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MARKET COMMENTARY

Ashmore

What's down with the Dollar?

By Jan Dehn

Quantitative Easing (QE) was the largest and most distortionary intervention ever made in global bond markets and it particularly favoured US markets. The Dollar rallied sharply as capital flowed into the US, but the Dollar eventually got expensive and investors got saturated. As the Fed began to tighten policy the QE tsunami began to lose strength. Contrary to popular perceptions the real challenge for the Dollar is not low Fed funds rates, but rather pregnant positioning and the fact that the Greenback is expensive in both real and nominal terms. In the context of still sluggish growth and excessive debts investors are slowly realising that the QE-motivated tide, which pushed the Dollar well beyond its fair value, is now turning. We described this dynamic in *"The View from Kilimanjaro"* in September 2015 and the dynamics are still highly relevant, in our view. Early movers out of the Dollar and back into EM currencies will be generously rewarded, in our view.

The QE tsunami

Unconventional monetary policies, particularly QE, have dominated global financing markets since the start of the decade. QE was the largest ever intervention in government bond markets and also, by far, the most distortionary. Enormous bond purchases were targeted at very specific fixed income markets and created a giant tsunami of capital, which flowed onto US shores from all corners of the world. Investors took the view that early recapitalisation of US banks meant that America would recover more quickly than other countries in a QE world: expectations of strong sustained growth and early rate hikes drove the Dollar higher.

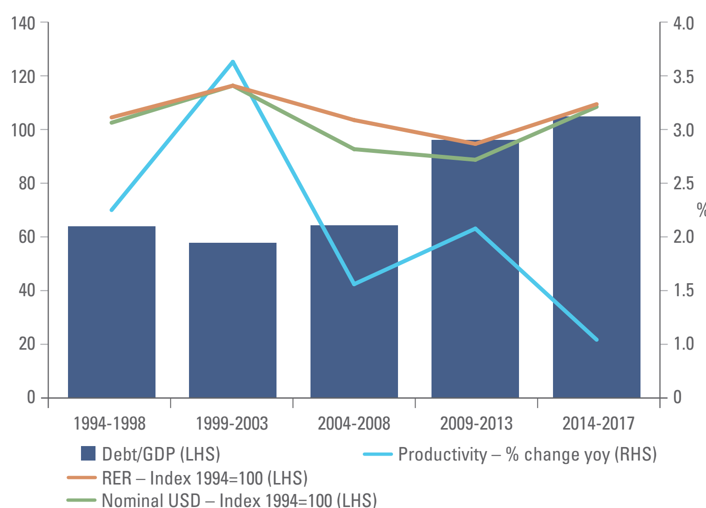
Dollar Dutch Disease

'Strong Dollar' became the overwhelmingly dominant consensus view in global currency markets as investors relentlessly piled into American assets for more than five years. The rising Dollar, especially versus EM currencies, was a direct reflection of capital inflows as the QE tsunami did what it was intended to do, namely to provide desperately needed financing for the US financial system.

Sadly, QE went much further than that: it also altered policy incentives. The extraordinarily easy monetary policies ensured that no US politicians felt inclined to deleverage, while surging stock markets took away all incentives to reform. Productivity therefore continued to fall and the economy remained sluggish despite abundant financing. Perversely, this weakness led the Fed to maintain QE for even longer and so inflows continued. The Dollar is now so high relative to US fundamentals that the US economy is suffering from a version of Dutch Disease caused by capital inflows rather than commodity prices.

America's Dutch Disease problem is neatly summarised in the chart adjacent. The Dollar is now back nearly at the same level (in both nominal and real terms) as during the period from 1999 to 2003, when debt levels were half as big and productivity growth was seven times greater. The overvaluation of the Dollar is now an important additional drag on the US economy.

Fig 1: **US: Exchange rates and productivity**



Source: Ashmore, BIS, Bloomberg.

The US needs a weaker Dollar unless things improve

The US fundamental backdrop does not encourage optimism for the Dollar: rising populism and ineffective government bodes poorly for trend growth rates. President Donald Trump openly favours a lower Dollar and a dovish Fed. A tax reform is still possible, but the twin failures of Obamacare Repeal and Border Adjustment Tax mean that there is little room in the Budget to cut rates, though debt levels may well rise. The most likely scenario is that of a small tax cut. This means a small fiscal stimulus, weak growth, low inflation and therefore a very gentle pace of Fed hikes. All this adds up to a weak case for the Dollar. Meanwhile, the productivity and debt challenges remain, so unless the government gets very serious about deleveraging and reforms, the Dollar may also have to fall in order to help the US economy to grow, while inflation may be needed to erode away the crippling burden of debt.

