

# The Killer Dollar



Q4<sup>2019</sup>  
**QUARTERLY** / OUTLOOK  
By #SAXOSTRATS

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GROUP



# Q4

## 2019

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# Taking down the Killer Dollar

By Steen Jakobsen

When history is written, 2019 will most likely be remembered as the beginning of the end of the biggest monetary experiment ever — the year that kicked off a global recession despite the lowest ever nominal and real interest rates in history. Monetary policy has reached the end of a very long road and has proven a failure. This is the legacy of Milton Friedman and others, who probably never expected a world in which central banks would consider and even enact negative yields to the extent we see today.

There are many reasons why monetary policy does not work over the full cycle, but first among them is the fact that classic easy-money monetary policy only works in “normal times”. Once rates get too high or low, the standard rules and models break down.

Take an emerging-market country like Argentina, for example, which should see massive inflow of capital with its 80% policy rate. Capital, meanwhile, should be fleeing Germany and its deeply negative yields. Instead, money is fleeing Argentina and being hoarded in Germany.

In our quarterly outlook at Saxo Bank, rather than looking for an extension of current conditions,

## “2019: the year that kicked off a global recession despite the lowest ever nominal and real interest rates in history”

we try to look ahead at the next likely policy response, given those conditions. In Q3 we — too early it turns out — suggested that fiscal stimulus was on the way after hitting the nail on the head in Q1 and Q2 with The Policy Panic (Fed hard reverse!) and False Stabilisation themes respectively. Our outlook for Q4 is the Killer Dollar. In a global system of failed monetary policies and a long and difficult path to fiscal policy, there is only one other tool left in the box for the global economy and that is to lower the price of global money itself: the US dollar.

There is an estimated USD 240 trillion of debt in the world, roughly 240% of global GDP. Far too much of this debt is denominated in US dollars due to the dollar’s role as reserve currency and the deep liquidity of the US capital markets.

In this respect, the prospects for all asset classes become a function of US dollar liquidity and direction. If the dollar rises too much, the strain in the system increases: not only for US exports, but also for the emerging market with its high dependence on USD funding and export machines.



## › Taking down the Killer Dollar

**The Fed's measure of USD recently reached an all-time high**



SOURCE: BLOOMBERG

The Fed's measure of the USD is at its strongest ever – north of even the 2002 peak and currently above 130 — versus a level of around 100 as recently as 2013.

US dollar liquidity, meanwhile, is going from scarce to scarcer, as our Christopher Dembik points out in his piece in this outlook, contracting even after the Fed has moved into an easing cycle.

A stronger US dollar and tight USD liquidity will weigh on global growth and create de facto disinflation despite central banks efforts to lower policy rates. Those low rates and the myopic focus on inflation targeting

are adding to the damage by driving an egregious misallocation of capital that destroys productivity. The credit mechanism and productive allocation of capital are by far the most important factors for long-term growth.

Into this mix comes President Trump with his calls for a weaker USD. His first avenue for this is the clumsy attempt to bully the Fed to cut interest rates. When – and not if – his patience with the Powell Fed runs out, he could activate the 1934 Gold Reserve Act which gives the White House broad powers to intervene by selling dollars to buy foreign currency. The Treasury keeps a fund

of USD 95 billion for this purpose. Furthermore, the Fed could print 'new dollars' and warehouse some of the intervention, so there is no real upper limit to the amount of intervention possible. Since 1995 the US has intervened only three times: 1998, 2000 and 2011, every time for international liquidity provision purposes.

Another important angle here is that USD intervention has bipartisan support — Elizabeth Warren is among the voices in Congress calling for a weaker dollar. In her new Economic Patriotism plan she talks about managing the dollar via taxing capital inflow.



## › Taking down the Killer Dollar

The same mechanism is found in the bipartisan Baldwin-Hawley bill. That bill would give power to Fed to tax US capital inflows to weaken the dollar. This reflects President Trump's successful campaign to make the trade deficit an issue and an enemy of the US. It also ties in well with US-China trade talks, which few people think will help reduce the value of the dollar.

In short, US policymakers of all stripes are increasingly warming to active policies intended to reduce USD strength, an extension of Trump's move away from multilateral global institutions and "America First" stance. It's a true case of an "us versus them" mentality.

Remember that all of this is happening at a time where the global credit impulse is weak and getting weaker, where credit transmission is structurally difficult

and setting up a lack of support for the real economy and finally, where the oil of the machine, the USD, is

early 1980s, when the US balance sheet was reset and the USD was anchored by Volcker's victory over

“Weakening the Killer Dollar will likely put the final nail in the coffin of the grand credit cycle”

strong and in short supply. That's not to say that the gambit to weaken the USD will succeed. The "going it alone", "beggar-thy-neighbour" policy will not. Make America Great Again, it will do the opposite: Create a fragmented system supported by government and central banks but without proper market forces and access to distribute money and credit.

Weakening the Killer Dollar will likely put the final nail in the coffin of the grand credit cycle that started in the

inflation after Nixon abandoned the gold standard in 1971. The grand cycle since then has been turbocharged by globalisation and by lending money into existence via offshore USD creation (EuroDollars). A weaker USD can only buy us some time, it won't offer a structural solution. It's the easiest quick fix to what ails global markets, and the one with the least political resistance. The mighty dollar is set to tumble. But be careful what you wish for, USA.



### Steen Jakobsen, Chief Economist & CIO

Steen Jakobsen first joined Saxo Bank in 2000 and has served as both Chief Economist and Chief Investment Officer since 2009. He focuses on delivering asset allocation strategies and analysis of the overall macroeconomic and political landscape as defined by fundamentals, market sentiment and technical developments in the charts.

@Steen\_jakobsen

# The end of US equity outperformance

By Peter Garnry

In April 2008, the USD weakness in real terms that started in February 2002 ended months before a historical credit crunch and tailspin that required astronomical policy effort to mitigate. Since then, the USD has strengthened by 22% in real terms. And in August 2019, it reached a high enough level for the US Treasury Secretary Steve Mnuchin to declare that the US government does not intend to intervene in the USD for now — although he also said that the Trump administration had weighed up intervention. In other words, the US is planning to intervene if the Fed does not manage to weaken the USD through monetary policy. This quarterly outlook examines how this situation will impact equity markets.

## Emerging markets will thrive on weaker USD

The Fed uses the trade-weighted broad USD index to measure how strong the USD is relative to its trade partners' currencies.

Over the period from July 1995 to August 2019, equity returns in the US, the world ex-US and emerging markets have had a negative correlation to the USD.

In other words, whenever the USD weakens equity markets should strengthen. As the world's reserve currency, largest trading currency and the currency used in commodity markets, the USD is an important component in financial conditions. Since the 2008 crash, emerging market countries have seen a large increase in issuance of USD bonds which has added another growth constraint from the USD.

