THE IFA's Wealth Gram

LA TRIBUNE MENSUELLE DES MEMBRES DU GSCGI
wealthgram@gscgi.ch • www.gscgi.ch
Vol. VIII - N° 84 - Mars 2019

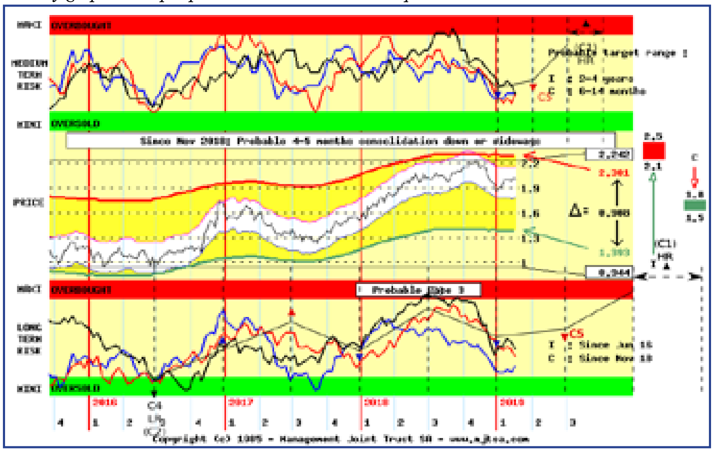
LE COIN TECHNIQUE

The US Dollar and the USD-Euro interest rate differential

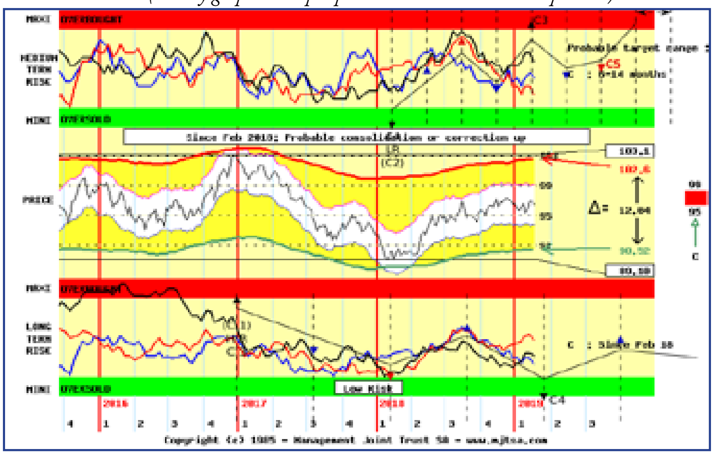
...article by Jean-Francois Owczarczak - CEO, Management Joint Trust SA - jfo@mjt.ch

Since US long term yields started to correct down last October, the US Dollar has stalled. US long term yields are more volatile than their peers in other regions of the world, and hence when they correct *(or re-accelerate up)*, their moves are usually more dynamic. Hence, the US Dollar to Euro interest rate differential currently rises and falls with US long term yields. Movements in the US Dollar are also closely related, yet with some discrepancies and some lags. Indeed, the other factor, which plays into movements in the US Dollar are US inflation expectations *(proxied by the TIPs vs Treasuries breakeven ratio)*. When these rise, the US Dollar is under pressure. Inversely, when these fall, the US Dollar is supported. Both factors take turns as to which one is the strongest. In Q4 last year, they pretty much leveled out, as declining US long term yields *(and a declining interest rate differential)* met a sell-off in inflation expectations *(these followed risk assets lower)*. The Dollar consolidated in a tight range and at high levels. Our rule of thumb in this environment is that during risk asset corrections, the Dollar should hold up rather well *(declining interest rate differential, declining inflation anticipations)*, while in a possible reflationary boom, a lot will depend "at the margin" on the FED: rising inflation expectations, rising yields, rising differential and a dovish FED will probably lead to temporary Dollar weakness *("à la H2 2017")*, while once/if the market expects the FED to start hiking again, the USD will accelerate higher *("à la H2 2016")*.

10Y USD-EUR IRS Swap rate differential
(Weekly graph or the perspectives over the next 2 to 4 quarters)



Dollar Index *(Weekly graph or the perspectives over the next 2 to 4 quarters)*



To illustrate the above rule of thumb, the H2 2017 period is indeed interesting. The FED had remained on hold that September, considering storm-related disruptions in the wake of hurricanes Harvey, Irma, and Maria. Then, during Q4, Oil, Equity markets, European economic data, US long term yields and the USD-EUR interest rate differential started to accelerate up again, and the US Dollar tanked. The market considered that the FED was behind the curve, and it took two rate hikes, in December 2017 and March 2018, for the Dollar to eventually reverse up. On the contrary in H2 2016, while reflationary assets (and the interest rate differential) were accelerating up, the FED signaled late September that the case for an increase in the federal funds rate had strengthened (although it actually raised rates only in December). The market considered this statement as being rather hawkish and the Dollar shot up. Going forward, we expect that following a potential retest/retracement down during the rest of Q1 2019 (our medium term oscillators; upper rectangle), the interest differential (and US long term yields) should reaccelerate up to retest last year's highs (right-hand scale) into the Summer. At the latest this moves starts midyear on our long term oscillators and extends into year-end. For the Dollar, a lot will depend on the FED's stance between late Q1 and early Q3, especially if reflationary assets continue to accelerate.

On our long term oscillators (lower rectangle), we believe the Dollar Index is building a base. It should act as a backstop to any extreme US Dollar weakness. On our medium term oscillators (upper rectangle), the sequence is still uptrending, yet may correct down at some point between now and mid Q2. This could be an interesting Buy the Dips opportunity. Indeed, following that, towards mid/ late Q2, we expect the US Dollar to accelerate up again, probably towards year-end, and above the resistance of our C Corrective targets to the upside (i.e. above 0.99).

MJT
www.mjtsa.com

Concluding Remarks: Following the sharp Q4 sell-off, it seems that the whole world is reflating. The FED has signaled a pause, China is ramping up its monetary and fiscal stimulus, while Europe and Japan have postponed any attempt at tightening. This environment should be very supportive for risk assets, inflation expectations and long term US interest rates, probably into the Summer. At some point, the Dollar risks being on the other side of that trade, at least, until the FED signals it intends to start tightening again. In the meantime, we expect some retracement on risk assets following the massive rally since December. This should support the US Dollar in short term, probably into late March, as inflation expectations could also retrace.