SOM *Macro Strategies*

State of the Markets: *The Return of The King—Positioning For A Stronger Dollar*

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Alan Brazil

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- ***Step 1: Macro Theme: The Return of The King—Positioning For A Stronger Dollar***
  - The USD has depreciated substantially over the last year, with more depreciation priced in the future
  - The USD could rebound as the forces that drove the weakness fade and potentially reverse
- ***Step 2: Fundamental Economic Framework***
  - The USD is weaker because growing US deficits increased the risk that they could push the current account wider--the "Twin Deficits" theory
  - The USD is weaker despite substantially higher interest rates than Japan/Europe because of the expectation that their central banks will also normalized monetary policy given recent economic trends
  - The USD is weaker because the current budget problems of the US could accelerate the move to the RMB as the new world reserve currency
  - However, the "Twin Deficits" theory is not supported by the data, as the opposite seems to hold true, as historically the private sector has increased savings to offset increased public borrowing
  - Japan/Europe may not normalize their monetary policy as growth and inflation are fading, while US growth is still strong
  - The USD will remain king as the dominate world reserve currency as the RMB is a long way from being a viable substitute
- ***Step 3: Find Potential Catalysts***
  - The USD could strengthen if US private saving could increase offsetting the pressure on the USD from rising deficits
  - The USD could strengthen if current wide interest rate differential weigh on the Euro and Yen as slowing economic growth and inflation reduces the probability of a change in their monetary policy
  - The USD could strengthen as the interest rate spread differential widens versus current market pricing if US growth accelerates and the FED actually follows the "Dots" .
  - The USD could strengthen from an increase in capital inflows from Europe reflecting the impact of US tax reform
  - The USD could strengthen as the impracticality of replacing it with the RMB gets highlighted as world trade continue accelerates
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Buy Euro Puts/USD Calls

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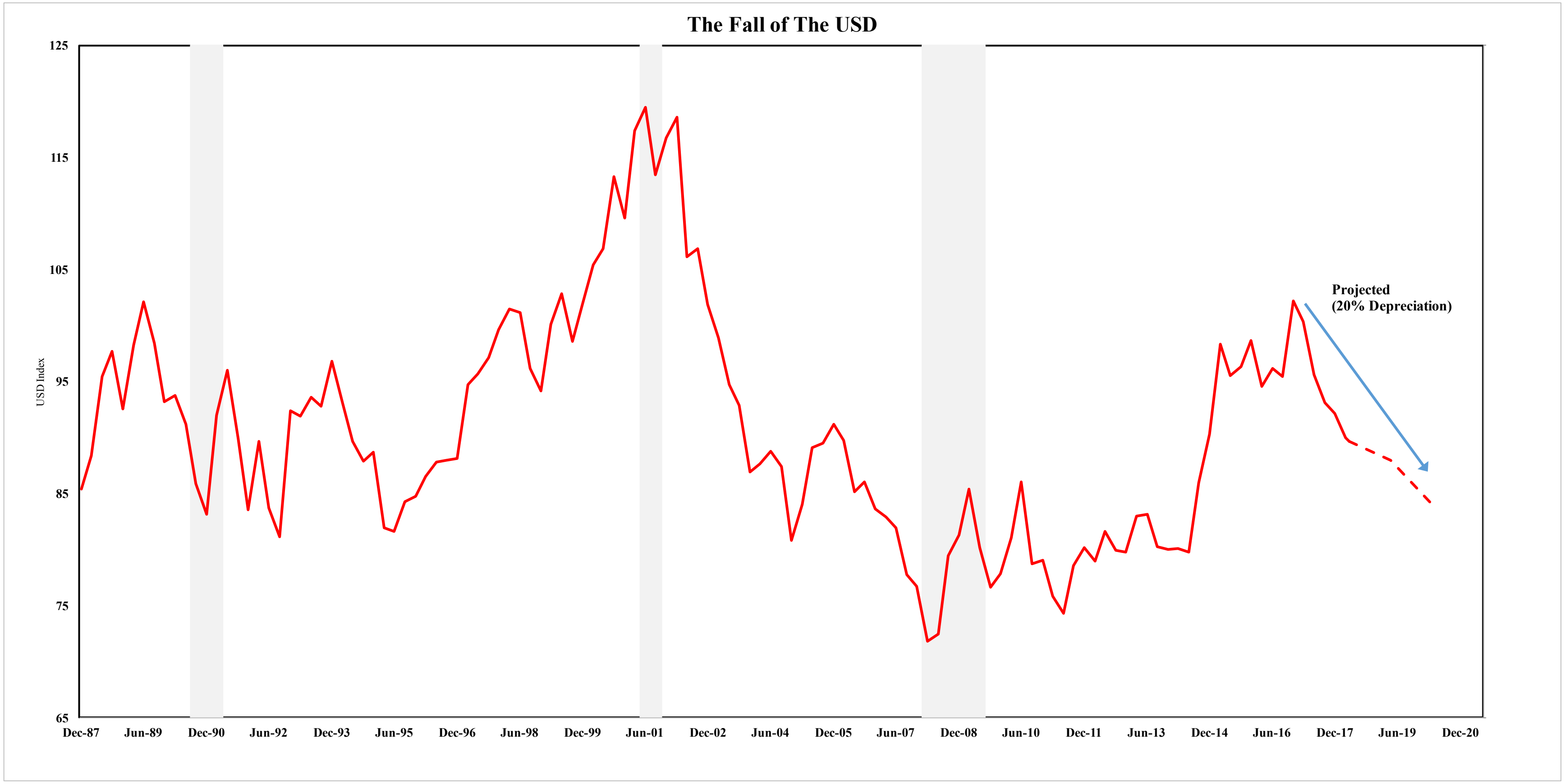
Step 1: The Macro Theme

The Return of the King: Position For A Stronger Dollar[1]

The USD Has Weakened Substantially Despite A Normalization of Economic Growth And Monetary Policy: Is It Still The Worlds Currency?



1. Bloomberg, and Authors calculations

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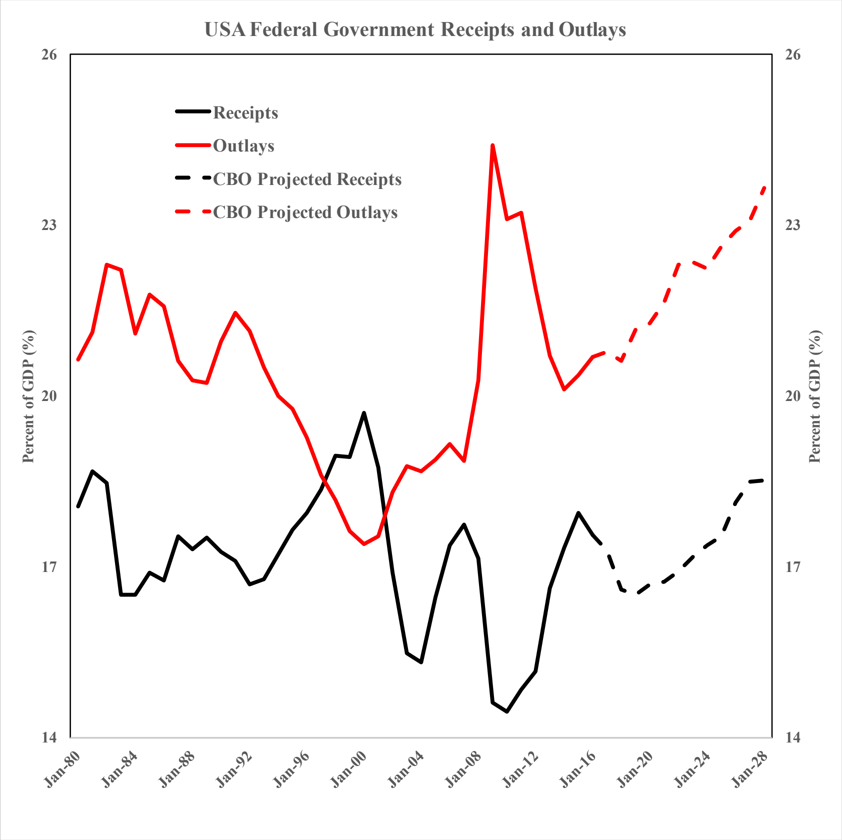
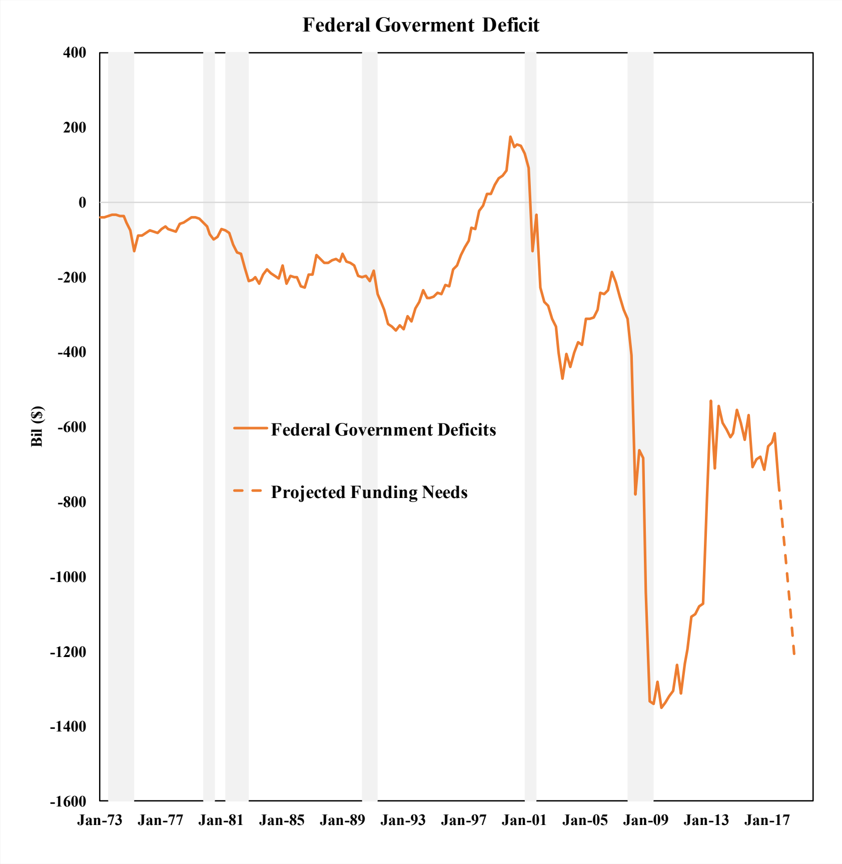
Step 2: Fundamental Economic Framework

