

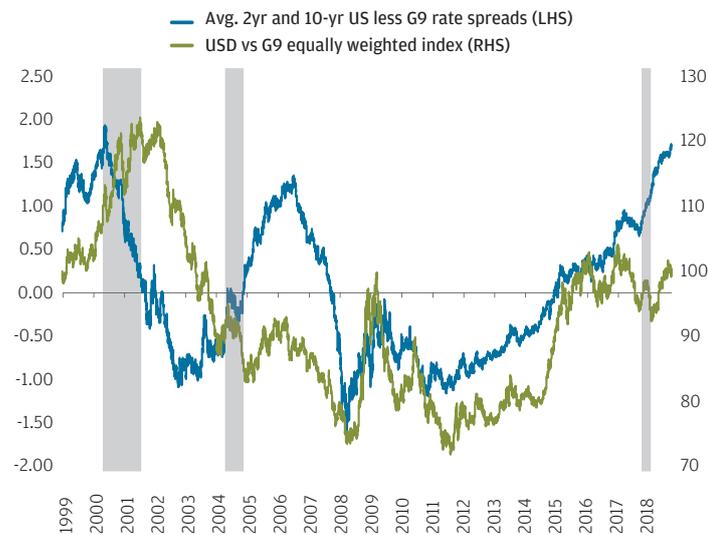
Currency Thoughts

September 2018

Why has the dollar diverged from rate spreads?

Towards the end of 2017 and through January 2018, the performance of the US dollar significantly diverged from relative rate spreads. In January, US yields rose 14 basis points relative to other G9 equivalents, while the US dollar fell almost 6%. This divergent performance was unusual when viewed from a historical perspective, but has reoccurred again, albeit to a lesser extent, in recent weeks.

HISTORICAL DIVERGENCE IN RATE SPREADS VS USD



Source: Bloomberg, 1 September 1999 - 25 September 2018.

Drivers of divergence

There was a great deal of debate in January 2018 as to the likely causes of the divergence. The prevailing environment was one of strong US and global growth, consensus overweight US dollar positioning, rising bond yields and equity markets, and also rising trade tensions between US and China. The market focused on the possibility that rising trade tensions had prompted reserve managers, notably China, to start to diversify their FX reserves away from the US dollar. However, the International Monetary Fund's COFER (Currency composition of official foreign exchange reserves) data for the first quarter of 2018 revealed little, if any, selling of US dollars from reserves managers, with subsequent data suggesting that private capital and merger & acquisition flows away from the US dollar were responsible for the dollar's divergence from rates.

Where are we now?

Over the past few weeks a similar trend of divergent performance between the US dollar and relative rate spreads has occurred. We believe the current divergence is largely, although not exclusively, positioning driven. Our view is that the US economy is likely to continue to outperform and rates spreads will continue to move in the US dollar's favour. Therefore, once the positioning flush of consensus overweight US dollar positions has been completed we will see some, albeit not complete, US dollar re-convergence to rate spreads.

However, we do also acknowledge that the longer-term outlook for the US dollar remains negative. The US dollar maintains pre-eminent reserve currency status, but we believe that status is being eroded over time. The fiscal outlook for the US is poor and question marks surrounding debt sustainability will inevitably rise the longer the US attempts to run fiscal deficits in excess of 5% of GDP. The increased use of the US financial system to penalise opponents of US policy (for example, the re-imposition of sanctions on Iran and Russia) will likely serve to accelerate the move by other major global powers to diversify away from using the US dollar as the major currency in trade and finance. China has a long-term ambition to increase the international use of the renminbi, while European Union Commission President Jean-Claude Juncker was explicit in his state of the union speech in September 2018 that he'd like to see an increased international role for the euro. The more isolationist approach by the Trump administration is also providing space for other global powers to increase their influence. The announcement that China intends to respond to rising trade conflicts with the US by cutting import tariffs from the rest of the world (excluding the US) is an interesting example of this.

Where next?

We believe there remains scope for future short-term US dollar outperformance based on cyclical developments. However, we are mindful that longer-term structural developments will act as a constraint to US dollar performance. Ultimately, the US dollar would be likely to decline sharply if yield support for the currency was to reverse.

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- Dynamic 'intelligent' currency hedging aims to reduce currency volatility from the underlying international assets and add long-term value over the strategic benchmark. A proprietary valuation framework is used to assess whether a currency looks cheap or expensive relative to the base currency and the hedging strategy is adjusted accordingly.
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NEXT STEPS

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