4X Global Research

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Fixed Income Research & Macro Strategy (FIRMS) – 19th April 2021

Dollar and the three bears

The US Dollar Nominal Effective Exchange Rate (NEER) traded in a narrow range of 1.8% between late-2020 and early March, according to our estimates. The Dollar then embarked on a 3-4 week rally, driven by rising US Treasury yields, the stretched valuations of other major currencies and still tepid global economic activity.

Since end-March the Dollar NEER has depreciated 1.8% to a 7-week low. Stronger US economic growth – fuelled in part by the government's $1.9 trn coronavirus relief package – alongside lower US yields across the maturity spectrum and rising US and global equities have weighed on the "safe-haven" Dollar's relative attractiveness.

Global FX volatility has remained subdued and well below its 10-year average. However, the performance of major currencies has, unlike in November-December, been far from even.

In particular, Non-Japan Asian currencies have underperformed which we attribute in part to NJA central banks' more pro-active management of their currencies.

This timeline, its drivers and the relative performance of the Dollar and major currencies, including in the emerging market space, have been in line with our expectations (see *Forecast review: USD, CNY, EM & global growth,* 21st December 2020, *Dollar – Diversification, rotation and valuations*, 18th January 2021, *Dollar's recent weakness – Blip, not new trend*, 12th February 2021 and *US and UK: The Comeback Kids*, 5th March 2021).

Further US Dollar depreciation in weeks ahead, in our view, remains conditional on both:

i) The ability of a dovish Federal Reserve and FOMC members to further jawbone lower or at the very least cap US Treasury yields; and

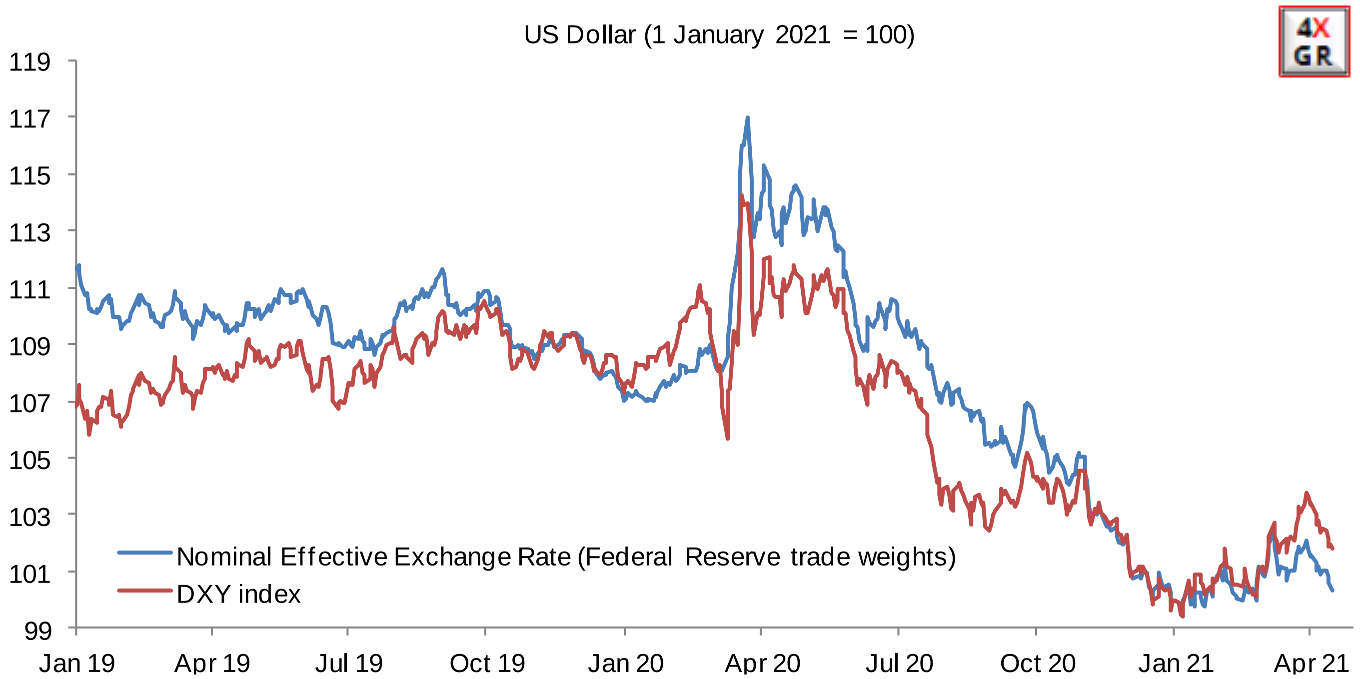
ii) Global macro indicators continuing to point to a pick-up in economic growth.

