**SOM**
*Macro*
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# *State of the Markets: Macro Commentary*

## The Return of the King Dollar and "Taper Tantrum II" for EM

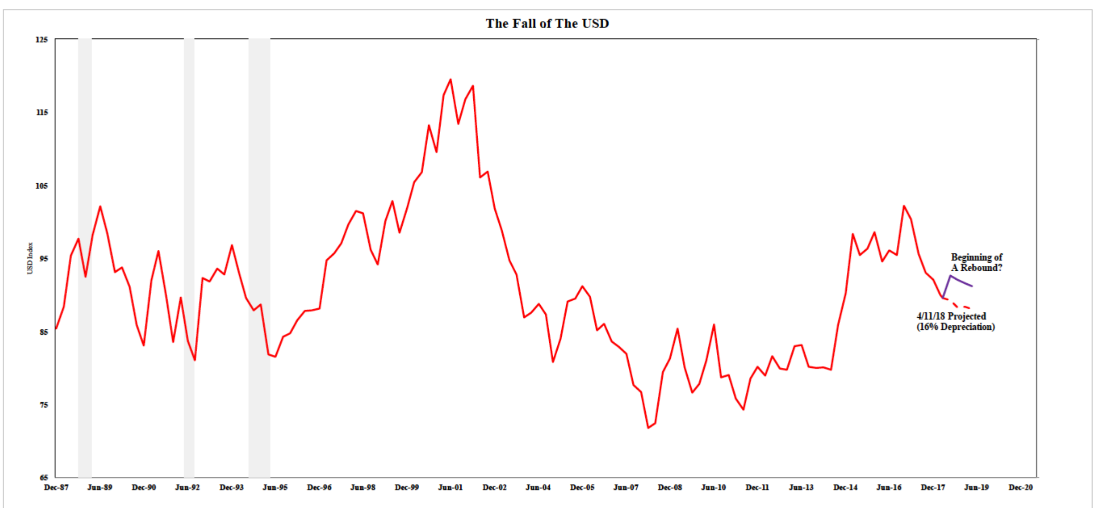
Over the last month I put out two pieces first on a stronger dollar then one on the impact of the stronger dollar on EM. I thought it would be useful for my clients to put out this simplified version of the two pieces, taking figures from both. So, here goes….

## My Thesis For A Stronger Dollar

When I put out my piece "The Return of the King Dollar" in late March, the market had priced in a depreciation of the dollar of over 15% vs major advanced economy currencies. However, in the last few weeks the dollar has rallied, as shown in figure 1. The question is it sustainable? Based on my fundamental economic framework I believe it is more likely than not, and provides the type of asymmetric trades that fit my selection process.

**Figure 1**

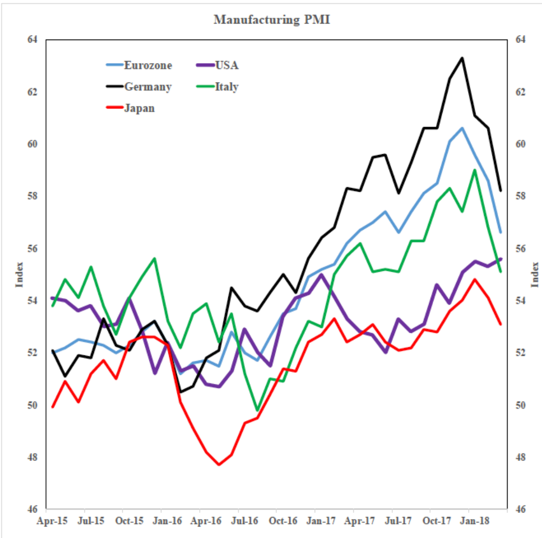
**The USD Has Recently Strengthened: Is This the Beginning of A Sustained Rally or Just A Blip Before Weakening Further?**



