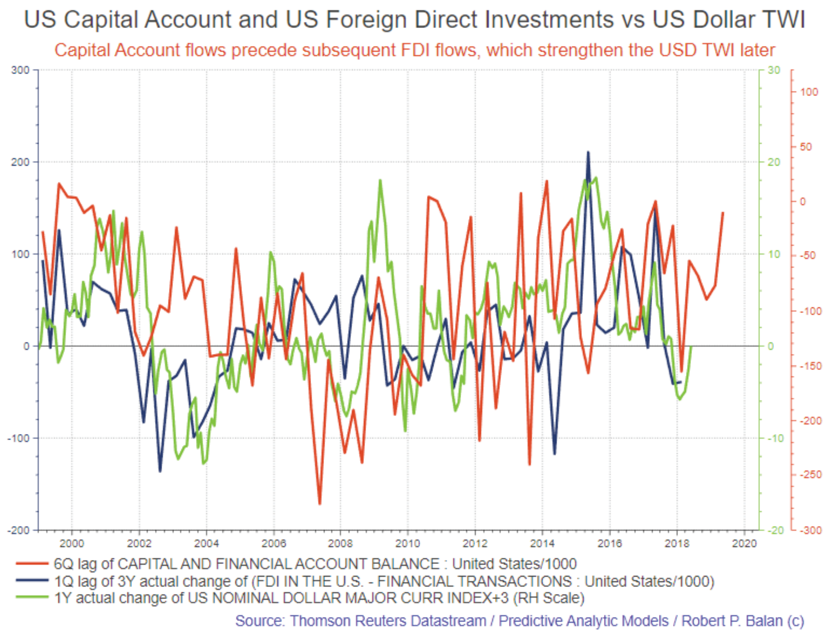
Changes in the US capital account normally show up in the valuation changes of the US currency 5 to 6 quarters later. Capital accounts improve when non-resident (external) capital inflows increase or resident (domestic) capital outflows slow. The sharp improvement in the domestic capital account since Q3 of 2016 will therefore likely to result in further rise of the US dollar during this year, a small decline from Q3 to Q4, and then we see a rising US currency during the first half of 2019 before falling again *(see 1st & 2nd graph on this page).*

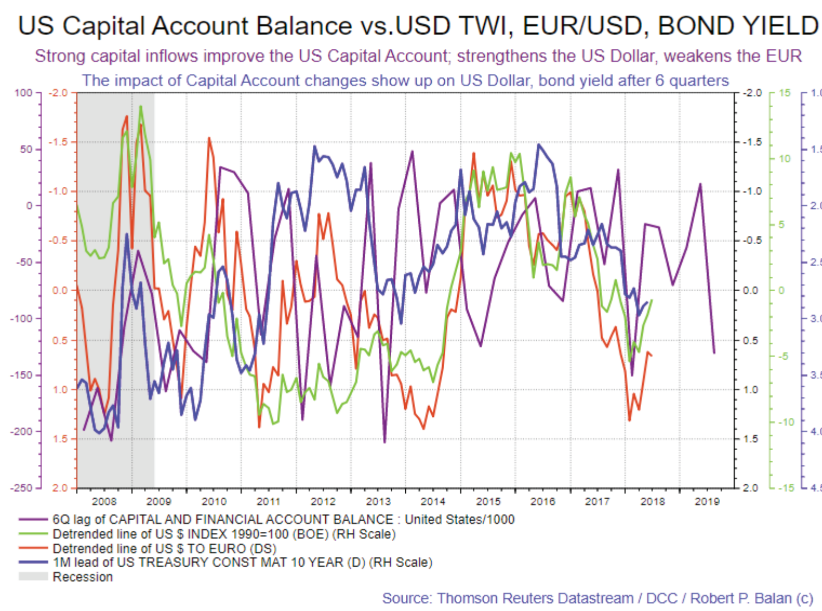
Since the publication of the June issue, the US Dollar did strengthen further, the Euro weakened and yields rose further *(see 2nd graph on this page)*. Other factors may have helped bring these developments about but the underpinnings provided by rising US Capital Accounts have facilitated these events into taking place.

