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Dollar's recent weakness – Blip, not new trend

In the past nine weeks major currencies and global equity markets have traded broadly in line with our expectations.

The US Dollar has traded in a very narrow range, confounding consistently bearish market expectations. Similarly, most emerging Asian currencies have barely moved, pointing to the ability and willingness of Asian central bank to intervene in FX markets in a bid to manage both the volatility and directionality of their currencies. Conversely, emerging currencies, particularly in Latin America, have been prone to sharp pull-backs.

Stretched currency valuations and still very weak global economic growth in January – which tallies with our forecast – has likely been a driver of currencies' performance.

In the past five weeks the inverse correlation between the Dollar and S&P 500 and between the Dollar and the steepness of the US Treasury yield curve has broken down.

Our take is that the broad-based diversification out of Dollars, driven by buoyant global risk appetite and market concerns about the Dollar's real carry, has stalled and slightly reversed. We suspect that central banks and sovereign wealth funds may have re-focussed on domestic factors, which has in turn led to a rotation between other reserve currencies.

This includes a rotation out of Euros and move into Sterling and a rotation out of the safe haven Swiss Franc and in particular Japanese Yen into commodity reserve currencies – namely the Canadian and Australian Dollars and Norwegian Krone – and New Zealand Dollar. These four currencies' NEERs are now near the top end of their three-month ranges. In each case specific drivers have been in play, in our view. Our analysis suggests that the Norwegian Krone may still be "cheap" relative to the current price of Brent crude oil.

Figure 8 suggests that a rotation in and out of other (EM) currencies which were 1-2 months ago trading at the extremes of their ranges may have also taken place.

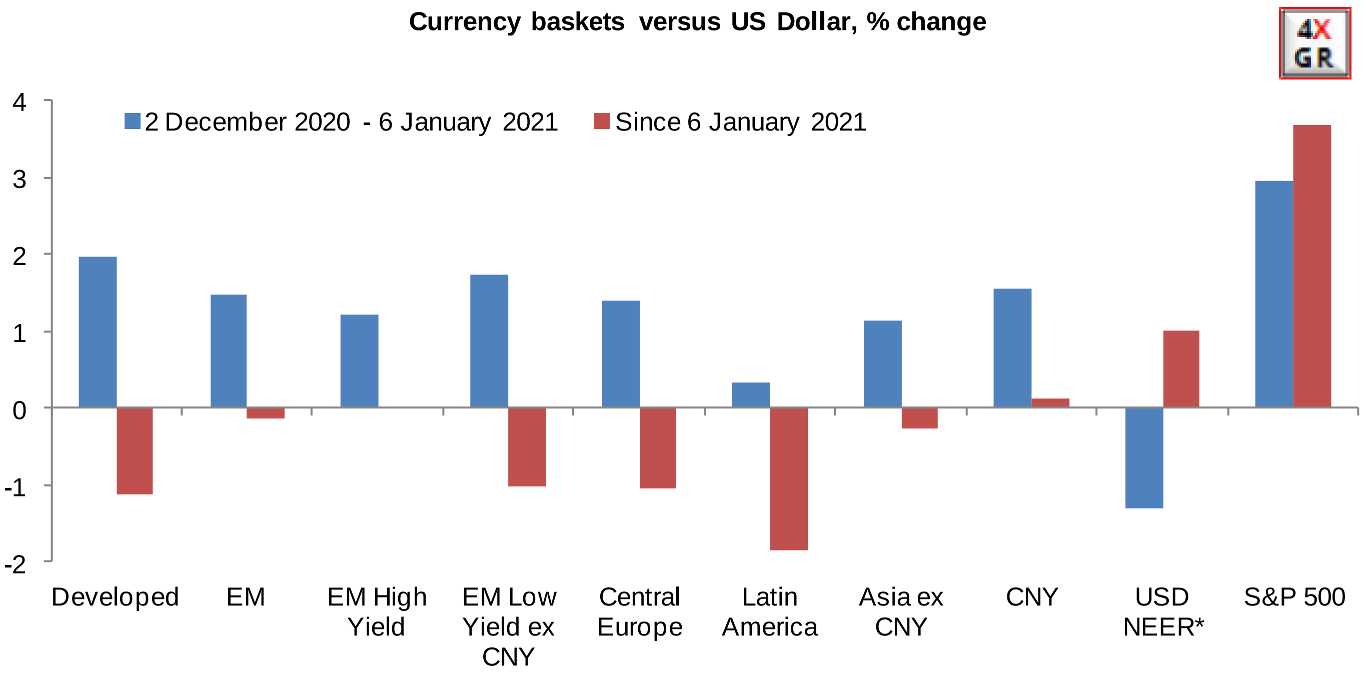
The Dollar NEER has weakened about 0.9% since 4th February and its inverse correlation with the S&P 500 (+1.2%) has re-established itself. We think this is a short-term correction, with another prolonged Dollar downtrend still a couple of months away.

Performance of Dollar, EM currencies and global equities in line with our forecasts

In the past nine weeks major currencies, including the US Dollar, and global equity markets have traded broadly in line with our expectations.

- **Global equities have continued to rally**, with the S&P 500 and MSCI All-Country World Equity Index up respectively 6.7% and 8.5% since 2nd December (see Figures 1 & 6). This has tallied with our view that "*global risk appetite would remain reasonably buoyant in coming months thanks to the not-so-distant prospect of one or multiple vaccines coming on line and the very high likelihood of Joe Biden fully assuming the US presidency on 20th January"*. The UK approved the Pfizer Covid-19 vaccine on 2nd December, the first country to do so (see Emerging Market currencies: Hopes and Realities, 2nd December 2020).

