

Flash Note

Currencies: US dollar

Down but not out

Pictet Wealth Management - Asset Allocation & Macro Research | 31 January 2018

The US dollar lost roughly 4.6% between 19 December, when the US tax cuts were ratified by the Congress, and 30 January.

Growth differentials and monetary policy divergence, which mainly drove USD performance from 2011 to 2017, have failed to support the US dollar since 19 December, despite an improved US growth outlook and a more hawkish Fed.

Among other drivers, strong capital flows into EM asset classes favoured by risk appetite and low US rates are likely weighing on the USD, which is usually used as a funding currency. However, strong US growth and higher funding costs could make EM investments less attractive in the period ahead.

Looking at the EUR/USD rate, we see the rate remaining roughly unchanged at USD1.24 per euro in the next 12 months, a view backed by projections of the real rate differential. In the coming months, improved US data should pave the way for a rebound in the US dollar.

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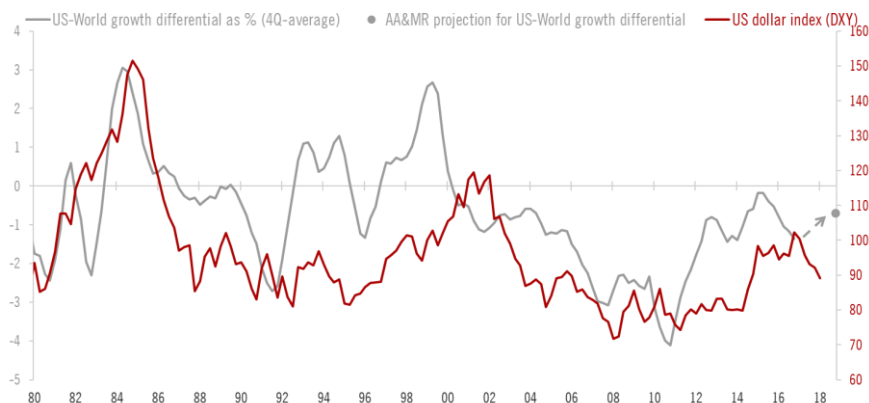
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The ratification by the US Congress of the Trump tax cuts on 19 December should pave the way, in our view, for a significant boost to the US economy (3% growth in 2018, see [Flash Note](#)). With the US economy already growing at an above-trend pace, the fiscal boost increases the risk of economic overheating, which should lead to a more hawkish Fed. One might think that the US dollar should strengthen on the back of these developments. Instead, from 19 December to 26 January, the US dollar index (DXY) lost roughly 4.6%.

In this note, we review some of the drivers of the US dollar and what they imply for its performance in 2018.

Chart 1: US dollar index and growth differential between US and world



Source: Pictet WM – AA&MR, Thomson Reuters, data as of 30 January 2018

Long-term US dollar cycle peaked in January 2017

We see the performance of the US dollar as being impacted by two key drivers: the growth differential between the US and the rest of the world and monetary policy divergence.

The growth differential peaked in the US's favour in 2015 (see *chart 1*), but has been weighing on the greenback since. However, our projections show growth differential narrowing again in 2018, supporting the US dollar unlike 2004-2006, when a widening gap between US and global growth meant the USD weakened in spite of Fed tightening.

Monetary policy divergence is playing less in favour of the US dollar as some major central banks have already tightened their monetary policy (Bank of

Canada, Bank of England) or a looking to normalise it (e.g. ECB). In particular, the ECB has become increasingly confident about the inflation outlook and the reduced impact of exchange-rate pass-through (see [Flash Note](#)).

However, the ECB remains highly dependent on domestic inflation dynamics. Our forecast of subdued core inflation in the months ahead means the ECB could stay cautious, with no rate hikes in 2018 (see [Flash Note](#)). This may limit somewhat the euro's upside potential.

Overall, these two drivers explain quite well the outperformance of the US dollar from July 2011 to January 2017, but fail to explain why the US dollar has been so weak since the start of the year.

US real rates not so supportive of the greenback

A potential explanation of the surprising performance of the greenback is that other currencies have also benefited from improving fundamentals. In particular, the 10-year real interest rate differential has been helping the euro more than the dollar since 19 December (see [chart 2](#)), explaining some of the dollar's surprising weakness in recent weeks.

Looking forward, our projection for the end of this year points to little change in the real rate differential. This would favour a neutral stance on the EUR/USD rate, which reached a spot rate of USD1.24 per euro on 30 January. While we find some explanation for the dollar's weakness against the euro in the real rate differential, why has the US currency been weak against other currencies as well?