Trump Tax Cuts While Increasing Spending Could Push Deficits Close to Levels of the GFC[1]

Tax Receipts Are Projected To Falls While Receipts Are To Fall



Deficits Could Increase Substantially



1. CBO

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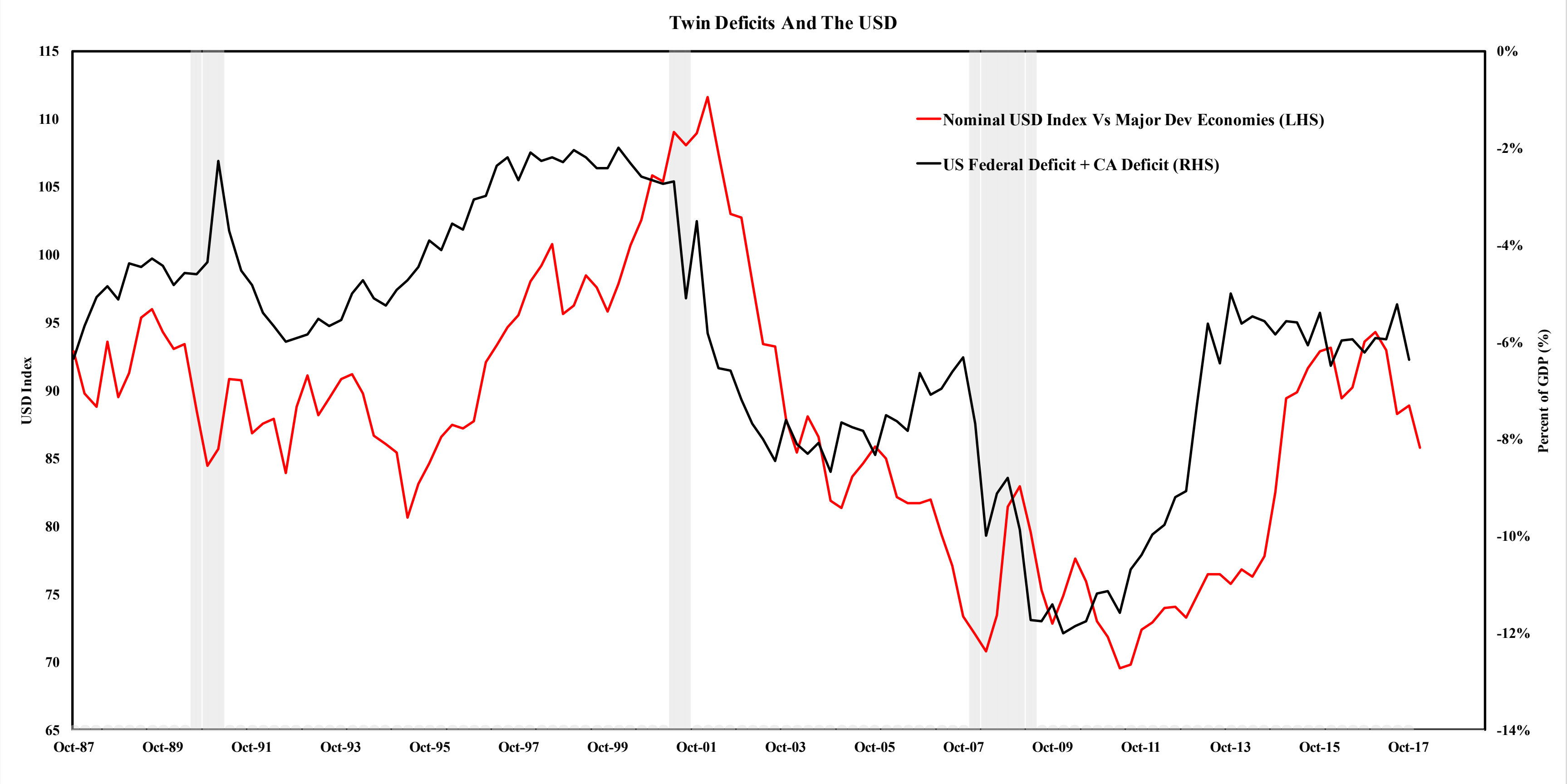
Step 2: Fundamental Economic Foundation

The Theory of The Twin Deficits Could Explain The Recent Weakness of The USD[1,2,3]

Theory of Twin Deficits Says That Government Deficits Translate Directly To The Current Account



1. Bloomberg
2. CBO
3. BEA

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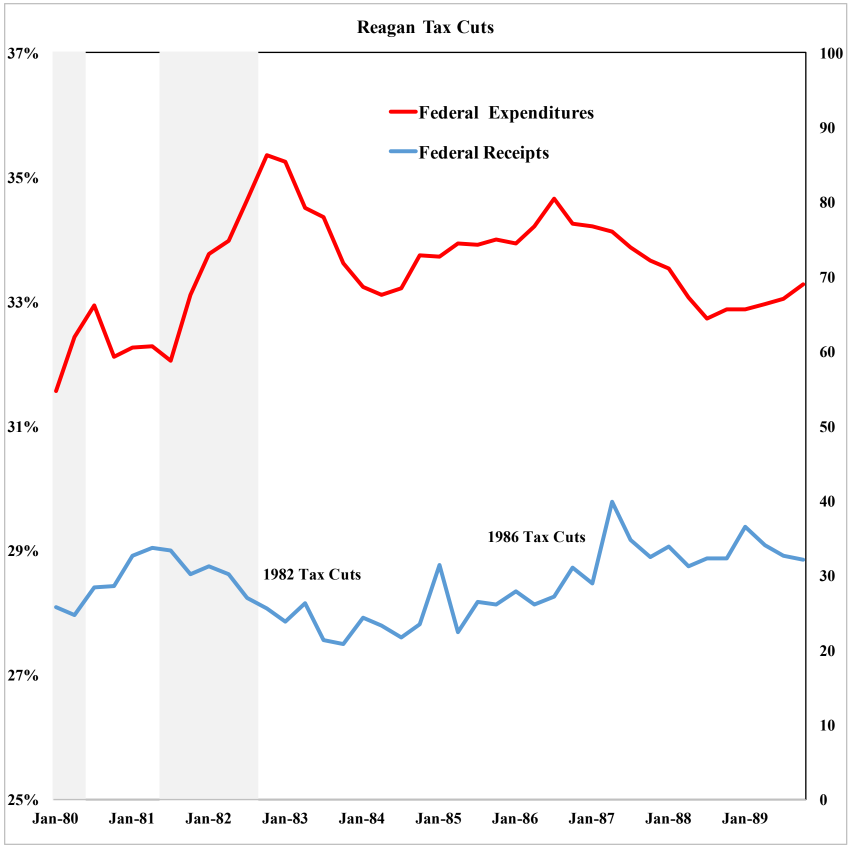
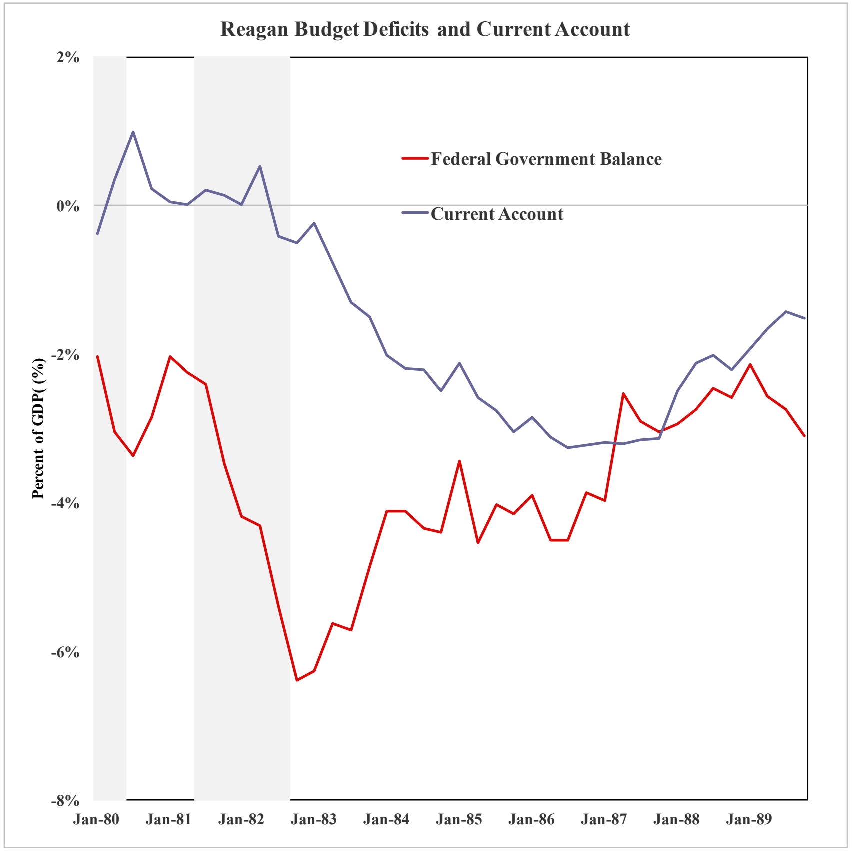
Step 2: Fundamental Economic Framework

