Ashmore

Weak Dollar policy

By Jan Dehn

The US economy is becoming seriously unproductive and the Trump Administration faces an important choice: support American business with heterodox policies such as import tariffs or abandon the strong Dollar policy?

We think the strong Dollar policy has outlived its purpose. A lower Dollar could provide the same support for US business at a much lower cost than border adjustment. We think border adjustment is a trap set by Congress Republicans to finance a large corporate tax cut, but Trump would be left holding the macroeconomic baby. Is the new US president smart enough to see that he is being played?

Introduction

Don't say that you were not warned. In the past few weeks and months, influential US policy makers and institutions have increasingly been complaining about the strength of the Dollar, including Donald Trump, US Treasury Secretary designate Steven Mnuchin, US trade advisor Peter Navarro, the US Fed and the IMF. Their statements are sometimes dressed up as attacks on other countries for weakening their currencies versus the Dollar, but this is ultimately the same thing as saying that the Dollar is too strong.

It is quite possible that a weak Dollar policy is now in the making. If so, it is about time. The strong Dollar was useful in the aftermath of the Subprime Crisis, but is now crippling the US economy. We have argued for some time that 2017 will likely see the Dollar begin a protracted decline, particularly versus EM currencies. Today, the big question facing US policy makers is this: is the best way to protect US business to impose tariffs – as Paul Ryan suggests – or is it to weaken the Dollar? We think the case for a weaker Dollar is far stronger, especially from the perspective of President Donald Trump. The only remaining question is whether he is smart enough to realise it?

Policy for a purpose

A weak Dollar is not always desirable. In fact, the strong Dollar policy served the US extremely well in the years immediately after the Subprime and banking crises in the US in 2008/2009. At that time, the overriding objective of government policy was to restore financing to the US economy, which needs to roll approximately 50% of GDP of debt every single year. Thus, when the US banking system collapsed it became imperative to restore financing to the system as quickly as possible to prevent an outright depression. While fiscal expansion and zero interest rates helped, the most important policy initiative by far was QE, which acted like a giant hoover that sucked money into the US from all corners of the world. The strong Dollar policy helped in this respect by reassuring investors that they could safely buy US assets.

The strong Dollar was useful in the aftermath of the Subprime Crisis, but is now crippling the US economy

Since then the US economy has recovered and stock markets in particular have staged a strong rally. Each Dollar that went into the US economy initially had hugely positive effects by providing much needed finance, but each inflow also had a negative effect at the margin by pushing up the Dollar, though, at first, the negative effect of the Dollar was dwarfed by the enormous benefit of accessing more finance.

Wind forward a few years, however, and the picture now looks very different. The enormous inflows to the US economy have lowered the marginal benefit of each Dollar inflow to zero or below as markets increasingly look overvalued. Meanwhile, the marginal cost of the stronger Dollar is becoming a serious impediment to growth as the real exchange rate slowly strangles the American economy.

Indeed, one can characterise the US economy as suffering from a particular version of Dutch Disease directly attributable to excessive capital inflows.[1] Why did the US economy only expand 1.6% in 2016 (0.6% net of population growth) despite unprecedented stimulus via negative real rates, fiscal deficits and limit long Dollar positions among nearly all the world's institutional investors? The answer is not unfair trade practices abroad. The reason is that the Dollar has become far too expensive for American businesses to compete.

The strong Dollar policy has therefore outlived its purpose. The US no longer needs the finance and would now benefit from a weaker Dollar, which would make it easier for American companies to export and help to fuel demand for such exports in the rest of the world as their financial conditions ease with capital inflows.