Figure 1: US Dollar, Asian and EM currencies and equities have performed broadly in line with our forecasts



Source: 4X Global Research, Federal Reserve, IMF, investing.com

Note: Developed is GDP-weighted basket of AUD, CAD, CHF, DKK, EUR, GBP, JPY, NOK, NZD and SEK; Central Europe is GDP-weighted basket of CZK, HUF, PLN and RON; EM High Yield is GDP-weighted basket of BRL, COP, IDR, INR, MXN, RUB, TRY and ZAR; Asia ex CNY is GDP-weighted basket of IDR, INR, KRW, MYR, PHP, SGD, THB and TWD; EM is GDP-weighted basket of African, Emerging Asian and European, and Latin American currencies; Latin America is GDP-weighted basket of BRL, CLP, COP and MXN; * USD NEER is US Dollar Nominal Effective Exchange Rate

- The **Dollar** Nominal Effective Exchange Rate (NEER) – a (Federal Reserve) trade-weighted average of the Dollar versus the currencies of the United States' main trading partners –

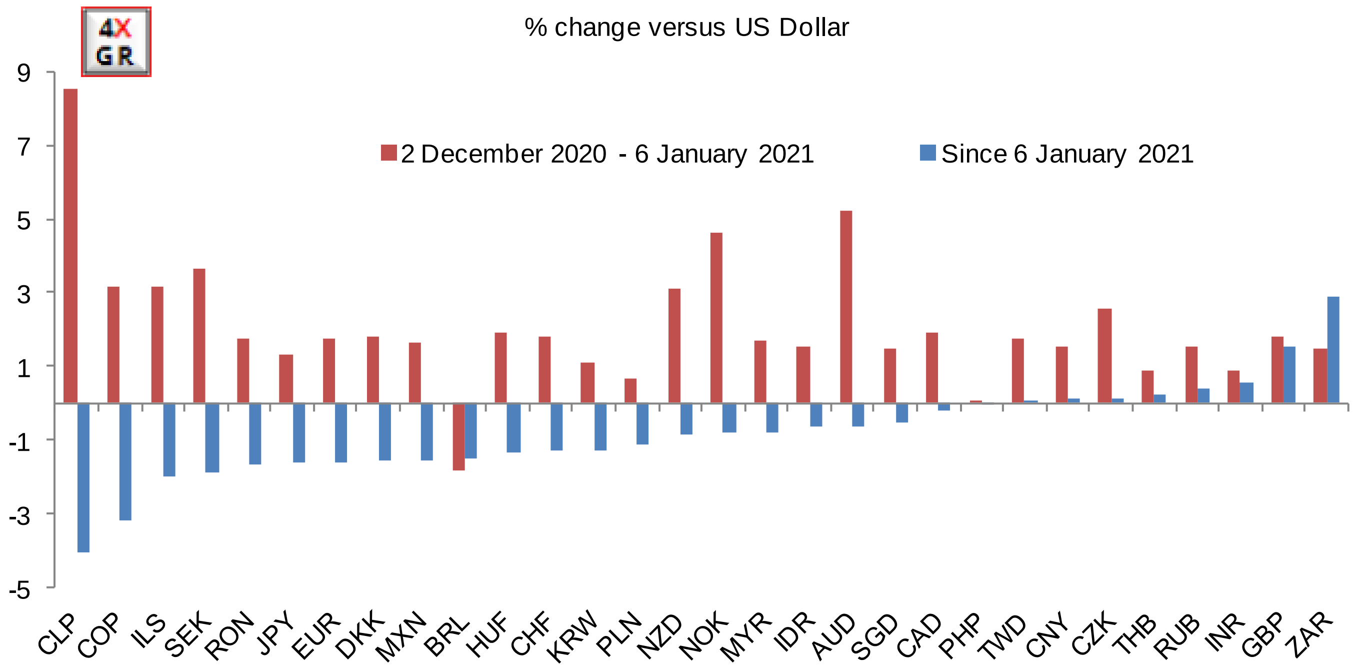
depreciated only 1.3% between 2nd December 2020 and 6th January 2021 – a 50-week low in the US Dollar NEER according to our estimates (see Figures 1, 5 & 6). This was again in line with our forecast that "*the Dollar would continue depreciating versus both developed and EM currency blocks but at a still very slow pace*" (see Emerging Market currencies: Hopes and Realities, 2nd December 2020).

- We also argued that "***Asia-Pacific economies** were likely to benefit from rapid Chinese economic growth and its robust imports but Asian central banks were unlikely to allow rapid currency appreciation given the still very uncertain global outlook*." A GDP-weighted basket of emerging Asian currencies (excluding the Chinese Renminbi) appreciated only 1.1% versus the US Dollar (see Figure 1).

- Finally our analysis led us to be believe that **Emerging Market (EM) currencies** would remain prone to sharp sell-offs (even if short-lived) due to:

    - In some cases stretched valuations (e.g. Brazilian Real and Colombian Peso);
    - The narrowing yield spread between EM and developed-market currencies;
    - A weaker US Dollar presenting an extra challenge for EM economies for which the United States is a major trading partner;
    - National lockdowns likely continuing to weigh on already very weak global GDP growth, the odds of the US approving a second fiscal stimulus package in the next 4-6 weeks remaining low and poorer, populous EM economies lagging richer nations in terms of distributing the vaccine to a significant share of their populations.

Figure 2: Emerging market currencies have been prone to sharp pull-backs in past month



Source: 4X Global Research, investing.com

Our predictions have mostly panned out. A number of EM currencies, particularly in Latin America (including the Colombian and Chilean Pesos) which had appreciated rapidly between 2nd December and 6th January have since weakened sharply (see Figure 2). The Brazilian Real – the weakest major currency since 2nd December – has weakened about 3.4% versus the Dollar.

Macro data point to still very weak economic growth in the United States in January while GDP growth likely slowed quite sharply in the Eurozone and in particular the United Kingdom due in large parts to tight national lockdowns still being in effect.

