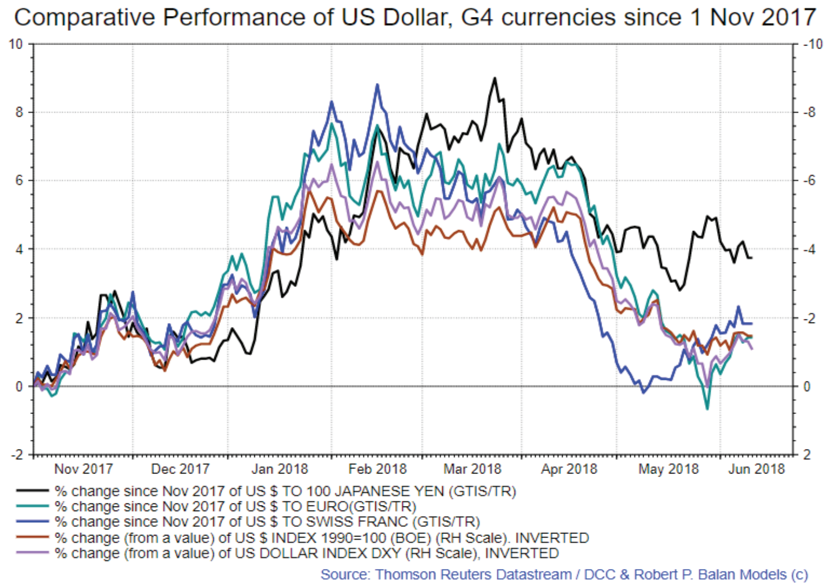
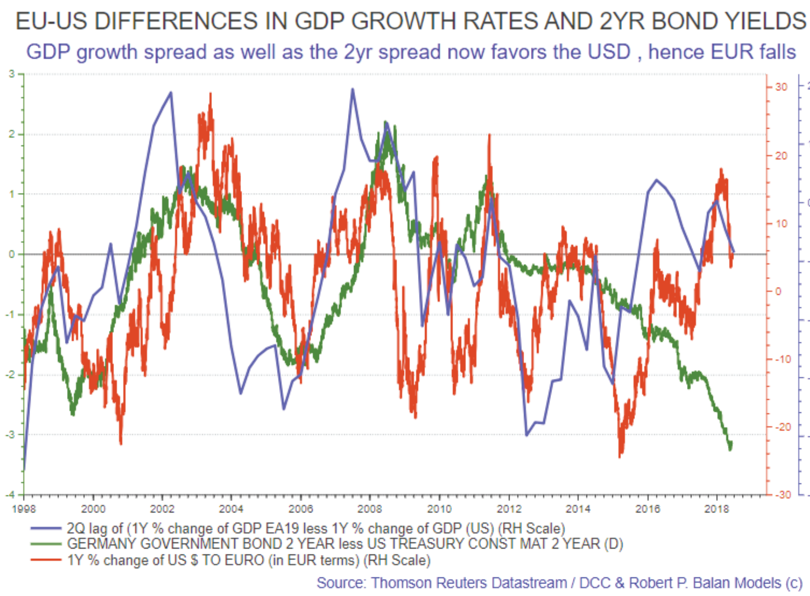
23 / U.S. Dollar: Forget Monetary Policy Divergence; Firming U.S. Capital Account Will Support A Rally Until Q3 2018 at least

Since April last year, the US Dollar TWI has been weak against a bevy of Developed Market (DM) currencies. It has been weakest against the euro at that time, but also had significant losses versus the Swiss Franc and JPY. It was no wonder therefore that DXY (The USD vs DM currencies) fell much further then the USD TWI did. However, since last February, the US Dollar rallied significantly against the EU and the rest of the DM. Most notably, the US dollar has been strongest on a broad trade-weighted basis and against Emerging Market (EM) currencies (especially against the Brazilian Real), and against some currencies from Eastern Europe. **The DXY made tremendous gains as DM currencies fell sharply on the greenback's reversal of fortunes** (*see 1st graph on this page).*

As early as January this year, we laid out the reasons why the US Dollar will bottom, and subsequently rally, during Q1 2018 (see "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", Capital Observer, January 2018). We identified the broad reasons why the US currency should finally very soon get a reprieve:

> *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 Dollar could bounce in Q1, re-test down in Q2 and then accelerate up in H2 2018.*





Many investors ascribe the new strength of the US currency to the divergence in official monetary policies between the US and the Rest of the World (RoW). Specifically, investors point to the Fed's stance of tightening monetary policy for the rest of the year, possibly in three more tranches, as the FOMC's Summary of Economic Projections (SEP) dot plots last December indicated. This contrasts with a still easier monetary policy expected from the ECB, which may only cease its Quantitative Easing programs only at the end of the year.