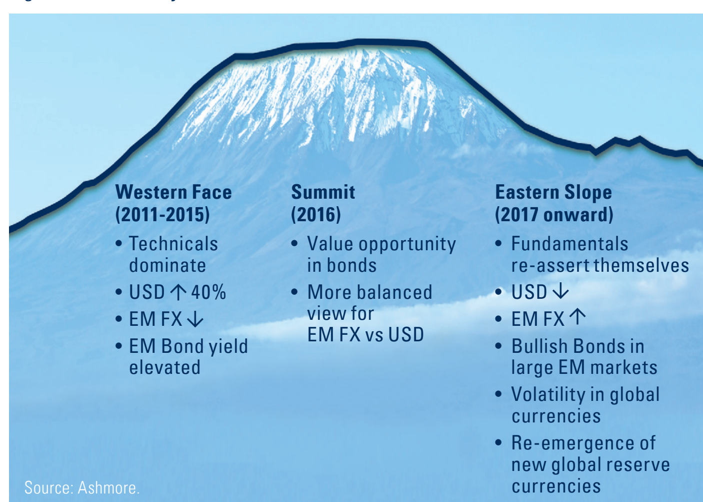
[1] Dutch Disease is a term used to describe the macroeconomic imbalances that occur due to large sudden capital inflows, usually due to commodity booms. The resulting inflows appreciate the exchange rate and raise domestic costs, thus making it difficult for non-booming export sectors to compete.

Continued overleaf

The Kilimanjaro Trades: A recap

We have been arguing for some time that the Dollar should begin to weaken around this point in the US business cycle. In a landmark report in September 2015 we explained that the likely path for the US dollar versus EM currencies will roughly trace the contours of Africa's tallest mountain, the Kilimanjaro. Hence, we labelled this view 'the Kilimanjaro trades'.[2]

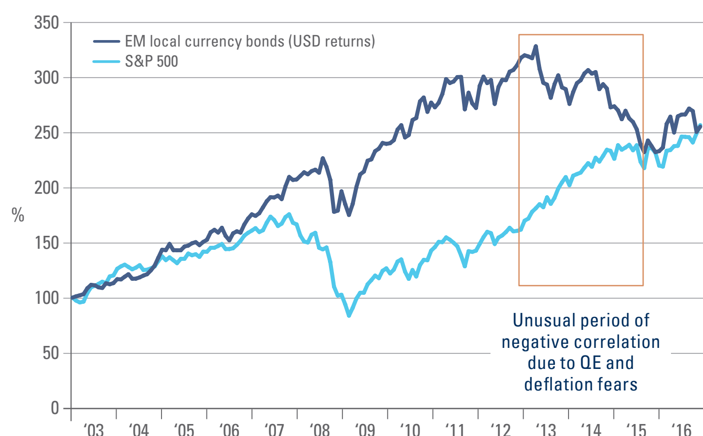
Fig 1: **The Kilimanjaro Trades**



The Kilimanjaro trades identify three distinct phases for the Dollar versus EM currencies. In phase one, which lasted from 2010 to 2015 the Dollar appreciated strongly as QE asset purchases across the Western world supported a bullish view on US recovery, while at the same time driving down developed market bond yields. Since the QE central banks did not buy a single EM bond QE had a powerful distortionary effect on global bond markets by inducing a powerful portfolio shift among institutional investors out of EM local markets to make room for more US equities and European fixed income.

The result was a highly usual, but transitory period of negative correlation between EM fixed income and developed market assets, which became especially pronounced from 2012 onwards as the ECB and BOJ really stepped up asset purchases. The fact that markets expected deflation in developed economies only added to the attractiveness of developed market bonds versus perceived 'risky' EM investments.

Fig 2: **Correlations between US stocks and EM fixed income**



Source: Ashmore, Bloomberg, JP Morgan.

Phase two of the Kilimanjaro trades was a plateauing of the Dollar in 2016. The view behind the call for a more stable Dollar in 2016 was US real exchange rate overvaluation. On the other hand, we saw no forces to push the Dollar off the peak, such as recession or inflation. Even so, the stabilisation of EM currencies alone had immediately positive implications for EM bond investors on account of the much higher yields on offer on EM bonds compared to developed market bonds. Thus, in 2016 EM local currency bonds returned 10% in Dollar terms compared to just 1.3% for similar duration US government bonds. EM currencies even outperformed the Dollar modestly last year despite Brexit, a Turkish attempted coup and Trump and have continued to outperform this year, revealing a great deal about positioning.

