U.S. DOLLAR TRIFECTA: INFLATION, ELECTIONS, POLICY

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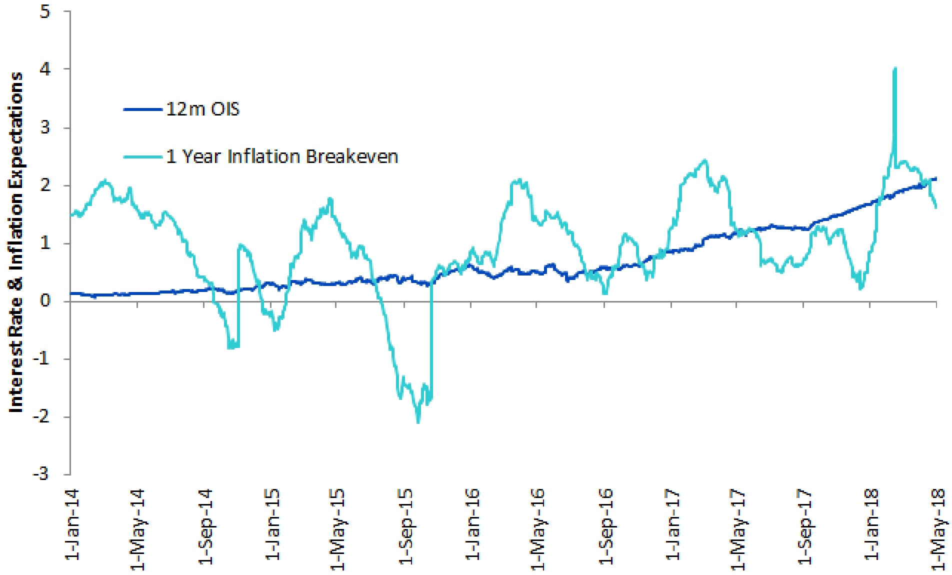
As we seek to understand movements of the U.S. dollar, we've noticed that there are three big-picture factors that come up time and again:

1. Inflation
2. Elections
3. Policy

Let's evaluate each of these in turn.[1]

Rising Inflation Can Push U.S. Dollar Toward Weakness

Interest Rate and Inflation Expectations (March 31, 2014, to May 2, 2018)



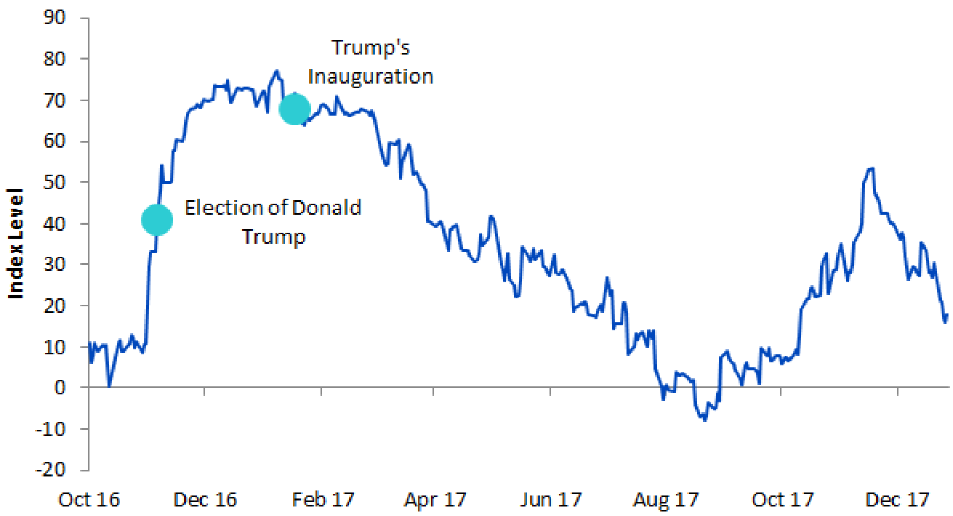
Sources: Bloomberg, Record Currency Management. Past performance is not indicative of future results. You cannot invest directly in an index.

- The 12-month overnight indexed swap (OIS) is indicative of what investors would receive if they were to roll the overnight interest rate over the course of a 12-month period, whereas the 1-year inflation breakeven takes the yield on the nominal 12-month t-bill minus the yield on the inflation-protected 12-month t-bill. Both have been on the rise as we've moved through 2017 and into 2018.

