The Buck Stopped There

Market Viewpoint: November 8, 2016

Well, finally we've reached the day when we learn who will be the next president of the United States. Hopefully. With the latest polls showing a decisive lead for Hillary Clinton, the markets have roared and pundits are saying that it's because investors think a Donald Trump win would be bad for stocks. But speculating about the election outcome based on polling data can be fraught with risk, as recent history has taught us. The Brexit vote outcome and the Colombian/FARC referendum are recent examples that oftentimes the polls can be way off base.

Whatever the outcome, MRP believes the most important near-term consequence of this election for the markets will not be the effect of SCOTUS judge appointments, trade, immigration, regulation, or even tax policies. These are, of course, critically important and will have a major effect in the long run.

But over the next year, MRP believes the biggest effect will come from monetary policy and its effect on the dollar's exchange rate. It would appear that a continued dovish path towards interest rate normalization, even in the face of rising inflation pressures, will be what emerges given a Clinton victory. Last December, we presented our very contrarian view that the U.S. dollar had topped out and explained why we expected a weaker dollar going forward. The consensus view at the time was that King Dollar would continue to rise.

> ***"The most important near-term consequence of this election for the markets will come from monetary policy and its effect on the dollar exchange rate"***

Notwithstanding a sideways move over the past year, the consensus view continues to be that the dollar will strengthen further, and, election drama aside, even the very recent strength in the greenback has been attributed by some to the imminence of the next rate hike in December. Yet, we do NOT believe the conventional wisdom is supported by the historical record, which shows many episodes in which rates went up but the dollar has sagged. As an update to last year's report, we have prepared some new charts that show why we remain bearish on the dollar.

To be sure, there are lots of reasons why exchange rates fluctuate against each other. Economists often cite current account deficits and surpluses, comparative GDP growth rates, and government deficits and surpluses …

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all of which do have a bearing on FX rates in the longer run. Over the very long run, Purchasing Power Parity is a central tendency that exchange rates eventually revert to.

But in the short-to-intermediate term, it's all about the returns on the money ... or rather, where people park their money to protect it and earn some level of return. Trillions of dollars are traded every day as corporate treasurers, governments, hedge fund managers, and various other players move money around the globe. The most obvious determinant of where the money goes is short-term interest rates and their differences from other currency regimes. Other things equal, it makes more sense to keep cash in a currency that has a higher rate of interest. Still, there is another key consideration: however enticing a short-term yield may be, it doesn't buy much if the purchasing power of the currency diminishes by more than the interest earned. This point is often forgotten in much of the FX narrative we see in the media every day.

Let's focus on euro/dollar, although similar outcomes can be seen for other major currencies. Over the four years up through last winter, the U.S. dollar's strength against the euro was often attributed to the usual suspects identified above. But the fact is, the Fed Funds rate had not budged since it was slashed to the 0-0.25% band in late 2008. On the other hand, the ECB rate was also slashed but then was raised again in 2011, until its high in November of that year. Subsequently, a series of moves over the next four years pushed the ECB refi rate down from 1.5% to zero%, knocking other related rates into negative territory. Cumulatively, the ECB overnight rate was cut by 150 basis points while Fed Funds held steady. As a result, the ECB rate went from much higher than the U.S. to a bit lower, and the gap between the U.S. and Eurozone nominal rates narrowed dramatically.