Fig 3: **2016 returns**

Asset class	% return (USD terms)
Fixed income	
EM local currency bonds	**9.94%**
EM external debt (USD)	**10.15%**
EM corporate debt (USD)	**9.65%**
3-5yr UST	*1.33%*
7-10yr UST	*1.04%*
Currencies	
EM FX	**0.54%**
*DXY Index**	*0.53%*
EURUSD	*-0.55%*
USDJPY	*0.58%*
Stocks	
EM stocks	**11.27%**
US stocks	*11.95%*

Source: Ashmore, JP Morgan, MSCI, Bloomberg.

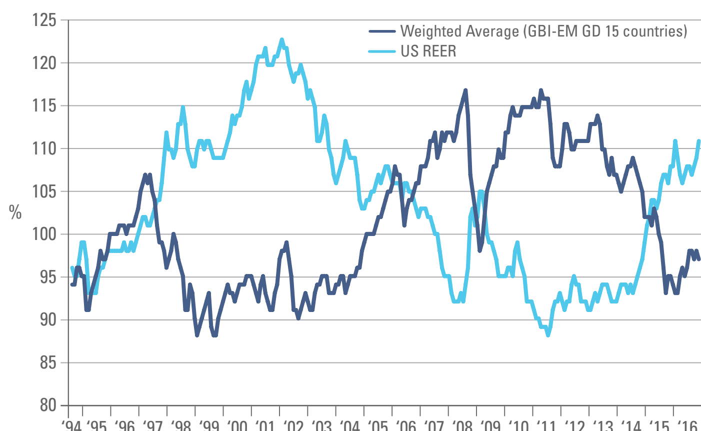
Phase three of the Kilimanjaro trades is a longer-lasting period of Dollar weakness, which may already be underway. EM currencies have continued to rally versus the Dollar in 2017 and the broad DXY index is down nearly 3% year to date. Dollar weakness is triggered by a combination of factors, including extreme valuations, the onset of US inflation, populism in the US and possibly a change in Dollar policy. US core inflation is already above the Fed target at 2.2%, the US is near or at full employment and the Trump administration is proposing more fiscal stimulus. Import tariffs, if implemented, would push up US inflation meaningfully.

With the Fed funds rate some 170bps below the rate of core inflation the Fed is already so far behind the curve that it is unlikely to be able to close that gap without triggering a recession. Deeply negative real rates in a rising inflation environment are obviously Dollar negative. At the same time EM real exchange rates are back to 2003 levels, the year the last major EM local currency bond rally began. Technicals also favour EM currencies over pregnant positioning in the Dollar. Hence, once underway we think the decline of the Dollar could last for some time.

[2] *'The View from Kilimanjaro: EM FX in a QE world'*, The Emerging View, September 2015.

Continued overleaf

Fig 4: **US and EM real exchange rates**



Source: Ashmore, Bloomberg, BIS.

Protectionism or a weaker Dollar?

Investors must now add a further layer of complexity: Trump's policies. Much noise and uncertainty surrounds them, but to us the central question is this: will the Trump administration favour a blanket tariff on imports in accordance with the proposal from protectionists in Congress led by Paul Ryan, or will Trump realise that he is being played, that a blanket tariff would leave him with a massive macroeconomic headache and that a weaker Dollar policy is a far smarter policy?

