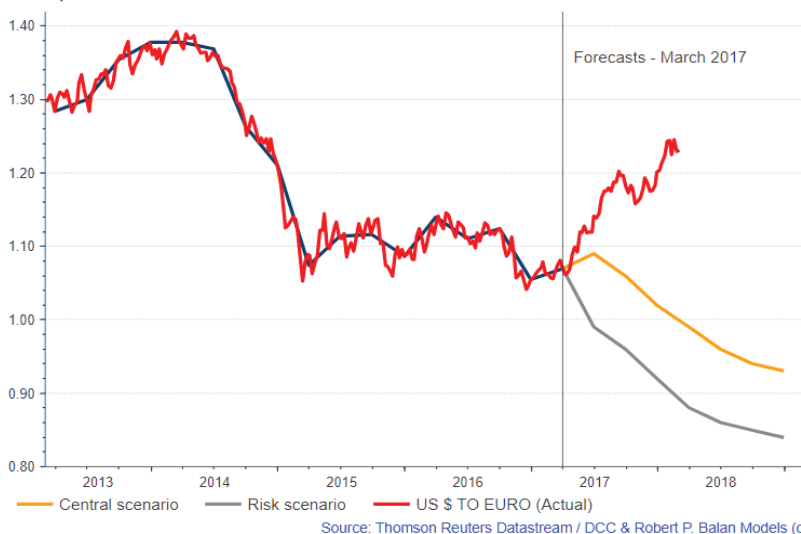


12 / The US Dollar has likely bottomed, as the EUR falters and as capital inflows to the US rise on favorable fiscal and monetary developments

A major factor which caused the US Dollar TWI's collapse in 2017 was the euro's strength -- the USD weakened more than 12% against the euro. **The reason for the EUR's strength last year: foreign investors bought large amounts of EUR bonds (EUR 1.27 trillion) as a result the European Central Bank's (ECB) Quantitative Easing, and those purchases were mostly unhedged. Another contributor to this move was U.S. investors in exchange-traded funds (ETFs) which shifted from hedged to unhedged European equity exposures. The strength and intensity of this EUR upmove caught many investors and analysts unaware, for good reason -- the European Central Bank (ECB) was continuing both its negative policy rate and quantitative easing programs in earnest at that time.** A sharp EUR appreciation at that time was unexpected -- the market consensus in Q1 2017 was for a decline in EUR in the near-term (see 1st chart on this page). The move higher accelerated when the «fear of missing out» (FOMO) on any further EUR appreciation overcame investors' natural aversion to «timing» currency hedges. **However, the EUR's upside momentum (and the US Dollar slide) may be coming to an end or may have even ended -- the greenback's trough may have been made during early February this year -- a USD bottoming process (and EUR peak distribution dynamic) may be going on.**

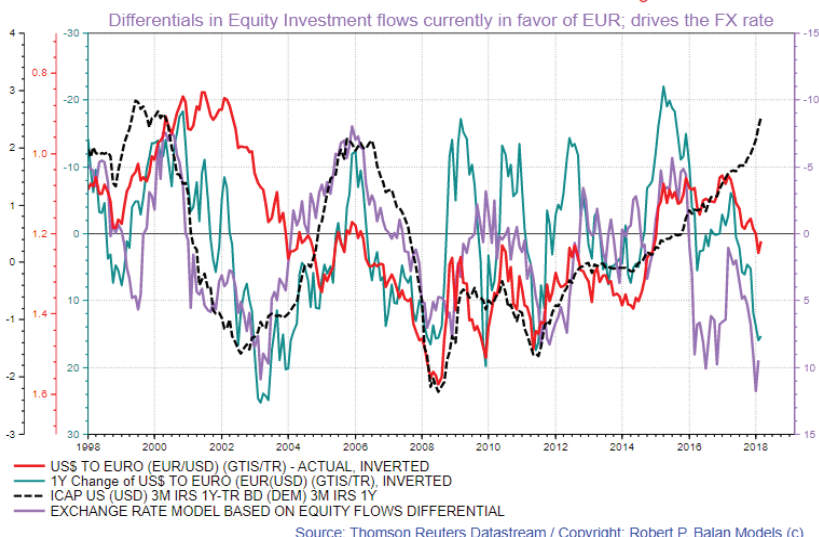
This possible reversal in EUR fortunes comes as the eurozone faces a new elevation of political risks. There were two short-term political risks: general elections in Italy (due on Mar. 4) and voting on grand coalition in Germany (March 4). In the first case, there was the risk that a euro-sceptic La Lega party in Italy unexpectedly wins more votes than anticipated, which they did.