[1] Dutch Disease is a term used to describe the macroeconomic problems associated with real exchange rate misalignment, usually in relation to commodity price booms. The original study of Dutch Disease looked at the effects of the discovery of North Sea oil on the economy of Holland, hence the name.

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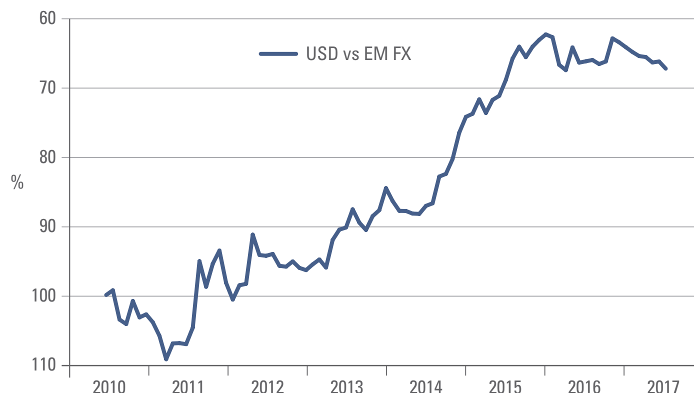
The tide turns

What will happen to the Dollar from here? The Dollar peaked against EM currencies in January 2016 barely two months after the Fed had begun to hike interest rates. The Dollar was stable versus EM currencies in 2016 and in 2017 it began to fall outright. This decline is spurred by the same forces that pushed the Dollar up, namely investor behaviour and central bank policies. The onset of monetary tightening is not helping the Dollar because the currency is quite simply overvalued and technicals are terrible. Both are the result of massive capital inflows as investors the world over jumped on the QE band wagon and bought into the US recovery hype. Neither the US economy nor the Fed is likely to deliver enough to be able to hold onto all the QE money and foreign capital which currently clings to the Dollar, especially as returns pick up elsewhere, especially in EM.

Fig 2: **EM currencies versus USD**

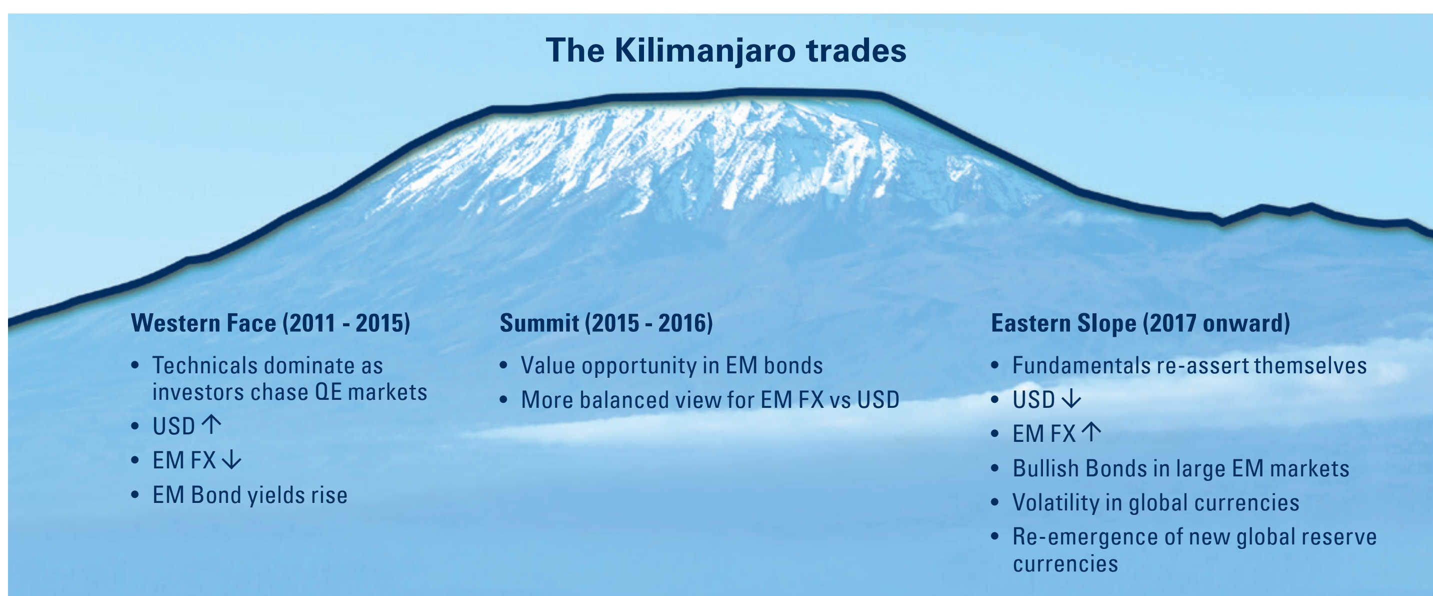


Source: Ashmore, Bloomberg, JP Morgan.