Our core scenario is that the Dollar will indeed lose further ground but that the performance of other major currencies will be conditioned by powerful, often inter-related domestic factors and thus remain far from uniform.

US Dollar has performed in line with our expectations in past four months

The Dollar Nominal Effective Exchange Rate – a (Federal Reserve) trade-weighted average of the Dollar versus the currencies of the United States' main trading partners – traded in a narrow range of about 1.8% between 21st December 2020 and early March 2021, according to our estimates (see Figure 1).

Figure 1: US Dollar's path, including Q1 strength and sell-off since late-March, has mirrored our expectations



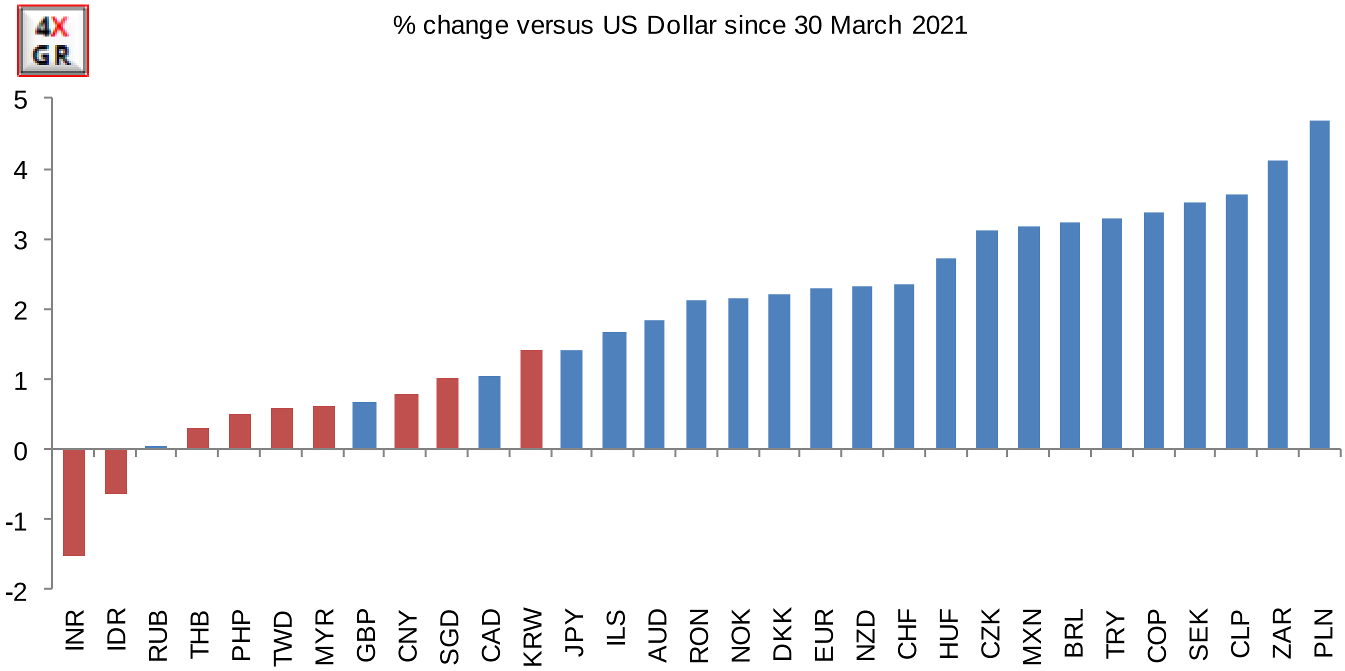
Source: 4X Global Research, Federal Reserve, investing.com