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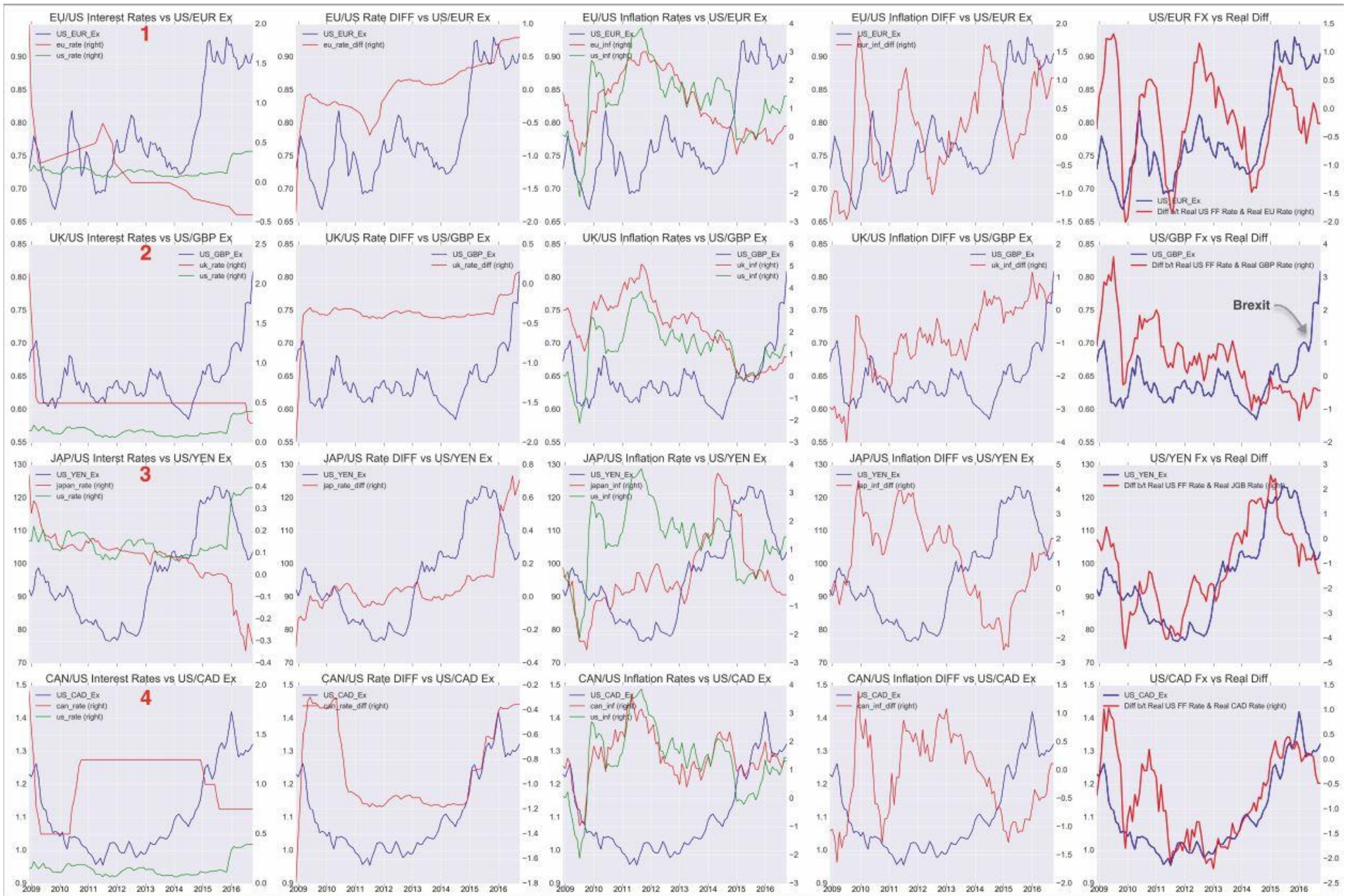
Over the same time frame, inflation rates in both places had fallen a lot, but they fell in the U.S. by slightly more. When overnight bank rates are adjusted for inflation, the swing in "real" rates is thus even more pronounced. International money flows chase "real" yield, however small the differentials may sometimes be.

Towards the end of last year, the consensus view also was that the dollar would strengthen further. The beginning of a rate hike cycle was cited most commonly. Lo and behold, rates got hiked, as expected, but the dollar stopped going up and has remained below its Nov. 30, 2015 high all year. The reason, we believe, is that even though Fed Funds rose by 25 bps, the U.S. headline inflation has soared from zero to 1.5% over that period, pushing the real short term rate down sharply. Over the next few months, the Fed Funds rate will surely go up another 25 bps, but we think as the impact of the oil price recovery kicks in this winter, the headline CPI will come close to doubling again from the recent 1.5% up to the 2.5-3% range. ECB rates are assumed to be unchanged, and inflation should pick up, although not as much as in the U.S. Put another way, the Yellen Fed has been falling behind the curve and we think is likely to continue to fall further, unless, of course, there is a surprise Trump win.

The charts below feature four countries and their inflation rate, interest rate, and foreign exchange rate with the U.S. The flow of the chart is from left to right, with each currency/country having its own row. Each sequential chart in the row provides an underlying variable of the final calculation that culminates in the final chart (i.e. the 5th chart in that row).



Joe Mac

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[1] The corresponding country's interest rate compared to the U.S. interest rate vs the foreign exchange rate

[2] The difference between the corresponding country's interest rate and the U.S. interest rate vs the foreign exchange rate

[3] The corresponding country's inflation rate compared to the U.S. inflation rate vs the foreign exchange rate

[4] The difference between the corresponding country's inflation rate and the U.S. inflation rate vs the foreign exchange rate

[5] The difference between the corresponding country's real interest rate and the U.S. real interest rate vs the foreign exchange rate