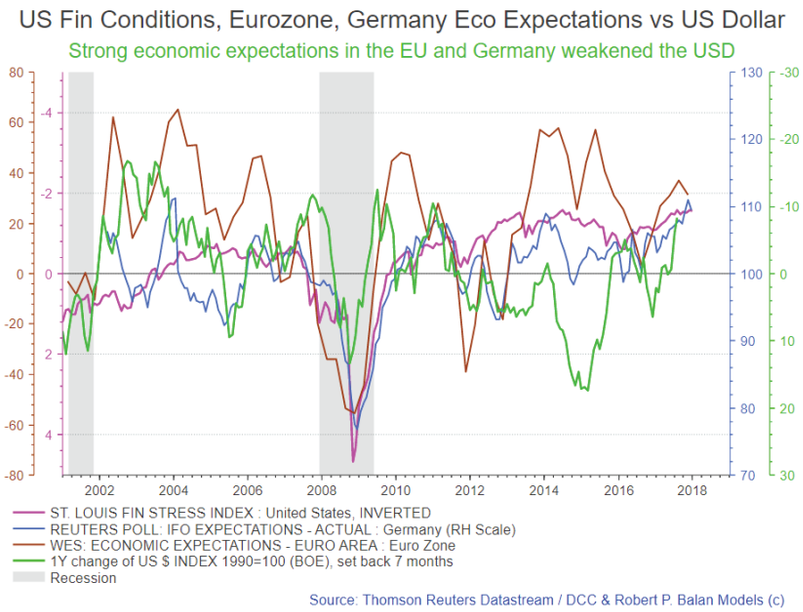
24 / The US Dollar will be boosted by capital inflows in 2018 and should rise again – that could push the economy, markets over the tipping point.

The dollar has weakened for most of 2017, and did so in several waves. It fell broadly from mid-April last year through early September and then again in November, and during the last two weeks of December. It fell further during the first week of January, but the disappointing December jobs report headline and the distraction of a new book claiming to portray inside the administration in an unflattering way did not do that much damage. FX technical newsflow took that as a sign that the US Dollar appears to be overextended, and are anticipating that an upside consolidative or correction stage is near. These high-frequency moves do not in any way represent the likely course of the US unit during the rest of 2018.

While the longer term macro fundamentals are beneficial later in the year, the foreign exchange markets had been shaped by two powerful, less friendly micro forces in the past few months, which explains a large part of the US Dollar's decline in 2017.

First is the still very accommodative global monetary policy stance. Country- or region- specific fiscal conditions have seen some variances – some relatively tighter, some relatively looser. The "looser" countries include the United States, where despite delivering the fifth rate hike in the cycle, policy rates adjusted by headline CPI remain negative. True, the Fed's balance sheet has seen a few months of reduction, on top of policy rate tightening, but financial conditions in the US are easier now than a year ago, nonetheless. One consequence of the year-long weaker USD has been the loose US financial conditions. Meanwhile economic expectations in German and the Eurozone have been rising strongly since Q3 last year. Historically, the greenback weakens as those metrics rise, on market perception that financial conditions in the EU will be correspondingly tighten much faster relative to the US *(see chart above).*