This was in line with our forecast that "*there is greater scope for more rapid Dollar depreciation and EM currency outperformance beyond February but the risk is clearly that this timeline will slip to March or April*" (see Forecast review: USD, CNY, EM & global growth, 21st December 2020). Specifically we argued that "*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 likely dent the Dollar's attractiveness*" (see Dollar – Diversification, rotation and valuations, 18th January 2021).

Dollar weakness in early February proved temporary, in line with our view that the Dollar NEER's 0.9% depreciation between 4th and 12th February was more likely "*a short-term correction, with another prolonged Dollar downtrend still a couple of months away*" (see Dollar's recent weakness – Blip, not new trend, 12th February 2021). Our moderately bullish near-term outlook for the "safe-haven" Dollar was premised on evidence that *"the broad-based diversification out of Dollars, driven by buoyant global risk appetite and market concerns about the Dollar's real carry, has slightly reversed*". This reversal was partly the result of currency valuations – an important factor for sovereign wealth funds in our view – and ongoing market concerns about still modest US and in particular weak global GDP growth benefiting the Dollar (see Dollar – Diversification, rotation and valuations, 18th January 2021, and below for GDP discussion).

The Dollar NEER hit a 3-week high on 30th March but on cue has since depreciated about 1.8% to a 7-week low (see Figure 1). The combination of a moderation in US Treasury yields alongside an acceleration in US economic activity in the past month and pick-up in global growth has matched our forecasted timeline and weighed on the Dollar while on the whole benefiting Emerging Market (EM) currencies.

Figure 2: Major currencies' performance since end-March has been far from uniform…



Source: 4X Global Research, investing.com

Note: Non-Japan Asian currencies highlighted in red

Orderly FX markets re-focussing on domestic, idiosyncratic factors

However, the performance of major currencies in the past 17 days has not been uniform. This has again been in line with our view that "*Dollar depreciation will […] in any case not be as broad based as in November/early-December, when all 31 major currencies we track appreciated versus the Dollar, with markets paying greater attention to domestic factors, including valuations"* (see Dollar – Diversification, rotation and valuations, 18th January 2021).

Since 30th March nine EM currencies and the Swedish Krona have appreciated by 3% or more versus the US Dollar but two currencies (the Indian Rupee and Indonesian Rupiah) have depreciated, the Russian Rouble is broadly unchanged while eight currencies have made gains of less 1% or less (see Figure 2). **A number of often inter-related domestic factors have been key drivers of this relative performance. They include:**

i) The extent to which national lockdown measures have been loosened or tightened and the impact on economic activity;

ii) Covid-19 related numerics (including cases, hospitalisation rates, deaths and the advent of new variants of the virus);

iii) Covid-19 vaccination rates;

iv) Interest rate policy. Central banks in Brazil, Turkey and Russia have hiked their policy rates in recent weeks (see EM currencies: Central bank friends and foes, 19th March 2021);

v) The extent to which national central banks have tried to manage their currencies, including via intervention in the FX market. We suspect that the tepid performance of Non-Japan Asian currencies since end-March (see red bars in Figure 2) is partly the result of NJA central banks' "hands-on" approach to exchange rate policy (see Non-Japan Asia: NEERs and FX intervention, 26th March 2021);

vi) Domestic politics (e.g. the recent appointment of a new central bank governor in Turkey);