## Correlation matrix

	US Trade Weighted Real Broad USD	MSCI USA Net Total Return USD Index	MSCI World ex USA Net Total Return USD Index	MSCI Emerging Net Total Return USD Index
US Trade Weighted Real Broad USD	1			
MSCI USA Net Total Return USD Index	-0,344	1		
MSCI World ex USA Net Total Return USD Index	-0,505	0,841	1	
MSCI Emerging Net Total Return USD Index	-0,503	0,735	0,832	1

\* Based on monthly returns

SOURCE: BLOOMBERG AND SAXO BANK



## > The end of US equity outperformance

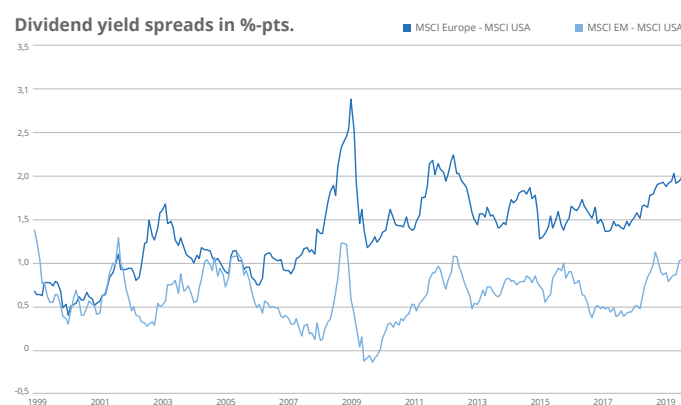
If we break the period into regimes of stronger or weaker real USD, then a clear pattern appears. Whenever the USD strengthens, the US equity market outperforms the world ex-US and emerging markets and vice versa. As explained in our Quarterly Outlook, some form of USD intervention is the next logical policy step. Monetary policy has lost its effectiveness and fiscal stimulus is coming to slowly to offset the weakness in the global economy (the OECD's leading indicators have been declining for 18 straight months). A great irony of any USD intervention is that it will partly help China, which is not exactly the strategy of the Trump administration but as with everything in life there are always trade-offs.

Period	US Trade Weighted Real Broad USD	MSCI USA Net Total Return USD Index	MSCI World ex USA Net Total Return USD Index	MSCI Emerging Net Total Return USD Index
Jul 1995 - Feb 2002	34,2	112,5	10,2	-26,8
Mar 2002 - Apr 2008	-28,6	34,4	102,7	329,0
May 2008 - Aug 2019	27,3	153,8	34,9	5,5

SOURCE: BLOOMBERG AND SAXO BANK

When the strong USD regime ends, investors should overweight European and especially emerging market equities. There is also good support for this strategic position from a valuation perspective as the valuation spread — measured on the dividend yield — has soared

to historically attractive levels for the world ex-US and emerging markets.



SOURCE: BLOOMBERG AND SAXO BANK

### US equities have had a historical run

As we have been writing over many quarters, US equities are expensive in both relative and absolute terms. They remain expensive due to multiple factors ranging from higher share of buybacks, safe-haven status, higher profit growth driven by technology monopolies and finally a healed financial sector. Valuation metrics are difficult to use as timing tools because the market can often remain insane for long periods and maybe we are going through such a period. But rich valuation premiums to other equity markets are typically not a good starting point for relative superior returns in the future.

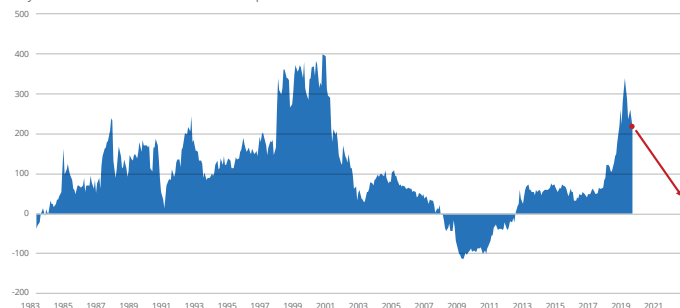
“In other words, whenever the USD weakens equity markets should strengthen”



## ➤ The end of US equity outperformance

### US equities vs government bonds

10-year annualised return difference in %-pts.



\* US equities are measured with the MSCI Daily TR Gross USA USD Index

\*\* US government bonds are measured with Bloomberg Barclays US Treasury Total Return Unhedged USD Index

SOURCE: BLOOMBERG AND SAXO BANK

In February 2019, equity markets celebrated the 10-year anniversary of the equity market bottom during the financial crisis. The celebration occurred with a historic equity outperformance over aggregate US government bonds of 339% or 16% annualised. This is one of the best 10-year periods for US equities relative to government bonds since 1973, only marginally topped by the dot-com peak. It is quite likely that the next 10 years will not offer attractive equity returns in terms of outperformance and especially not when factoring in the downside risk relative to upside risk.

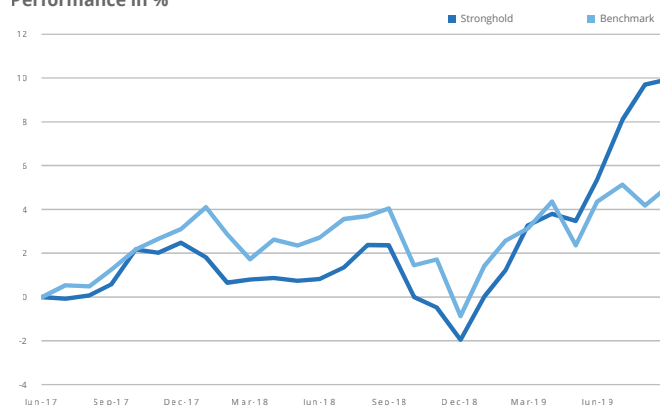
### Stronghold EUR is not in panic mode yet

Our team's tactical asset allocation strategy, Stronghold, went online during the summer on our trading platforms through Saxo Bank's managed portfolio service SaxoSelect. The model behind Stronghold is based on a pure mathematical framework aimed at reducing drawdowns while trying to maximise returns. The model

has a strict risk budget and therefore cuts risk quickly if the market structure become highly correlated across asset classes.

The EUR version of the model is up 10.6% as of mid-September and increased exposure in equities slowly over the first half of the year. But in the last three months, its equity exposure has been reduced to around 40% with the main exposure in minimum volatility stocks. The portfolio is balanced as of September also reflecting our general stance to clients. Remain invested in equities but in high quality and minimum volatility stocks. Investors attempting to escape low yields with pure equity exposure are running portfolios that are at risk to policy mistakes and a potential global recession — which has a probability of around 25-40% within the next 6-12 months.