EURUSD exchange rate, and market forecasts in Q1 2017
Spot rate



USD/EUR Models: based on swap rate, equity investment flows differentials

The US Dollar weakened even as USD rate differentials widened against the EUR



In the second case, the risk was that the members of Social Democratic Party of Germany (SDP) vote against the deal with Angela Merkel's CDU party. The German risk was removed after the SDP voted to join the coalition on March 4. The Italian electoral risk, the fact that La Lega won more votes than expected on March 4, had not impacted the EUR as badly as the market thought it would, but the framework of a new Italian government is still unknown -- this could weigh on the currency going forward. **Moreover, euro bulls have been too optimistic for too**

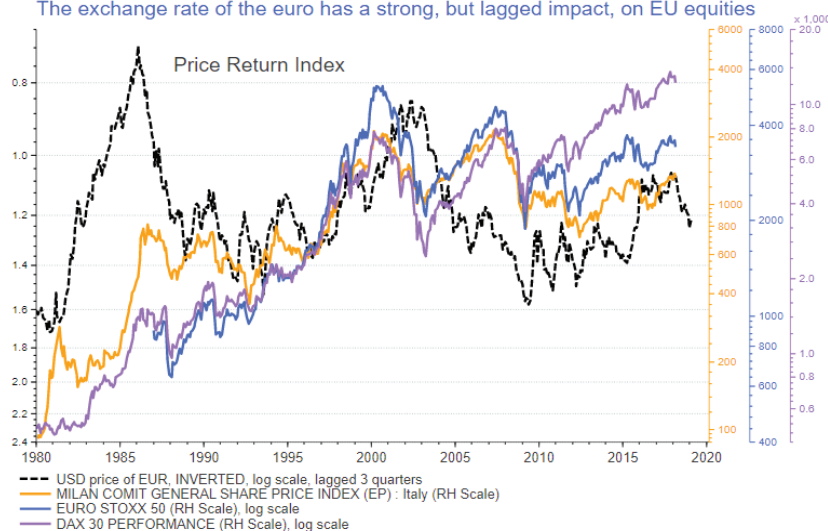
long and far too much. It has been reported that open interest on euro futures has increased 36% yoy, while a composite net long position has reached a massive 340,000 futures contracts (as of the end of January) -- an all-time record even if adjusted for higher open interest. Should political developments disappoint in Italy, the EUR bulls could start heading for the exit. That would invigorate a bid for US dollars which is slowly firming and gaining momentum, as fundamentals (which are mainly USD-bullish, longer term) slowly reassert.

One US Dollar-positive factor is the divergent monetary policy between the Fed and the European Central Bank (ECB). **The Fed minutes from the FOMC January 30-31 meeting, indicated that the Fed sees increased economic growth and an uptick in inflation as justification to continue to raise interest rates.** New Fed Chair Jerome Powell actually affirmed increased growth prospects in his first report to the US congress, but he clawed back some of it in a subsequent speech. We actually believe that the Fed is even more hawkish today than several weeks ago, when the FOMC held their January meeting. Barring an exogenous shock to growth or markets, there will be four rate hikes this year. **By contrast, the ECB is keeping its monetary policy unchanged. In fact, as recently as December last year, the ECB said that it stands ready to extend stimulus if needed. A few days ago, Mario Draghi stated that there are «very few chances» that ECB will change interest rates this year.** Indeed, the chart above most vividly demonstrates the divergent expectations of central banks' policy. The spread between US Dollar and EUR 3m swap rates is nearing 2.35%, a huge divergence in favor of the US currency, something that is currently not imputed in the EUR/USD exchange rate. **The factor that is currently driving the EUR/USD exchange rate is the differential in equity investment capital flows** (see 2nd chart on previous page). But that advantage is already fading as the equity flows start to favor the US again as a delayed response to the recent strength in the EUR – Eurozone equities historically weaken a few quarters after the common currency has strengthened (see 1st chart on this page). We expect equity investment flows to revert to the US stock markets, not too long from now – that would help firm up the US Dollar.