Reaganomics in the 1980s, Seems to Support This View[1,2]

Tax Cuts And Spending Increases During Reaganomics



CA Rose As the Deficit Increased



1. CBO
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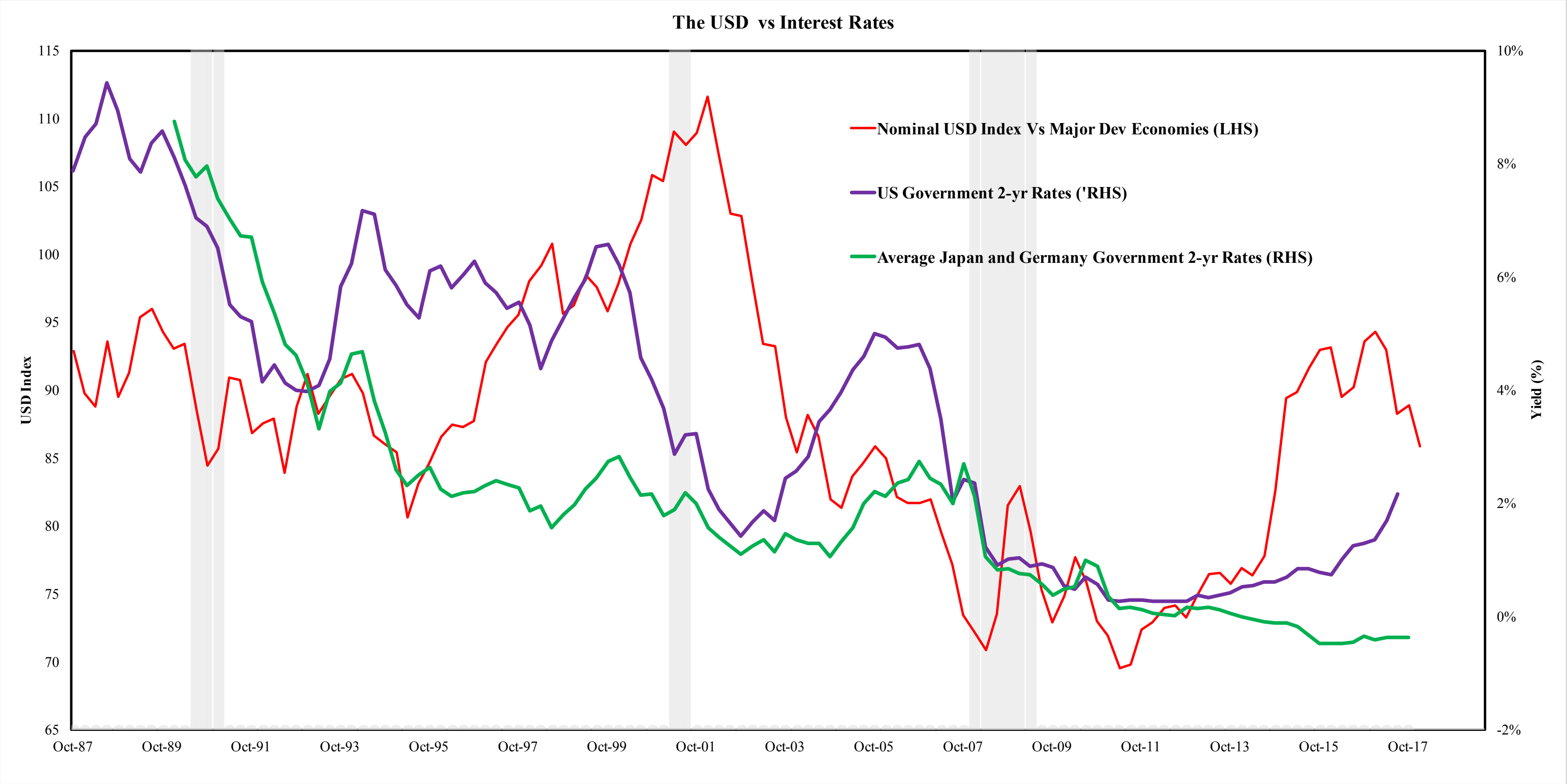
Step 2: Fundamental Economic Framework

Dollar Has Weakened Even With Rising Interest Rates Vs Other Developed Market Economies[1]

Something Needs To Happen to Japan/European Rates For The Dollar to Weaken Given These Rate Differentials



1. Bloomberg

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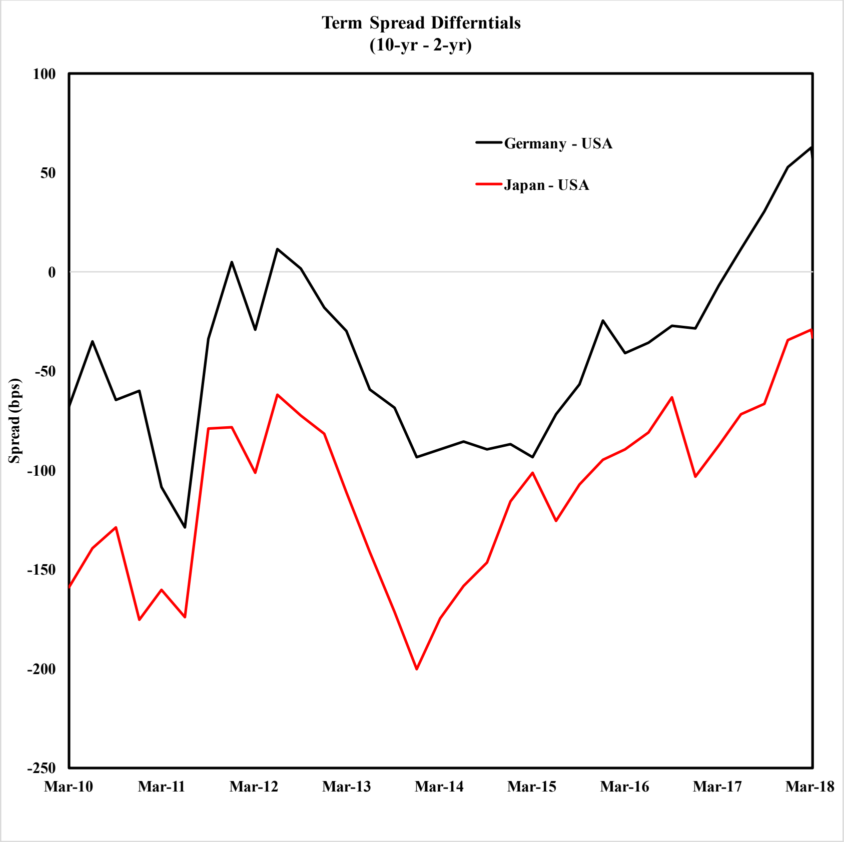
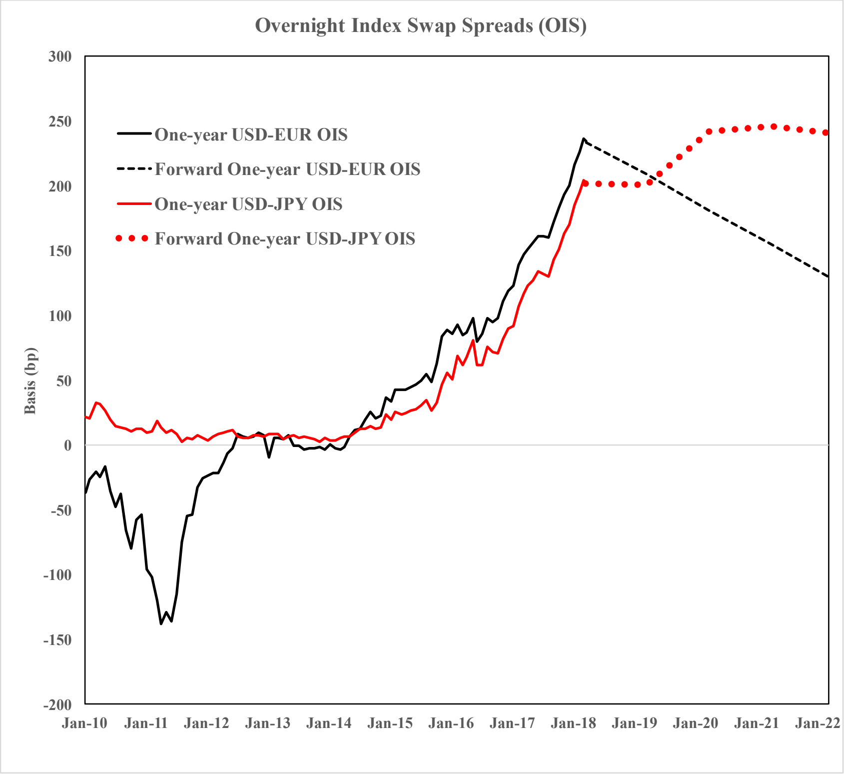
Step 2: Fundamental Economic Framework

At That Something Need Be A Normalization of European/Japan Monetary Policy[1]