- In the United States, economic activity only rebounded marginally in January based on so-far released macro data (see Figure 3 and Biden's trump cards and challenges, 12th January 2021). Two months on from our 2nd December 2020 report and President Joe Biden's $1.9trn coronavirus stimulus package, which the Senate approved on 5th February (in a hung vote decided by Vice-President Kamala Harris' casting vote), has yet to be approved by the House of Representatives and signed into law by President Biden.

Figure 3: US macro data point to still weak economic growth in January

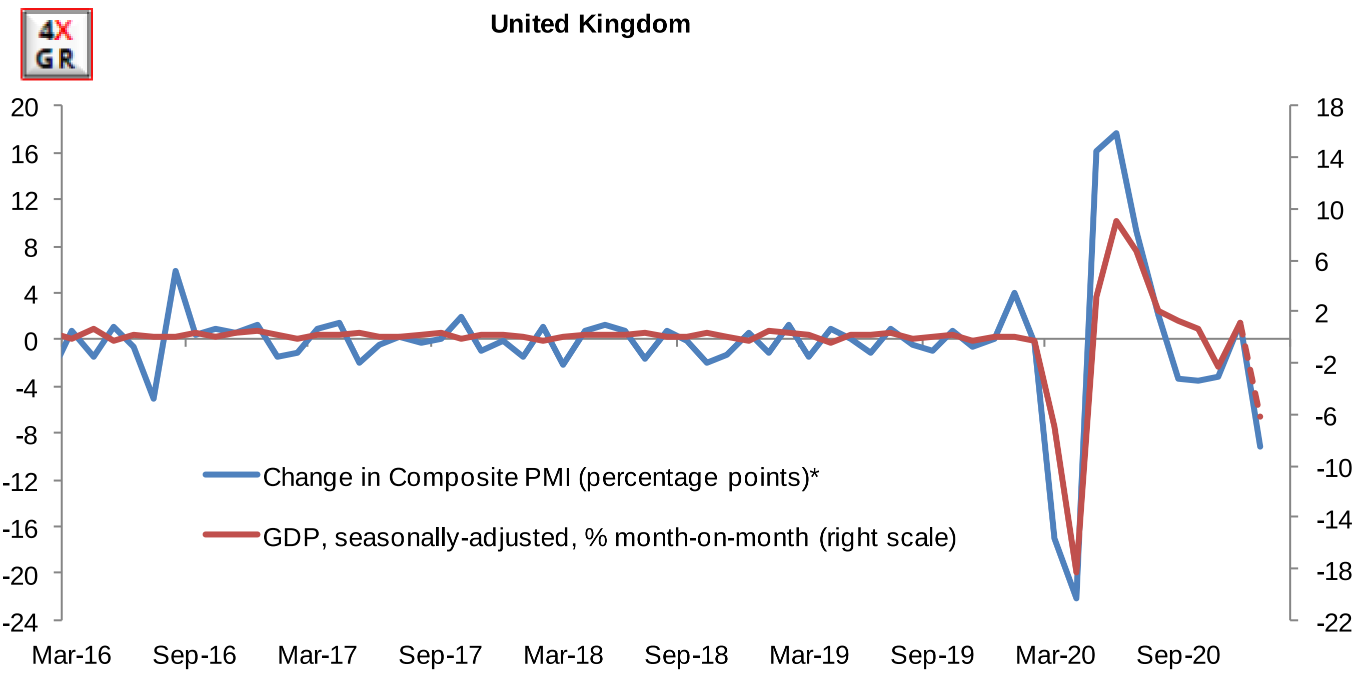
United States Macro Indicators	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21
Core CPI-inflation, % year-on-year	1.4	1.2	1.2	1.6	1.7	1.7	1.6	1.6	1.6	1.4
Core PCE-inflation, % year-on-year	0.9	1.0	1.1	1.3	1.4	1.5	1.4	1.4	1.5	
US Dollar Nominal Effective Exchange Rate, % change in monthly average	2.7	-0.4	-2.5	-0.4	-1.1	-0.5	-0.1	-1.4	-1.7	-0.1
Personal disposable income, constant prices, seasonally-adjusted, % month-on-month	15.6	-4.8	-1.8	0.5	-3.3	0.6	-0.8	-1.5	0.2	
Personal Consumption Expenditure (PCE), constant prices, seasonally-adjusted, % month-on-month	-12.3	8.5	5.9	1.2	0.9	1.1	0.2	-0.7	-0.6	
Retail sales, constant prices, seasonally-adjusted, % month-on-month*	-14.3	18.1	8.0	0.9	1.1	1.6	-0.1	-1.4	-0.8	
Non-Farm payrolls, seasonally-adjusted, change (thousands)	-20,679	2,833	4,846	1,726	1,583	716	680	264	-227	49
Conference Board consumer confidence index	85.7	85.9	98.3	91.7	86.3	101.3	101.4	92.9	87.1	89.3
Manufacturing output, seasonally-adjusted, % month-on-month	-15.8	3.8	7.7	4.2	1.4	0.1	1.3	0.8	0.9	
ISM manufacturing PMI, seasonally-adjusted, percentage point change	-7.6	1.6	9.5	1.6	1.8	-0.6	3.9	-1.8	3.0	-1.8
ISM non-manufacturing PMI, seasonally-adjusted, percentage point change	-10.7	3.6	11.7	1.0	-1.2	0.9	-1.2	-0.7	1.8	1.0
Durable goods orders, seasonally-adjusted, % month-on-month	-18.3	15.0	7.7	11.8	0.4	2.1	1.8	1.2	0.2	
New orders for non-defense capital goods excluding aircrafts, seasonally-adjusted, % month-on-month	-6.6	1.5	4.3	2.6	2.4	1.9	1.7	1.0	0.6	
Goods & services trade balance, seasonally-adjusted, $ bn	-52.5	-56.2	-51.9	-62.1	-65.6	-62.7	-63.8	-69.0	-66.6	
New privately-owned housing units started ("Housing Starts"), seasonally-adjusted, % month-on-month	-26.4	11.1	21.9	17.5	-7.7	4.7	6.5	3.1	5.8	
GDP, quarter-on-quarter seasonally-adjusted annualised rate (%)		-31.4			33.4			4.0		
S&P 500, % month-on-month	12.7	4.5	1.8	5.5	7.0	-3.9	-2.8	10.8	3.7	-1.1