Chart 2: US-euro area 10-year real rate differential vs. EUR/USD



Source: Pictet WM – AA&MR, Bloomberg, data as of 30 January 2018

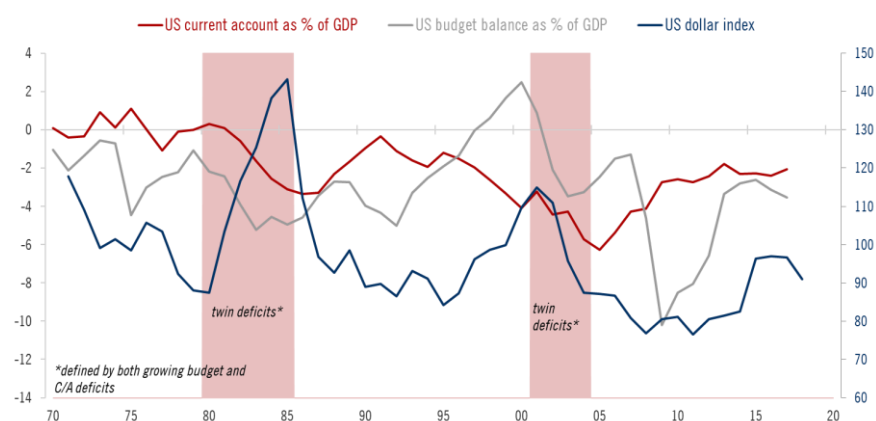
Return of the US twin deficits

Reasons might be found in the US's current account and budget deficits (see [chart 3](#)). However, the US current account deficit has narrowed since 2005 and does not seem near levels that would require a sharp depreciation of the US dollar to reduce it. Furthermore, the UK's current account deficit has not stopped sterling from performing well since the end of the year.

The US budget deficit has narrowed from the highs it reached in 2009. But it has recently shown signs of deterioration with the US tax cuts an additional drag. Coupled with concerns that the US federal government will reach its debt ceiling around March and the strong divide among US lawmakers in

Congress, it could explain some weakness in the dollar. However, during previous debt ceiling 'crises', notably between April and August 2011, the US dollar did not underperform, even though it ultimately led to a credit downgrade by Standard & Poor. Furthermore, the worsening of the budget deficit caused by the Trump fiscal boost is more a longer-term concern, whereas the boost's positive impact on growth should prevail in the short term.

Chart 3: US twin deficits vs. US dollar index



Source: Pictet WM – AA&MR, Thomson Reuters, data as of 30 January 2018

Mind the flows

A consequence of the improving global growth outlook in 2017 has been a rise in risk appetite. Low US rates throughout 2017 favoured flows into higher-yielding asset classes elsewhere, such as into emerging market bonds, at the expense of funding currencies such as the US dollar (*see chart 4*). Interestingly, the US tax cuts increase the prospect of higher US nominal rates through the boost they give to growth and the heightened risk of economic overheating. This has likely generated a second outflow of investments from the US, as global investors, who have bought US bonds in recent years at low rates face up to the risk of a decline in prices. These outflows are mostly detrimental to the US dollar, fitting in well with recent market behaviour (higher US yields, lower dollar).

The attractiveness of emerging-market assets is likely to decrease as the yield on US domestic assets increases. The stronger the US growth outlook, the more quickly the attractiveness of emerging markets could fade. There is also a point where the coupon offered by US bonds will be high enough for investors to return to US bonds.

Finally, we do not expect any significant currency impact from repatriation of earnings held abroad by US companies as the majority of their cash is thought to be already in dollars while a good portion of their other currency holdings is likely to be kept overseas for operating reasons.

Conclusion: USD to rebound as US data improves

Although flows are difficult to predict, they mostly reflect the relative attractiveness of US assets compared to the rest of the world. Our baseline scenario is that the Trump tax cuts will provide a significant boost to US growth. This boost, which is not being fully priced in by markets (the

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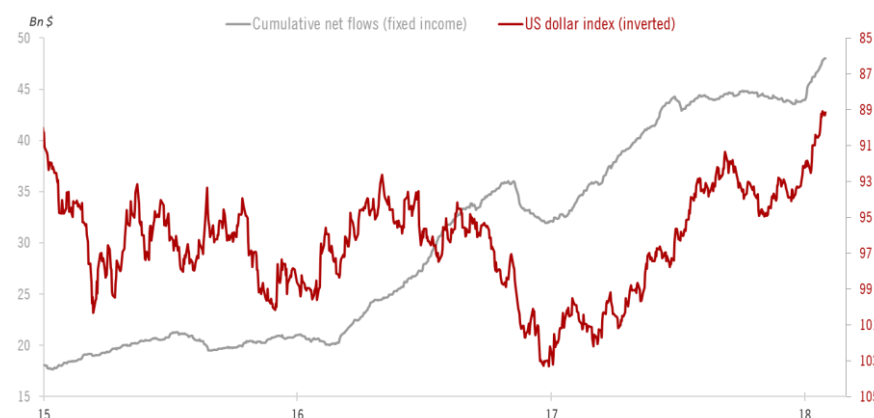
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consensus forecast is for 2.6% GDP growth in 2018), will lead to a more hawkish Fed (with an increase in its 'dot plot' projections for rates due in March). All in all, factors that point to a strengthening of US growth should help the attractiveness of US assets, including the dollar.

Looking at the EUR/USD rate, our forecast for strong US data in the months ahead should pave the way for a rebound of the USD, pushing the value of the euro slightly below USD1.20. But the USD's rebound should be temporary, in our view, with the euro rising back towards USD1.24 by the end of the year as US growth becomes fully priced in and the focus shifts back to the ECB's rate normalisation.

Chart 4: EM fixed income net flows (in USD billions) vs. US dollar index



Source: Pictet WM – AA&MR, Bloomberg, data as of 30 January 2018