### Performance in %



The strategy has a reference benchmark consisting of 65 % global government bonds (EUR-hedged) and 35 % developed market equities (EUR hedged). Stronghold performance includes trading costs and management fee. Past performance does not guarantee future results, which may vary. The value of investments and the income derived from investments will fluctuate and can go down as well as up. A loss of capital may occur.

“ Investors with pure equity exposure are at risk to a potential global recession ”



### Peter Garnry, Head of Equity Strategy

Peter Garnry joined Saxo Bank in 2010 and is the Head of Equity Strategy. In 2016 he became responsible for the Quantitative Strategies team, which focuses on how to apply computer models to financial markets. He produces trading strategies and analyses of the equity markets as well as individual company stocks, applying advanced statistics and models to beat the market.

@PeterGarnry



# If the Fed won't kill the dollar, Trump will be happy to lend a hand

By John J. Hardy

We have been trying to call the US dollar weaker this year, with the caveat that the path might prove difficult as the Fed would have to get ahead of the curve — which it has thus far not been able to do. Market expectations are that the Fed's policy path will remain largely unchanged from where they were a quarter ago, and there is increasing evidence that the Fed may not have the tools – or more importantly the will – to get ahead of the curve. Enter the Trump administration, which is likely set to pull out all of the stops.

After the realisation that hiking policy rates in cratering markets in December 2018 was a policy mistake, the Powell Fed's subsequent turnaround and easing has proceeded at a sedate pace. That, even after the initial shocking reversal in rhetoric in admitting the policy mistake in January of this year.

Indeed, while two 25 basis point Fed rate cuts are in the bag from the July and September FOMC meetings — and at least one more is priced for Q4 — USD liquidity and funding issues in the US banking system have become so dire that the Fed was forced to launch a large overnight repo operation the day before the September FOMC meeting in order to maintain control of funding rates. This is a major crack in the Fed's credibility and effectively tips the market off that it is losing control of its balance sheet.

The fact that this issue could sneak up on the Fed so easily should be of concern, hinting that the central bank could remain slow in responding to further USD liquidity issues. At the September FOMC meeting, Chair Powell suggested an ad hoc or TOMO (temporary open market operations) approach to dealing with funding pinches like those that led to their September repo operations, rather than immediately opening up for the idea of POMO (permanent open market operations, or essentially QE) just yet.

**“Something has to give, and that something will be the Fed: whether it wants to or not.”**

The main force driving US dollar's liquidity/funding issues is the mounting difficulty the US is having in funding its current account deficit. This is driven by the twin trade and Trump deficits — the latter having ballooned to a \$1 trillion-a-year clip under Trump's tax cut regime.

As foreign central banks have lost their ability to, and interest in, accumulating USD reserves, the funding for these deficits has largely shifted to domestic sources. US savers' and US banks' balance sheets simply can't absorb the torrent of issuance. Something has to give, and that something will be the Fed: whether it wants to or not.

So far, the Fed has proven too cautious to get ahead of the issue. But in Q4, it is likely that they will be forced to respond in ever larger amounts to further liquidity provision. More importantly, the



## › If the Fed won't kill the dollar, Trump will be happy to lend a hand

Trump administration may wrest control of policy, as suggested in Steen's piece in this Outlook.

Its lofty talk of political independence aside, the Fed cannot entirely avoid politics. And going full in on resuming balance-sheet expansion to control policy rates acts as a powerful endorsement of Trump administration deficits, something it is not likely happy about. Let's not forget former NY Fed Governor Dudley's

speech in Q3 telling the Powell Fed to stick it to Trump to ensure that he is "enabled".

A heel-dragging Fed and dark clouds gathering over the economic outlook almost ensures that the Trump administration will be

scrambling for the funding it needs to ensure Trump's re-election in 2020. Ironically, after a quarter in which the entire world fretted the risk of perma-deflation, this policy mix almost guarantees that we are set firmly on the path to the return of inflation, and likely stagflation.

“This policy mix almost guarantees that we are set firmly on the path to the return of inflation, and likely stagflation.”

### Outlook for selected currencies:

**EUR** – it was clear at the ECB's September meeting that the Draghi ECB era is over and that the central bank is at the end of its policy rope, because virtually all core EU country representatives on the Governing Council were against the resumption of QE. We like EURUSD significantly higher as there is plenty of room for fiscal measures in Europe and new EU leadership in Q4 may well deal with the EU's economic weakness.

**JPY** – USDJPY is another no brainer way to express USD depreciation if the Fed and/or Trump get ahead of the USD funding issues – looking for a move to 100.00 and possibly lower.

**CHF** – the SNB mobilised its intervention policy to ease the franc's ascent, but the sense that

the ECB is done for the cycle after the September meeting may mean there is little further pressure on the franc to appreciate versus the single currency. Especially as any EU existential concerns seem banished for some time now by the awkward new Italian coalition.

**GBP** – We don't even pretend to have a crystal ball here. Brexit questions are at a point of maximum uncertainty as Q3 draws to a close. At some point, either elections or a second referendum would seem necessary, but a hard exit on October 31 can't be ruled out. Either way, further delay will do the UK no favours, as the credit impulse suggests an ugly recession baked into the cake for the UK in the coming quarters. Caution is advised.

**Smaller DM currencies** – these are the trickiest to assess in the coming environment. A weaker USD is a general relief to the global economy, but traders may have to pick their moments as we see strong risks of rising volatility. SEK and NOK look the most undervalued, with SEK possibly set to respond the most sharply if we see a switch to a fiscal approach to stimulus in the EU and/or Sweden.

**EM and China** – all eyes are on October's talks between the US and China. Stabilisation is the best we can hope for, and a weaker US dollar eases China's USD funding needs as well. But EM currencies may be in for a volatile ride as USD weakness provides relief on the one hand while growth outlook concerns and rising market volatility apply negative pressure.



### John Hardy, Head of FX Strategy

John Hardy joined Saxo Bank in 2002 and has been Head of FX Strategy since October 2007. He focuses on delivering strategies and analyses in the currency market as defined by fundamentals, changes in macroeconomic themes and technical developments.

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# Commodities: Weaker dollar propels gold to the next level

By Ole Hansen

The global fiscal panic which we gave special attention in our last quarterly outlook could, over the coming months, be joined by a weaker dollar — as our CIO Steen Jacobsen outlines in the introduction to this outlook for the final quarter of 2019.

The combination of these two developments will, despite recessionary risks, provide underlying support for metals (industrial and especially precious) as well as key US agricultural commodities depending on a weaker dollar to compete with producers from other regions. The energy sector, meanwhile, remains troubled by slowing demand growth. But increased tensions following the Aramco attack should ensure the addition of a geo-political risk premium over the coming months.