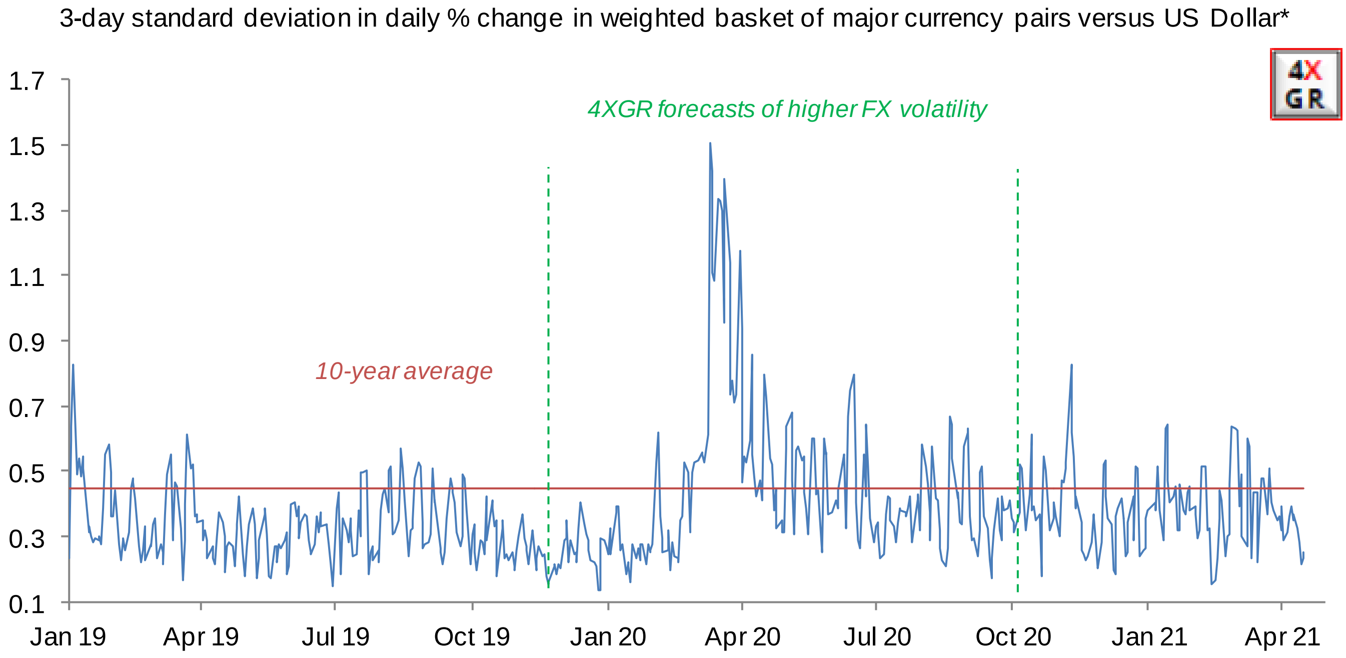
vii) Fiscal policy, including in the US households receiving Covid-19 relief cheques from January onwards (see US and UK: The Comeback Kids, 5th March 2021);

viii) The evolution of international commodity prices and their impact on countries' national balance of payments; and

ix) Geopolitics (e.g. Russia).

We would add that these major currencies' moves against the US Dollar have on the whole been orderly with global FX volatility having fallen to well below its 10-year average (see Figure 3).