Source: 4X Global Research, Conference Board, Federal Reserve, Institute of Supply Management, investing.com, US Bureau of Economic Analysis, US Bureau of Labour Statistics, US Census Bureau

*Note: *US Dollar-value of retail sales deflated by headline PCE-inflation*

- GDP in the **United Kingdom** rebounded 1.2% mom in December but the 9.2 percentage point collapse in the Composite Purchasing Managers Index (PMI) in January points to a sharp contraction in GDP, led by a service sector which has largely been mothballed, in the first month of 2021 (see Figure 4 and Forecast review: USD, CNY, EM & global growth, 21st December 2021). The Eurozone composite PMI fell 2.3 percentage points in January.

Figure 4: United Kingdom's GDP rebounded in December but this was likely a false dawn



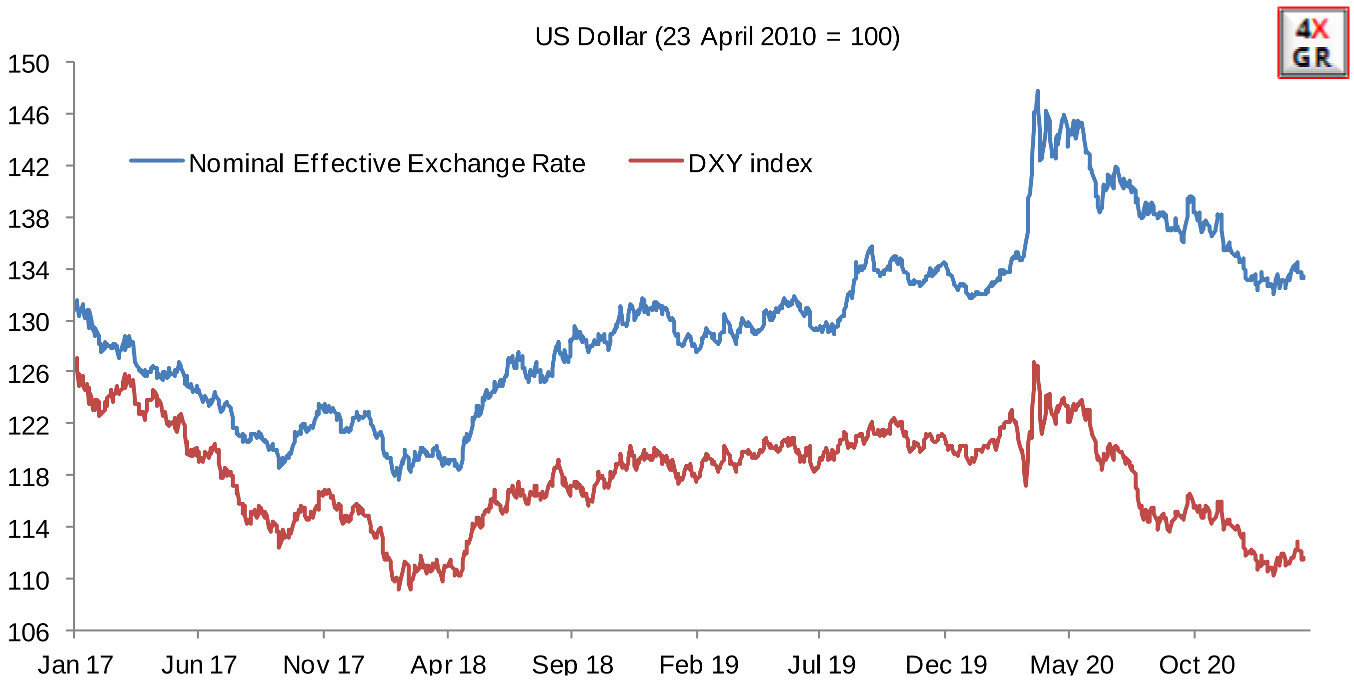
Source: 4X Global Research, IHS Markit/CIPS, Office of National Statistics

Note: * Composite PMI is a weighted average of the manufacturing output index and the services business activity index. Latest data point for GDP growth (January 2021) is 4X Global Research forecast.

Breakdown in correlations points to diversification out of Dollars having stalled

Since 6th January 2021 the US Dollar NEER has appreciated about 1.0% (see Figures 1, 5 & 6), in line with our view that "*greater scope for more rapid Dollar depreciation and EM currency outperformance was only likely beyond February"* (see Emerging Market currencies: Hopes and Realities, 2nd December 2020). The corollary is that in the past nine weeks the US Dollar NEER has moved very little, remaining in a very narrow range and confounding markets' overwhelmingly bearish view (see Figure 8).