**“Gold looks set to continue to benefit from numerous tailwinds over the coming months”**

Gold, which finally left five years of range-bound trading behind to

reach our \$1485/oz target, looks set to continue to benefit from numerous tailwinds over the coming months. The Q3 rally was driven by the collapse in global bond yields — without any support from the dollar which strengthened by almost 2% against a basket of major currencies. We maintain a bullish outlook for

gold, based on the assumption that the dollar will weaken and global bond yields stay low.

Following a period of consolidation, gold could move higher to reach \$1550/oz by year end before moving higher into 2020.

The main reasons for maintaining a bullish outlook for gold (as well as silver and platinum), given relative value plays, are:

- The US Federal Reserve is likely to continue to cut rates, while embarking on another round of quantitative easing
- Nominal and real bond yields expected to stay low and, in some places, negative. This removes the opportunity cost associated with holding a non-coupon and non-interest paying asset
- Continued buying by central banks looking to diversify and, for some, reduce the dependency on the dollar (so-called de-dollarisation)
- The US-China trade war and geopolitical concerns related to the Middle East provide support for a safe-haven perspective
- The dollar, as mentioned, is on its final leg of strength with the emerging risk of US action to weaken it

## › Commodities: Weaker dollar propels gold to the next level

The biggest risk to rising precious metal prices is the potential that a major trade deal between the US and China will reduce expectations for how much US rates will have to fall. However, looking at the data, credit impulses globally continue to indicate that the economic low point is ahead of us, not behind us. The rapid accumulation of long positions through futures and exchange-traded funds is another potential challenge. Overall, however, the bullish outlook for gold should be able to withstand a correction all the way back to \$1384/oz, the level which signalled the breakout of its five-year range.

Last quarter, silver and platinum's comparative cheapness to gold reached historical levels, before relative value players stepped in to take both metals up 15% in a matter of days. The gold-silver ratio, which measures the number of silver ounces needed to buy one ounce of gold, collapsed from above 93 to near its five-year average at 77 — while platinum saw its discount to gold drop from a record \$680/oz to \$550/oz.

While there is potential further gold-led upside to both metals, the potential for outperforming further has been reduced. Increased fiscal spending towards infrastructure and fighting climate change would change this outlook back in favour of industrial metals, to which both silver and platinum also belong.

HG copper remains rangebound with speculators maintaining a short position despite several failed

selling attempts. Looking ahead, support will be driven by supply constraints offsetting current demand worries before a pickup in demand occurs. Infrastructure spending and the move towards copper-intensive electrification will only continue to accelerate as the public increasingly calls for action to combat climate change and pollution. We see a wide \$2.5/lb to \$2.8/lb trading range for the remainder of the year.

Additional support for industrial metals in general comes from the prospect for a weaker dollar. That would bring relief to emerging-market economies troubled by too much debt: most of it in dollars.

Crude oil remains stuck in a wide range, with the pendulum continuing to swing between the risk of lower demand as global economic activity slows and the risk to supplies from sanctions and conflicts. The IEA sees the risk of a supply glut emerging into 2020 with OPEC and other producers potentially being forced to cut production in order to avoid an even lower price.

However, the mid-September drone attack on the world's biggest processing plant in Saudi Arabia showed just how vulnerable the global oil supply chain can be. A supply-driven

price surge at a time of slowing demand rarely ends well. While we see Brent crude at \$60/b by year-end a geo-political risk premium is likely to keep the market higher during the coming weeks until Saudi production normalises, and the threat of a conflict hopefully begins to fade.

“The mid-September attack on the world's biggest oil processing plant showed just how vulnerable the global oil supply chain can be”



### Ole Hansen, Head of Commodity Strategy

Ole Hansen joined Saxo Bank in 2008 and has been Head of Commodity Strategy since 2010. He focuses on delivering strategies and analyses of the global commodity markets defined by fundamentals, market sentiment and technical developments.

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# USD liquidity: It's going to get worse before it gets better

By Christopher Dembik

## Main takeaways :

- USD funding problems will likely increase in the short-term due to the expected ramp up of USD Treasury bill issuance following compromise over the debt ceiling
- The dollar shortage could reach an annualised peak of between \$800-900bn in the coming months
- In general, the USD shortage has positive implications for DXY and negative implications for risk appetite, credit market, EM currencies and the EUR
- Into 2020, US liquidity is expected to increase on the back of improvement in central bank liquidity and global credit impulse

There is only one thing that really matters these days, and it is global USD liquidity. We operate in a dollar-based world, so USD liquidity serves as a key driver of the global economy and financial markets. Since 2014, the world has faced a structural problem of dollar shortage on the back of the Fed's quantitative tightening (QT) and lower oil prices leading to less petrodollars in circulation.

“The massive US Treasury issuance taking place in a period of pre-existing high USD demand will drain liquidity out of the market”

A dollar shortage implies a more volatile environment, a growth slowdown, deteriorated financial conditions, higher USD funding costs — especially for non-US banks — and a sell-off of risk assets. Emerging markets are among the most vulnerable, as noticed in Spring and Summer 2018 when they were hit by high volatility and capital outflow.