The Bank of Japan has been talking off and on about modifying its QE programs as well, with the intention of tightening policy somewhat. But with no real, consistent progress in its inflation targets, the BoJ is clearly a central bank that is adrift, policy-wise. We do not expect any significant shift by the BoJ to a tightening stance very soon.

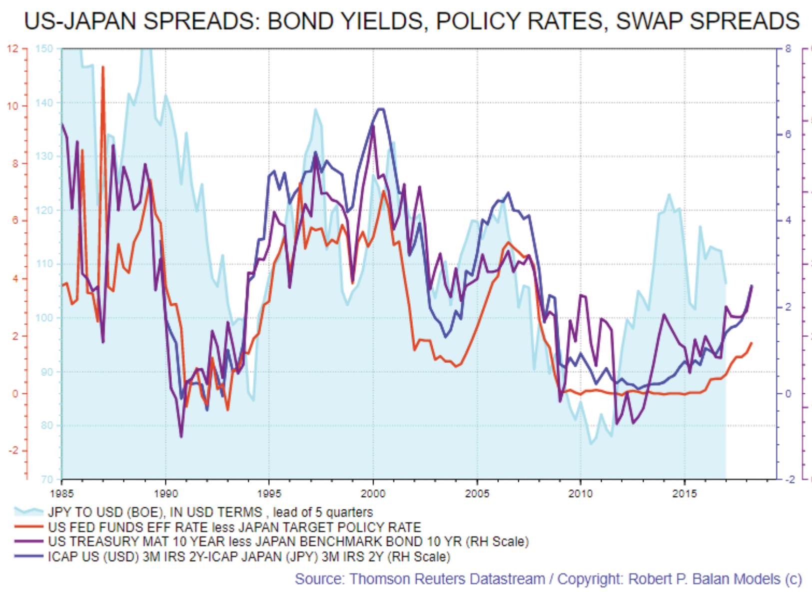
The US dollar is now winning the FX "beauty contest"

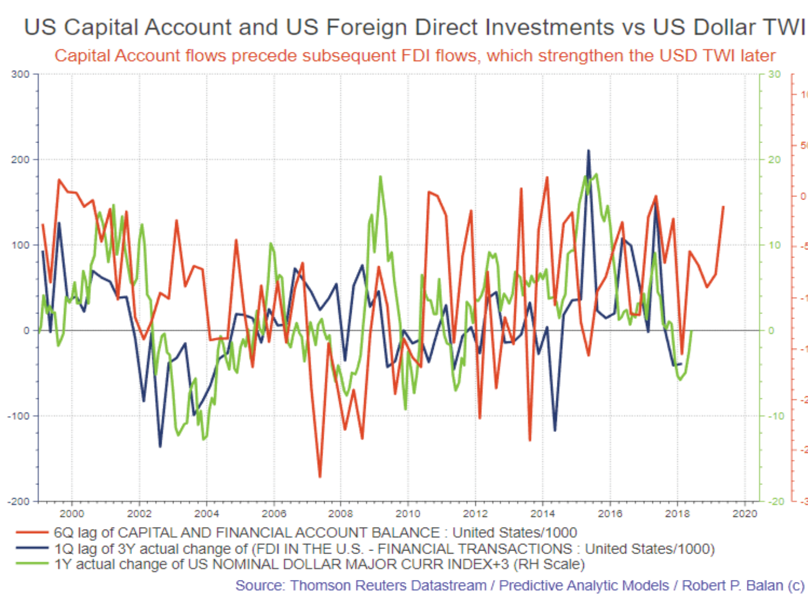
Almost all the macro factors remain in favor of the US currency, especially those that matter in FX currency valuation. Against the EUR, the dollar's most stalwart rival, GDP growth spreads now lean favourably towards the U.S. With regards to the spread of the 2yr bond and 2yr bund (instruments closest to the official policy rates), it's almost no contest – the spread is massively in the U.S. dollar's favour (*see 2nd graph above*)

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.