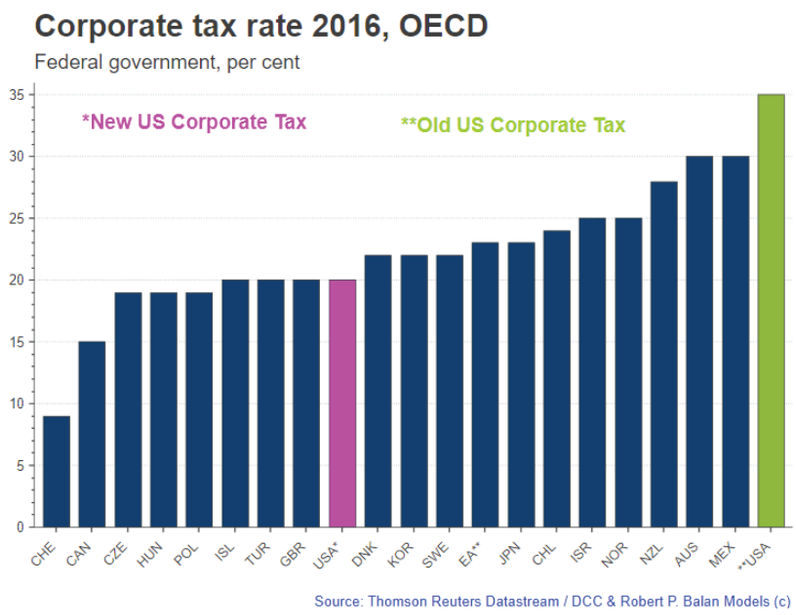
Here is the ostensive reason for that belief: the ECB´s bond purchase program has been cut in half to 30 bln euros a month starting January (which contributed to recent EUR strength and USD weakness). However, that is the most visible part of the ECB's extraordinary monetary policy. Not so spoken about (and not so visible) are other elements which belies the apparent tightening of ECB policy, and that includes the minus 40 bp deposit rate, the full allotment of fixed rate refi operations, and the quality of the assets and collateral (which leaves much to be desired).

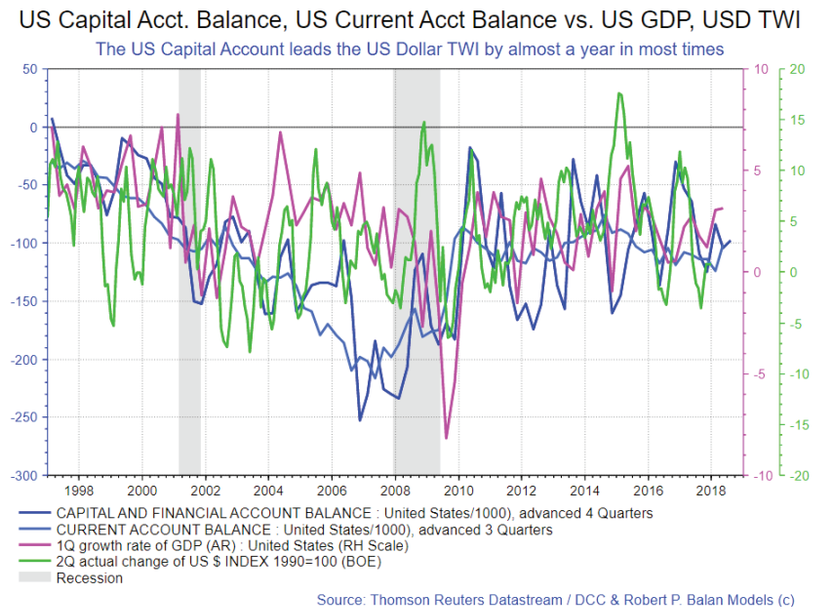
Here is another factor that was largely low-visibility to the FX markets: EU banks will be able to pay back Targeted Long-Term Repos outstanding borrowings (estimated at EUR750 bln) early, starting around mid-year. Given that there is a dearth of strong borrowing demand in the EU, and given further the negative rates at the ECB, we suspect that that some banks will take advantage of the opportunity to return funds back to the central bank. Even a conservative estimate of 10% being returned would still offset 2.5 months of ECB asset purchases, expanding the ECB´s balance sheet. It would be doing so at a time that ECB officials will be considering what to do post-September, the current program's soft end-date. **Given all these factors, the recent appreciation of the EUR, which was based on perceived ECB policy tightening, was likely based on false premises. The EUR's perceived advantages should wilt under closer scrutiny, further out.**

Second, the response by investors to the incentives partly created by the combination of monetary and fiscal policy will soon determine the near-term course of the US Dollar and its counterparts. This is an aspect where the US is ahead of G5 countries, by a mile. The US just announced significant tax cuts even as the economy showed signs of accelerating. **The reduced corporate tax should encouraged capital repatriation and**

new inflows of foreign capital. The US has morphed from having the highest tax regime in the G5 to the lowest *(see 1st graph on this page)*. **This could be a game-changer for Foreign Direct Investments (FDIs) which play a large part in a currency's long term valuation.** And even though it does not make it into the headlines often, the deregulation efforts by the Trump government are significant. On top of this, an infrastructure initiative is expected to be unveiled shortly. **Furthermore, the first official read of Q4 GDP is due at the end of the month, and GDP growth higher than 3% would be the third consecutive such quarter, the longest streak since H2 2004 and Q1 2005.** Collectively, these factors should provide a firm floor to the US currency sometime soon.