Figure 5: Dollar stuck in a very narrow range in the past two months



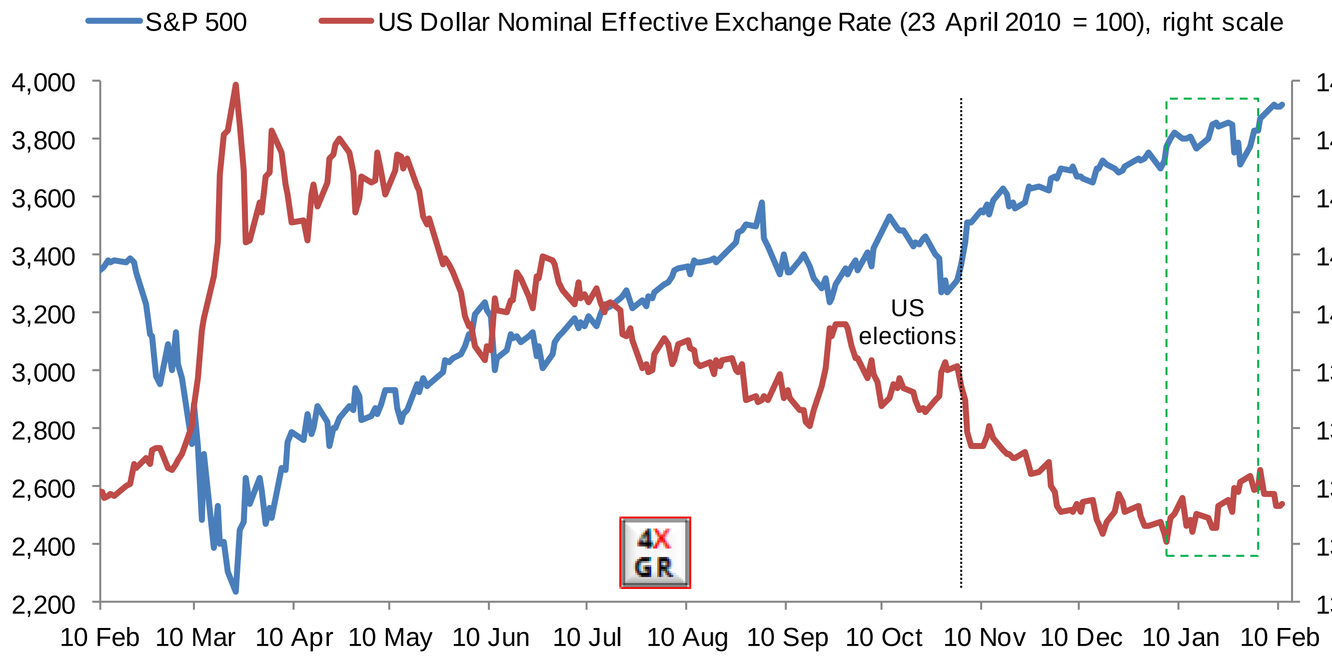
Source: 4X Global Research, Federal Reserve, investing.com

Note: DXY index is weighted average of the Dollar against the Euro, Japanese Yen, Sterling, Canadian Dollar, Swedish Krona and Swiss Franc

Importantly, well established historical correlations have somewhat broken down in the past five weeks.

Between February 2020 and early January 2021 the "safe-haven" Dollar NEER was inversely correlated with the S&P 500 (a proxy for global risk appetite). However, between 6th January and 4th February this negative correlation largely broke down, as highlighted in Figure 6 (and in Figure 1). The Dollar NEER rallied about 1.9% in the four weeks to 4th February, almost as much as the S&P 500 (+2.5%) according to our estimates.

Figure 6: Negative correlation between Dollar and S&P 500 broke down in January



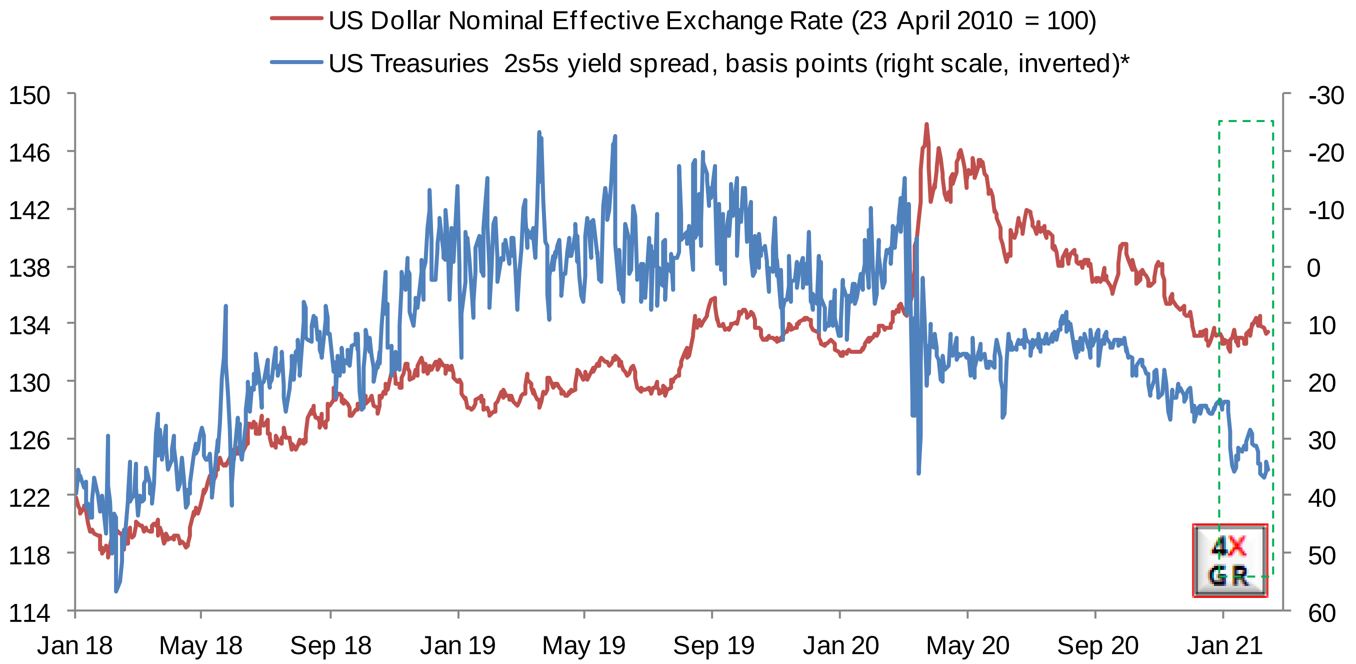
Source: 4X Global Research, Federal Reserve, investing.com

Moreover, the inverse correlation between the Dollar NEER and the steepness of the US Treasury yield curve has also become far more tenuous in recent weeks (see Figure 7).