Figure 3: …but currency moves have on the whole been orderly with global FX volatility subdued



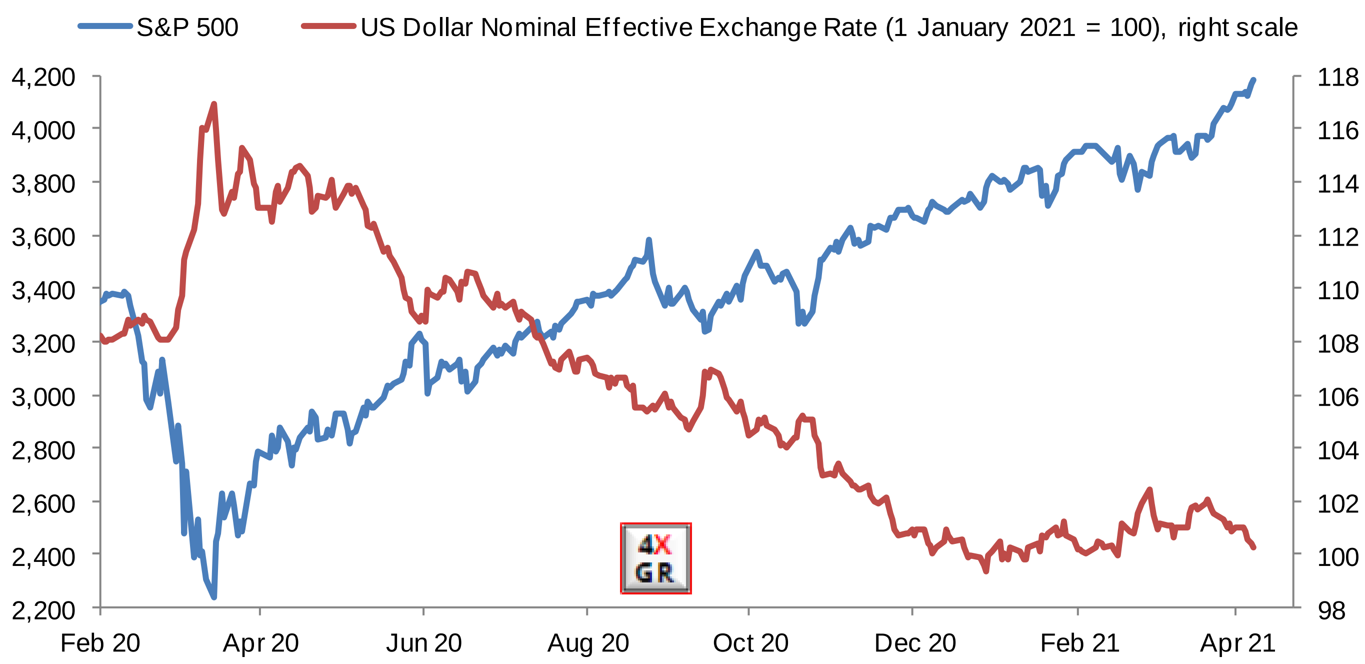
Source: 4X Global Research, BIS, investing.com

*Note: *Basket weighted by currency-pair turnover in 2019; currency pairs versus US Dollar are AUD, CAD, CHF, DKK, EUR, GBP, JPY, NOK, NZD, SEK, ARS, BRL, CLP, COP, MXN, CZK, HUF, PLN, RON, RUB, ZAR, TRY, ILS, CNY, IDR, INR, KRW, MYR, PHP, SGD, TWD and THB.*

Lower US Treasury yields, economic growth pick-up and equity rally weighing on Dollar

The Federal Reserve's consistently dovish rhetoric has, for now at least, done its job and pushed down US Treasury yields from their early-April highs. FOMC members have been broadly united in their view that they would look through any temporary rise in US CPI-inflation and not consider a tapering of the Federal Reserve's asset purchase program, let alone policy rate hikes, until there was strong evidence that economic growth and higher inflation were well anchored (see EM currencies: Central bank friends and foes, 19th March 2021).