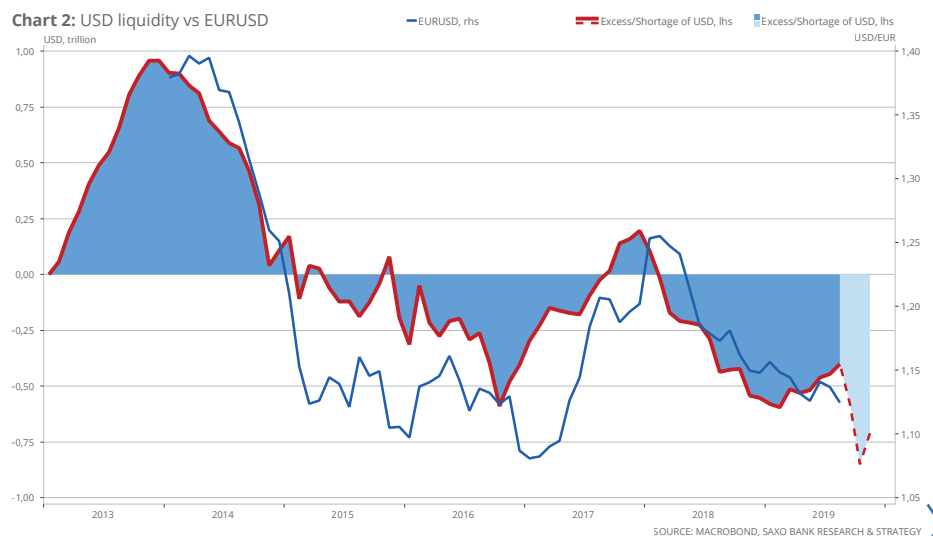
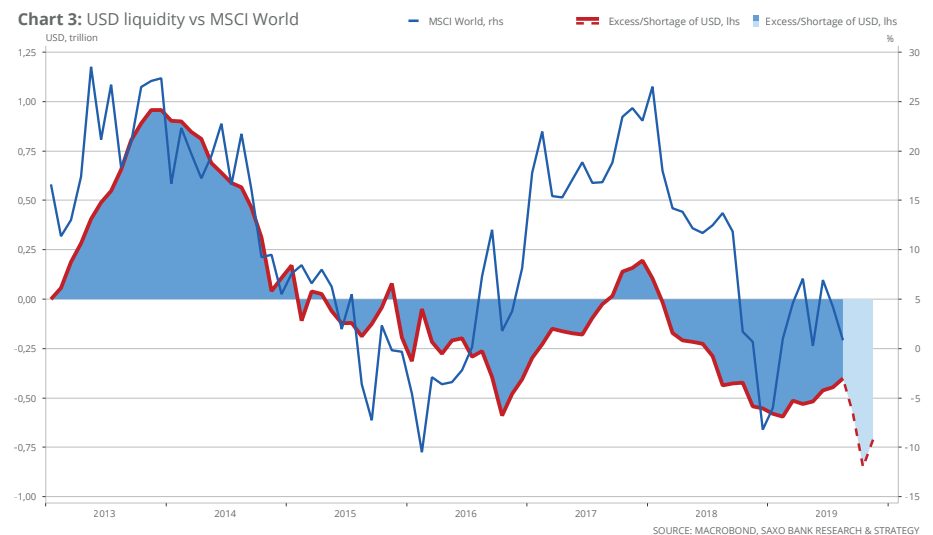
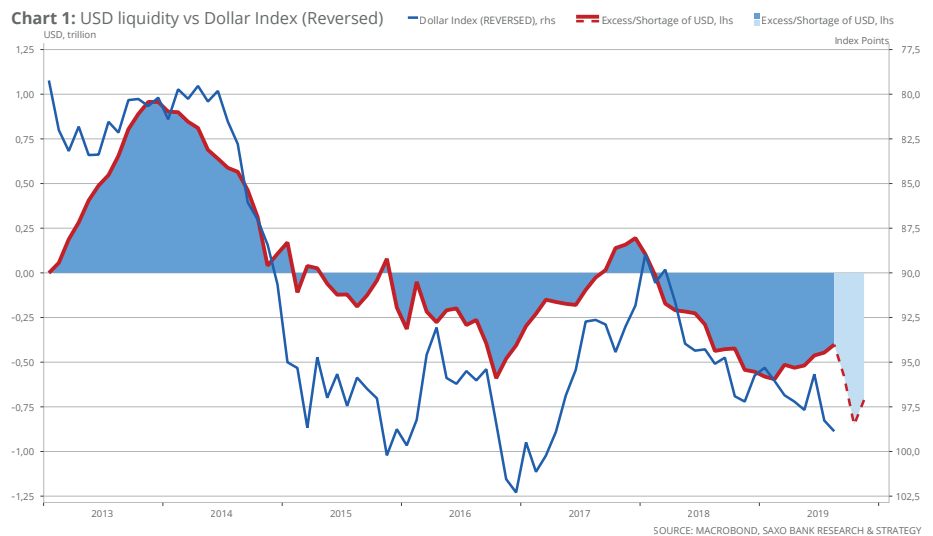
## > USD liquidity: It's going to get worse before it gets better

### The dollar shortage is likely to increase in the short-term

In recent weeks, USD funding problems have increased again. Investors must pay higher premiums to swap euros, pounds, Australian dollars and yen into USD for three months. There is a wide range of explanations behind this, but a key factor is the agreement reached on 2 August concerning the US debt ceiling. It is suspended for two full years and, as a result of the compromise, the Treasury plans on borrowing an additional \$443bn over a three-month period, versus only \$40bn in the previous quarter. This will have major consequences for USD liquidity.

To assess the risk of USD shortage, we use as a proxy the evolution of excess dollars in the US banking system. This is a very good indicator as, in a period of dollar shortage, excess reserves at the Fed stop growing. As of now, the dollar shortage already stands at \$445bn, and it may reach an annualised peak of between \$800-900bn in the coming months. As you can see in the charts below, there is a strong correlation between excess dollars and a wide range of assets, including EURUSD, DXY and MSCI World.

The massive US Treasury issuance taking place in a period where there is pre-existing high USD demand will drain liquidity out of the market and further tighten financial conditions in the fall (October/November), ultimately increasing risks to market segments that are already in a fragile position.



