Fixed Income

After the U.S. dollar selloff: What's next?

The dollar has experienced a setback. Uneven positioning and low market depth might have contributed to the selloff.

Who cannot relate to this? Imagine a hot summer day, you are thirsty and reach for a bottle of sparkling water, waiting to be refreshed. You turn the bottle cap, only to find the cool liquid spraying in all directions. Instead of experiencing a well-deserved refreshment, you are left with a big mess to clean up. Occasionally, this situation is accompanied by words that we should rather not mention here. More or less, this is how investors and analysts might have felt over the past months in light of the U.S. dollar movements.

It became apparent that the dollar's strength would eventually come to an end. The dynamics between the "Greenback" and other currencies like the euro had been changing over the past months for a variety of reasons and were quite capable of triggering exchange-rate moves. Yet, both the speed and extent of the exchange-rate moves were surprising. What may be an explanation? And how could it continue?

Interest-rate differential

The stronger support for the U.S. dollar in recent years mostly stemmed from the divergence of interest rates and yields. Already in 2014, the U.S. central bank the Federal Reserve (Fed) had phased out its bond-buying program. Four interest-rate hikes have followed since the end of 2015. During the same time, the European Central Bank (ECB) has initiated its own bond-buying program, and has conducted an experiment with negative interest rates. Right now, the debate is heating up about the exact timing of the ECB starting to exit its purchasing program. We expect an announcement over the next couple of months, and the execution in 2018. However, in our view, we will have to remain patient for the first ECB interest-rate hike. Market expectations as implied by short-term rates seem too optimistic in our view, putting the ECB in the position of having to perform. This in turn could lead to disappointment for the euro. In our view, dollar investors should continue to retain a nice yield advantage, one that should increase even further if the Federal Open Market Committee, led by Ms. Yellen, chooses to hike the federal funds rate further. Hence, interest-rate differentials remain strongly in favor of the Greenback.

Purchasing-power parity

Relative valuation is the first thing that comes to mind when considering the concrete indicators that allow for an exchange-rate analysis. Comparable goods should cost the same, both domestically and abroad, after adjusting for exchange rates. Experts refer to this as purchasing-power parity. A simplified version of

Stefan Kreuzkamp
Chief Investment Officer

In a nutshell

- Despite the continuously high interest-rate differential, the U.S. dollar experienced a setback.
- Some of the dynamics influencing exchange rates have changed with support for the euro stronger today than it has been in recent years.
- Uneven positioning in markets, coupled with low market depth in the summer months, might have increased the extent as well as the speed of the price development.
- In light of the strong dollar setback in the last weeks, we see the potential for a temporary rebound.

this concept is the "Big Mac Index," which compares the price of a large hamburger in different countries. If one considers a more diverse product basket, the EUR/USD exchange rate should be at around 1.16 according to our calculations of purchasing-power parity. Based on this, one can neither infer significant appreciation nor depreciation pressure at current levels.

Political stability

Another factor has been political stability. Especially for fiat money regimes, it is of utmost importance that the government backing a certain currency is stable. A look at the Swiss Franc's exchange rate demonstrates just how important the assessment of stability can be: Neither purchasing-power parity nor interest-rate levels justify the strong exchange rate of the Franc. It is rather the proven stability of Switzerland, a track record built over generations. This in turn has made the country such an interesting investment destination, and has strengthened the Franc. How to evaluate this factor when it comes to the relation between the U.S. dollar and the euro? In light of the experiences made in recent years, one might argue that the political factor should be strongly pro-dollar. Indeed, it was not too long ago that the entire European common-currency project stood on the brink of failing. Still, in 2016, after the Brexit referendum, one could read about centrifugal forces in Europe that would sooner or later put a question mark behind the whole project of a single European currency. At least temporarily this dynamic has changed: with Emmanuel Macron, an outspoken pro-European politician has made it into the Élysée Palace in France, while in the Netherlands, the access to power has been denied to euroskeptics. The German election this fall is unlikely to change the pro-European stance of Europe's biggest economy. Increasing stability in Europe is hence compared to a political reality in Washington that so far has fallen short of the high expectations. Taken together, might the political factor already be euro-supportive? We do not want to make that case today, but at least, at the margin, it is not supporting the dollar either.

Economic development

What about the economy? Capital tends to flow to areas where returns are high. As higher growth rates translate into higher returns on capital, economic growth is an important factor in assessing global investment opportunities. After last autumn's U.S. elections, markets entered into a phase of euphoria. Having a business man in the White House, a business-friendly cabinet, supported by majorities in both houses of Congress – what could possibly go wrong? Sentiment indicators shooting up to levels in some cases not seen for decades, seemed to justify rising stock prices, rising yields, and a strong dollar. Looking at the economic numbers now, however, suggests that the growth lift-off has rather happened on the other side of the Atlantic. First quarter gross-domestic-product (GDP) growth in the U.S. disappointed again, much like in previous years. For sure, one cannot blame the new administration for the economy's dismal start into 2017, but the prevailing optimism took a hit, nevertheless. We have seen a pickup in economic momentum in the second quarter, but high-flying expectations of decisive,

business-friendly reforms have not materialized thus far. It doesn't help either that sentiment indicators seem to have leveled off.

Across the pond in Europe, the economic recovery is broadening, also geographically. Spain has been recording growth rates of three percent for more than three years, and the French economy is picking up speed, too. It's possible that Germany, Europe's number one growth engine for several years, drops to fourth place among the Eurozone's five largest economies. With 2.1% growth for the past twelve months, the Eurozone has clearly beaten expectations, while the U.S. economy fell short of the high expectations. Hence, we see the economic development as a supportive factor for Europe's common currency. And running a sizeable current-account surplus is strengthening the euro further.

To sum up these factors, today's euro strength vs. the U.S. dollar seems justified, compared to the situation one or two years ago. Nevertheless, we are skeptical that this alone explains the speed and strength of the dollar's decline. We believe that very uneven positioning has amplified the trend. According to positioning surveys, there was a clear preference for the U.S. dollar vs. the euro in the first half of the year, resulting in the dollar being heavily overweight. In a way, that was similar to too much pressure in the abovementioned bottle of water, with the French election outcome being the trigger for the cap to be opened. Low trading volume and liquidity (market depth) during the summer months might have added to the ferocious price action.

Where from here?

Current positioning data suggests that the bulk of the position adjustment is behind us, and markets are probably in balance now. That leaves us with the longer-term outlook: we acknowledge that some weakening of the dollar had been foreseeable, and we had taken this into account when we adjusted our exchange-rate forecast by 10%. Given the massive move, which took us well beyond our target, we see a chance for a setback from here.

Glossary

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Federal Open Market Committee (FOMC)

The **Federal Open Market Committee (FOMC)** is a committee that oversees the open-market operations of the U.S. Federal Reserve.

Fiat money

Fiat money carries no intrinsic value and is not tied to any commodity.

Greenback

Greenback is a commonly used expression for the U.S. dollar.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "the **Fed**", is the central bank of the United States.

United States Congress

The **United States Congress** is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed

annually as a percentage based on the investment's cost, its current market value or its face value.

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