Moreover, economic expectations in German and the Eurozone, which have been rising strongly since Q3 last year, are already showing

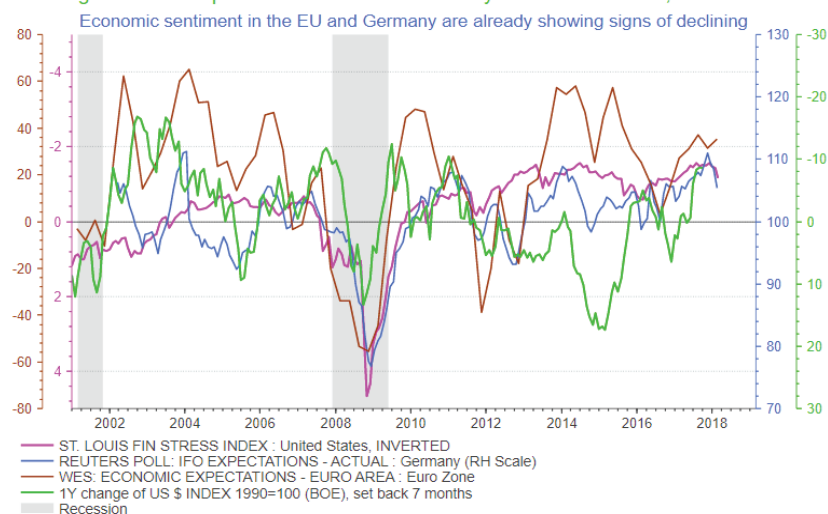
EUR / USD exchange rate, Milan Index, Dax Index, Stoxx 50

The exchange rate of the euro has a strong, but lagged impact, on EU equities



US Fin Conditions, Eurozone, Germany Eco Expectations vs US Dollar

Strong economic expectations in EU and Germany weakens the USD, and vice versa



a topping out process. Historically, the greenback weakens as those metrics rise, on market perception that financial conditions in the EU will correspondingly tighten much faster relative to the US. But that also true in the inverse – the US Dollar tends to rise when those metrics fall, and they are already showing early signs of reversal (see 2nd chart on this page), and will be US Dollar-friendly as we go along. The EUR-USD exchanged rate is a harbinger of future strength of the US Dollar Trade Weighted Index (TWI) – if the greenback strengthens against the common currency, the USD TWI is well on its way to strengthen across

the currency board (with the possible exception of the Japanese Yen, which runs against the US Dollar according to a different drumbeat).

In the February issue of the Capital Observer, we noted that differentials in the incentives created by the combination of monetary and fiscal policy should soon determine the near-term course of the US Dollar and its counterparts. And we also noted that this is an aspect where the US is ahead of G5 countries, by a mile. The Trump administration and the Republican Party dominated Congress passed enacted significant tax cuts even as the economy showed signs of

accelerating. The reduced corporate tax should encourage 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 chart on this page). The IMF estimates that benefits from the new tax laws could add 1.5% a year to the US GDP until at least 2020. A stronger growth outlook could be a game-changer for Foreign Direct Investments (FDIs), driven by capital inflows, which play a large part in a currency's long term valuation (see second chart on this page). And even though it does not make it into the headlines often, the deregulation efforts by the Trump government are also significant contributors to growth. On top of this, an infrastructure initiative is expected to be unveiled shortly.