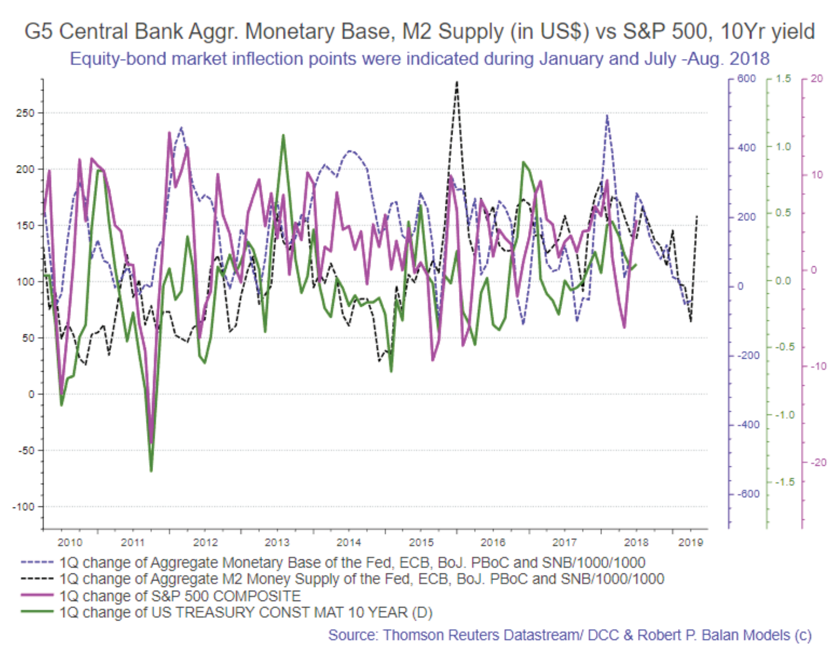
Continuing strength of the US Dollar during most of 2018 will have repercussions to a lot of assets and asset classes. The commodities asset class can come under pressure if this projection actually happens. This thesis has already been validated by the practical collapse of Precious Metals and Miners in the last few weeks, following the sharp surge in DXY and the US Dollar TWI.

Further US dollar strength may contribute further to stresses in the Chinese economy - a stronger US dollar piles further pressure on the Chinese CNY, which also strengthens in the wake of a firmer US Dollar, after a short time lag. A strong CNY is not welcome in China at this time, and the rising trajectory of US policy rates are specially vexing as the PBoC feels constrained to match it commensurately. **The rest of the Emerging Markets have also been devastated by the recent US Dollar strength and are reeling again from new blows from the US currency's recent appreciation.** However, there could be a brief EM reprieve soon if risk assets will rally from here (early July) until late July (as we expect), and as indicated by the lagged flows in global central bank assets *(see 3rd graph on this page).*

Original graph accompanying the June article







If the systemic liquidity flows are a guide, the US Dollar weakens from here to late July but will thereafter strengthen again, especially against EM currencies *(see 1st graph on this page)*. That will likely hammer EM equities and other risk assets as well.

A short term inflection points in equities, bond yields, crude oil, and EEM is due as we write this article, when the distributed lagged effect of systemic liquidity flows converge. The recent lows likely mark a significant temporary trough in risk assets, followed by a rally into a late July/early August *(see 2nd graph on this page)*. The US Dollar (DXY) follows the move lower in those risk assets after a week or two of lag .

However, by the time a new US Dollar rally is on its way up, risk assets, especially EEM, should already be falling vigorously. **Distress in financial assets tends to drive the valuation of the US currency even higher, as many investors seek the safety of US Treasuries, with concomitant capital inflows, which strengthens the US Dollar.**