Spot Spreads Should Favor The USD



However, Forward Spreads Look To Support A Weaker USD



1. Bloomberg

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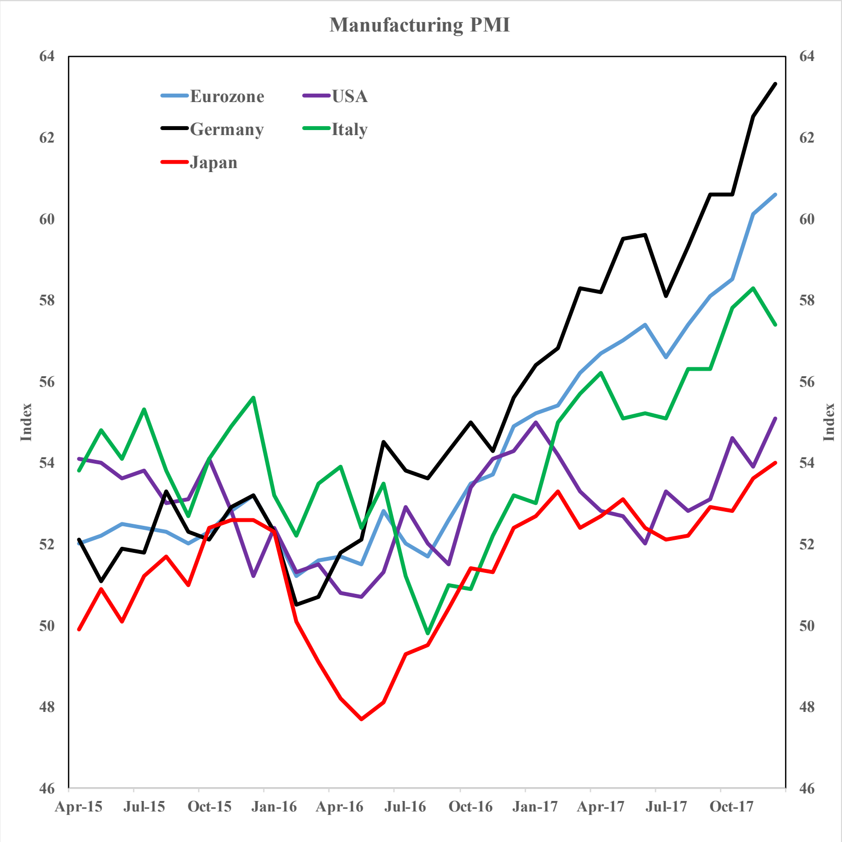
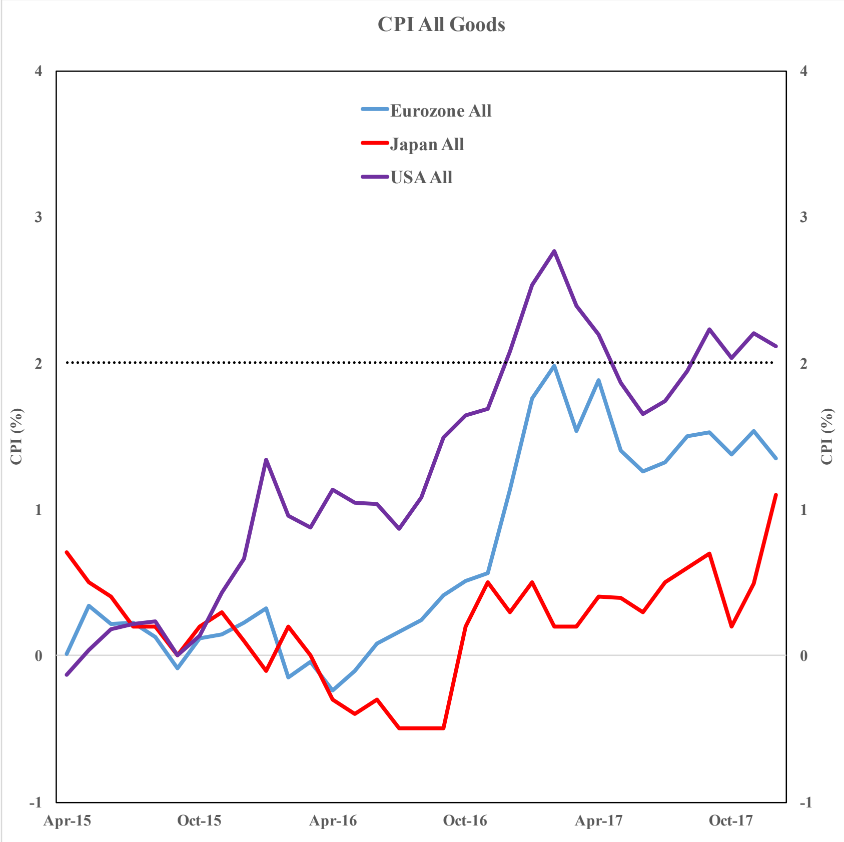
Step 2: Fundamental Economic Framework

At The End 2017, Growth and Inflation Supported This View About Europe/Japan Monetary Policy[1]

Growth In Europe Was Exceeding That of The US At The End of 2017



Inflation In Japan and Europe Were Also Approaching Targets



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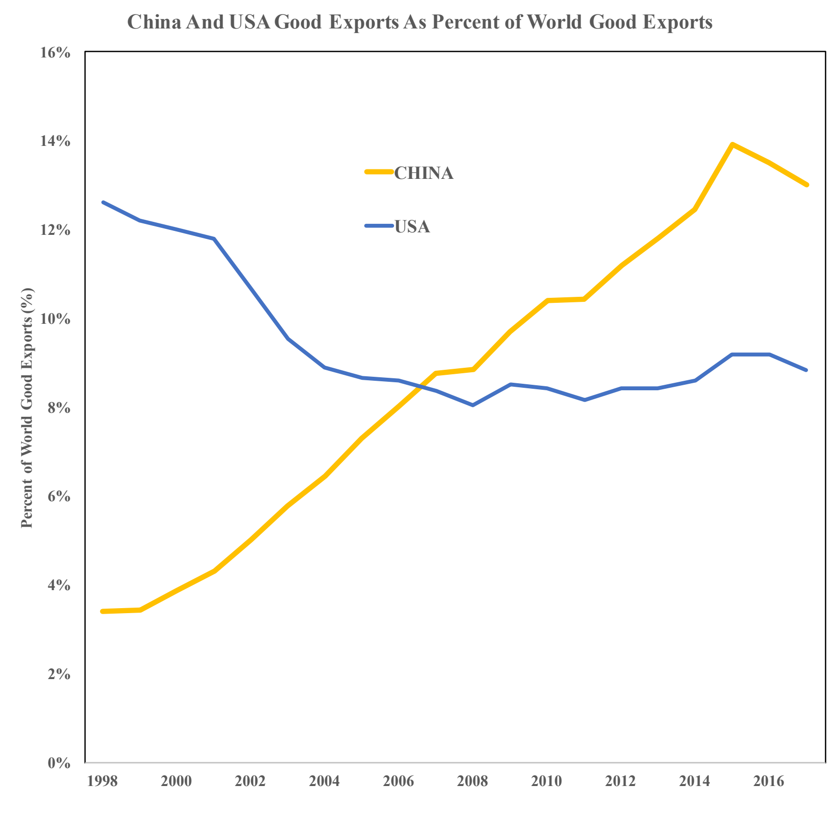
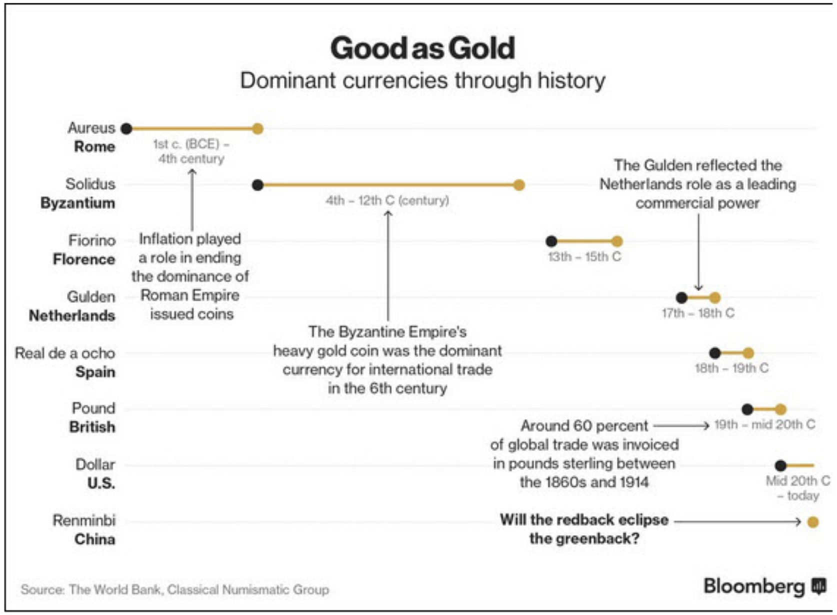
Step 2: Fundamental Economic Framework

The Weakness of USD Could Also Reflect The RMB Taking On the Role As An Alternative to The USD

China Has Become The Dominate Trading Partner in The World[1]



The Era of The USD As Reserve Currency Could Be Over[2]