The longer-term (12 to 16 months) fortune of the greenback may depend less on what the Fed and its global counterparts will do, but may depend more on the lagged effect of the fiscal policy measures taken by the Trump administration last year. The recently enacted US tax reforms will likely encourage capital repatriation to the US and encourage the inflow of foreign capital. This will have significant impact on the course of US bond yields and the US Dollar during 2018 and perhaps beyond. The transmission mechanism of those capital inflows is via the US Capital Account, which at its simplest definition is the net change in ownership of national assets, i.e. whether there is surplus or there is deficit. 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. These statements are simplification of relatively intricate balance sheet operations, but they describe the flows well. **We believe that the US Dollar would be significantly stronger later in the year and beyond, due to the influx of domestic and foreign capital during the year.**



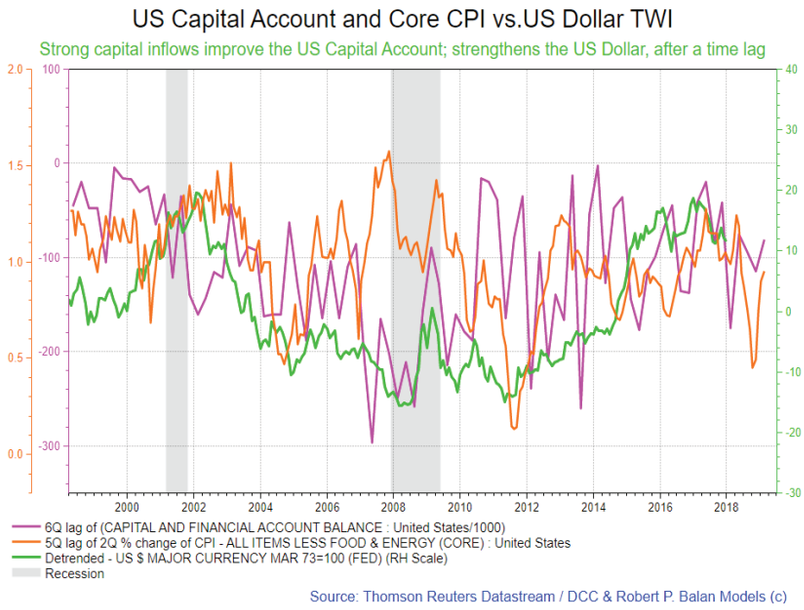


A currency's higher valuation due to improvement of the country's capital account generally keeps its uptrend for longer, when compared to improvement in valuation brought about by interest rate differentials. Although a higher interest rates relative to those of other major central banks tends to attract funds via the capital account, which acts to raise the value of the domestic currency, changes in inflows via this channel tend to be volatile. **Moreover, since the capital account has a distributed lag of circa 4 to 6 quarters, once this channel sets the currency valuation dynamics in motion, the directional bias stays on for at least a year** *(see graph on next page)*. The Capital Account has been rising since Q3, so the end of the distributed lag of 4 to 6 quarters will soon redound to a firmer US currency.

The US Capital Account surplus has been increasing for some time and will likely increase even more this year. So if we fall back on classic definitions, that means foreigners have been investing more in the US than Americans are investing outside it. More foreign money has been coming in to finance the US economy than there is flowing out -- thus there are more infrastructures being built, more factories started. This of course means an increase in employment, and it will

also lead to an increase in wages – as well as inflationary pressures generated by rising workers' compensations *(see graph on the right).*

The combination of rising US Dollar and rising inflation, which we both expect to see not so long from here, will lead to tighter financial conditions later in the year. If the Fed follows through with its self-imposed regimen of three policy rate increases of 25 basis points for 2018, it may just push the financial markets and the economy over the tipping point. The US dollar is the most important asset class to watch in 2018.



Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)