Specifically the consensus view has been that President Biden's $1.9trn stimulus package, which would come on top of the already approved $900bn package, will lead to higher US inflation. But this will not result in a corresponding increase in the Federal Reserve policy rate (due to the central bank's asymmetric inflation target) nor in short-term government bond yields, at least in the near-term. FOMC members in recent weeks have confirmed that a tapering of the Federal Reserves' QE program, let alone policy rate hikes, were very unlikely near term as loose monetary policy was still needed to support a weak US economy. As a result US 2-year Treasury yields have continued to inch lower, ultimately devaluing market expectations of the Dollar's real (i.e. inflation-adjusted) carry.

At the same time loose fiscal and monetary policy today tends to presage tighter monetary policy tomorrow and 5-year Treasury yields have inched higher in the past five weeks, resulting in a further steepening of the 2s-5s curve. However, the Dollar has appreciated (even if marginally), not weakened.

Figure 7: Dollar has appreciated, even if marginally, despite further steepening of 2s-5s Treasury yield spread



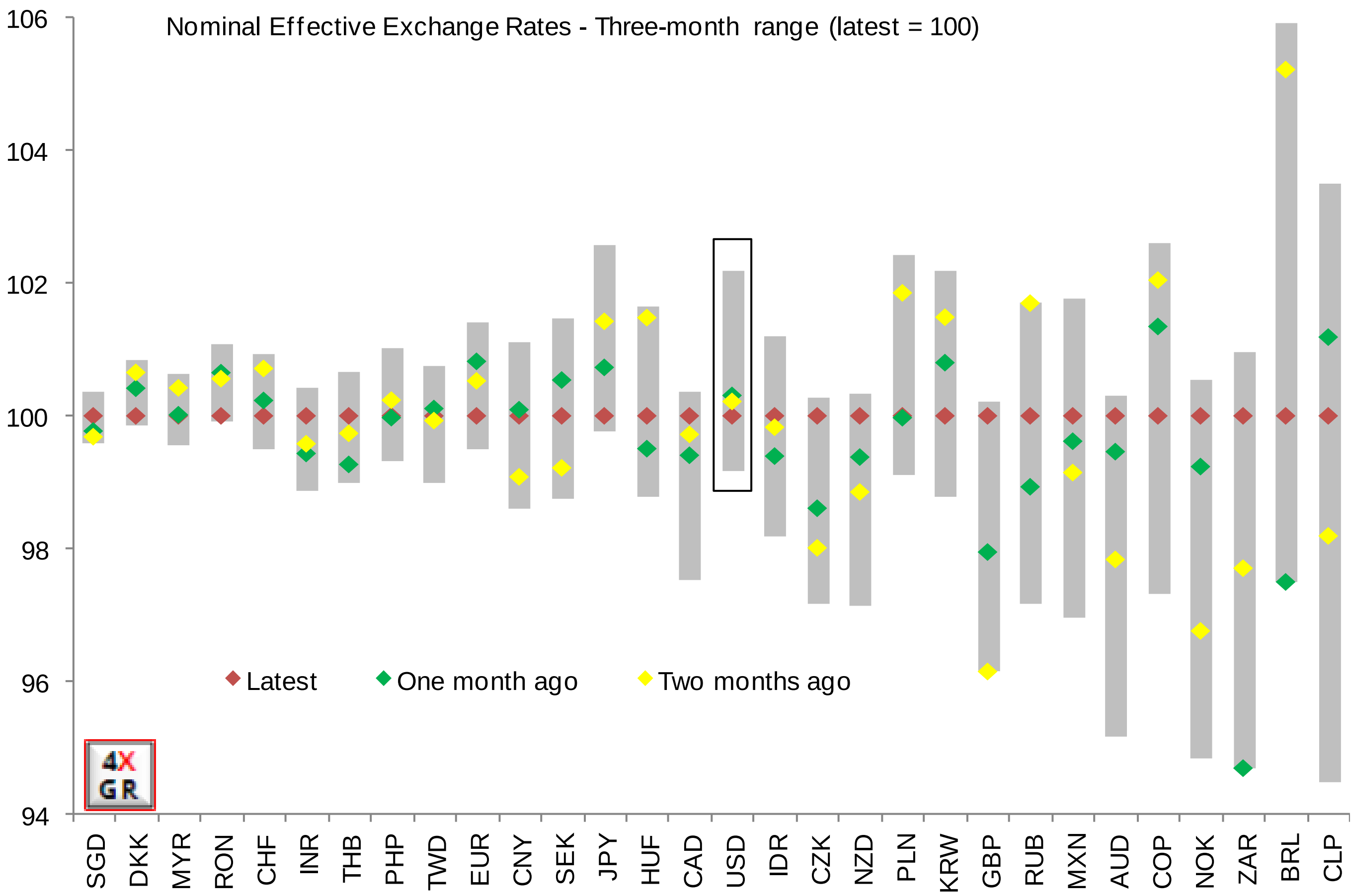
Source: 4X Global Research, Federal Reserve, investing.com

Dollar Diversification has given way to rotation among other major reserve currencies

This breakdown in historical correlations would tend to confirm in our view that the broad-based diversification out of Dollars, driven by buoyant global risk appetite and market concerns about the Dollar's real carry, has stalled and slightly reversed since early January (see Dollar – Diversification, rotation and valuations, 18th January 2021). We suspect that central banks and Sovereign Wealth Funds may have re-focussed on (stretched) currency valuations and domestic factors, which has in turn led to a rotation between other reserve currencies, including a move out of Euros and corresponding move into Sterling.

