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INVESTMENT INSIGHTS

GIM Solutions-GMAG – Weekly Strategy Report

1st December 2014

FOCUS ON CURRENCIES

- One of the most crowded short-term trades
- Longer-term dollar fundamentals remain positive
- Currency wars or skirmishes?
- Chart of the week: Real oil prices since 1861

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One of the most crowded short-term trades. The U.S. dollar has become a significantly crowded trade. Recent data from the CFTC show that there are sizeable long positions in the currency, standing just below the highest levels for 10 years. Survey data, such as the Bank of America Merrill Lynch Fund Managers Survey, as well as our own proprietary sell-side survey, show sizeable overweight positions. Finally, the DXY trade-weighted USD index is trading at a 52-week Sharpe ratio of 2.0, signalling the highest risk-adjusted returns in at least 18 years. None of this suggests that the dollar will reverse rapidly and correct, but it does suggest that the dollar is more likely to react to bouts of bad news, rather than to pieces of good news.

Longer term, however, we believe the dollar uptrend has further to go. One sell-side analyst has observed that the last two dollar bull markets in the 1970s/80s and the 1990s lasted for six to seven years each, with trade-weighted appreciation of 67% and 40% respectively. In contrast, the current upturn, which started in 2011, has seen an appreciation of 21%. So in the context of the past 40 years, this dollar bull market does not look exhausted.

Longer-term dollar fundamentals remain positive. Despite these short-term observations, we remain constructive on the dollar. The U.S. economy continues to outperform the other major regions. Real GDP growth was revised higher in the past week, from 3.5% annualised to 3.9%. Moreover, there is clear evidence of global decoupling: according to our currency team, using two-year growth differentials, there is a clear acceleration in the U.S. relative to its trading partners and this has historically led to a trade-weighted appreciation of the dollar.

On the face of it, policy normalisation should add further support to the dollar, and the U.S. is likely to lead the rate normalisation process in 2015. However, the case for Federal Reserve (Fed) tightening, which is now priced in to start in 3Q 2015, is not an open and shut one. Inflation expectations have been in a downtrend recently, with the U.S. 10-year break evens falling to 1.83% this week, compared to 2.27% as recently as June. Indeed, our favoured metrics to gauge the inflation/deflation pendulum have fallen towards levels that signal possible deflationary concerns. On balance it is likely that reduced inflation expectations are a key reason why expectations for Fed tightening have been pushed back until later in 2015.

One of the drivers of lower headline inflation has been the decline in oil and commodity prices, which have fallen further (though the tightening in the U.S. labour market should underpin core inflation). The oil price is now off by 36% since June, which provides a massive effective tax cut for the oil importing developed world. The only question is whether this could prove to be *deflationary*, with lower terms of trade compressing income growth in the oil producers (especially in the

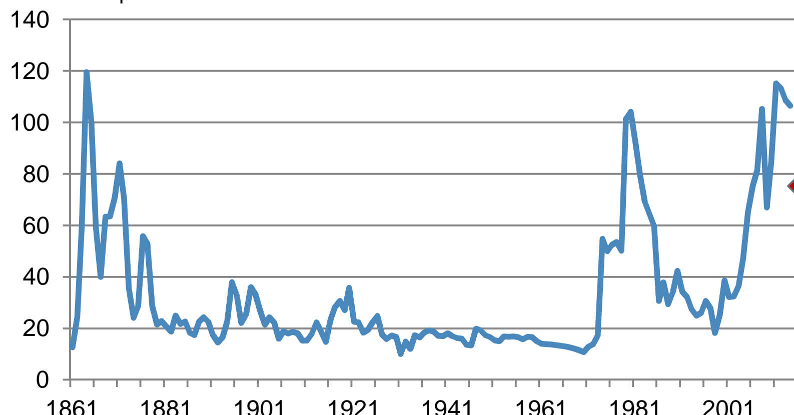
Chart of the Week

Our COTW shows crude oil prices in constant prices. Crude oil prices in nominal terms have fallen to USD 72.8 per barrel, a 29% drop year to date. However, in real terms the average decline is much less, with the 2014 year-to-date average down slightly from the 2013 average. We have shown the estimated latest price in real terms, which suggests that the market declines are modest compared to the traumas of the 1860s and 1980s.