Figure 4: Inverse relationship between safe-haven Dollar and S&P 500 has been robust in recent weeks



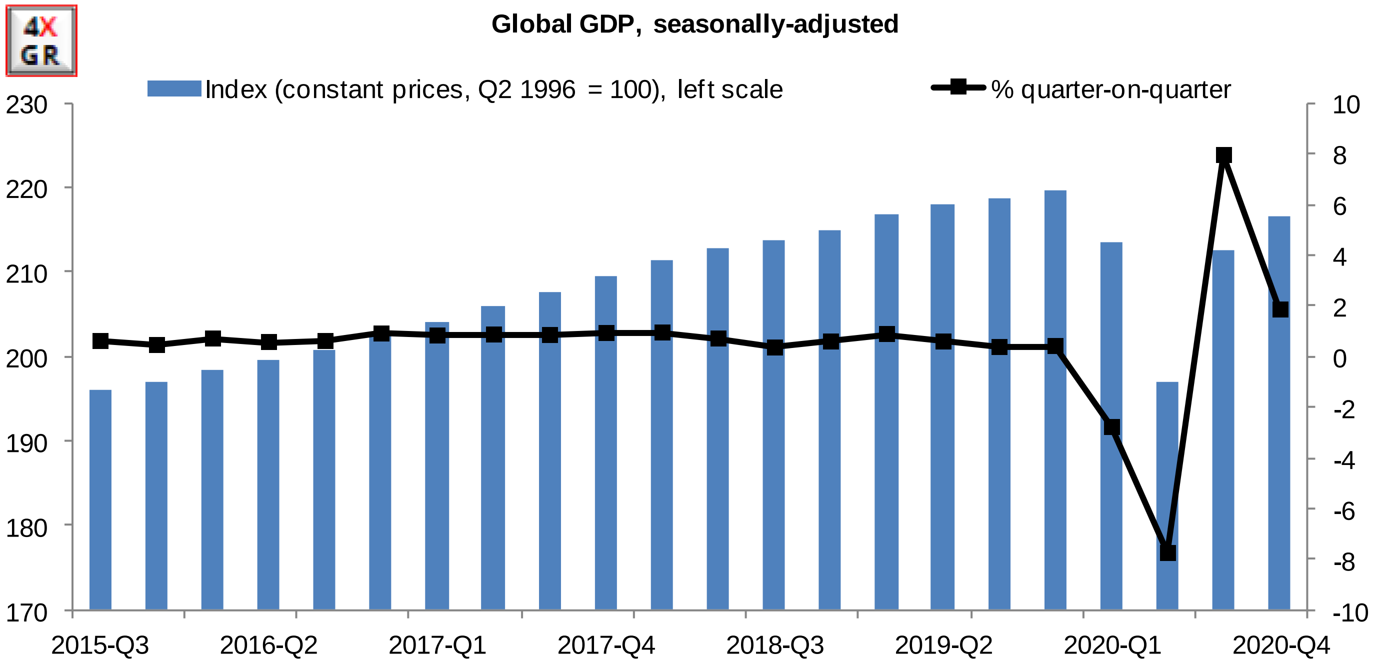
Source: 4X Global Research, Federal Reserve, investing.com

The fall in 2, 5 and 10-year US Treasury yields of 2.3bp, 13.3bp and 12.4bp respectively since their early-April peaks and flattening of the 2s-5s and 2s-10s yield curves have reduced the Dollar's nominal (and real) carry and thus its relative attractive versus riskier assets, including US equities. The inverse relationship between the "safe-haven" Dollar NEER and the S&P 500 (which has hit record highs in eight of the past eleven sessions) is once again well entrenched (see Figure 4).

The pick-up in global and in particular US economic growth in the past month has been the cherry on the icing for equities and a further headwind for the US Dollar, in our view. US economic growth – as measured by income and consumption – recovered in January-February, albeit from a low base, thanks in part to fiscal stimulus measures, a strengthening of the labour market and reasonably loose social distancing measures (see US and UK: The Comeback Kids, 5th March 2021). The majority of US macro indicators have pointed to an acceleration in economic growth in the past month or so, in our view.