The GBP/EUR cross rallied a further 1.6% since 18th January to a nine-month high just above 1.14 at time of writing. We still in large part attribute this uptrend to the relative pace of vaccination in the United Kingdom and the Eurozone, with the UK maintaining a healthy lead over its European counterparts. The UK has to date given about 14 million Covid-19 doses whereas in comparison France has only given about 2.7 million (both countries have similar population sizes). As a result the Sterling NEER is now trading at the very strong end of its three-month range whereas the Euro NEER, which a month ago was trading in the upper half of its range, is now in the weaker half (see Figure 8).

Figure 8: Rotation in and out of (reserve) currencies has likely coloured currency performance



Source: 4X Global Research, Bank of England, BIS, European Central Bank, Federal Reserve, investing.com

There has seemingly been a rotation out of other major reserve currencies, including the safe haven Swiss Franc and Japanese Yen. In particular the Yen NEER has weakened from the strong end of its range to the weak end. Conversely, commodity reserve currencies – namely the Canadian and Australian Dollars and Norwegian Krone – have appreciated. The New Zealand Dollar has also outperformed in the past two months. These currencies' NEERs are currently at or near the top end of their three-month ranges (see Figure 8). In each case specific drivers have been in play, in our view.

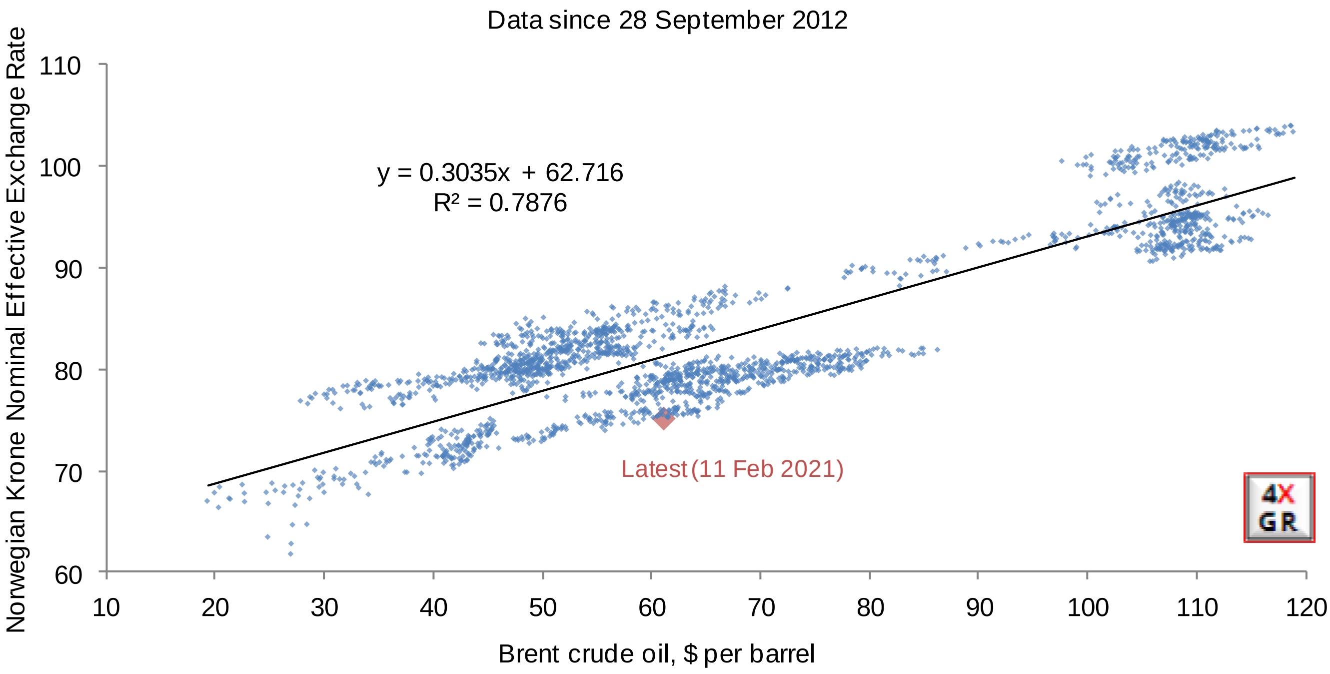
- The **Australian Dollar** has arguably benefited from the rapid recovery in the economy of China, Australia's largest trading partner.

- The **Kiwi Dollar** has benefited from New Zealand having successfully quashed the Covid-19 virus, the economy having returned to near normality and an ongoing widening of the external trade surplus. Moreover, market expectations are that the Reserve Bank of New Zealand, faced with surging property prices, will hike (not cut) its policy rate going forward.

- The **Canadian Dollar** has likely benefited from expectations of a more cordial relationship between Canada and the United States since Biden's election as president. The sharp rise in the price of crude oil since late-October has also likely been a key factor behind the ascendancy of the Canadian Dollar and **Norwegian Krone,** in our view.

Historically (and perhaps unsurprisingly) the Norwegian Krone NEER has correlated strongly with the price of Brent crude oil (see Figure 9).