- Monitoring the picture of U.S. inflation using market-oriented gauges like this is of great value because it can help us look even beyond the U.S. dollar toward a toolkit of investments that might respond in a rising inflation environment. Stocks with growing dividends are of interest, as are other real assets, such as commodities, which can see their prices rise as somewhat of an inflation hedge.

U.S. Dollar Positioning Has Indicated Disappointment with President Trump

Citi FX Positioning Alert Indicator (PAIN) Index: USD Positioning (December 29, 2015, to December 29, 2017)

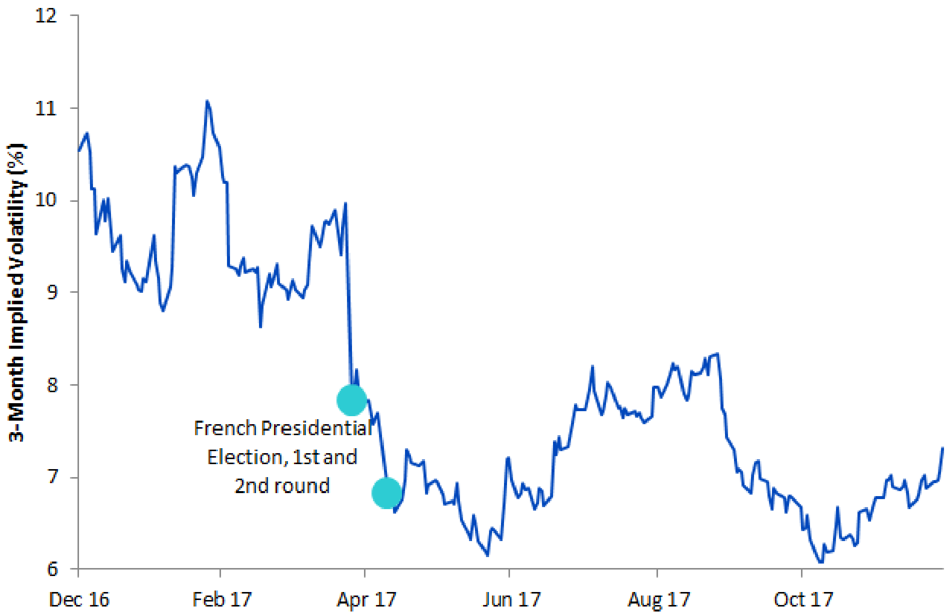


Sources: Citi, Macrobond, Record Currency Management. Past performance is not indicative of future results. You cannot invest directly in an index.

- The election and inauguration of Donald Trump saw great enthusiasm among dollar bulls who positioned themselves with lots of long-U.S. dollar exposure. The basis of this view was that the new administration would have the potential to extend the natural growth cycle, doing things like tax cuts and infrastructure spending late in the economic cycle.
- With the benefit of hindsight, we now know that even with Republican control in both the legislative and executive branches of the U.S. government, it was far from easy to implement a tax bill. An infrastructure spending policy remains to be seen as of this writing. This manifested itself in many dollar bulls becoming bearish, dramatically reducing their long-U.S. dollar positions. At times people have characterized the dollar weakness of 2017 as flow-related—this is a good gauge to provide evidence to that view.

Macron Election Opened the Door to Euro Strength

EURUSD 3-Month Implied Volatility (June 30, 2016, to December 29, 2017)

