



Neil Staines
Head of Trading

The US dollar: Last chance to get short?

"I would as soon leave my son a curse as the almighty dollar"

Andrew Carnegie

Correlations

The global economy has been through some very turbulent times over recent years, from the sub-prime debt crisis to the credit crisis (and the collapse of Lehman Brothers), to the banking crisis, the European debt crisis, the Middle East crisis and the natural disasters (human crises) in New Zealand, Australia and Japan.

Throughout the earlier of the aforementioned crises, there was a common theme, irrespective of the derivation or geography of the origin of the crisis, there was a high correlation between investor concern and the value of the USD, or to be more concise the USD benefitted from its safe haven status. More importantly, the safe haven status of the USD has waned in the recent trading environment, despite safe haven status being clearly apparent in CHF and JPY.

There are a number of reasons why the USD has not benefitted in its role as the global 'store of value' in times of trouble as it has in the past. This paper aims to point out some of the underlying concerns for the USD and in its conclusion outline why I now feel that the USD is about to embark on a very significant devaluation.

Global backdrop

Firstly in summarising the global economic backdrop it is important to set out the core financial market themes. Global interest rates remain, on the whole, around zero in the major economies (ex China) and yet despite the low rates, broad risk aversion has left the markets awash with cash whilst investment and risk criteria were pared back as the credit crunch and banking crises struck. With Bond yields now so low in the US and other major economies (ex periphery Europe), the value of Bonds has become moot (the worlds biggest Bond fund exiting all US government debt an example of this). Despite the increasing tensions in MENA (Middle East and North Africa) and the natural disaster (in addition to nuclear concerns) in Japan, global equity markets have been extraordinarily well supported. This can be seen as a very positive sign for investments in equities. In a world where expectations of returns have moderated, but the quest for return still exists, combined with a surplus of cash, suggests an underinvestment in equities which is a very positive backdrop for global stock markets.

As the global economy stabilises, the balance of growth in the global economy will be spread more evenly as major economies pick up pace and emerging economies moderate from the double digit growth witnessed in the initial stages of the recovery. This equalisation of global growth, whilst not being a straight line, will further reduce the flows of funds to safe havens. I have argued above that USD will not benefit to the same degree going forward in a 'risk off' environment, however, the opposite is not true. In a broad positive – 'risk on' environment the equalisation of expectations will lead markets to express views based on differentiation of growth and monetary policy. In this regard the USD continues to rank below GBP, EUR and Scandinavian currencies which I believe are likely to outperform.

Despite the official protestations that the USD remains the world's predominant global reserve currency there is a clear undercurrent emerging across the major reserve holders (China, Russia, Singapore, Middle East, etc.) of a desire to shift, or at least reduce the percentage holdings, of reserves away from the USD and US Treasury holdings. The size of global foreign exchange reserve holdings in the USD are currently so large that even a subtle shift in the bias is enough to induce a significant depreciation of the USD. There has been some evidence of reduced demand in Treasury auctions from China recently and, while this may be a result of the temporary


















Market Themes: *the US dollar*

March 2011



Neil Staines
Head of Trading

trade deficit that China is experiencing, the sentiment towards USD holdings has clearly cooled. For example, Chinese Ministry of Commerce sources recently stating that they are actively looking to curb the growth in the trade surplus with some countries is another negative for USD. No reserve holder or SWF (Sovereign Wealth Fund) is likely to say explicitly that they are looking to reduce exposure to USD or, indeed, that they are selling any of their USD holdings due to the negative impact on their vast current holdings, the gradual and perhaps surreptitious reduction in USD reserves could have a major impact on USD going forward.