Global GDP growth collapsed to about 1.8% qoq in Q4 2020 from 8% in Q3 according to our estimates and that of the World Bank's (see Figure 5). This was in line with our forecast that, with the risk tilted towards tighter national lockdown measures curtailing the service sector and labour markets still weak, "*global GDP growth would slow in Q4, potentially quite sharply, and not just because of less favourable base-effects*" (see Global growth: Collapse, Recovery, Slowdown…Repeat?, 24th September 2020).

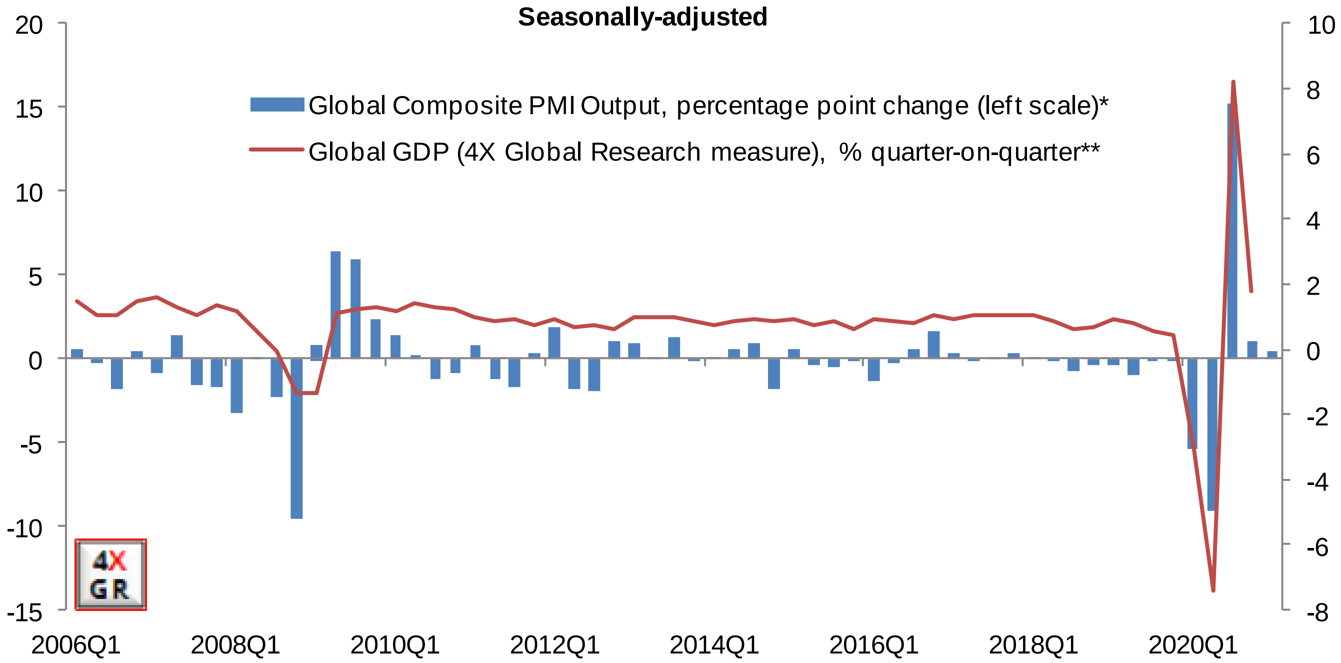
Figure 5: Global GDP growth slowed sharply in Q4 2020, in line with our expectations…



Source: 4X Global Research, Eurostat, IMF, national statistics offices, OECD, World Bank

Our historical analysis of global GDP growth and the Global Composite PMI, which increased by only 0.4 percentage points in Q1 2021, suggests that GDP growth may have slowed slightly in the first quarter of the year and in any case remained modest (see Figure 6). Chinese GDP growth, which in Q4 2020 accounted for about 28% of global growth according to our estimates, slowed to in 0.6% qoq in Q1 2021 from 3.2% qoq in Q4 2020 (China is so far the only major economy to have released Q1 2021 GDP data).