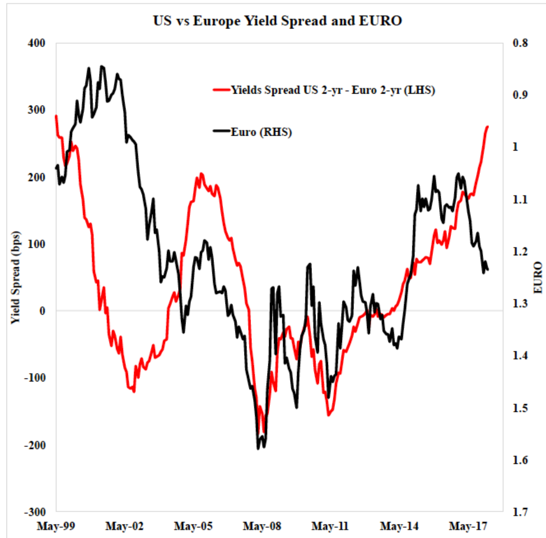

I put out my piece on stronger dollar because I thought there were two sources of event catalysts vs the EUR and YEN. Either EUR and YEN could weaken or the dollar could strengthen. Based on my fundamental economic framework, I thought that the market was pricing higher policy rates in Japan and Europe given the stronger-than-expected economic data from previous two quarters. Further in my framework, these levels of economic growth and inflation were not sustainable given the inherent problem of both areas. Clearly with the slowdown in PMI, this scenario could be playing out, see figure 2.

**Figure 2**

**PMI In Japan/Europe Has Ebbed But Not the USA**



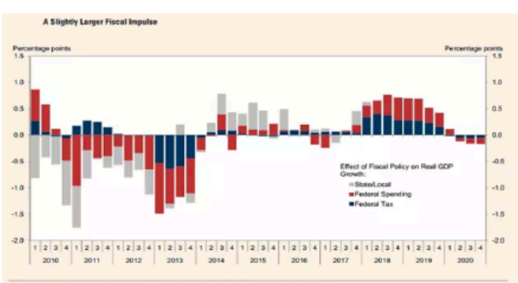

**However Many Factors Could Reverse This Depreciation**



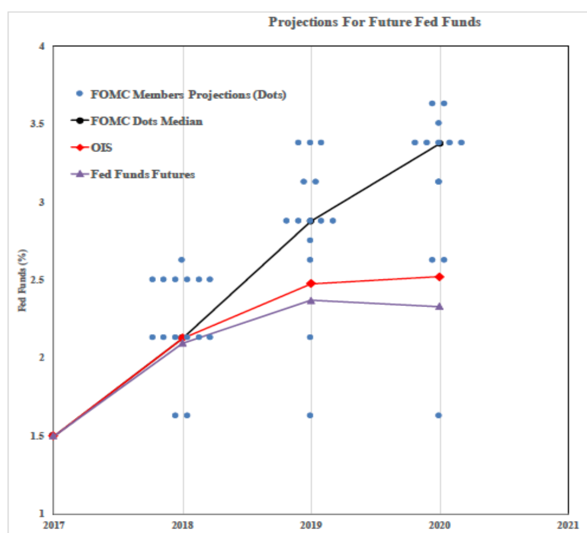

The other part of the convexity was US Tax Reform which could strengthen the dollar. The Fed could raise rates higher than projected given the impact of Tax Reform on economic growth. This growth would only start to appear as we economy started to move into summer, see figure 3. I also argued that Tax Reform could strengthen the dollar by generating a surge in capital flows into the US from Europe