In a US-Japan comparison, the US currency is also ahead. The variance in monetary policy rates is now significantly in favour of the US Dollar. That goes true as well for long-term bond rates and short-term market rates. These developments have helped strengthen the Dollar versus the Yen, although the Yen has firmed up in recent weeks (*see 1st chart on this page*).

Given all these, it is a wonder why almost all FX analysts (us NOT included) expected the US Dollar to resume its decline from April last year, almost in a straight line. We have compiled the reasons for the pessimism of analysts for the future trajectory of the US Dollar, and the primary underlying reasons can be traced to the analysts' dislike for President Donald Trump and his economic and trade policies. Not very sound rationales in the cold-blooded arena of Foreign Exchange, where personal sentiments can quickly turn into land-mines. This is a world that works off macro numbers; the currency which has the most plusses, wins.





The Fed will almost certainly decide to raise policy rates by 25 basis points during the FOMC meeting this week. However counter-intuitive it may seem, the US Dollar may actually fall for a short time after policy rates are notched higher. That has been true for most of the times that the FOMC have raised rates, and it could be happen again this time around. We do not have any explanation for this well-known market history, but it does underline the fact that it is not only spreads in interest rates that drive the valuation of the US Dollar (or any global currency for that matter). **Nonetheless, the divergence of the direction of policies between the US Fed and other major central banks, will be a major linchpin in bullish arguments looking for further US dollar strength down the road. But that is not the sole argument for our enthusiasm for the US currency. Extra support is coming from elsewhere.**

Improving US capital account balance supports Dollar strength

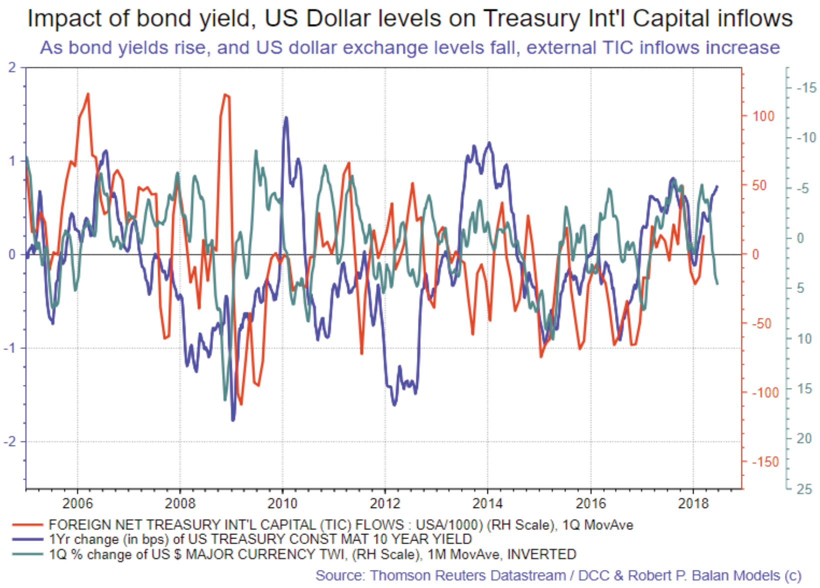
We suggest instead that the US dollar's continuing strength is, and will be, coming from the steady improvement of the US Capital Account Balance. The capital account balance reflects net change in ownership of national assets and is one of the components of a country's Balance of Payments ledger, the 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. These statements are simplification of relatively intricate balance sheet operations, but they describe the flows well (*see 2nd graph above*).