1. IMF, Direction of Trade Data Base
2. Bloomberg

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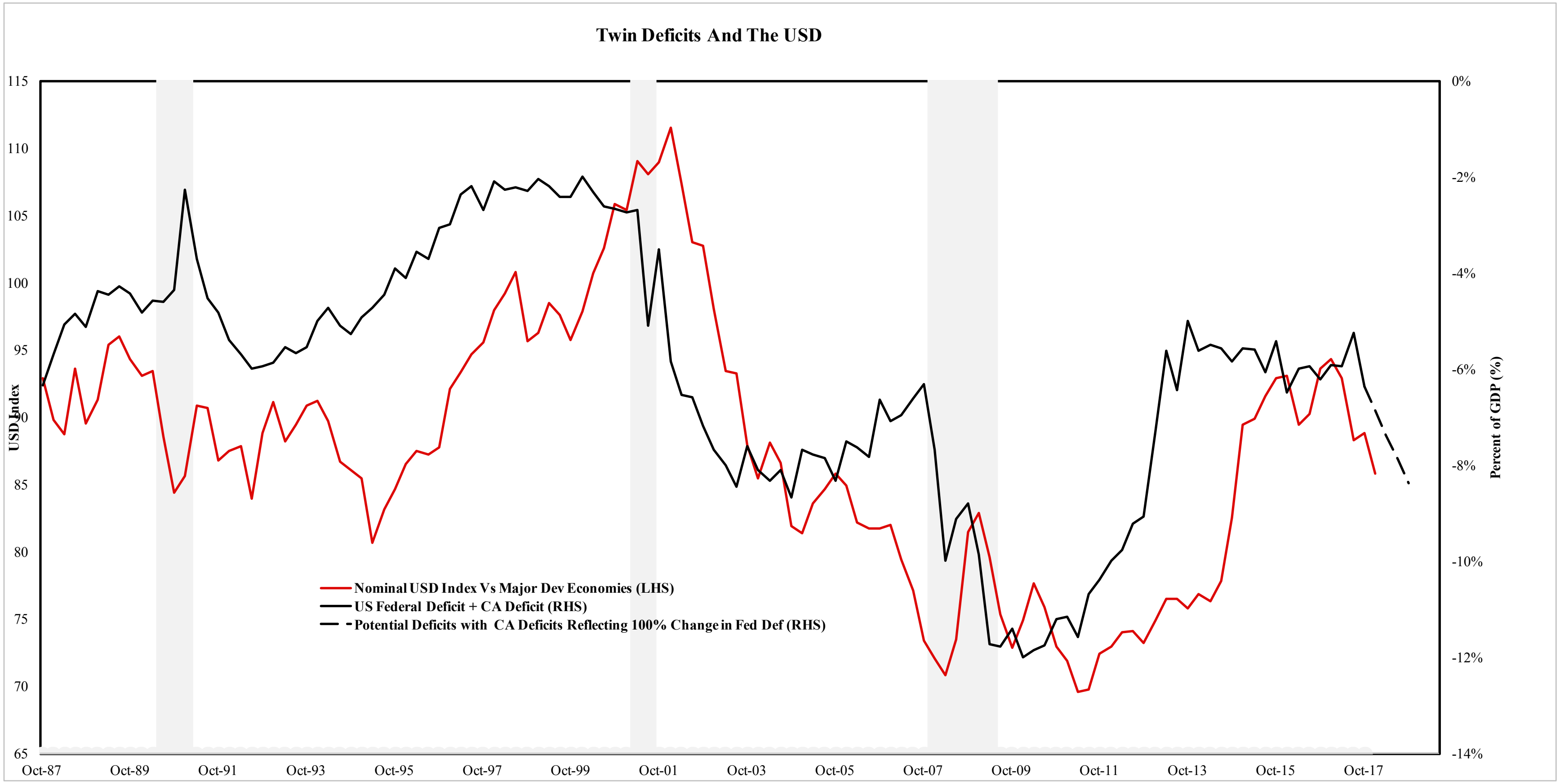
Step 2: Fundamental Economic Framework

Even If the "Twin Deficit" Theory Holds, Market Is Already Pricing In The Total Effect[1,2,3]

USD Could Already Be Reflecting Impact of Increasing Deficits on Current Account



1. Bloomberg
2. BEA
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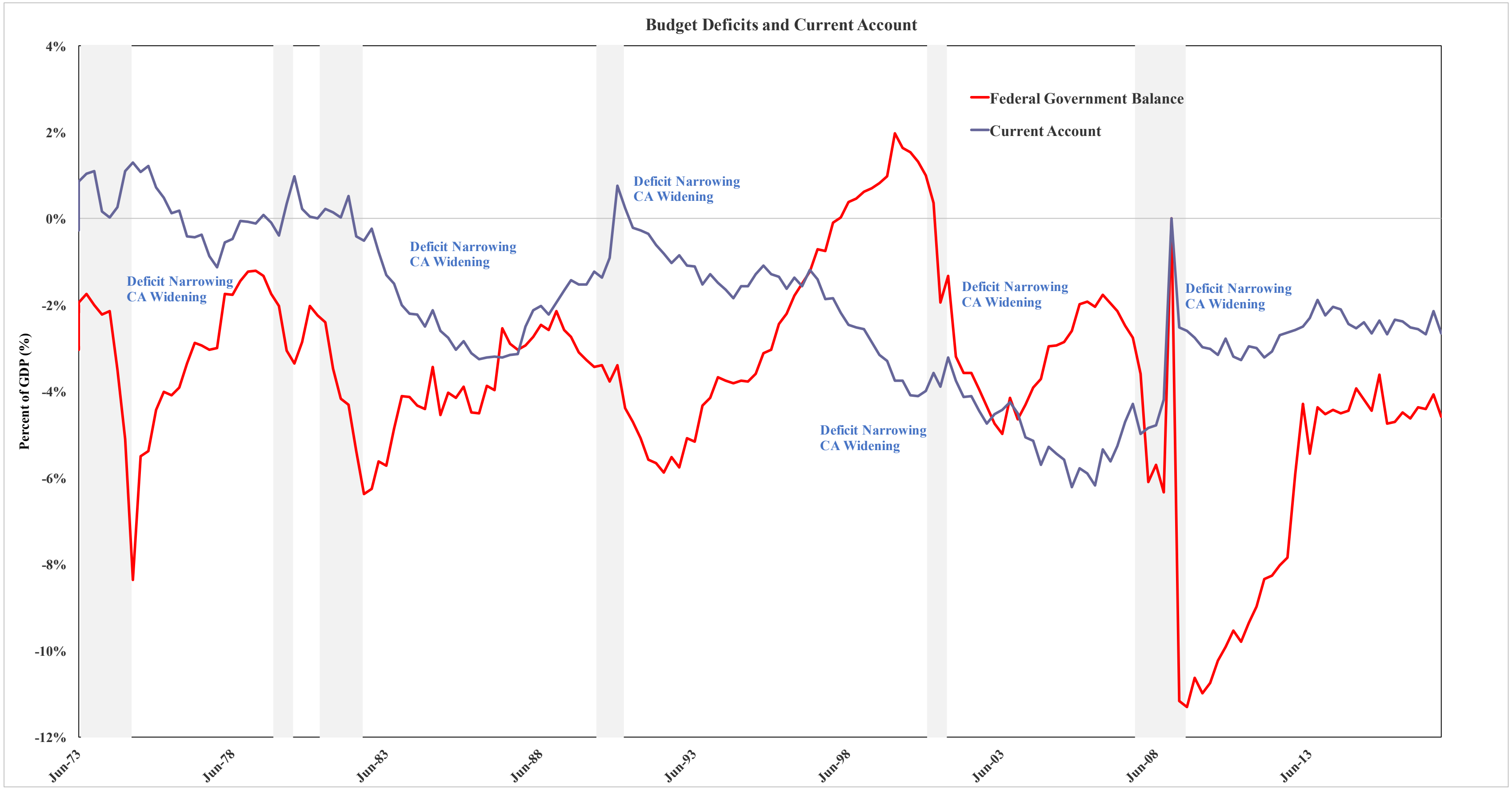
Step 2: Fundamental Economic Framework

However, The "Theory" Is Not Supported By The Data[1,2]

Other Than Recession, The Opposite Holds True: Current Account Narrows When The Deficits Widens



1. Bloomberg
2. BEA

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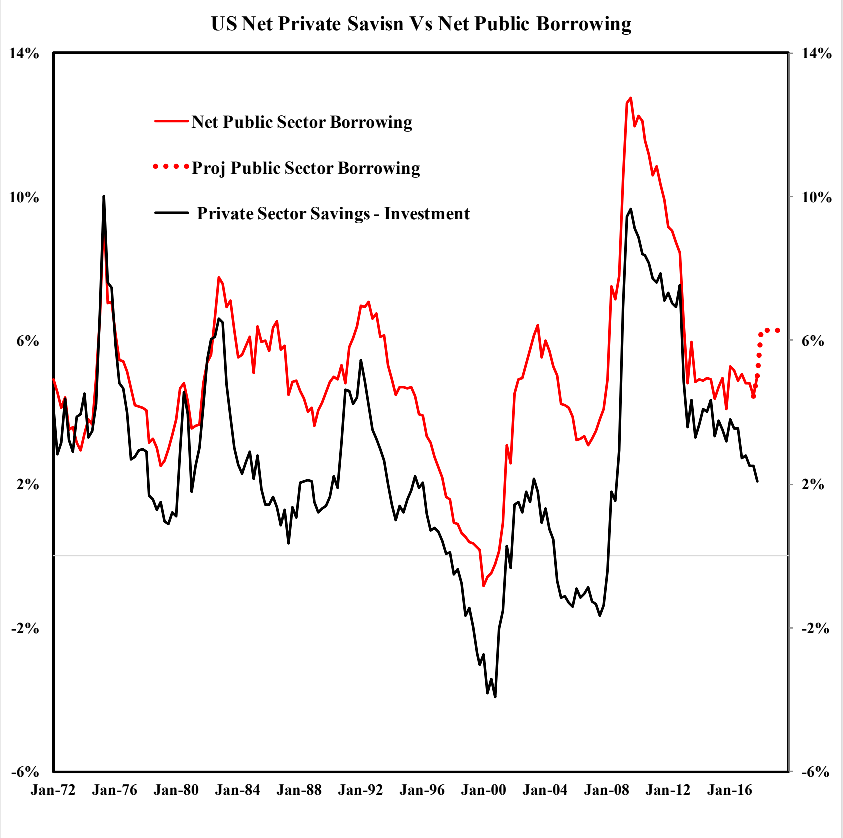
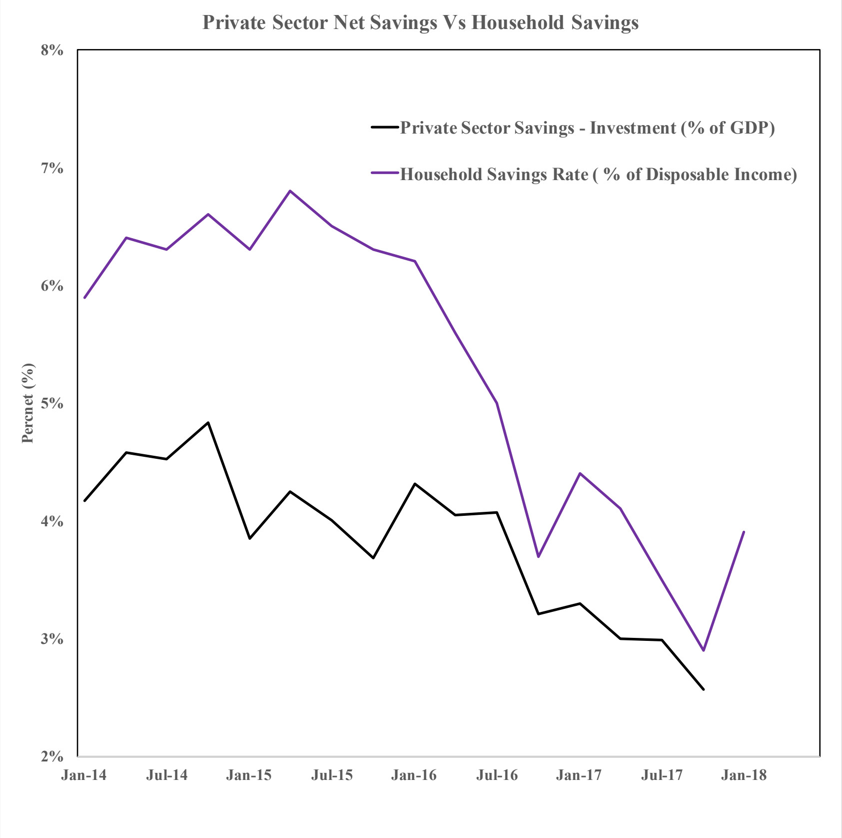
Step 3: Find Potential Catalyst