Rank	Country/Monetary Authority	FX Reserves (\$ millions)	Figures as of
1	 People's Republic of China	2,622,000	Dec 2010
2	 Japan	1,091,485	Feb 2011
-	 Eurozone (EU member states which have adopted the euro, including ECB)	769,949	Jan 2011
3	 Russia	484,158	Jan 2011
4	 Saudi Arabia	456,200	Dec 2010
5	 Republic of China (Taiwan)	387,200	Dec 2011
6	 India	299,226	Jan 2011
7	 Brazil	297,696	Jan 2011
8	 Republic of Korea	295,956	Jan 2011
-	 Hong Kong	273,176	Jan 2011
9	 Switzerland	271,667	Jan 2011
10	 Singapore	227,110	Jan 2011
11	 Germany	217,144	Feb 2011
12	 Thailand	181,915	Mar 2011
13	 France	160,841	Jan 2011
14	 Italy	153,931	Jan 2011
15	 Algeria	150,100	Dec 2010

IMF Data: The above data show the ranking of Foreign Exchange Reserve holdings of international monetary authorities. It is important to note that these numbers are quoted in 'USD equivalent' amounts and, while the USD is by far the dominant percentage of the total numbers, each country has its own split across relevant trade and investment flows.

Monetary matters

Currently, the most important fact in terms of the near-term direction of USD is the monetary policy stance of the Federal Reserve. The Fed has a dual mandate to manage monetary policy with a view to maintaining price stability and to promote growth, while its European counterparts are mandated to maintain price stability. This has led to a growing divergence between the US monetary policy-makers and (most obviously) the MPC and ECB. This divergence is widening further due to MENA concerns, which have driven the oil price significantly higher, compounding the price pressures in Europe but adding little to the core inflation outlook in the US. Core prices have begun to stabilise in the US and the threat of deflation has clearly moderated. However, while real US rates are firmly

Market Themes: *the US dollar*

March 2011



Neil Staines
Head of Trading

negative and US interest rates look likely to remain low for an “extended period”, USD will continue to remain on the back foot. In the current economic climate, as interest rate differentials (and policy rate expectations) between the US, UK and Europe continue to diverge, this stimulus to a weaker USD will be exacerbated.

Conclusion: imminent opportunity

I have outlined some of the macro economic arguments and theory to suggest a weaker USD. There will undoubtedly be some commentators who will likely offer well-reasoned counter arguments as to why USD should benefit from various macroeconomic, structural, ‘risk’ or value-based arguments and, ultimately, that is what makes a market.

My view, however, is unwavering in the face of opposing conjecture. There will be bumps in the road to regaining global economic prosperity. But we will get there in the end and, in this instance (unlike a number of global downturns), the US will *not* lead the world back to recovery. As such, the USD value – at least until the Fed signal a return to tightening monetary policy – will continue to fall. Arguments of differentiation of economic growth and diversification of global reserves will add to the case for GBP and EUR to outperform.

Increasing global prosperity and a continued boost to business and consumer wealth from rising equity prices will be supportive of the global risk environment. Above I suggested that USD will be a big loser in this scenario, but in the major FX space there are some very clear exceptions to the rule: notably JPY and CHF. Both, in my opinion, are very overvalued. Short positions in JPY and CHF have been held for a long time, and recent moves will have seen all long-held positions capitulated.



EURUSD likely to move back towards the 1.60 all-time highs. Source: Bloomberg

So far, I have not mentioned the scale of my expectations for devaluation for USD. In terms of its value against EUR and GBP I feel that we are likely to move 10-15% before the markets begin to question the rationale. In terms of the GBP and EUR crosses *versus* CHF and JPY, the extension could be even further.

Market Themes: *the US dollar*

March 2011



Neil Staines
Head of Trading



GBPJPY likely to move back towards 180. Source: Bloomberg

It is now – at a time where the global backdrop looks at its worst since the start of the financial crisis – the most efficient time to express this view. It is now that we should be looking to be "greedy while the market is fearful". The scenario that I have outlined above is **not** the central view of the market by any means and, once it has become a core expectation, the moves will become more volatile and a significant amount of the revaluation will already have happened.

USD, at least for now, has had its day.