Figure 2 shows the trajectory of the Dollar versus EM currencies since 2010. If this chart looks familiar it may be because it closely resembles the shape of Africa's highest mountain, the Kilimanjaro (chart below).

In a publication from September 2015 titled *'The View from Kilimanjaro: EM FX in a QE world'* we predicted the Dollar's peak, stagnation and eventual decline. The report argued that the US dollar's trajectory versus EM currencies in a QE world would follow three distinct phases:

The view from Kilimanjaro



- Western Face (2011-2015):
  The Dollar appreciates versus EM currencies as investors sell EM assets in order to allocate to the QE market with the best prospects for growth and normalisation of monetary policies, i.e. the US. This happened: EM currencies declined 43% between April 2011 and January 2016.
- Summit (2015-2016):
  The Dollar flat-lines against EM currencies as the Fed scales back the market's expectation of QE purchases. Also labour markets slowly approach full employment with prospects of outright monetary tightening. However, neither recession nor inflation creates any strong directional forces for the Dollar. This also happened: EM currencies ended flat (+0.54%) versus the Dollar in 2016, which was impressive given that three Fed rate hikes were priced in in April 2016 and the year also witnessed Brexit, the Turkish coup attempt and Donald Trump's rise to the presidency.
- Eastern Slope (2017 onwards):
  In this final phase one of two dynamics drive the Dollar lower. Either inflation forces the Dollar lower as the Fed is compelled to favour inflation over growth in order to protect weak growth. Or US growth disappoints and the Fed has to be even more dovish. So far the latter dynamic has prevailed.

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Living on hope

The rollback of QE drives the Kilimanjaro View of the Dollar. An outright collapse of the Dollar is a distinct possibility, but it is not our base case. Just as the Eastern Slope of the Kilimanjaro is long and uneven, so we expect the Dollar's decline to be protracted and occasionally wobbly. Denial dies slowly and acceptance takes even longer. A lot of rebalancing is needed before central banks, sovereign wealth funds, pension funds and other institutional investors have positioned their currency exposures in accordance with the best future returns, which is no longer in the US currency. Besides, investors also have short-term memories and still fear to allocate to EM after the volatility of recent years. Many others also cling to the hope of yet more QE from central banks to provide support for US stocks in case the economy goes down.[2]

Purchase power illusion

Placing one's faith in a permanent rescue bid from the QE central banks is just as misplaced as permanently fearing allocations to EM. Taking profits in the QE markets means selling Dollars. Reducing Dollar exposure is not just relevant to non-Dollar based investors. It is fallacy to think that a falling Dollar does not matter to US investors. The whole point of investing should be to protect and ideally increase the purchasing power of savings in the future. Purchasing power illusion – the notion that a decline in the currency in which you measure your assets does not matter – is a fallacy. The US imports about a fifth of all the goods it consumes. A 10% fall in the Dollar therefore destroys purchasing power equivalent to 2% of GDP. That is roughly how much the US economy grows in a whole year.

As they face the sheer brutality of EM's outperformance and stronger fundamentals it will eventually dawn on everyone that the QE trades are over

Early bird discount

EM is cheap and strong. In early 2016 EM currencies reached their cheapest level in real terms since 2003, the year of the start of the last major EM local currency rally. EM countries suffered a temporary slowdown in growth when capital fled, but they were able to survive with remarkably few casualties due to much stronger fundamentals. Early movers back to EM currencies will be rewarded. We estimate that EM currencies will appreciate about 20% against the Dollar between 2017 and 2021 with another 30% return available from the interest paid on local currency bonds. No other government bonds with 4.5 years of duration in the QE markets are likely to beat the 50% return in Dollar terms, which we estimate to be available in EM local markets over this period. The realisation the QE trades are over may only be dawning slowly, but it will eventually become clear to everyone as, day by day, they face the sheer brutality of EM's outperformance and stronger fundamentals versus those in the United States.

[2] See *'The Capital Markets Trap'*, Market Commentary, 27 July 2017.

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