Historically, An Increase in Public Sector Borrowing Is Offset By In Increase in Private Sector Savings[1,2]

Private Sector Savings Will Need To Increase Substantially



But Already Personal Savings Rate Is Responding



1. BEA
2. CBO

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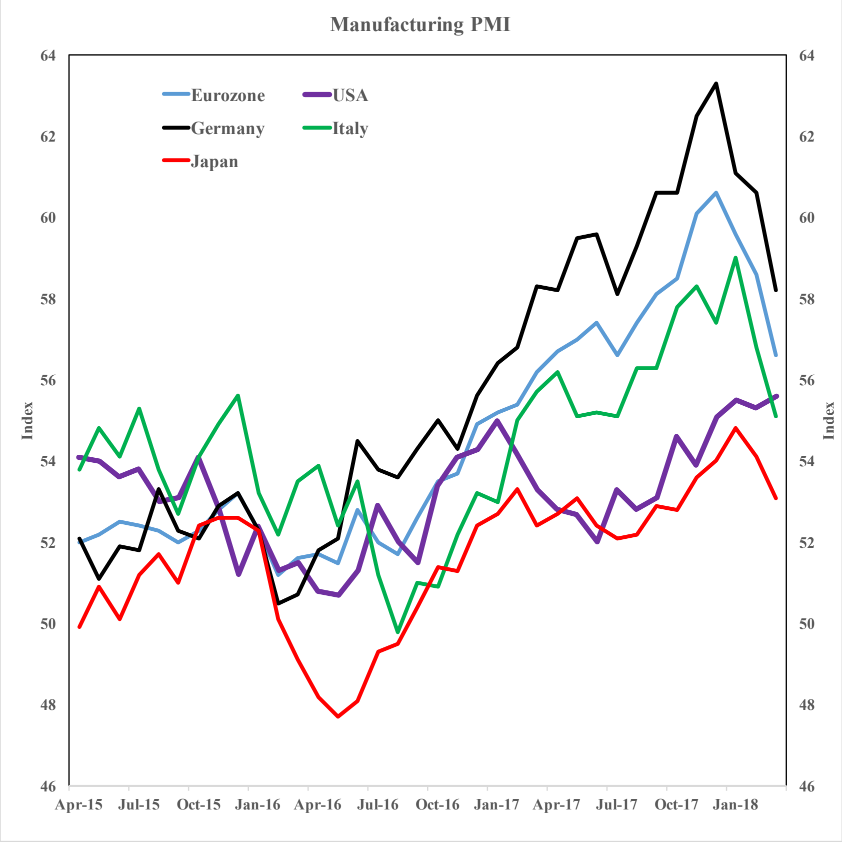
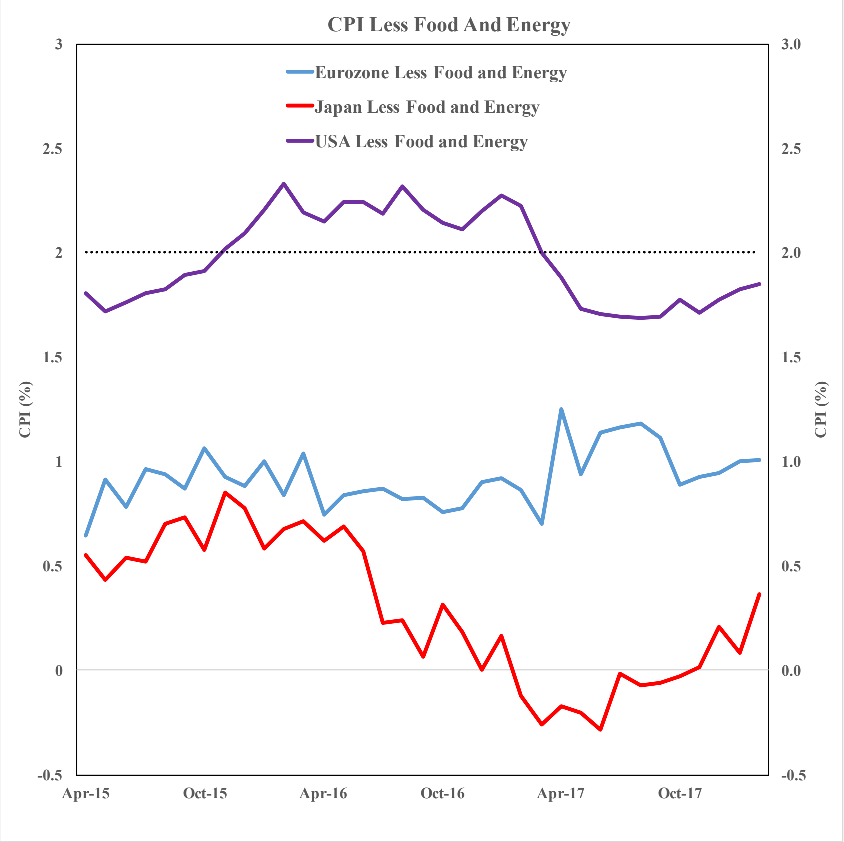
Step 3: Find Potential Catalyst

Recent Performance of Their Economies Could Reduce the Likelihood of BOJ/ECB Hiking Rates[1]

PMI In Japan/Europe Has Ebbed But Not the USA



Japanese/European Rate Hikes Not Supported By Current Inflation



1. Bloomberg

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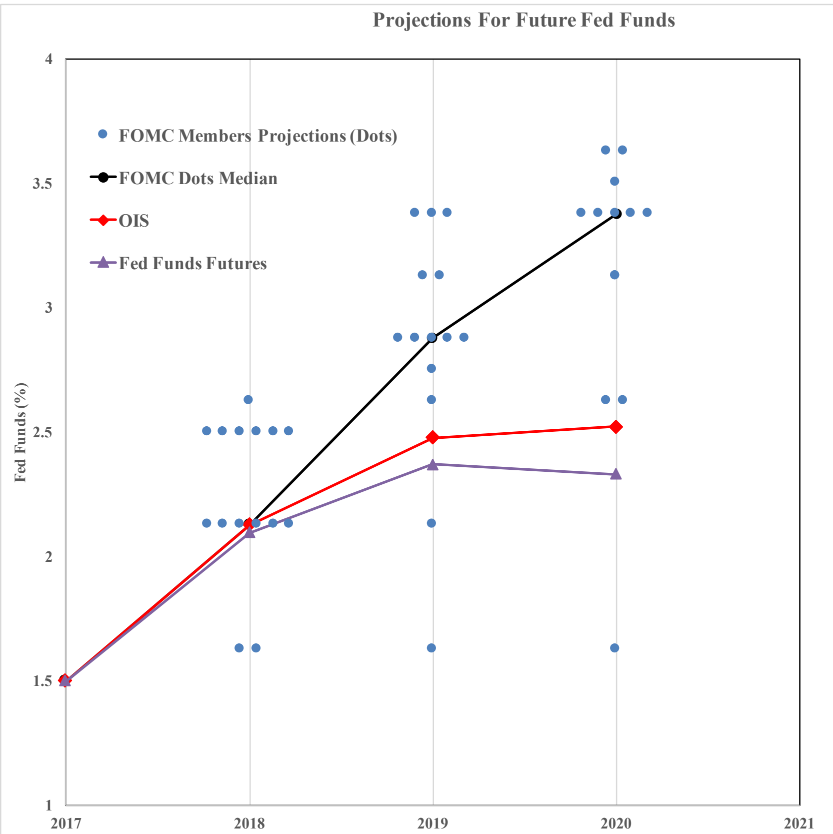
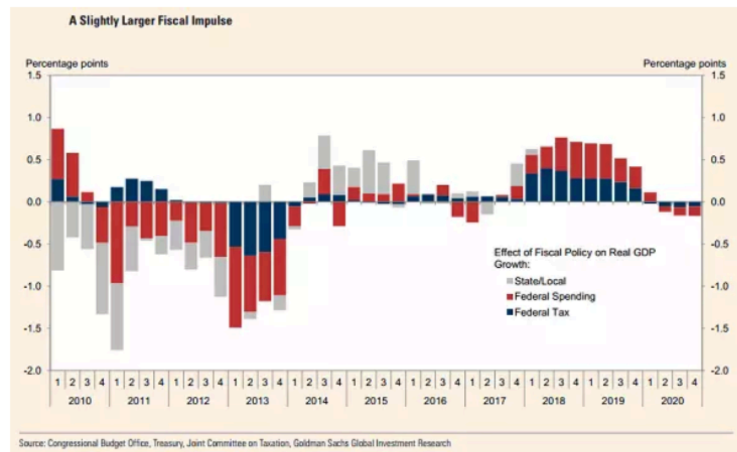
FOMC Projections of Rate Hikes Not Priced Into USD: They Could Follow the ”DOTs” Given Growth

