In the past seven months, the U.S. dollar has done just about everything. As evidenced in the chart below, from November 2017 to January 2018 it suffered losses against many of the other major currencies. Then in February and March 2018 it went basically nowhere, almost as if it were patiently watching the big moves in other markets. Now in the spring, the dollar has rallied. Last year, the case for stronger dollar seemed very convincing, so the initial sell-off surprised a number of forecasters. Often it takes time for different themes in the market to play out in price action. That can make it just as surprising when a theme finally does play out. And it can make a modest move by historical standards seem enormous.

The 2017 arguments for a stronger dollar were based on the divergence in monetary policy. The U.S. was hiking rates, while much of the rest of the world was not. Despite some fairly strong European data, the European Central Bank promised to keep rates low. Many forecasters expected that the U.S. tax bill would exacerbate this divergence by stimulating growth and increasing inflation. [1] There was initially some talk that the changes to the repatriation tax would lead to dollar inflows, but this was effectively debunked when folks realized that much of the foreign money held by U.S. corporations was already held in dollars. [2]

The arguments for a stronger dollar made sense, but markets don’t always focus on the most obvious or logical stories. In this case, market participants may have started worrying more about the twin deficits in the U.S. than growth or inflation. The twin deficits were nothing new—the U.S. has run both government and current account deficits every year since the early 2000s. [3] To finance these deficits, the U.S. has sold a lot of bonds to foreign investors. [4] Many forecasters thought the tax cut would increase the budget deficit and could increase the current account deficit to the point of becoming problematic for U.S. assets. Suddenly the U.S. dollar’s yield advantage didn’t look as attractive. The U.S. may have needed higher rates or a cheaper currency to attract the necessary financing.

This also came at a time of some political uncertainty. There was (and still is) talk of trade conflict. Currency devaluation is one tool
countries can use to improve trade competitiveness. The Treasury Secretary may have added some confusion when he kind of, sort of, maybe said that the U.S. would consider such a policy. [5] This was of particular concern because the U.S. is the most widely held global reserve currency. Foreign reserve managers probably don’t want to hold their national savings in a currency that is being purposely devalued. At the very least, uncertainty about the long-held strong dollar policy may have made them uncomfortable.

Since then, a few things have changed. While trade remains a hot topic, talk around intentional U.S. dollar devaluation has quieted. And more importantly, U.S. rates have risen both in absolute terms and relative to those in many other countries. While there is no way to know exactly what level of rates is high enough to bring in foreign investment, it seems as though differentials are wide enough to compensate for the twin deficits. U.S. assets may now be attractive again.

At the same time, volatility has gone up in equity markets. [6] which creates a potential demand for safe haven assets. There has been a lot of debate over the years as to whether the dollar is a risk-on or risk-off currency, and at varying times it has acted like one or the other. Some strategists have tried to explain this by talking of a “dollar smile,” which means that the dollar rallies when the economy is either really good or really bad. When the economy is middling, the dollar performs poorly. This does seem to fit the data, but the reasoning behind it often seems convoluted.

Whether or not the “dollar smile” exists, the dollar has been a fairly reliable safe haven this year. We’ve argued in the past that there isn’t one single safe haven; rather, different markets protect against different risks. Some of the big concerns markets have right now — such as emerging market debt, European politics, and slowing global growth — are dollar friendly. [7]

Of course, the dollar does not exist in a vacuum. If the dollar is going up, it means something else is going down. The euro is the second most widely held reserve currency and is widely regarded as the most natural dollar alternative. The European economy had been doing well in the past couple of years, but has started to slow, and inflation remains low around the continent. The elections in Italy have provided a reminder that the euro still has political risks. The ECB, which was already planning a very subdued timetable for normalizing rates, now has more reasons to be cautious.

Because the recent move in the dollar is not particularly large, its effects across markets and economies have been limited. The strong dollar is putting pressure on some of the more indebted EM countries, in some cases forcing them to raise rates or seek outside assistance. [8] But it hasn’t brought commodity prices down, even in dollar denominated markets such as crude oil. It also hasn’t led to any obvious changes in developed central bank behavior or rhetoric. In the future, unless there’s a global economic crisis, interest rate differentials should continue to be a major driver of the dollar. Despite the improvement in its relative political and economic position, the U.S. will still need to import a lot of capital. And that comes at a cost.