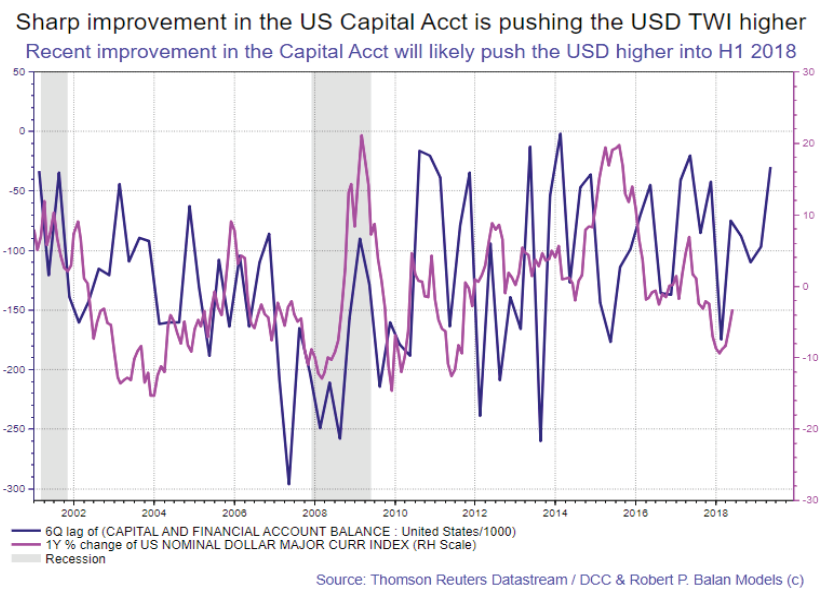
Although a higher interest rate relative to those of other major central banks tends to attract funds via the capital account, which acts to raise the value of the domestic currency (USD in this case), rate differentials may not be the primary impetus for the recent improvement of the capital account balance. For instance, anecdotal evidence of US real estate assets being attractive to external investors (the US property market is booming) have been highlighted in recent quarters. Foreigners are snapping up US residential and office building properties in increasing quantities, requiring more US Dollar denominated funds. Foreigners are also eyeing to buy ownership of smaller US technology companies (especially desired by the Chinese).

The recent rise in yields of US Treasury and agency bonds, along with the recent weakness of the US Dollar also provide some empirical evidence, via the Treasury International Capital (TIC) flows, that non-resident capital has been moving into the US fixed income markets. It is interesting to note that as bonds become cheaper in price (higher yields), and the US dollar's exchange rate declines, the cross-border TIC volume picks up. Conversely, higher bond prices (lower yields) and firmer US Dollar exchange rate tend to slow down the inflows (*see 1st graph on this page*).

This bit of information is useful to us, as we see it as evidence that non-resident investors have been buying US assets on price dips. That was true in the fixed income market, but we can only speculate if it was also true in the equity markets.

The latest TIC data shows that inflows remain strong. There was $61,838 million worth of Treasury International Capital flowing into the United States in March, 2018. That compares to the $23,323 million worth of external capital flowing to the U.S. in December 2017.





Changes in the US capital account balance lead USD changes by 5 to 6 quarters

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 H1 this year and perhaps early Summer, a small decline from Q3 to Q4, and then we see a rising US currency during the first half of 201**9 (*see 2nd chart on this page*).