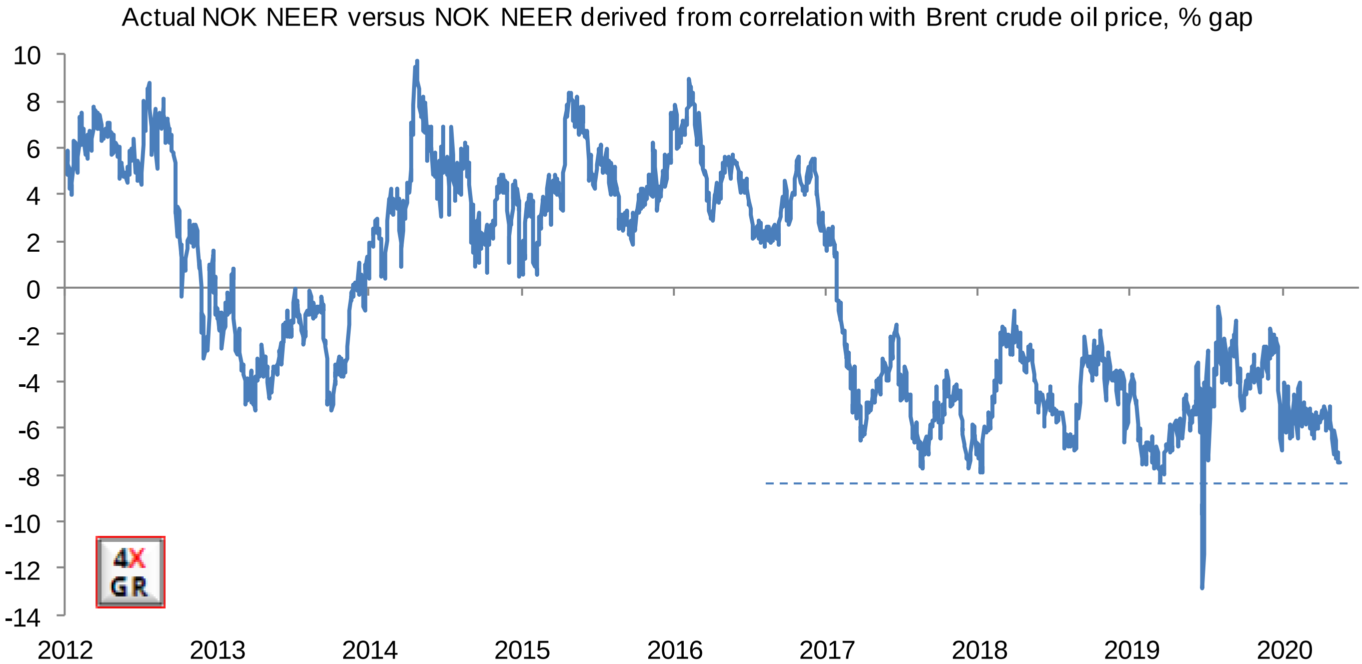
Figure 9: History suggests that sharp rise in crude oil price has materially benefited Norwegian Krone



Source: 4X Global Research, BIS, investing.com

Moreover, the Krone may still be “cheap” relative to the current price of Brent crude oil (about $75 per barrel). Based on the historical relationship between the Krone NEER and Brent crude oil price – which has an R-squared of almost 0.8 – we estimate that the Krone NEER is currently about 7.5% weaker than where it should be trading all other things being equal (see Figure 10). This gap in the past 8.5 years has rarely been larger, with the exception of March 2020 when global risk aversion saw the Norwegian Krone significantly underperform relative to the prevailing price of Brent crude oil.

Figure 10: Norwegian Krone still looks "cheap" relative to crude oil price



Source: 4X Global Research, BIS, investing.com

Note: NOK NEER is Norwegian Krone Nominal Effective Exchange Rate which we derive from spot exchange rates and BIS currency weights

Figure 8 suggests that a rotation in and out of other currencies which were 1-2 months ago trading at the extremes of their ranges may have also taken place. These include currencies which have appreciated from the weak end of their ranges (e.g. Chinese Renminbi, Singapore Dollar, Thai Baht) and currencies which have depreciated from the strong end of their ranges (e.g. Colombian Peso). Other currencies have found their feet broadly in the middle of their three-month ranges (e.g. Hungarian Forint, Swedish Krona).

Broadly speaking emerging Asian currencies, with perhaps the exception of the Korean Won and high-yielding Indonesian Rupiah, have continued to trade in relatively narrow ranges. We again attribute this to the ability and willingness of Asian central banks to actively manage their currencies' volatility and directionality. In particular the Thai Baht, Malaysian Ringgit, Taiwan Dollar and even high-yielding Indian Rupee NEERs have barely moved in the past two months, suggesting that these currencies' central banks view current exchange rate levels as broadly optimal from a perspective of maintaining export competitiveness while avoiding domestic inflationary pressures.

Recent Dollar dip – Blip or start of new downtrend?

The Dollar NEER has weakened about 0.9% since 4th February (its strongest level since end-November) and its inverse correlation with the S&P 500 (+1.2%) has re-established itself (see Figure 6). This begs the question of whether the Dollar is about to embark on another prolonged downtrend, with Dollar diversification once again driven by market concerns of its relative attractiveness, or whether this is just a small, short-term correction.

At this stage we think it is more likely the latter and stick to our view that material Dollar depreciation may not resume for another couple of months, until it becomes clearer that a matrix of loose US fiscal policy but still low US interest rates will dent the Dollar's attractiveness. At the same time we think the slow start of the vaccination process in many major developed and EM economies could delay a rebound in global confidence and GDP growth and in turn act as a brake for EM currencies as a whole.

In any case we think that any resumption in Dollar depreciation is unlikely to be as broad-based as it was in November and early-December when all 31 major currencies we track appreciated versus the Dollar. Put differently, we think that markets will continue to pay greater attention to domestic factors, including valuations and potentially monthly seasonal patterns, when picking their winners and losers in the currency space (see Currency seasonality's slow comeback?, 2 February 2021). We will explore this theme in greater detail in forthcoming Fixed Income Research & Macro Strategy reports.

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