Sources: Bloomberg; BP statistical review of world energy 2014, yearly data up to 2014

Real oil prices since 1861

In 2013 USD prices



J.P.Morgan Asset Management

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Miscellaneous Musings

- There are 18 currencies that have outperformed the U.S. dollar year to date (with the Somali shilling the star performer), while 11 others have been broadly flat vs. the dollar. However, these 29 currencies are generally minor.
- After its recent declines, the Russian rouble currently trades at 49.5 to the dollar. In real effective exchange rate terms, it is down 23% year on year. This is some transformation: the rouble is 3.1 standard deviations below its five-year average, suggesting it is now undervalued having been 2.1 standard deviations overvalued as recently as January 2013.
- On the Russian equity front, the RTS index has fallen drastically by 53% from its peak in 2011 to the currently level of 974. This compares to previous declines of 80% in 2008/09 and 93% in 1997/99. Extreme lows have tended to bring massive recoveries: the Russian market rose an annualised 50% between 1999 and the peak in 2007, so perhaps when political risk calms down in Russia, we may be at an attractive entry point.

emerging markets) thereby leading to a consequent reduction in demand for OECD exports. Given that the emerging markets in aggregate (including both oil exporters as well as importers) have accounted for 57% of global real GDP growth from 2010/14 (which compares to an average of just 36% from 1992/07), then this terms of trade shock (and it is a shock) could have more complex effects. Clearly, there will be winners as well as losers. The winners are more likely to be found in Asia, with the Middle East and part of Latam set to be hurt.

But should lower oil prices prove to be beneficial to the OECD, which we think it probably will, then one of the shorter-term risks to continued dollar strength could be a much stronger recovery in the eurozone than is currently priced in. It is notable that eurozone data remains weak, although the most recent releases have been slightly better than (dismal) consensus estimates. Our sense is that the eurozone weakness has been due in large part to an excess inventory, which is currently adjusting. The PMI data show a decline in new orders less inventories, suggesting a potential build-up of inventories that are being unwound through a slump in industrial production. Inventory cycles tend to be short and unpredictable but if this thesis is correct, eurozone activity could reaccelerate into 2015, with a consequent boost to earnings growth. Stronger growth in Europe could thus act to slow the rise in the dollar—provided, of course, that the ever-mercurial political establishment in Europe doesn't ferment renewed instability.

Currency wars or skirmishes? One potential investment theme in 2015 could be the use of unorthodox policy measures as a means of fiscal deleveraging. This leads to the question of monetisation, especially given the recent easing in Japan, and whether the global economy is entering into a series of currency wars. The weakness of the yen, which has fallen by 33% in trade-weighted terms since July 2012, has exported deflationary pressures to Japan's trading partners in Europe and Asia—which may offer some colour on why 10-year Bund yields have converged towards JGB levels. But Japan's policy action raises the question of whether there will be retaliatory measures adopted.

This author has been eagerly watching out for any signs that the Chinese authorities will signal their discomfort by allowing the renminbi to depreciate to protect China's industrial and export sectors. The ECB appears likely to resort to full QE by purchasing sovereign governments bonds—if only in an attempt to achieve its stated objective of increasing its balance sheet by EUR 1 trillion. Full blown balance sheet expansion in Europe, Japan and perhaps China is likely to bring volatility in the FX markets and some sizeable changes in competitiveness.

At this stage, we see the currency environment as more akin to guerrilla warfare rather than full hostilities. But if, say, the yen/dollar rate were to weaken much further than the current JPY 118 level, it would be easy to imagine that policymakers in Frankfurt, Beijing—and Washington—could become very concerned. So, while it has been a great run, the "easy money" in the long dollar/short everything else trade has been made. There is a fundamental rationale for continued dollar strength, but dollar bulls may need to be more inventive and nimble to avoid potential drawdowns.

David Shairp

All data sourced from JPMAM, Bloomberg, and Datastream, unless stated otherwise.

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