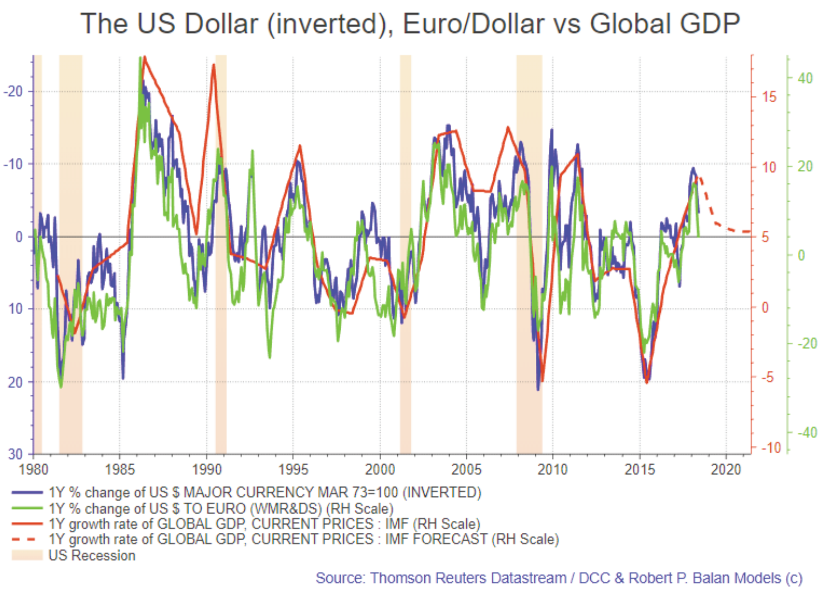
Putting all the elements together

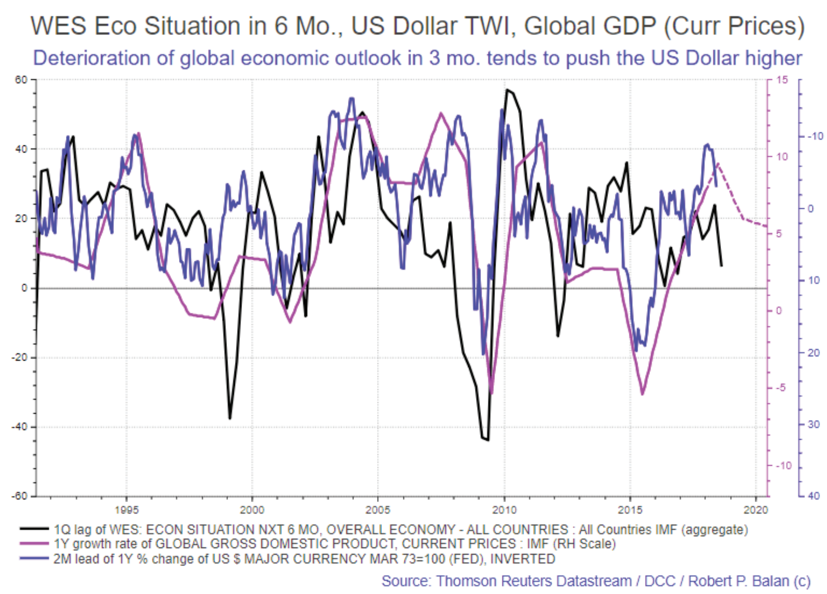
Interpretation of the balance of payment ledger could be nuanced, so it is critical to obtain evidence that the putative relationship between changes in the capital account and changes in the US dollar that we claim are indeed valid and operational at this time. We have taken the following steps:

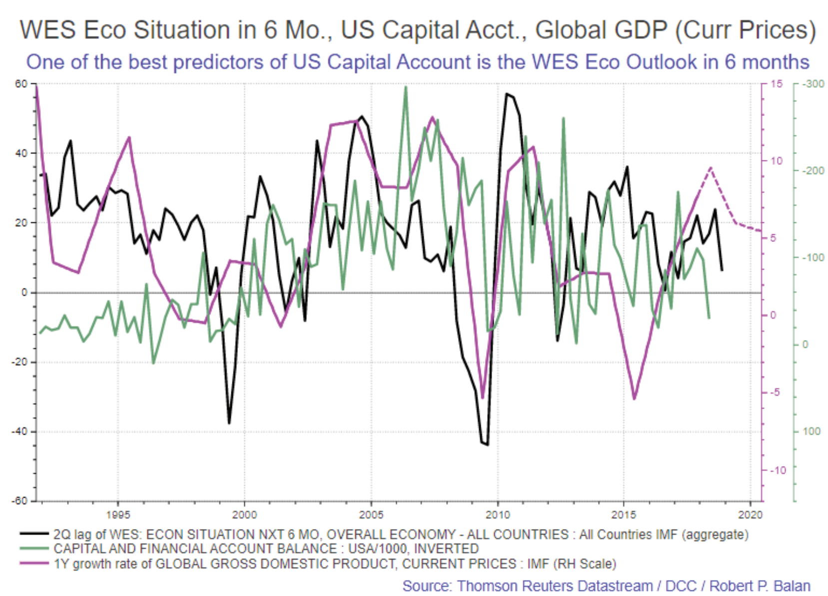
First, we showed the correlations between global growth, the US dollar and the EUR/USD. The relationship is positive between the euro and global GDP, and negative between the US dollar and global growth. In more direct terms, the US dollar firms up when global growth wanes, and the EUR strengthens when global growth picks up (*see 1st graph on next page*). I**n effect, we want to show that there is a negative link between the US Dollar and global growth (and vice versa). And indeed, we see that in the graph.**

Second, we selected a survey-based leading indicator for global growth that has a long success history. We chose the IFO Institute's WES economic situation in 6 months to provide the near-term outlook. The chart below shows how changes in global GDP and changes in the US Dollar match with the twists and turns of the WES economic outlook in 6 months. And there are reasonably good matches between the changes in the variables – **3 months after a deterioration of the global economic outlook, the US Dollar strengthens** (*see 2nd graph on this page*).

