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Around THE Curve

The Deal on the Dollar: Divergence

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Bad things tend to happen when the U.S. dollar rises too much. Unfortunately, there has been a lot of that lately, with most of it playing out in the emerging world, at least so far. The dollar is up a little more than 7% against other major currencies this year. However, the JP Morgan Emerging Markets Currency Index has fallen to a new low, down almost 15%. The iShares MSCI Emerging Markets ETF has tumbled 20% from its peak this year. Meanwhile, Turkey and Argentina are in crisis mode. Perhaps most important, the CRB Raw Industrials Spot Price Index is down for the year along with the MSCI Global Equity Index.

The emerging world's systemic vulnerability to dollar strength derives from balance sheets and national income statements. The balance sheets of emerging market corporates are loaded with U.S. dollar-denominated debt, having taken advantage of cheap dollar credit fostered by unorthodox monetary policy in the developed world over the last 10 years. Systemic balance sheet risks and even specific idiosyncratic risks can lie fallow for long periods during which time foreign investors can earn a handsome carry. It takes a rally in the dollar for these vulnerabilities to manifest into investment losses and emerging market stress. In these instances, dollar strength weakens any emerging market-based borrower's ability to service dollar-denominated debt. As for their income statements, those developing countries running large current account deficits are first in line when foreign lenders go on strike. When it comes to dollar strength and emerging market current account deficits, the lesson to foreign lenders from past crises is to panic early and panic often.

This kind of systemic dollar risk is really no different from any borrower's or debtor's vulnerability to more stringent lending conditions—except for scale. The problem is that more than half of global gross domestic product (GDP) comes from the developing world and China; the great majority of incremental growth over the last several years also originates from these countries. Yet, the bulk of world trade and finance continues to be conducted in U.S. dollars. Therefore, excessive dollar strength can be a meaningful threat to global economic growth. Weakness in emerging markets and the recent slides in the CRB and industrial metals equate to deflationary pressures.

So what's the deal on the dollar?

There is a macroeconomic story embedded in an asset price at any moment in time, and the current story lifting the dollar is "divergence." The two anchor countries in the global economy, the U.S. and China, are on different trajectories. The U.S. economy is in a mini-boom while China's economy is in a mini-slump. Big tax cuts and deregulation have helped stimulate the U.S. boom. Chinese policymakers' renewed focus on deleveraging has triggered slower growth due to a big fiscal contraction—public sector investment spending has fallen to zero from roughly 20% in the last year—and an attack on shadow bank lending. Monetary policy in both countries is also diverging. The Federal Reserve (Fed) is raising rates and shrinking its balance sheet partly because President Trump's tax cuts make the central bank more confident about the outlook. The People's Bank of China is slashing market rates partly because the fiscal contraction makes the central bank less confident about the outlook.

The escalating trade war is clearly part of the economic divergence. Investors have concluded that China and the emerging world have a lot more to lose than America. The Shanghai Composite Index is down 25% this year; broad U.S. equity markets are close to or at all-time highs.

The last time we had this kind of economic divergence was 2014 - 2015. U.S. economic growth rallied from 1.5% in the first quarter of 2014 to 4% in the first quarter of 2015. In contrast, China's economic growth slowed throughout this period on the back of policy measures aimed at deleveraging the economy. Correspondingly, the broad dollar index exploded 27%. By early 2016 there were clear signs of stress across the emerging market corporate sector as dollar stringency started to claim its victims.

The story of economic divergence ended in 2016 and so did the dollar bull market. The U.S. economy retreated from a growth rate of 4% back to 1.3% by mid-2016. Chinese nominal GDP bottomed around 6% at the end of 2015 and topped 10% a year later. There were multiple drivers to the convergence, not the least of which was the overvalued U.S. dollar itself. Dollar strength combined with the bust in energy led to a profit recession in the U.S. economy which in turn drove an economic slowdown and sidelined the Fed's normalization plans. Gross private investment in the U.S. fell from roughly 7% in 2014 to about 1% by the end of 2015. China's policymakers, for their part, engineered the biggest credit reflation since 2009. This feat drove the rebound in Chinese nominal GDP growth, helping lift the developing world and commodity prices at the same time. From its peak in 2016, the broad dollar index dropped roughly 11% to its low in late 2017.

Many have drawn parallels between the current environment and this earlier period of economic divergence. While there are signs that the divergence in growth might be cresting, there is still not much evidence pointing to economic convergence just yet:

- China's policymakers are beginning to dial up fiscal spending in an effort to stabilize the economy and the People's Bank of China has been cutting reserve requirements and money market rates. At the same time, policy rates have been left unchanged and the government still has its eye on the shadow banking system. The focus on deleveraging has really not lifted nor has the growth rate in total social financing. In addition, the government may be keeping its powder dry if the trade war heats up with the U.S. next year.
- In the U.S., the profit outlook remains strong. Profit growth from abroad has peaked but domestic financial and non-financial profits remain in an uptrend. This strength should continue to feed a robust domestic capital spending cycle as well as encourage the Fed to keep tightening the screws.

Obviously, there is a limit to economic divergence. In theory, there is an inflection point where the dollar gets so strong, emerging markets so weak, and commodity prices so depressed that U.S. profits begin to weaken and the domestic cycle turns lower. Our sense is that the divergence is already rather stretched and U.S. growth is probably near a peak. President Trump also seems concerned that any further strength in the dollar will sap U.S. vitality, judging from the salvos of criticism and his promise to keep waging war with the Fed.

One added concern is that the profit picture in the U.S. might not be as positive as it looks. It is possible that Trump's tax cuts may only have a one-off, transitory impact on earnings. Furthermore, the tax cuts could be concealing a weaker trend brought on by the combination of a strong dollar, higher interest rates and energy prices, and the added operating costs related to tariffs.

Markets act to adjust to equilibriums. Dollar strength is both a manifestation of the divergences in the global economy and a corrective mechanism. If this divergence has peaked, as we think it has, then there could be some—but not much more—upside in the greenback. However, a significant weakening in the dollar is not likely before there is a more defined convergence between the U.S. and China. That may take time, and the trend may be obscured by what could be a lot of volatility associated with upcoming trade negotiations.

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