Ryan's proposal is to impose tariffs on US imports for one purpose only: to finance his proposed USD 1.8trn corporate tax cut. The problem is that the proposed corporate tax cut is so large – about 10% of US GDP – that it would ruin the Republicans' claim to be in support of small government unless they can find revenue somewhere else. They obviously do not want to tax Americans, so Ryan's brilliant idea is to tax foreigners instead via his so-called border adjustment. Unfortunately, the border adjustment is not as uncomplicated as it appears. For one, it would kill US exports by appreciating the already overvalued Dollar. In addition, it would raise inflation sharply and force the Fed to hike rates, thereby risking a recession. A blanket import tariff would also lock the US into mostly unnecessary trade wars with literally every one of its 232 trade partners around the world. While Ryan would walk away with a big tax cut to satisfy his constituency the policy would prove hugely costly for the economy as whole and Trump alone would be left holding the baby.

On other hand, if Trump opposes the blanket border adjustment then clearly a USD 1.8trn corporate tax cut would not be feasible due to a lack of financing. The tax cut would then have to be scaled back to a more modest USD 600bn, which means fewer fiscal stimuli and less growth, but also lower inflation and therefore fewer rate hikes.[3] The Dollar would have no impulse to rise and could even fall. In this scenario, it would be beneficial to the US economy if the Dollar were lower. It would help American exporters, reduce bubble risks and support demand in the global economy and therefore increase demand for US exports.

Note that Trump would still be able to maintain the pretence of being a protector of US businesses by threatening border taxes, but he would do so in an ad hoc manner rather than via a blanket tariff on all imports. By targeting particular industries in certain countries rather than targeting everyone at the same time he would retain the impression of potency at a much lower cost to the overall economy and ultimately to himself.

Given these trade-offs, we think the US will end up implementing a lower border adjustment than is currently feared and may indeed abandon border adjustment altogether. A weaker Dollar policy would simply be much cheaper in economic and political terms, more timely given the state of the business cycle and ultimately more effective.

A macroeconomic case for a weaker Dollar

The real case for Dollar weakness is macroeconomic. The US economy is now suffering from a version of Dutch Disease caused by excessive capital inflows, exacerbated by a bad case of reformophobia. There is quite simply far too much money chasing far too few genuine opportunities in the real economy. Inflows not only create asset bubbles in the financial markets, but also undermine America's export capacity via Dollar appreciation.

The ideal way to return the US economy to a competitive state would be to seriously reduce debt and engage in major productivity-enhancing reforms. This seems unlikely, however. The political sentiment is far more suggestive of populist policies, such as fiscal spending, protectionism or indeed currency manipulation.

Within this world of the second best the least costly option would be to inflate and devalue the USD back to competitiveness. This prescription is clearly more realistic in today's political environment. Inflation would erode the real value of the excessive US debt burden over time at a cost to future generations, but since they do not vote in current elections perhaps that is ok. Meanwhile, the weaker Dollar would make American businesses more competitive and help to restore overall macroeconomic equilibrium. Flows of capital back to EM would also stimulate growth outside the US and thus increase demand for US exports.

One of the risks of adopting a weak Dollar policy is that once Dollar weakness gets underway it quickly becomes a rout. After all, positioning in the Dollar is very heavy and the Dollar is very expensive, possibly implying very little further upside. Indeed, the only time in recent history where the Dollar was more expensive than today was in the early 2000s, when markets briefly believed that the US was experiencing a productivity miracle – which would have justified a stronger Dollar – only to realise it was the DotCom Bubble. The Dollar dropped in real terms for eleven years in a row after the Dotcom Bubble burst.

Despite the risk of a Dollar rout we think the Greenback's decline will turn out to be relatively gentle, at least to begin with. It is not just that Trump's policies with respect to border adjustment and/or Dollar weakness remains unresolved. It is also that most investors still do not see EM markets, the only fixed income and currency markets in the world to offer decent value, as genuine alternatives to developed market fixed income and currencies. Often entirely unaware that they have a way out of their pregnant positions, investors are fearful. And fearful investors rarely allocate to EM. There will also be volatility along the way. When bouts of volatility occur EM investors should aggressively buy dips in EM FX, but experience shows that volatility often makes them do the opposite.