What We’re Watching

**Eurozone Preliminary CPI (Thursday)** In recent years, the European Central Bank (ECB) has maintained an accommodative monetary policy stance, encompassing a negative target for short-term interest rates and a sizeable asset purchase program. While these policies may have contributed to improved growth in the region over the last couple of years, they have yet to produce clear progress in pushing CPI readings towards the ECB’s goal of inflation “below, but close to, 2%.” [9] Core CPI, which excludes the volatile impacts of food and energy prices, rose just 0.7% YoY in April, a far cry from the 2% goal. [10] The minutes of the most recent ECB meeting noted that “measures of underlying inflation remained subdued and [have] yet to show convincing signs of a sustained upward trend.” [11] If inflation readings in the months ahead fail to show some evidence of acceleration, the ECB could well decide that its asset purchase program should be extended beyond its current scheduled end date in September.

**U.S. Employment Report (Friday)** Historically, the most-watched elements of the Bureau of Labor Statistics (BLS) monthly employment report have been the net change in non-farm payrolls and the unemployment rate. Recently, those two components have told a more or less consistently positive story. The BLS estimates that job growth has averaged 190,000 per month over the last year, comfortably above the pace needed to keep up with growth in the working-age population. Unemployment fell to just 3.9% last month, the lowest rate since the peak of the tech boom in 2000. While trends in payrolls and unemployment have been fairly straightforward, a puzzle has emerged with respect to wage growth. Despite statistical (and anecdotal) signs of a tight labor market, readings on average hourly earnings growth have shown little upward momentum over the last couple of years. [12] A continuation of subdued wage growth would suggest that the labor market is still not overheating, which would allow the Fed to remain patient in tightening monetary policy without worrying too much about upside risks to inflation. Conversely, a pickup in employee compensation could prompt a more aggressive approach from the central bank, potentially weighing on U.S. equity and fixed income markets.

**U.S. ISM Manufacturing PMI (Friday)** The Institute for Supply Management’s Purchasing Managers Index (PMI) is watched closely by economists and market participants to assess the strength of the manufacturing sector as well as the broader U.S. economy. The index reached its strongest level in over a decade earlier this year, but has since cooled off slightly. [13] PMIs from Europe and Japan have also drifted lower since the start of the year, [14] and further declines in the ISM moving forward might indicate that momentum in the global manufacturing cycle has peaked.

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[2] You thought you would make it through a weekly without seeing a strawman? Think again!

[3] The U.S. has run an average budget deficit as a percentage of GDP of -4.1% and an average current account deficit as a percentage of GDP of -3.6% from January 1, 2001 to December 31, 2017. Source: Bloomberg.
This supports the dollar to the extent that buyers of U.S. bonds don’t hedge their currency risk. Current account deficits can also be funded in a number of other ways, such as foreign direct investments or even bank deposits.

"Mnuchin backs weaker dollar in break with tradition," Financial Times 1/24/18.

The VIX Index has averaged 18.6 between February 1, 2018 and May 23, 2018 versus an average of 10.6 between November 1, 2017 and January 31, 2018. Source: Bloomberg.

If the main concern in the global economy was the U.S. current account deficit, maybe the dollar wouldn’t be so good.

Two recent examples have been Turkey and Argentina. After several weeks of rapid depreciation in the Turkish lira, the central bank of Turkey held an emergency meeting on May 23, 2018 and announced a 300bps rate hike aimed at stemming lira depreciation. After rapid depreciation in the Argentinian peso, the central bank of Argentina hiked its key policy rate aggressively to 40% and the Argentinian government announced on May 8th it was beginning talks with the IMF, seeking a credit line to help fund the government.

ECB, "The Definition of Price Stability."

European Central Bank.

BLS, Account of the monetary policy meeting 25-26 April.

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