## > USD liquidity: It's going to get worse before it gets better

### USD liquidity is expected to improve into 2020

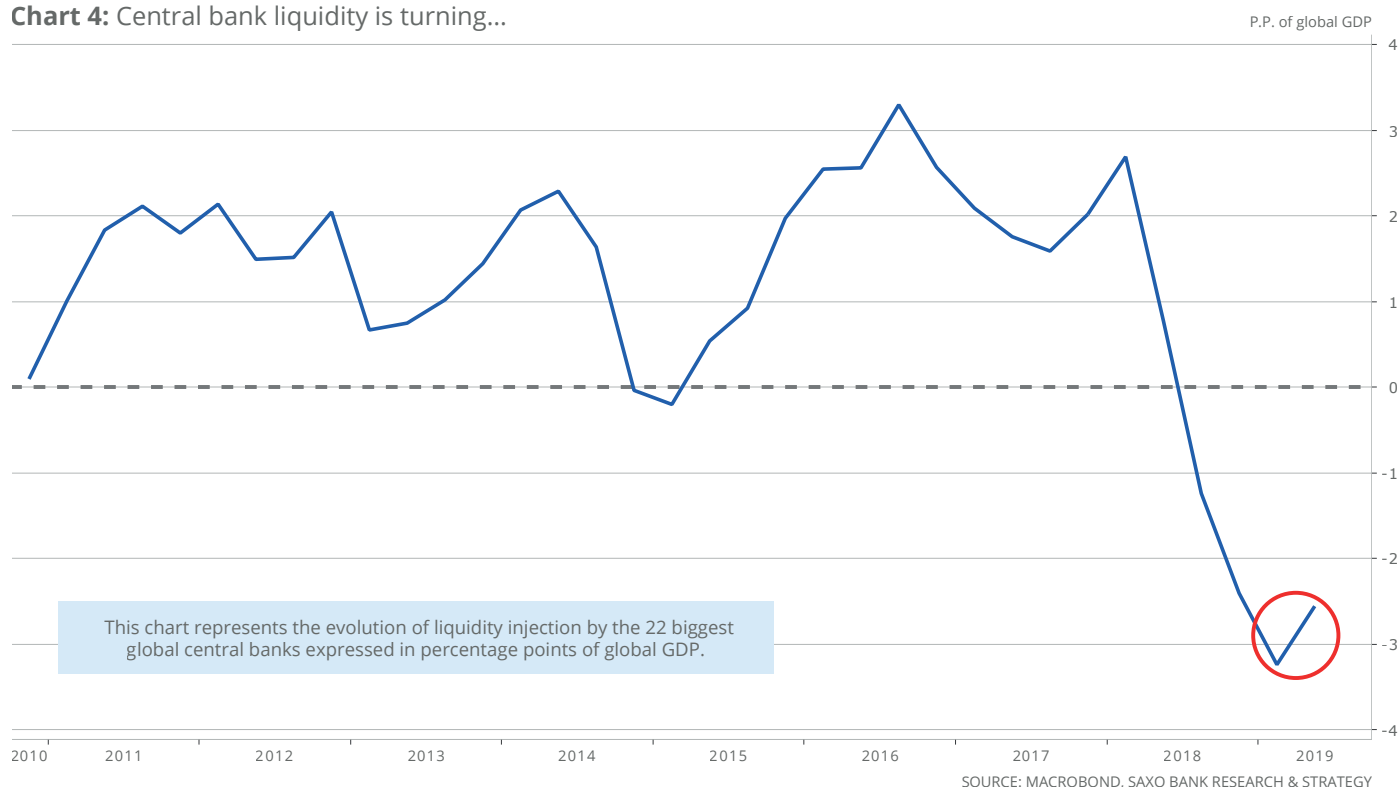
Going into 2020, the view is more positive, as financial conditions and USD liquidity should improve. Central banks should go big in the

coming months to cope with global trade recession, trade war friction and global slowdown.

The chart below tracks the evolution of liquidity injection by the 22 biggest global central banks

expressed in percentage points of global GDP. After years of massive central bank asset purchases, central bank liquidity has started to contract since early 2018. Based on the latest data, there is an emerging trend: central bank

Chart 4: Central bank liquidity is turning...



liquidity is slowly turning. It is still deeply in contraction territory, but it is moving upwards, currently at minus 2.5% of global GDP. For now,

the bulk of the improvement is related to positive liquidity injection from the BoJ. Other global central banks will follow as tightened

financial conditions push the Fed into a dovish corner and as the ECB will need to support the euro area economy for a prolonged period.

“ There is an emerging trend: central bank liquidity is slowly turning ”



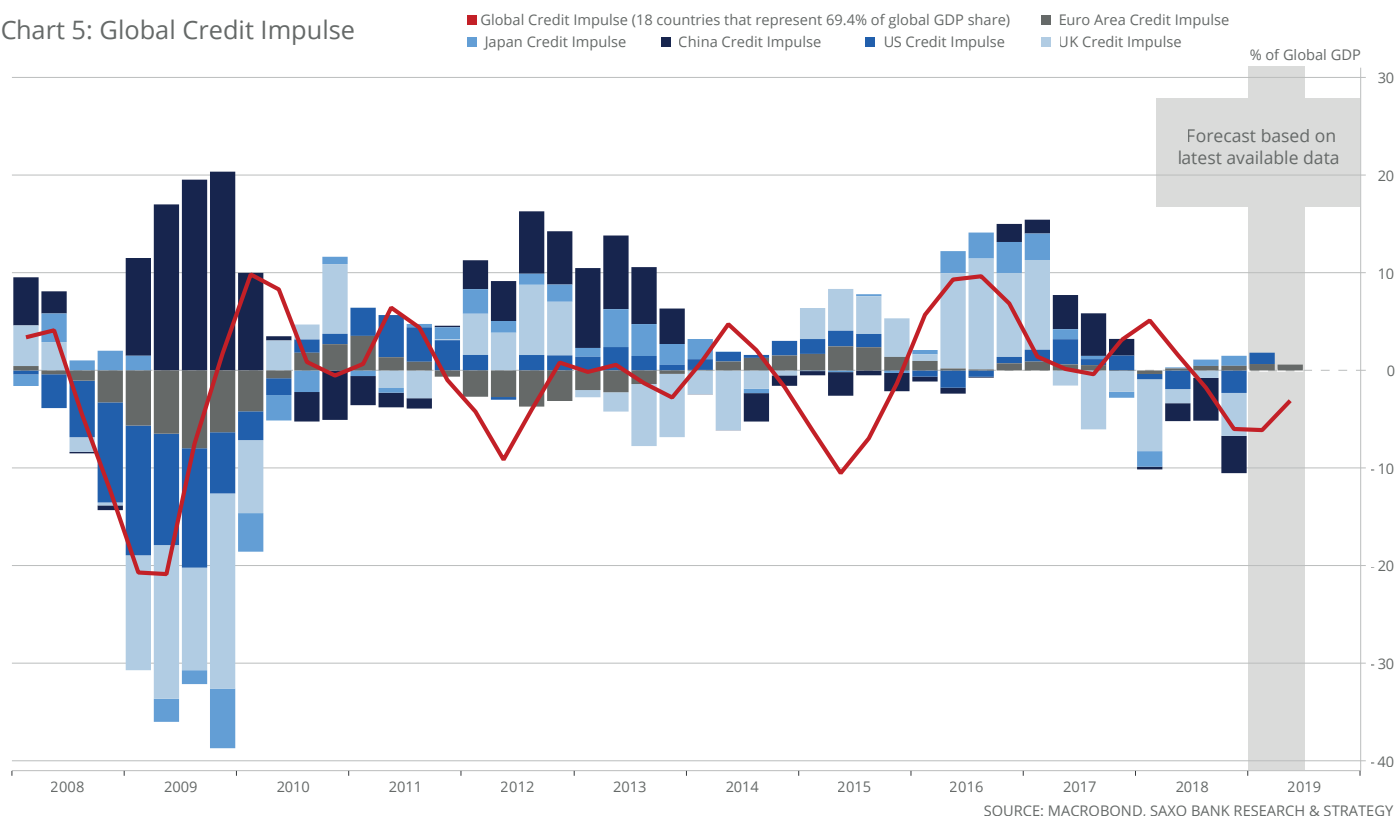
## > USD liquidity: It's going to get worse before it gets better

We may also start to see an improvement of our favorite macro gauge, the global credit impulse, that points out to a potential global growth rebound in H1 2020, mostly

driven by the US. Based on our latest update, US credit impulse stands at its highest level since early 2018, at 1.2% of GDP. The effect of the credit impulse will be amplified

by fiscal push in many countries. If it is confirmed — and this is still an early call — it could open more positive macroeconomic and market perspectives for 2020.