Market is Pricing In A Much lower Path of Fed Funds Than FOMC[1]



Trump Tax Reform And Increase Spending Could Accelerate Growth[2]



1. Federal Reserve policy minutes
2. Gavyn Davies, FT, ”Trump’s fiscal gamble and the US twin deficits”, 3/31/2018

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Step 3: Find Potential Catalyst

Capital Flows Into the The US Given Tax Reform Could Support a Stronger Dollar[1]

Tax Reform

		FDI Satus Quo ($ USD)		Change In FDI From Tax Reform ($ USD)			
Country	Sector	US Position In EU	EU Position in the US	US Position In EU	EU Position in the US	Net Increase Into US	Percentage Increase Into US
EU 28	**All**	**1,537,612**	**1,575,403**	**46,528**	**325,903**	**279,375**	**18%**
	Manufacturing	311,095	439,034	42,888	140,107	97,219	22%
	Service	1,226,517	1,136,370	3,640	185,796	182,156	16%
Germany	**All**	86,893	190,614	4,520	27,407	22,887	**12%**
	Manufacturing	9,573	19,875	880	5,074	4,194	21%
	Service	77,320	170,739	3,640	22,333	18,693	11%
Ireland	**All**	17,582	27,835	3,530	6,648	3,117	**11%**
	Manufacturing	4,398	10,603	1,392	3,627	2,235	21%
	Service	13,184	17,233	2,139	3,021	882	5%

1.ZEW, "Analysis of US Corporate Tax Reform Proposals and their Effects for Europe and Germany", 2018

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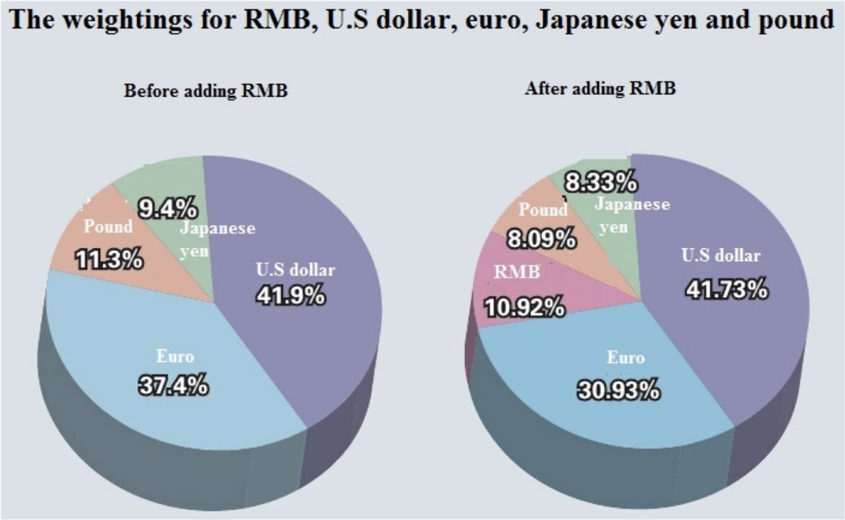
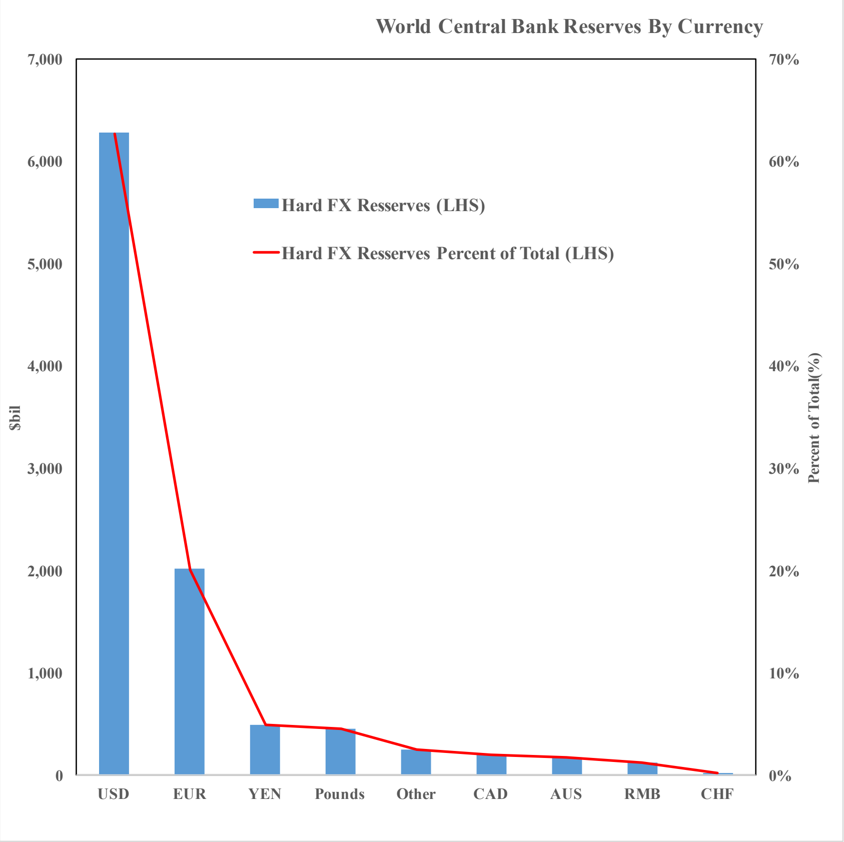
Step 2: Fundamental Economic Framework

The Chinese RMB Has Only Started the Path To Replacing the USD As The Worlds Reserve Currency[1]

Including The RMB Into SDRs By IMF Did Not Dent the USD



RMB Is Rounding Error Vs The USD Hard Currency Reserves

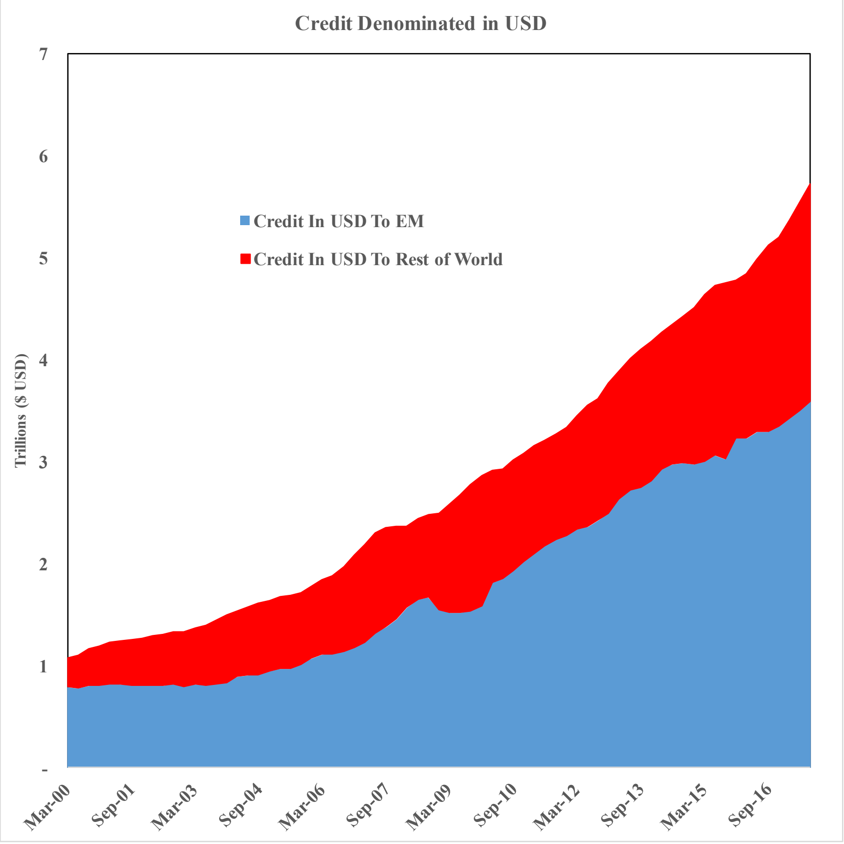


1. IMF

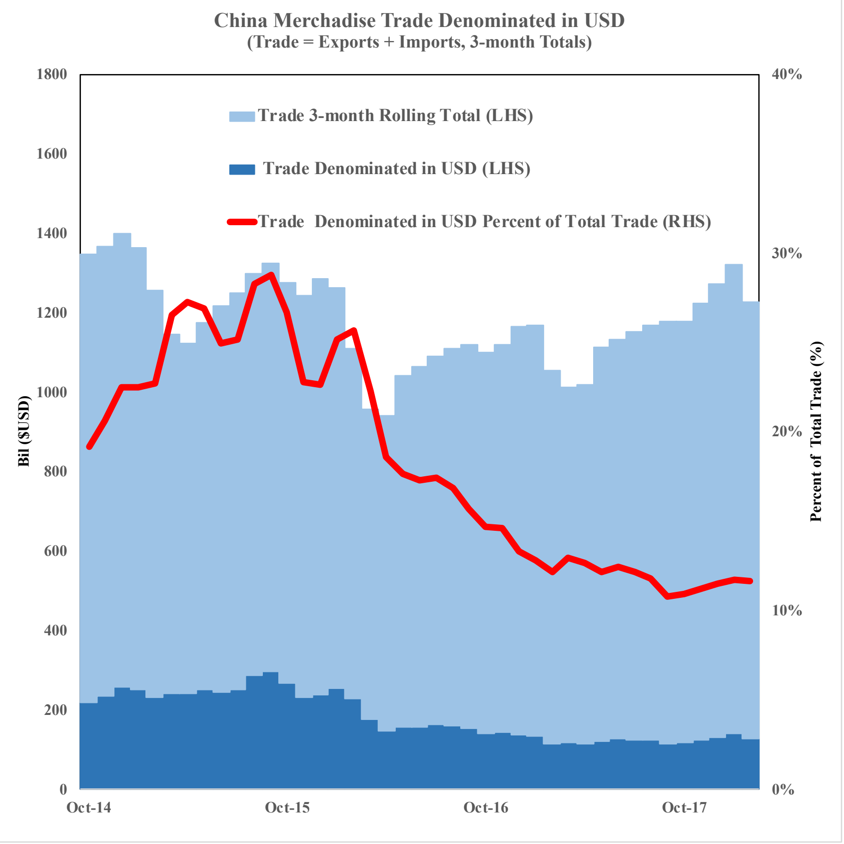
Step 2: Fundamental Economic Framework

USD Is Still Dominate in Both Credit And Trade Even With A Focus On China To Change That