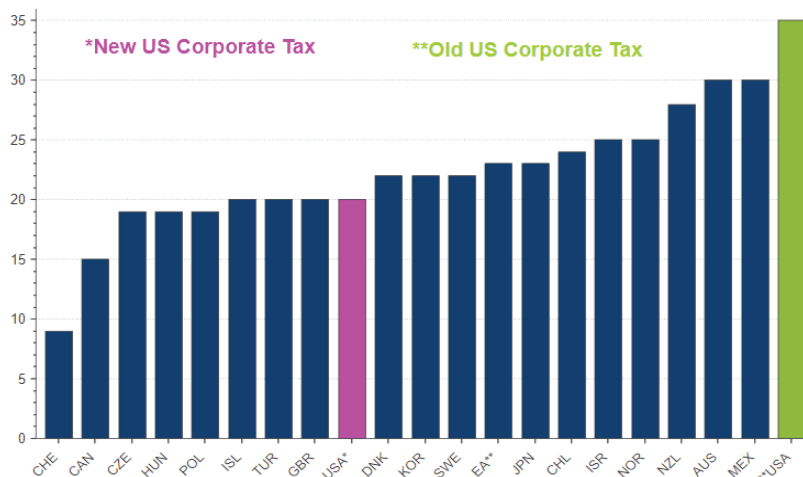
Let us sum up what we expect of the US Dollar and its counterparts to do in 2018:

In the immediate-term (6 to 9 months), the trajectory of the US Dollar will likely depend less on what the Fed and the other global central banks will do – it 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 to the real economy 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

Corporate tax rate 2016, OECD

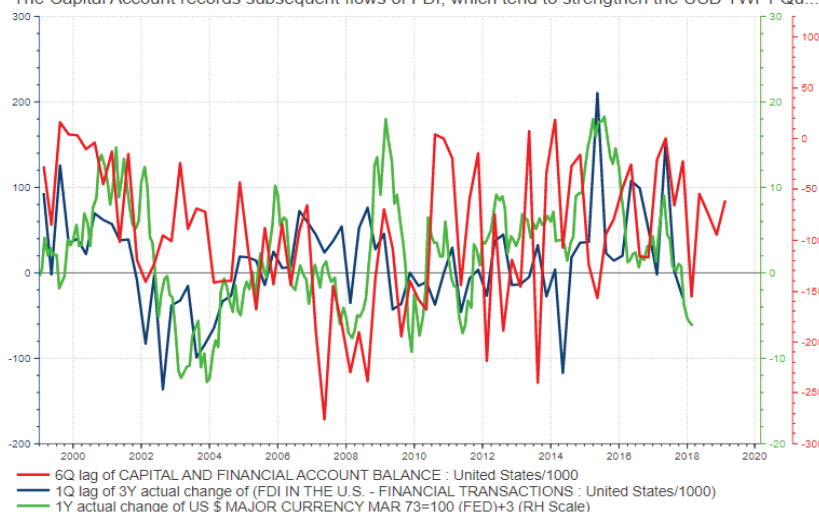
Federal government, per cent



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

US Capital Account and US Foreign Direct Investments vs US Dollar TWI

The Capital Account records subsequent flows of FDI, which tend to strengthen the USD TWI 1 Qu...

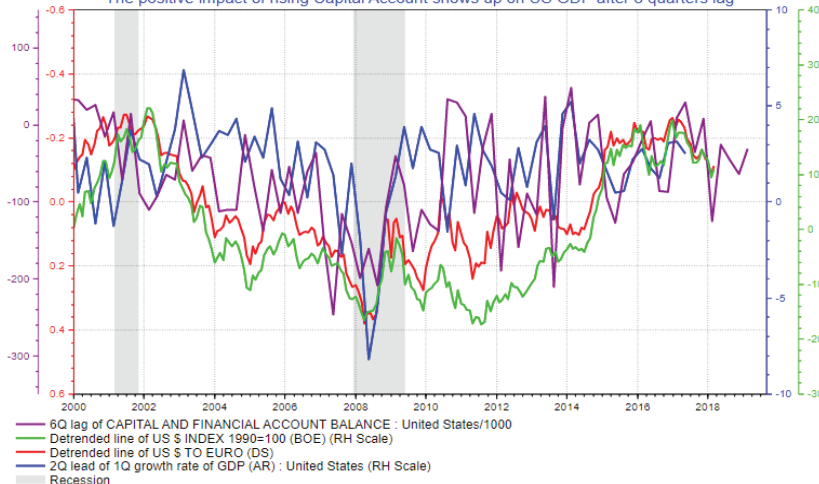


Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

US Capital Account Balance vs.USD TWI, EUR/USD, US GDP

Strong capital inflows improve the US Capital Account; strengthens the US Dollar, weakens the EUR