**Figure 3**

**US Growth Could Accelerate Reflecting Impact of Tax Reform[1]**




**Market Is Pricing In A More Benign Fed Rate Path Than The "Dots" [2]**

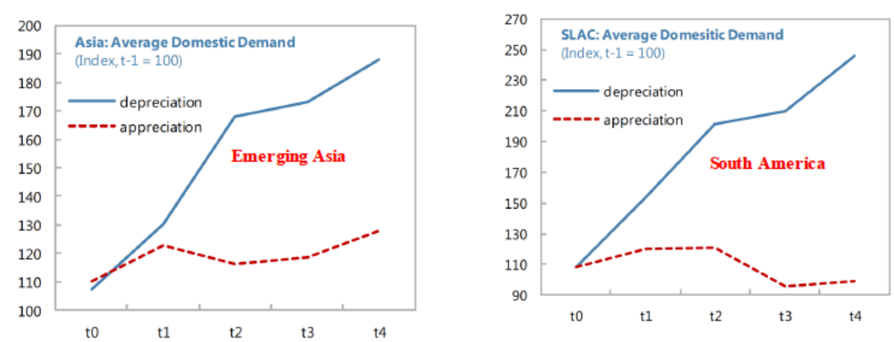


## The Impact of a Stronger Dollar On EM

Based on my fundamental economic framework, a stronger dollar and higher US rates would be effectively the perfect negative storm for EM. Historically, as shown in Figure 4, a stronger dollar pushes real domestic economic growth in EM to zero EM (measured by domestic demand, which takes out export.) Again, my view is that the rebound in EM growth since 2015 can almost directly be attributed to the weaker dollar. Accordingly, the stronger dollar will reverse this growth cycle and potentially creating a "taper tantrum" on steroids for EM.

**Figure 4**

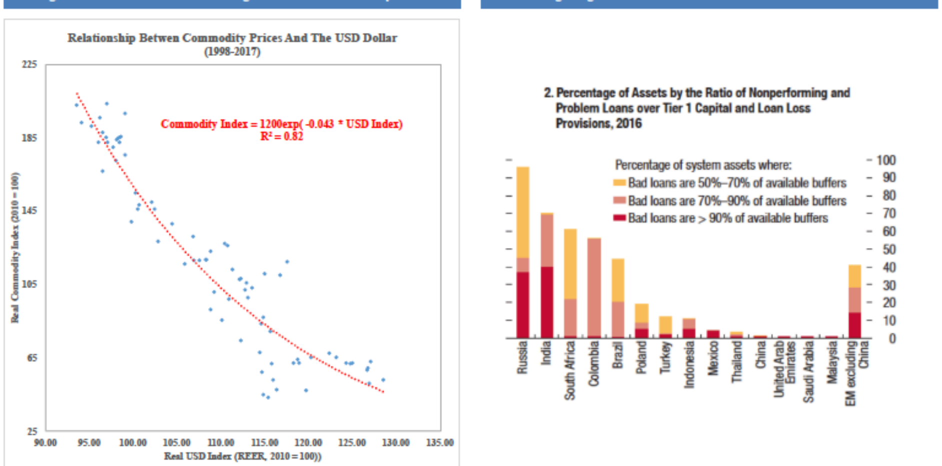
**Historically EM Domestic Demand Is Very Sensitive to The USD**




The stronger dollar will work its magic on EM growth through many channels. In figure 5, I show the first two of these. The first channel is the linkage between the dollar and commodities. As the dollar strengthens, commodities prices in dollar terms falls. This puts pressure on commodity country economies by depressing terms of trade. The second of the channels shown in this figure is the potential impact on NPLs on EM bank balance sheets. EM banks already have very high level of NPLs. A slowing economy with weaker dollar commodity prices could push these even higher. This could push EM banks to slow credit event further, making the slowdown in EM economies much worse, e.g. does Brazil slide back into a recession?