Third, we determined whether or not the WES survey has predictive property relating to future developments of the US current account balance, and if changes in the US current account balance can be explained by broad changes in global growth. The answer is affirmative on both counts (*see 3rd graph on this page*): **the WES outlook correlates well with the US capital account, and the US capital in turn, provides a high-frequency summary of the evolving global GDP.**

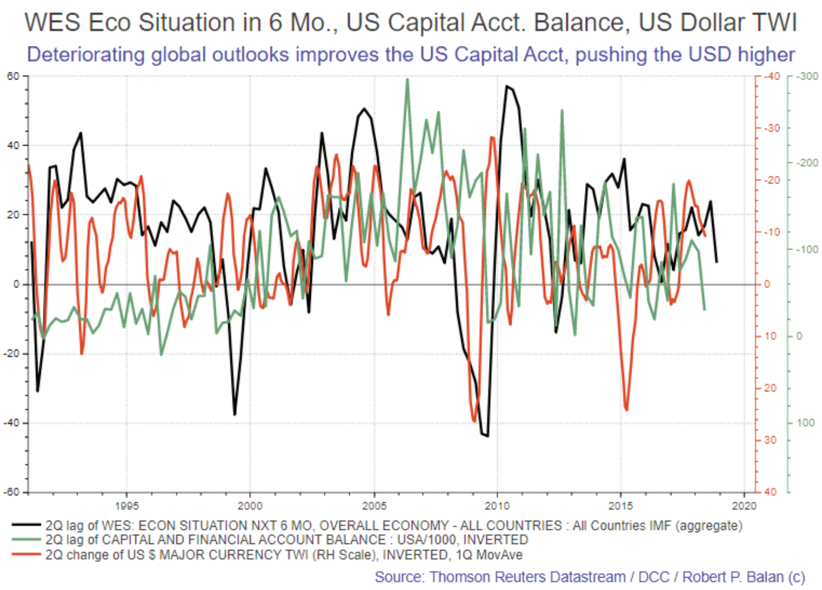


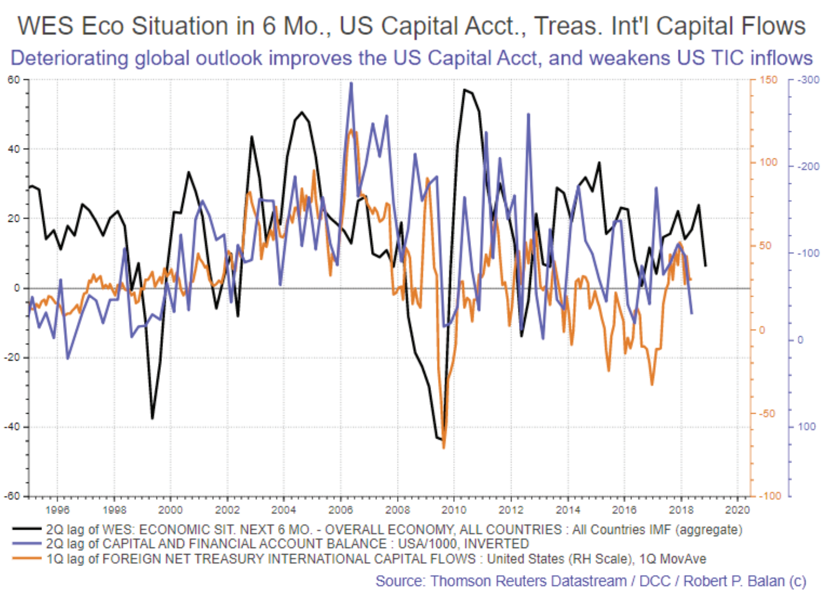




F inally, we wanted evidence that the WES outlook and the US capital account balance can project a 6-month path for the US Dollar with some reasonably good outcomes. We are satisfied that both variables deliver what we require (*see 1st chart on this page*).

T o square the circle, we also decided to see if the Treasury TIC flows may have some correlation with either the US capital account balance or with the WES outlook. TIC flows correlate well with the changes in US capital account balance (as should be expected), but the TIC flow-WES outlook relationship is not as close as we expected, although the relationships is there to see (*see 2nd chart on this page*).





Summary and conclusions:

T he sharp improvement in the domestic capital account since Q3 of 2016 will therefore likely to result in further rise of the US dollar during H1 this year and perhaps early Summer, a small decline from Q3 to Q4, and then we see a rising US currency during the first half of 2019. That will likely hammer EM equities and other risk assets as well.