The positive impact of rising Capital Account shows up on US GDP after 8 quarters lag



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

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 due to the

influx of domestic and foreign capital which has already been going on for several quarters. **The impact of those capital inflows on GDP growth should be seen during H1 2018 (see last chart above).**

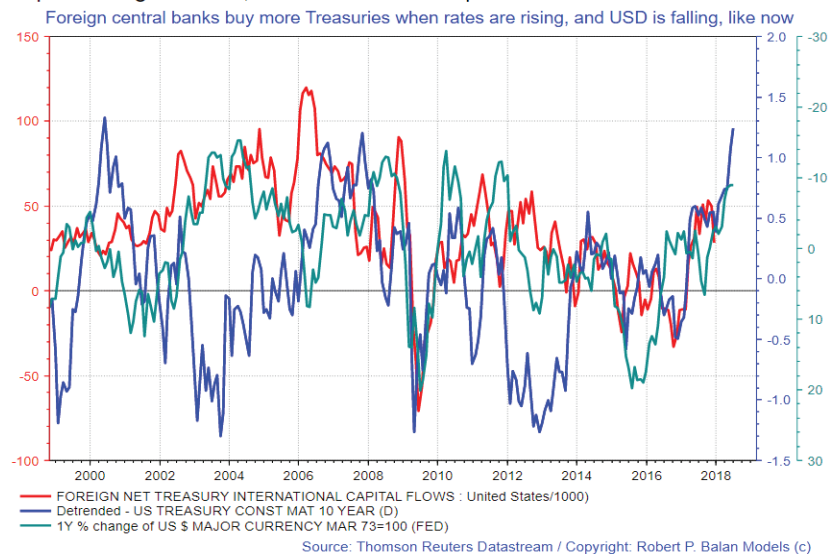
It is also supportive of the US currency that conditions are optimum for foreign central banks and entities to purchase US debt, and that is reflected at the Foreign Net Treasury International Capital (TIC) Flows.

According to Bloomberg, foreign holdings of U.S. securities rose to a record \$18.4 trillion as of the end of June, per a preliminary data released by Treasury in early March. Foreign investors have been buying US debt again due to the optimum conditions currently availing. Foreign central banks buy more Treasuries when rates are rising (*see 1st chart on this page*), and USD is falling, like seen recently. The TIC data (which currently lag behind by almost 1 quarter) will show that foreign buyers have been buying massive amount of US paper as from Q1 2018 and should be the case until at least the end of Q3 2018. That will support the sentiment for the greenback. The sell-off in USD in H2 2017 was due to negative sentiment generated by a “strike” of foreign US debt buyers due to unfavorable conditions, which caused several failed Treasury auctions in Q4 2017. By late Q1 2018, that is being reversed. Central banks have fiduciary duties to optimize their balance sheets -- hence they increase purchases of US debt paper when optimum conditions appear, as is the case today. **If the conditions are favorable, foreign central bank and investors will buy US paper. It is a pure asset-liability management exercise -- no ideology involved.**

As we also noted in the February Capital Observer, the US dollar is the most important asset class to watch in 2018. The combination of rising US Dollar and rising inflation, which we both expect to see not too long from here (*see 2nd chart on this page*), will lead to US and tighter global financial conditions and lower USD excess liquidity later in the year.

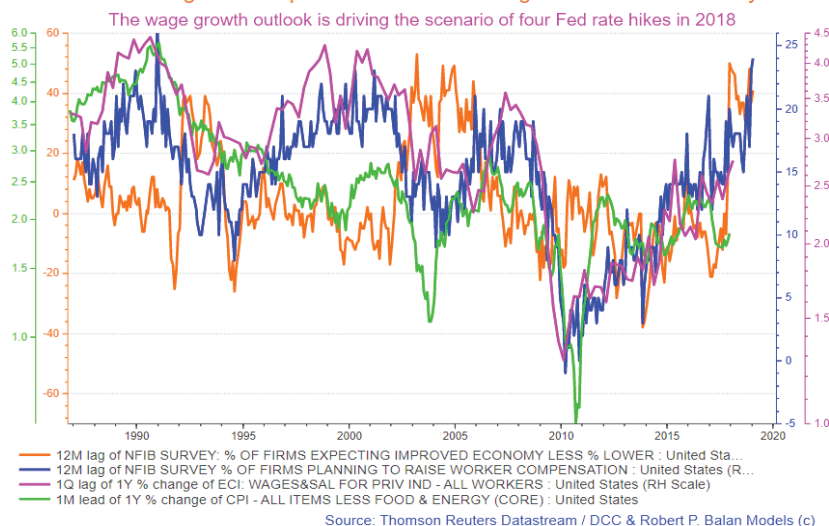
If the Fed follows through with its self-imposed regimen of three policy rate increases of 25 basis points for 2018 (and possibly four), that would push the USD even higher -- and the tightening of USD excess liquidity would bring on