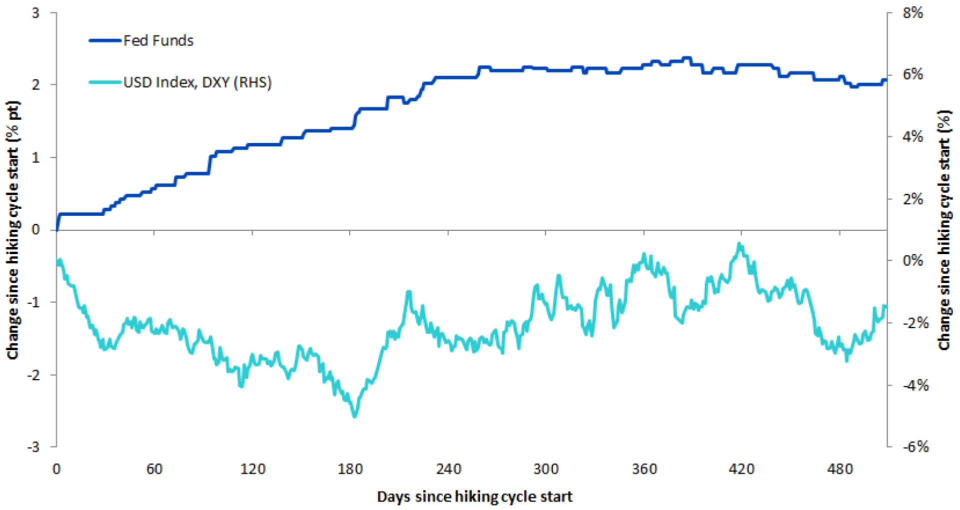


Sources: Bloomberg, Record Currency Management. Past performance is not indicative of future results. You cannot invest directly in an index.

- One of the most influential (and in 2017 most surprising) currency pairs was the euro versus the U.S. dollar. The biggest story in the first part of 2017—especially after the Trump election victory—was of the so-called "populist uprising." For markets, the most significant embodiment of that was Marine Le Pen. Her loss to Emmanuel Macron allowed investors to become a lot more comfortable with holding long-euro positions, as it was feared that a Le Pen victory would be a major turning of the tide toward euro skepticism.
- The euro-U.S. dollar 3-month implied volatility behavior does indicate a substantial lowering of implied risk in this exchange rate, the catalyst for which was the French election. During elections through the rest of 2017, the market never quite placed the same level of risk in the concept of euro skepticism, and one could think of this as removing an impediment to euro strength, as opposed to anything specifically related to dollar weakness.

Do Investors Have the Concept of Central Bank Policy Divergence Incorrect?

USD Index during Hiking cycles



Sources: Bloomberg, Record Currency Management. Average of past five hiking cycles (1986–88, 1988–90, 1994–96, 1999–2001, 2004–06).

- Capital flows toward higher relative interest rates and pushes up the value of higher-interest-rate currencies compared to lower-interest-rate currencies, right? In theory, yes, but in practice, like many aspects of thinking about currency movements, it is not that simple. Here we look at the average of the past five interest rate hiking cycles at the U.S. Federal Reserve (Fed). In general, these policy shifts have been more likely, at least historically speaking, to be accompanied by a weaker dollar than a stronger one.
- An explanation of the phenomenon, especially valid in today's markets, is that the Fed is very apt to communicate a lot about its intended path of policy, not wanting to spook markets. As a result, when then Fed Chairman Benjamin Bernanke started talking about tapering quantitative easing purchases in May 2013, global markets reacted in a way that we now call the taper tantrum. Broad-based dollar appreciation followed. When we began 2017 or 2018, in contrast, market participants broadly have a baseline of SEVERAL EXPECTED policy hikes, and if anything the surprise would occur only in the other direction.

Bottom line: When thinking about central banks, investors should start from a standpoint of what might surprise markets with new information, rather than a widely anticipated environment of policy divergence.

Considerations for 2018 & Beyond

It will be important to continue monitoring these different factors, thinking about the potential for surprises. Will weaker economic data out of the eurozone inspire further easy monetary policy from the European Central Bank? Are there political risks in Europe, perhaps from Italian elections, that cause questions about the euro area? Will U.S. inflation surprise to the upside in significant fashion? The answers to these types of questions, in our view, will have the potential to shift the tides in currency markets much more than what investors largely know and expect today.

[1]We'd like to thank Record Currency Management, a global thought leader on currencies, for analytical support in this blog series.

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DEFINITIONS

Inflation : Characterized by rising price levels.

Overnight Index Swap (OIS) : an interest rate swap that consists of both a fixed and a floating rate component. The floating rate part uses an overnight rate index, in the case of the U.S. dollar the Federal Funds Rate, while the fixed portion is set at an agreed-upon rate between the two parties.

Break-even inflation rate : For a given bond maturity, for example five years, the interest rate on the five-year nominal bond minus the interest rate on the five-year inflation adjusted bond; meant to approximate expected inflation over that time frame, in this case five years.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Bullish : a position that benefits when asset prices rise.

Implied volatility : The estimated volatility of a security's price. Implied volatility is a way of estimating the future fluctuations of a security's worth. It is backtracked from live option prices with a future maturity date.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Taper tantrum : a period in which global interest rates rose dramatically in 2013 as a response to a shift in monetary policy by the Federal Reserve.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).