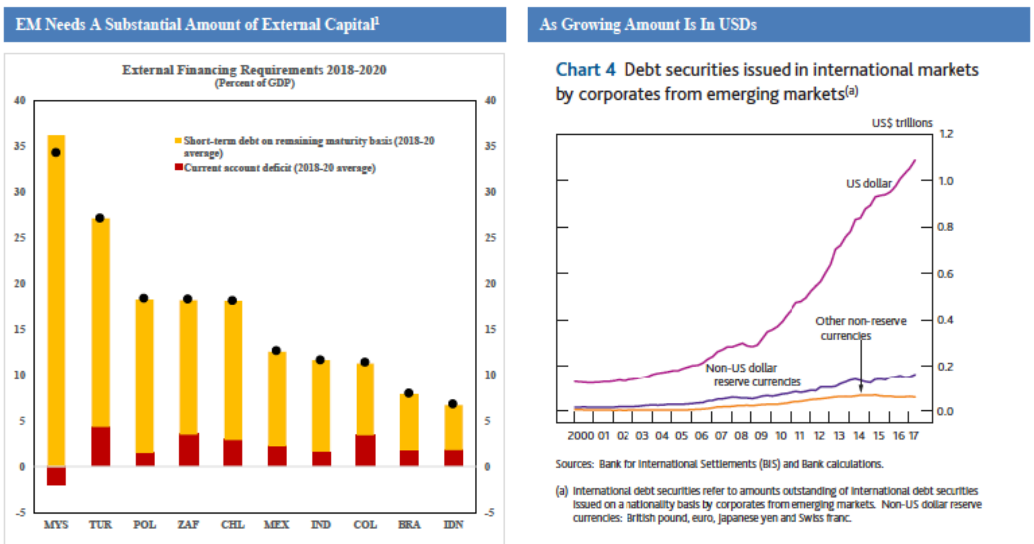
**Figure 5**

**Stronger USD Will Affect EM Through A Fall In Commodity Prices** | **Also Though Tighter Domestic Credit As NPL Problem Gets Worse**



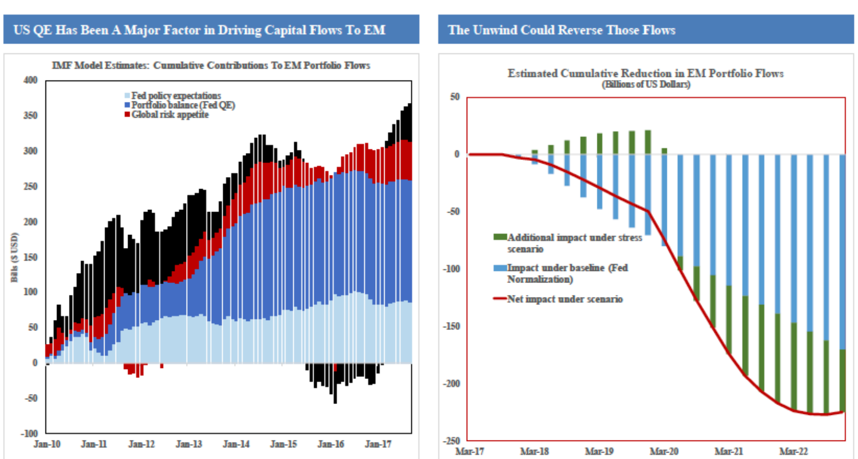
A more important channel for the stronger dollar to impact EM economies is through their dependency on external capital. A stronger dollar could push up their cost of external capital as well as cause capital outflows both of which would slow EM economies. In figure 6, I show the short term external financing demands for EM substantial (LHS) The cost of this capital will rise as the dollar strengthens and US rates rise given that most of this capital is denominated in USDs (RHS)

**Figure 6**




While EMs might be able to weather the impact of higher rates, a potentially bigger problem is keeping the external capital they already have much less source new external capital. As shown in figure 7, the IMF estimates that most of the external capital inflows EM were the direct result of US QE (LHS). So, as the Fed unwinds QE, that capital leaves (RHS). Further, if you believe the IMF analysis, this capital outflow and the subsequent funding crisis for EM is likely to happen ***even if the dollar does not strengthen*.**

**Figure 7**



## Conclusions

Let me be clear I am not arguing that the dollar is absolutely going to strengthen, and EM assets will meltdown. My framework does not work that way. I am arguing that betting on a stronger dollar is an asymmetric trade with a high payout ratio. The knock on effect on EM potentially is an even bigger trade, even if the dollar does not strengthen.

Again, these figures are excerpts from much more detail pitch books on a stronger dollar and weaker EM, which also contain my trade recommendations. Let me know what you think

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