Impact of higher rates, lower US Dollar on purchases of US debt instruments



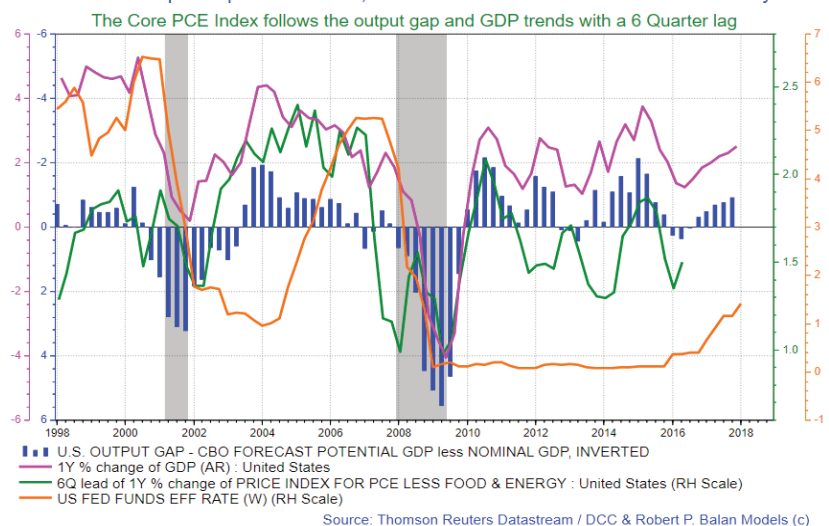
US NFIB growth and wage survey vs ECI raising wages and Core CPI

The future wage outlook provides a case for rising Core PCE later in the year



US Output Gap, US GDP, Core PCE Index, Fed Funds Eff. Rate

The US Output Gap has vanished; there is little slack over-all in the US economy



a deflationary bust. It all depends on how the Fed will respond to an uptick in inflation later in the year – and we do see potential for a Fed overreaction, especially as an inflation surge may be fueled by tightening labor conditions,

which the Fed is starting to sound alarm about. And this all happening as the US output gap disappears, which will further embolden the Federal Reserve to ratchet up monetary policy (*see 2nd and 3rd charts above*).

If the Fed allows inflation to rise, it is also possible that we could have an inflationary bust instead. But for us, that is the least likely scenario. It is of course difficult to predict what a Powell-led Federal Reserve will eventually do, but allowing inflation unchecked is simply not in the genes of the Federal Reserve (or any central bank for that matter). More so at this time, when the US economy is today more under threat of inflationary conditions than any other period during the Great Financial Crisis (GFC), see (*1st chart on this page*). The only possible reason we can see for the Fed to allow unfettered inflation (or even allowing it to go beyond their line in the sand) is to help offset some of the sting from a national debt that is building up (and will likely build further during the term of office of The Donald). But that is not the remit of a central bank, so this likelihood has little to no chances of happening.

We do fear a deflationary bust late in the year, as we expect the Fed to overreact and to overtighten – killing growth prospects and inflation on their tracks. Some may ask the importance of differentiating the two -- a bust is still a bust whether it is inflationary or deflationary. But it does matter – your investment strategy later in the year could be radically different from that today, depending on which kind of bust we may have. A deflationary bust, for one, could be deleterious to the health of commodities, but good for the bond market (yields tend to fall sharply on outlook of deflation). It is of course, the other way around, in case we have an inflationary bust – good for commodities, and bad for bonds.