Chart 5: Global Credit Impulse



### Christopher Dembik, Head of Macro Analysis

Christopher Dembik joined Saxo Bank in 2014 and has been the Head of Macro Analysis since 2016. He focuses on delivering analysis of monetary policies and macroeconomic developments globally as defined by fundamentals, market sentiment and technical analysis.

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# For the Asia Pacific region the US Dollar is top of mind

By Kay Van-Petersen

The US trade-weighted USD basket is trading at all-time highs and USD, like an unchecked fire, has continued to draw oxygen out of the room with its steady grind higher this year. This, despite overall lower hedge fund positioning on dollar longs (CoT reports) as well as jawboning from Team Trump. Why has the dollar been so strong and market participants so wrong on the USD call this year?

In hindsight, a few factors come into view. It looks like they'll remain relevant into Q4 and beyond:

1. It's a relative world, and the US has continued to outperform the rest of the world (RoW) economically. The US consumer demand continues to tick along, with an Aug ISM non-mfg. of 56.4% beating expectations of 54.0%
2. Despite starting to cut rates, the Fed still has by far the highest yielding central bank rate in the developed world, at a time when a host of other countries have been relentless with cuts (for instance, New Zealand's 50 base point surprise cut in Q3 2019)
3. Trump's tariffs and international posturing is causing more pain for the rest of the world than it is for the US, thereby reinforcing the US outperformance of the RoW. His actions are strengthening USD, not weakening it
4. The combination of US economic outperformance with still greater yielding assets makes a very strong case for asset allocation flows into the US – which is US dollar positive. The relatively slow economic growth outside of the US makes a case for international-facing US companies, and those based internationally, to focus on the US
5. The bar for a weaker USD is quite high. We would need much more aggressive rate cuts from the Fed for RoW economies to start outperforming the US. We also perhaps may need some kind of Bretton Woods agreement, which looks unlikely given the high level of polarity in geopolitics

For the USD to structurally weaken other currencies must structurally strengthen.



## › For the Asia Pacific region the US Dollar is top of mind

### Will the DollarYuan finish the year above or below 7.00?

Whether USDCNH closes above or below 7.00 by year end, as well as how it fares next year, likely comes down to one factor: Trump's 2020 US Presidential Election strategy. Will he run as a deal maker and negotiator, seeking win/win terms with China and the likes of the Eurozone? Or will he run a tariff campaign, continuing the wave of escalation for another year?

“There is no bear-term ceiling on the DollarYuan as long as Trump is on the attack”

The consensus seems to be on 'the art of the deal', but running on tariffs may make him come across as stronger to his voting base — as well as allowing him greater control of the news flow in 2020. Not to mention that he may be able to justify a bigger fiscal spend down the line if the economic headwinds from the tariffs continue. For now, there is no bear-term ceiling on the DollarYuan as long as Trump is on the attack.

In many ways, Trump may be the best thing to have happened to China. Reforms and much-needed structural measures may have taken longer if there was less stress around the globe.

A pathway for USDCNH back below 7.00 would entail the US dropping trade tariffs and coming to a win/win agreement with China. That, plus a sustainable bounce in Chinese economic growth.

### What currencies have been able to outperform vs. the USD?

Two of the top four currencies to have outperformed the USD YTD are Asian: the Thai Baht and Indonesian Rupiah at roughly +8% in total return as of mid September. For Thailand, it has been a combination of a Goldilocks environment with very tame inflation and decent growth. For Indonesia, it has been a combination of inflation being in check, favourable elections and a central bank that has been easing – drawing inflows to the local bond market.

On the flip side, Asia also has one of the worst performers against the USD YTD in the Korean Won. The KRW is down around -5% in total returns vs. the USD – but this is actually a tailwind for the export-heavy country, as its goods should be cheaper for USD buyers.

“It's a relative world, and the US has continued to outperform the rest of the world economically”



### Kay Van-Petersen, Global Macro Strategist

Kay Van-Petersen joined Saxo Bank in 2014 as a Global Macro Strategist, based in Singapore. He focuses on delivering strategies and analyses across asset classes based on monetary and fiscal policies, global geopolitical landscapes as well as other macroeconomic fundamentals. He also takes into account market sentiment, technical and momentum factors, and corporate bonds with attractive risk and return.

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# USD strength fueling the new normal of slower growth and lower rates

By Eleanor Creagh

The drumbeat of negativity and ubiquitous uncertainty resounded through markets over the summer as the trade war escalated, PMIs collapsed, and multiple geopolitical flashpoints came to a head. The USD, meanwhile, remained strong — breaking out to its highest level in over 20 years — tightening financial conditions globally, killing any green shoots and cementing the path for weaker economic growth. This culminated in the global “race to the bottom” dominating the narrative over summer and resultant highly correlated price moves across a whole host of assets.

This narrative may be taking a late summer sojourn, but will no doubt return once confidence in central banks’ magic wand lapses again, meaning this quarter will likely be turbulent.

Elevated uncertainties have led to larger forecast ranges, less reliable prediction intervals and an inherent negative skew as uncertainty stymies investment and consumption decisions for all economic actors. As pessimism peaked in August and investors sat on the negative end of that forecast range — with extreme positioning across safe havens anticipating economic armageddon — a temporary reprieve on the trade front, and a run of data no longer surprising as dismally to the downside, has seen a sharp reversal in sentiment.

The unwinding of this extreme negative skew and poor positioning for any positive news drove notable consolidation across safe havens and culminated in a seismic rotation under the markets’ surface as the

Momentum factor plunged (and with it, low beta/minimum volatility) and value rebounded sharply. This leaves room for a temporary reprieve on the “race to zero” tape action throughout September while the policy responses aimed at counteracting fading growth steal the limelight in driving price action, particularly as rising geopolitical tensions pause in the run up to China’s Golden Week celebrations and the Central Committee’s fourth

“**Political discontent remains unresolved, and slower growth and lower interest rates will persist**”

plenary session. Citigroup’s global surprise index has broken its record-setting 524 calendar days of negative surprises and is now on the uptrend, supporting risk sentiment as the narrative that nothing is

getting any worse takes hold. However, on a balance of probabilities these moves are probably part of a temporary countertrend bounce. Political discontent remains unresolved, and slower growth and lower interest rates will persist throughout an extended period of economic underperformance. In Australia the RBA cut the cash rate again in early October, and in the US the FOMC will deliver another 25 base point rate cut by year end as US growth catches down to the rest of the world.

