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Palos Weekly Commentary

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Macro View

By Hubert Marleau

The Main Event in Osaka Was Not the G20 Summit; It Was the Meeting Between Trump and Xi, Making the Currencies More Important Than Deals to Boost U.S. Exports

There is some divergence within the Federal Reserve when it comes to making a case for cutting interest rates in July and beyond. The presidents of the Dallas Fed and the Minneapolis Fed are using realized inflation outcomes, and concerns about falling expectations, to justify their view. However, the leading players like Chairman Powell and Vice Chairman Clarida are emphasizing trade tensions and concerns about lackluster global economic activity to defend theirs. While the stance of both camps is subject to changes in the forward outlook for inflation, the manner in which the trade negotiations evolved last weekend will weigh heavily on the Fed's actions from hereon. The agreement for another ceasefire in the ongoing trade dispute between the world's two largest economies will in the short term force the Fed to reassess the emphasis of easing monetary policy, dropping the idea of a 0.50% rate cut in July. Nevertheless, bond traders are aware that the declared truce in the U.S.-Sino trade war has not eliminated the overhang of the existing duties. They will be reluctant to pare their wagers for a quarter point rate cut in July and around 1% of total reduction by the end of next year. The absence of a time limit on new trade negotiations reveals that they are a long way from having a comprehensive deal.

The initial market reaction collaborated with the above conjecture--bond yields, stock prices, industrial commodity prices, the dollar and the Yuan rose while gold prices decreased. It makes good sense because investors now fully rather than partially believe that this situation may be changing for the better. The China-U.S. trade truce could in time restore confidence in the global economy, allowing interest rate differentials between the U.S. and the rest of the world to narrow further and permit the dollar to weaken.

Macro View cont.

By Hubert Marleau

It looks like a political win-win for both parties. The U.S. would like a lower Dollar to erase the trade deficits and the Chinese want a higher Yuan to avoid a currency crisis. The 2020 presidential election is playing a considerable role in the attempt to achieve a trade truce. Trump is making the bet that the economy and the stock market will hold better with an open-ended detente and Xi probably figures that he will be able to get a better deal under Trump than with anyone of the Democratic candidates, many of whom are advocating an even harder line on China. Joseph Nye, a clever political analyst, argued that President Xi possibly realized that he may have made a mistake last May, making nationalism and politics more important than raw economic calculations.

Thus, they are back on track, averting the all-in tariff scenario, letting U.S. companies sell products to Huawei, committing to a one-China policy and wanting a mutually acceptable deal. Trump's willingness to make concessions was based on not wanting to risk a corporate rebellion, the spread of more Chinese threats or a trade-related recession at a time when recent polls show that he's badly trailing.

However, while the intention of the resumption of high-level talks is to solve the trade imbalances with dialogue, it's not that simple. It is an almost impossible task because international trade is very income, quality and price sensitive. It explains why the Osaka-ceasefire is short on key details and must deal with the reality that the fundamental imbalance in U.S. savings and investment is what drives the trade deficit--meaning either too much domestic investment or not enough domestic savings. The point is that Americans spend too much on goods and services and, in turn, do not save enough to finance their investment needs. Thus, they rely on foreign borrowings to make ends meet.

In this regard, there is a consensus among currency forecasters that a weaker greenback is necessary. The best way to fix a trade deficit is to be competitive. This can be achieved through currency devaluation. And, in order to make good on the desire for a weaker currency, the U.S. government will have to publicly abandon its long-held doctrine that a strong dollar is in the nation's best interests. Because many professional currency analysts and government officials believe that the playing field is no longer level, many political representatives of both the right and the left in the U.S. have put forward various plans to actively manage US$ values to promote exports. For example, Trump has an unlikely ally in Senator Warren who has made several proposals to actively manage the dollar to counter foreign investors and moves by foreign central banks.

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Macro View cont.

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On this latter point, the Treasury Department is responsible for exchange rate policy and it is part of the U.S administration. Last week, Trump accused the EU and China of weakening their currency to gain a competitive edge. Wall Street banks think that the U.S. may intervene directly in the foreign exchange markets, especially if the Fed continues to defend its independence when it comes to comments on the level of the dollar. This would be a distinct new chapter in currency management and strategy. It has been the macro-view since 1995 that a strong-dollar formula reflected a healthy economy, bolstering foreign demand for U.S. assets and reducing the fear of currency losses. Yet in 1985, several nations conspired to weaken the dollar in what was called the Plaza Accord. If trade deals become too difficult to negotiate the U.S. may try to imitate this process internally.

Although the G20 conclave has surreptitiously reaffirmed that exchange rate commitments made last March will stand, it remains that the currency status quo will likely be disrupted. Selling the currency of one country in exchange for dollars could be interpreted as competitive devaluation by another country---on and on. A currency clash can only be postponed for so long, if the intent of the U.S is to dramatically reduced trade imbalances. The above backdrop and the awareness that all the heavy-hitting central banks seem ready to restart a monetary stimulus is what the dollar bears have been awaiting. This is likely to convince the Fed to modify its current stance and jump in with both feet because it can afford to be the most dovish player in the world arena. The extra yield available on Treasuries relative to European bonds and Japanese bonds is still wide.

There is also good reason to let interest rates go to zero as have the EU and Japan. The newly released CBO projections for the U.S. federal budget showed that government borrowing which now amounts to 4.2% of N-GDP will rise to 8.7% by the end of 2049. On average the federal government now pays an average of 2.4% to borrow. The CBO predicts that this will rise to 4.2% over time. The easiest way to avoid a fiscal crisis from happening is to cut interest rates to zero and keep them there as Japan and the EU are doing. This is called fiscal dominance.

Macro View cont.

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From a big picture perspective, the US$ may be about to start its fourth multi-year bear market since 1970. A combination of a structural widening of the budget and current account deficits, an easier monetary policy and a weak dollar policy should drive the greenback lower. The last time the Fed embarked on an easier cycle than its peers, the dollar dropped. When economic growth slows and interest rate differentials narrow, the trade balances can play a huge role in determining currency valuation. The yen looks cheap, but it has a trade surplus. The swiss franc looks expensive and has a trade surplus--both currencies are strong. There you have it. If the U.S. wants a cheaper dollar, declaring a trade peace is the best way to get it. The U.S. dollar index (DXY) touched a 3-year high at the end of May of 98.25---it was 72.23 on March 31, 2008 and registered an 18-year all-time high of 120.25 in 2001. This morning the DXY was 96.32

P.S. As a rule, every month the U.S. current account has a deficit, but it also has a narrowly defined capital account surplus to balance things out. This happens more or less on a regular basis. It's almost axiomatic. The reality is that the narrowly defined capital account surplus, which excludes the central bank's official reserves, does always not exactly equal the current account deficit. This discrepancy occurs when the U.S. is not attracting sufficient private capital from foreign investors to finance the current account deficit. On such occasions something must give--either the dollar must fall, or official reserves of foreign central banks must rise. Imagine the following situation---a current account deficit combined with a narrowly defined capital account deficit. If foreign central banks refuse to increase their reserve for fear of being tagged as currency manipulators, only one thing can happen---a lower dollar.

P.S. The stock market rages on because investors are counting on a lower discount rate as a growing body of bond traders expects zero bound interest rates pushing currency traders into believing that the dollar will eventually stumble. It's why it may be a good idea to stick with the market and continue to buy dips.

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