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Macro View

By Hubert Marleau

The Big Picture: The Fed Is Gearing Up to Weaken the U.S. Dollar, Over-Easing When Domestic Conditions Doesn't Warrant It

The U.S. dollar is squarely on the back foot, finally succumbing to falling bond yields and the prospects that the monetary trail will lead to several rate cuts with a full stop of the quantitative tightening process. As a rule, the Fed cuts rates more than just once, even when there is no recession. There is both theoretical validity and empirical evidence that when monetary easing is greater than it ought to be, the exchange value of the home currency tends to weaken. A key part of this equation a potential truce with China. We will know about this one after the G20 meeting this weekend. Suffice it to say that a conciliatory outcome on trade may force the Fed to reassess the urgency and emphasis of easing monetary policy. Nevertheless, several Fed governors--Bullard, Clarida and Kashkari—have signaled that the time has come to turn the corner. As I mentioned last week, the Fed has much more leeway to ease than all the other central banks. I believe the Federal Reserve; the Treasury and the Commerce Department are conspiring against the dollar. Gold as it turns out has been a better safe haven of late—gold price is up 10% year to date, signaling that a broader bearish trend for the dollar is developing.

A dollar slide is due because the U.S. is shifting away from a "strong dollar" policy. Officials of the U.S. Treasury are preparing the ground to place aggressive and forceful currency policies in their trade arsenal. Bloomberg reported last month that the U.S. Treasury increased the number of economies they scrutinize to 21 from 12 and expanded its watch list from four to nine, adding countries such as Ireland, Italy and Singapore under tougher criteria. Meanwhile, the Commerce Department is proposing that the U.S. should seek trade sanctions on goods from countries with "undervalued currencies" and include the threat of sanctions in new U.S. trade agreements. Moreover, Trump's intervention in international economic policy by signaling that certain counties are currency manipulators when they are not is making matters worse. It would not be the first time that the U.S. has bullied others into agreements to forcefully address market manipulation, hoping to soften the dollar—1980 Plaza Accord.

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Given where domestic growth and inflation rates presently stand, the monetary policy pivot is more dovish than it ought to be. The inflation content of the Misery Index and Palos Monetary Policy index are both high by historical standards, strongly suggesting that there are no domestic reasons for the Fed to ease its monetary stance--an even keel policy is what is appropriate. The current environment is a paradox of conflicting data. Some data suggests that the economy is rolling over while other suggests otherwise. Aleksandar Kocic--Deutsche Bank's economist--frames the current dilemma as a "Schrodinger plates" scenario. There is no way of knowing if the economy is a broken arrow or in nirvana. Thus, a source of vigorous debate. It begs the question as to why Chairman Powell took a dovish position, if we are not really dealing with an imminent recession. In the press conference following the FOMC meeting, he had a hard time explaining if a rate cut would help the domestic economy. As I argued in last week's commentary, the Fed is essentially clueless because it is not dealing with probabilities but with uncertainty. He said: "It's really trade developments and concerns about global growth that are on our minds." So, it's about the dollar. Indeed, the best way to get the inflation to a confirmed rate of 2.0% is to lead the dollar down. And that will take lower rates. Neel Kashkari of the Minneapolis Fed, not-to-be-out-done, manifested its ultra-dovish forward view, advocating for a 50-bps rate cut to 1.88% from 2.38% and a commitment not to raise rates again until core inflation reaches the 2% target on a sustainable basis. He could just as easily have said until the DXY is substantially down from its recent high.

Additionally, the inflation bias that has structurally shaped Fed policies for the past 40 years is diminishing. While traditionally policy makers have focused on preventing high inflation from occurring, the deflationary bias is increasingly attracting attention. In this regard, the Fed is probably willing to ease more than it should in order to collect the positive inflationary effect of a lower valued currency. Fed Vice Chair Richard Clarida is on record saying that the Fed is not independent of what is going on in the international money markets. The fact is that the dollar is the dominant reserve currency, the anchor for international rates and the transactional currency of preference. Consequently, the Fed cannot just take its cue from what is going on domestically. In a world of global capital and trade flow, interdependence has its consequence. Thus, there are limits to how far U.S. interest rates can diverge from foreign rates without causing financial, commercial and economic volatility. The limit may have been reached but we do run the risk that market players may lose confidence in the monetary authority pursuing its price stability objective. A situation that could raise inflation expectations and undermine the dollar.

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The curve is inverted, and the neutral rate is lower than the policy rates not necessarily because domestic confidence has been shaken. In fact, the market and several Fed officials want the Fed to adopt a policy of "all-out dollar weakness". As a matter of fact, currency traders are just starting to amass short dollar positions, believing that the Fed is about to embark on an interest rate path that will restore a better equilibrating value for the greenback in the foreign exchange markets. The DXY is universally retreating from a year-to-date high of 98.25, testing its 200-day moving average--a measure of momentum. This morning the DXY opened at 95.87. A deviation from the goal of a strong dollar policy should accelerate the DXY downward trend.

The Fed officials have a few legitimate alibis, helping avoid the blame that the trade dispute is driving monetary policy. The emerging world believes that U.S. rate cuts could be framed as a cure-all for the global economy, economists know that the growth divergence between the U.S. and the rest of the world is closing and currency traders are aware that the dollar is grossly overvalued. On this last point, the "Big Mac" approach to gauging currency valuations reliably shows the euro is about 15% too cheap. Similarly, the OECD's Purchasing Power Parity calculation shows that the Euro is undervalued by 23%. This reality has suddenly been supported by recent events in the marketplace. Price for gold is up, the belly of yield curve has bullishly steepened, interest rate spreads with the rest of the world have narrowed and market-based inflation expectations have risen.

What does this mean for investors? One should be aware that three main equity reflation trades--materials over technology, value over growth and Canada versus U.S.--are at secular lows and sensitive to a directional change in the dollar, offering an attractive entry point for contrarian investors. I would not jump the gun but would also shy away from low yielding bonds. Lower money rates at a time when the inflation rate is pretty much on target can only bring trouble to the long end of the bond market.

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