Don’t be fooled by the can kicking on the geopolitical front: tensions remain high. The reality is that modern geopolitics continues to fray as issues are not solved, just postponed. The long list of flashpoints cannot be swept back under the rug and 2019 is becoming influential in shaping the decades to come. This is one factor that leads us to believe that in the period ahead active investment strategies are likely to outperform passive strategies.



## > USD strength fueling the new normal of slower growth and lower rates

In valuing a company, we estimate cash flows forever (or at least for very long time periods) and then discount the future cash flows to present value. Lower interest rates have kept valuations high until now, because when rates are lower, the market values future growth more richly. And if the risk-free rate falls while risk premiums and cash flows remain the same, then the effect on valuation is explicitly positive. However, we cannot ignore the impact from the forces that are pushing interest rates down on other valuation inputs. As the economic cycle slows and growth momentum wanes, the effect on valuations from lower rates is countered by falling profits/margin degradation. So there comes a point where lower yields no longer translate to higher multiples.

This outcome will be dependent on the nature and competitive strengths of the individual companies. The risk to valuations then arises from overly optimistic assumptions for expected growth, particularly for highly cyclical businesses masked as secular growth stories or profitless companies for which future cashflows and adoption curves may be overstated. Therefore, equity investors must become more discriminating and focus on companies with strong balance sheets and resilient earnings duration and growth.

Once valuation models are recalibrated with lower long-term rates, then sticking with defensive positioning across bond proxies with consistent and growing low-risk earnings streams, minimum volatility and quality factor exposures remains justified — a position we have maintained since our Q1 outlook.

While the USD remains strong and liquidity tight, macro data globally continues to decelerate and earnings growth evaporates. This will remove the buyback bid, meaning the back up in yields and corresponding rotation into cyclicals and reflation trades will be short-lived: particularly while the Fed remains behind the curve and divided on the path for future rate cuts. For value to continue outperforming quality we need to see a reacceleration in economic growth as we did in the second half of 2016 or, alternatively, an imminent recession spurring rotation into cyclicals in anticipation of the recovery post-recession.

The biggest risk to this view is that monetary stimulus has one last kicker left and policy makers have acted quickly enough to successfully pivot the economic cycle, reminiscent of the reacceleration in growth that we saw in 2016 post Shanghai Accord. We doubt this and have long lamented that monetary stimulus is ineffective in remedying the structural challenges economies endure. Worse, it exacerbates those structural problems inhibiting growth.

Meanwhile, China's stimulus package continues to be targeted and hampered by transmission problems so will not be the reflationary impulse that saves the globe this time around. And when it comes to the drag on growth from the trade war, central bankers are ill-equipped to deal with the fallout. This means growth is likely to remain subdued for a prolonged period and a US recession remains a very real risk.

If we are on the cusp of an imminent upturn in the business cycle, then the current downdraft

in momentum and unwind of the long growth and quality stocks vs. short value and cyclicals would continue in a painful manner. At present we maintain that this is a low probability outcome and view the current rotation as a temporary correction rather than a structural regime shift. Particularly as we begin to approach Q3 earnings season where consensus estimates remain optimistic against a backdrop of elevated uncertainties, margin degradation and the lagged effect of tariffs hikes.

Without real game changers such as a weaker USD, a comprehensive and finalised "real" trade deal reigniting animal spirits or a coordinated fiscal stimulus package from global policy makers there is little reason to retreat from cautious and defensive positioning regardless of tactical bounces in sentiment. While there are whispers of fiscal stimulus being floated, proposals to date fall short of the extensive fiscal stimulus which would be necessary to reignite growth and buy into the value rotation with confidence.

Australia is the poster child of this dynamic, whereby the tax cuts already implemented have done little to spur consumer spending or confidence. The propensity to spend extra cash has been reduced as Australian consumers remain overleveraged and devoid of any pick up in wage growth while economic uncertainty is on the rise. More substantial fiscal stimulus will be needed as monetary stimulus loses its potency in order to boost productivity and reignite the private sector.

As global economic data resumes its downdraft and the lagged effect of the September tariff materialises, the retracement across safe havens

## › USD strength fueling the new normal of slower growth and lower rates

and defensive positioning will run its course. This represents a buying opportunity at better entry levels for those assets which outperform against the backdrop of lower growth and lower rates.

With respect to trade, the real problems are still unresolved and President Trump still has a Twitter account ready to unleash volatility. Despite the temporary ceasefire, tariffs have been hiked in May and September and uncertainty is rife. This weighs on confidence and capital spending decisions and accelerates the bifurcation of global trade and technology.

An interim deal addressing the trade deficit could be reached but there appears to have been no progress made on key issues such as IP reforms, technology transfer practices or enforcement of any deal. The underlying dynamics which reach far beyond trade call for continued escalation in tensions, despite any intermittent off ramps, which means that over the medium-term pressure on risk assets lingers.

The relationship between the US and China has fundamentally changed. We have crossed the Rubicon in terms of the potential for these ructions to trigger a broad economic dislocation. Equities

remain in a precarious position, near all-time highs as the business cycle continues to slow, earnings growth fades against consensus estimates remain too optimistic. Dollar liquidity is tight, and the risks of a bleed of recessionary dynamics in the manufacturing and industrial sector into services, jobs and the consumer are building. Monetary stimulus, meanwhile, provides less

of the economy and is where the bulk of employment sits. Consumers are carrying the US economy and the Fed must move to arrest the bleed into the consumer and outlook for private consumption, which would accelerate the end of cycle undercurrents and significantly raise recession risk. At present, the Fed has been clear in its intention

“Equities remain in a precarious position, near all-time highs as the business cycle continues to slow”

of a cushion than in previous cycles. As yet, the ongoing retrenchment in capital expenditures and recessionary dynamics in the manufacturing sector has yet to fully permeate the services sector or the consumer. But this is a very real risk — and one to be avoided as private consumption continues to underpin the economic expansion in the US.

The manufacturing sector represents a smaller part of the economy so growth can continue even while that subsector exhibits recessionary dynamics. The problem is that the manufacturing sector typically leads the services sector lower, which represents a larger part

to extend economic expansion. But they have leant against dovish market pricing in their rhetoric and remain behind the curve. This is a problem, because as trade uncertainty looms and the economy continues to deteriorate, neutral rates will also track lower, meaning the Fed will have to move aggressively in order to provide relief and ward off a sharper slowdown. Without being well and truly ahead of the curve, the Fed will also not be able to engender dollar weakness: which will continue to be a significant hinderance to any reflation.



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Eleanor Creagh joined Saxo Bank in 2018 and serves as the bank's Australian Market Strategist, responsible for creating, implementing and monitoring equity strategies and research for traders and investors, as well as developing quantitative models and customised mathematical frameworks for institutional clients. Eleanor holds a double major in Finance and Economics from the University of Sydney.

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