Deciphering Dollar Moves

January 26, 2018

The weak US dollar has meant financial conditions have continued to ease, while market moves could get more dangerous if positioning across investors becomes too consensual

With world leaders gathering in Davos over next several days, the dizzying upward ascent of global equity markets is a development which appears to be attracting increased attention in policy-making circles. Over the past 12 months, US stocks have gained by an impressive 26%, with over 10% of these gains occurring in the past couple of months, as trends towards greed have appeared to accelerate and price action has turned more parabolic. With wealth effects benefitting consumption and the return of 'animal spirits' also boosting investment spending, the global economy continues to appear set to continue to accelerate, in our view, and it has been interesting to pick up increased chatter with regard to pay increases from employers as diverse as Starbucks or IG Metall in the past several days. With manufacturers such as LG announcing that it is to raise prices for its washers in response to tariffs imposed in the US this week, this adds to our sense that price pressures may be tilting to the upside – even if inflation remains at very subdued levels for now, and US core CPI data prints could edge lower in Q1, due to seasonal base effects, before heading higher through the rest of the year.

This week's European Central Bank meeting contained little new information in our eyes and more generally, global bond yields have been little changed over the past week, with FX markets providing much more of a focus. Against the bullish global backdrop, the US dollar has come under renewed downward pressure with the DXY index breaking below 90, down 10% from a year ago. Flows into overseas equities have pushed a number of currencies stronger and with the US Administration seemingly happy to talk the dollar down; the greenback has found itself with few friends of late. We would observe that FX markets can be fickle and driven by a prevailing theme or a fashion, which will shift from time to time. We think there will be periods when interest rate differentials will dominate. Other periods will see a commodity theme, a carry theme, a focus on structural imbalances or a focus on central bank reserve diversification. However, at the moment it appears to us that portfolio flows and changes in relative growth differentials are in the ascendancy when it comes to driving price action in FX. In this context, strong US data is being trumped by even stronger data gains overseas and with trend following investors such as commodity trading advisor's (CTA) dominating short-term flows, trend price action has had a habit of becoming self-reinforcing with many of these fund's closing in on double-digits returns on a year-to-date basis.

In our view, another way of interpreting US dollar weakness is that US monetary policy is currently too easy. Certainly, since hiking in December 2016 it has been striking to see financial conditions ease progressively and this would suggest to us that the Federal Reserve (Fed) is 'pushing on a string', with rates sub-2%, in the same way as was the case when rates dropped below this level, following the onset of the Global Financial Crisis. This leaves us thinking that bond yields are likely to continue to rise and that ultimately, the Fed will need to adopt a more hawkish stance. However, such a step seems unlikely in the near-term and we doubt that the Federal Open Market Committee (FOMC) will want to surprise markets at its meeting next week. In addition, it seems hard to think how Jerome Powell, as incoming Fed Chair, will be able to pour too much cold water on the stock market rally as his first act in office, when he was recruited by a President who seems increasingly fixated on the S&P, as a barometer of his Presidential virility.

GS US Financial Conditions Index

01.23.2018
Source: Bloomberg

Looking forward, our general investment thesis has changed little. Greed is dominating and there appears little on the immediate horizon to upset risk markets. Notwithstanding this, experience suggests that when stock markets rise 6% in a straight line within a calendar month, this party is getting a bit out of hand and conditions could be getting more dangerous if positioning across investors becomes too consensual. Consequently, we think it makes sense to start realising some partial gains on long risk positions here and adopting a slightly more cautious view even if we continue to believe that the combination of long risk and short rates is the right combination to maintain. Valuations are less compelling than at the start of the year and prudently trimming risk will allow positions to be added, should markets see a short-term reversal. After all, with world leaders gathering in the mountains, we need to watch for signs of short-term altitude sickness after such a rapid climb.

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