Credit To DM and Particularly To EM Is Denominated In USD[1]



China's Push To Denominated Trade in RMB Failing[2]



1. BIS
2. Bloomberg

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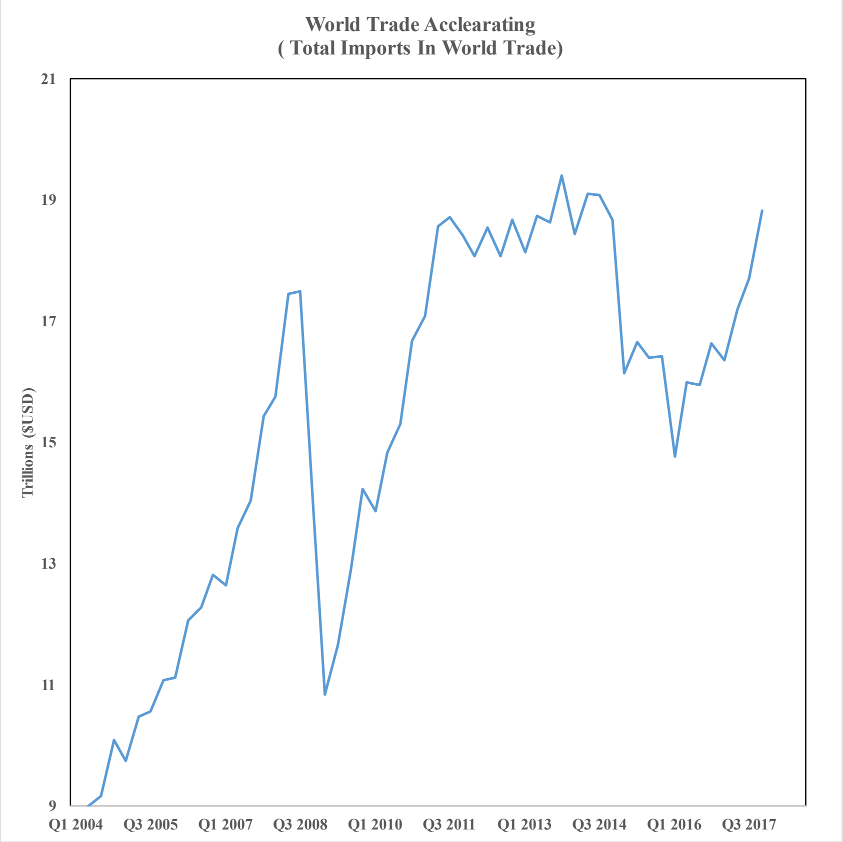
Step 3: Find Potential Catalyst

Accelerating World Trade Could Provide A Tail Wind For Demand For USD

RMB Is Also Rounding Error Vs USD For International Trade[1]



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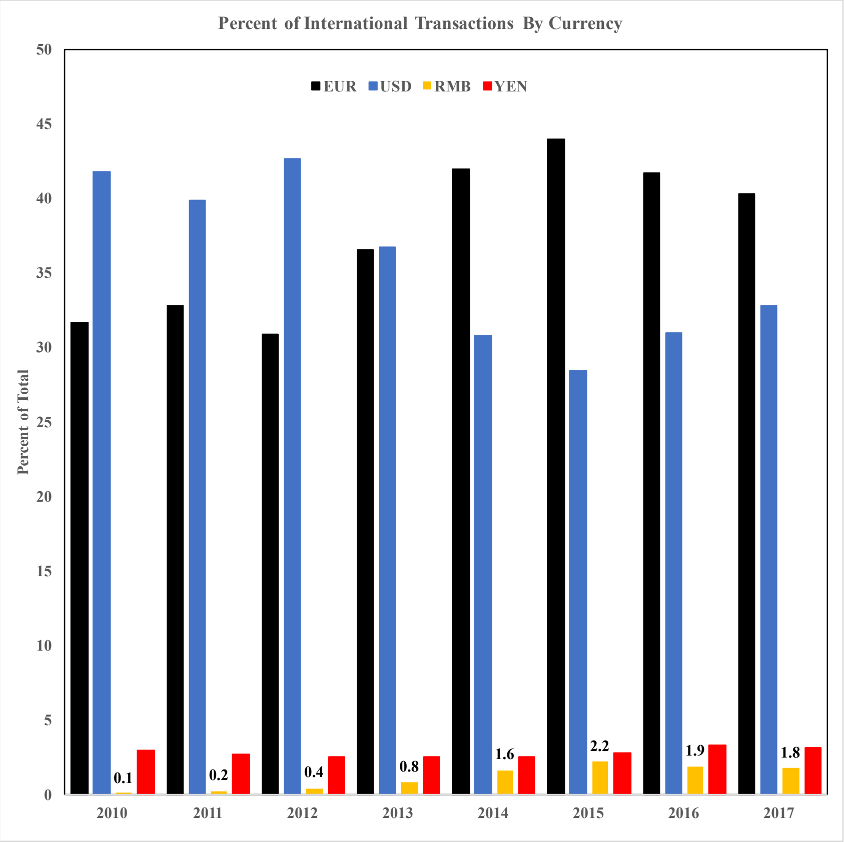

1. IMF Direction of Trade data
2. Swift

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Step 4: Find Asymmetric Trades

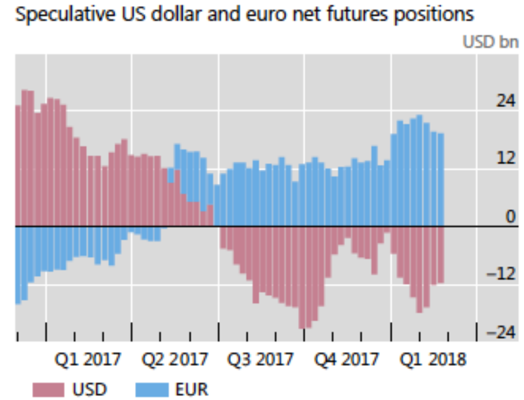
Trade 1: Position For A Stronger USD—Buy OTM EUR Puts/Dollar Calls

Trade Thesis

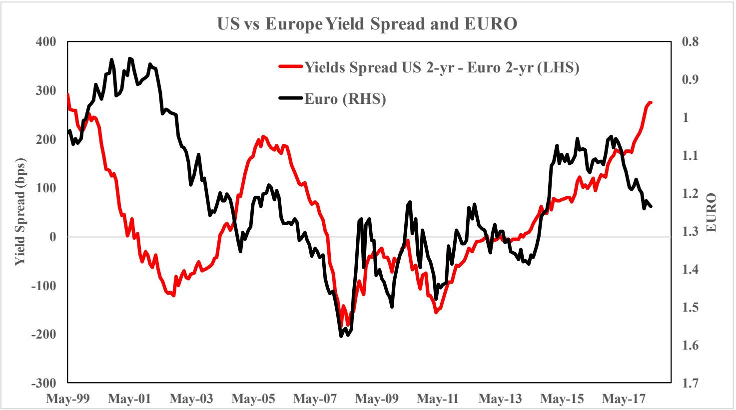
- USD could rebound from current weakness
  - Impact on USD from rising "Twin Deficits" from increasing federal borrowing could be offset by rising private savings
  - Continued Economic growth in the US/weakening growth in Europe could further widen interest rate differentials
  - World trade growth will increase demand for USD given that RMB is not yet a viable alternative for trade denomination
  - US tax reform could increase demand for USD vs Euro from a substantial increase in capital flows into the US from Europe
- Buy 9-month OTMF of Euro Puts/USD calls

Risk is continue weakening of USD

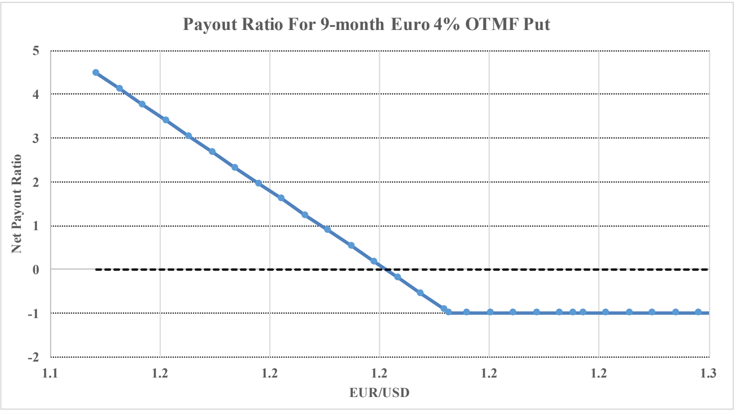
Rebound Could Be Swift Given Current Positioning[2]



Euro Looks Vulnerable if ECB Does Not Normalize Rates[1]



Potential Net Payouts of Euro Put/USD Calls



1. Bloomberg
2. BIS Quarterly review, March 2018

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