Figure 6: ….and likely remained weak in first quarter of 2021 based on Global Composite PMI data…

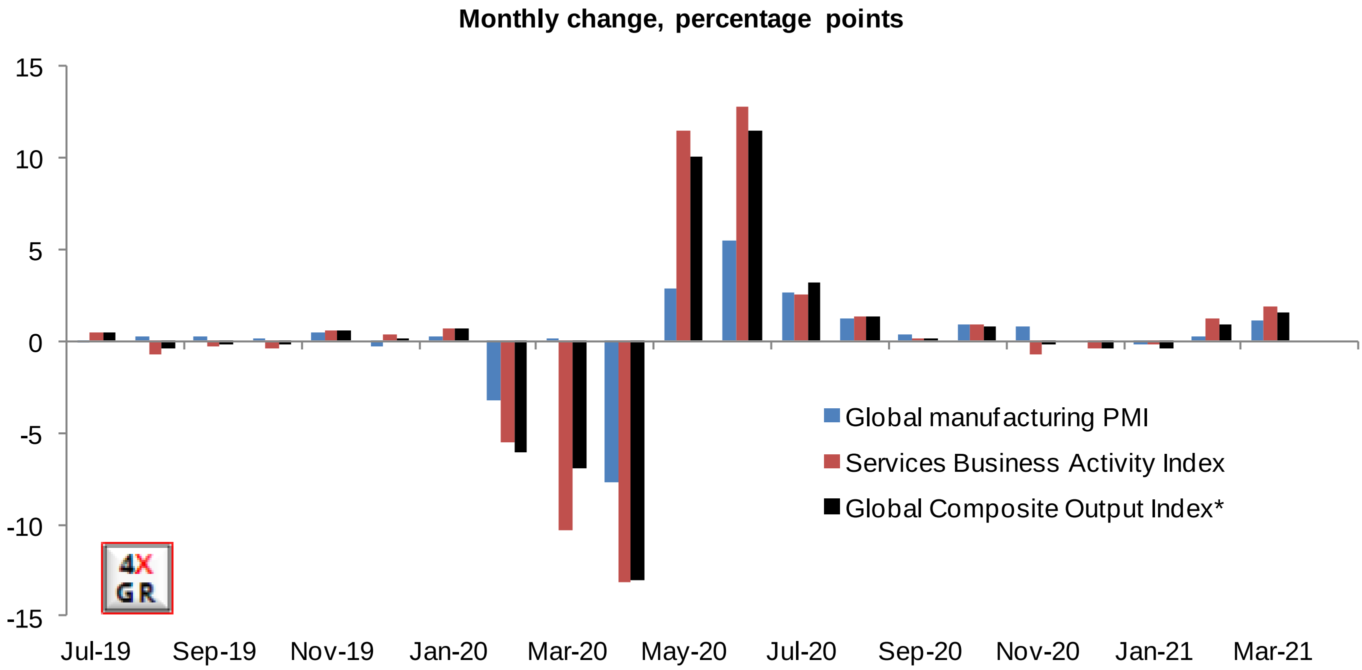


Source: 4X Global Research, IHS Markit, JP Morgan, World Bank

*Note: *Commonly referred to as Global Composite PMI. ** Calculated using IMF purchasing power parity weights.*

However, momentum in the Global Composite PMI picked in February and again in March, particularly in the service sector (which accounts for the largest share of GDP in developed economies), with the global PMI hitting a 79-month high of 54.8 in March (see Figure 7). We attribute this trend in part to national vaccination programs allowing a gradual loosening of lockdown measures and thus a pick-up in economic activity, alongside still very loose global monetary and fiscal policies.

Figure 7: ….but momentum in global economic activity picked up in March



Source: 4X Global Research, IHS Markit, JP Morgan

*Note: * The Global Composite Output Index is a weighted average of the Global Manufacturing Output Index (which accounts for 25% of the Global Manufacturing PMI) and the Global Services Business Activity Index (one of the eight components of the Services Index.*

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