[3] We arrive at USD 600bn on the assumption that without the USD 1.2trn in revenue from border adjustment the proposed tax cut of USD 1.8trn would have to be scaled back by this amount, i.e. USD 1.8trn less USD 1.2trn = USD 600bn.

Continued overleaf

Ashmore

Even if the border adjustment policy goes ahead, however, we think there would be serious negative consequences for the US economy as well as the Dollar, which would quickly reverse any short term gains for the latter.[4] The bottom line is that border adjustment would materially worsen America's already serious real exchange rate overvaluation problem and thereby jeopardise the expansion. Markets would arrive at this conclusion sooner or later and then opt to reduce exposure to US markets, including the Dollar.

What about the corporate tax cut? We are somewhat sceptical that a big corporate tax cut is feasible and even if it happens whether it would generate a productivity miracle that could push the Dollar up sharply. US effective corporate rates are in line with those in other developed countries. They are not the problem. The real problem is macroeconomic and worsening the macroeconomic picture further, which is what Ryan's policies would do, will not help to improve confidence in the future at all.

Conclusion

We do not know if the Trump administration will adopt a weak Dollar policy. However, it would make sense if it did. The US no longer needs to attract as much capital from abroad as it did in the aftermath of the crisis and the Dollar is already so strong that it is hurting the US economy. A weaker Dollar would help unproductive US companies. Tariffs would do the same, but only in the short term and at a much higher cost to the rest of the economy. Ryan wants the border adjustment, but Trump would end up holding the macroeconomic baby.

The bigger picture is this: the US economy is now at a critical juncture, where, after years of stimulus the demand side of the economy has caught up with the supply-side. From this moment onwards further stimulus of the economy would generate serious macroeconomic imbalances, including growing external deficits, inflation and even worse real exchange rate overvaluation. The Trump administration could seek to smother these symptoms with heterodox policies, such a trade protection, but this would not end well. Argentina did exactly the same in the mid-2000s with very poor results – and ultimately a much weaker currency.

The ideal policy at this point in the US business cycle is to begin to address supply-side issues and ensure that any further expansion in demand is matched by an increase in productivity. This would obviously require reforms and debt reduction. If such policies are not possible in the current political environment then next best policy choice is to weaken the Dollar and to invite a bit of inflation. These policies would help American exporters and erode some of the excessive debt stock. Ultimately, this would be better for the US than going heterodox. Just ask the Argentinians.

A weak Dollar and inflation would therefore contribute to resolving America's economic problems. However, they would pose major risks for anyone holding Dollar-denominated assets, especially in fixed income, especially if they are outside of the US. Big foreign holders of Dollar-denominated fixed income, such as central banks, would be robbed and the real purchasing power of their assets would decline sharply. This works for Trump, because it spares American tax payers from the pain of repaying the debt, but it is a disaster for investors in US fixed income.

US and non-US investors alike should therefore begin to protect themselves by diversifying away from the Dollar. They should go into EM currencies and bonds, which have become very cheap in recent years. By rotating into EM fixed income investors will access markets with much stronger debt and growth fundamentals, better technicals, major currency upside and above all higher returns.

[4] For a deeper discussion of these issues see *"Trump and EM"*, The Emerging View, January 2017.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2017.

Important information: This document is issued by Ashmore Investment Management Limited ('Ashmore') which is authorised and regulated by the UK Financial Conduct Authority and which is also, registered under the U.S. Investment Advisors Act. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore and its respective officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in units or shares of any Fund referred to in this document. The value of any investment in any such Fund may fall as well as rise and investors may not get back the amount originally invested. Past performance is not a reliable indicator of future results. All prospective investors must obtain a copy of the final Scheme Particulars or (if applicable) other offering document relating to the relevant Fund prior to making any decision to invest in any such Fund. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment in any such Fund. Funds are distributed in the United States by Ashmore Investment Management (US) Corporation, a registered broker-dealer and member of FINRA and SIPC.