Origo Insights – The shrinking USD?

Opportunities in forex markets are rare as markets are generally highly efficient. We view odds are increasing for a USD weakening potentially of some 20% eventually taking EUR/USD towards 1.45. Procyclical forces covered in "[a sector rotation is building]" of 17 August are contributing to the dynamics – so are maybe also secular forces.

That sinking feeling

When judging the USD we usually compound 4 parameter factors: sentiment, yield spreads, balance of payments and technical factors.

The faster moving components (yield spreads and technical factors) suggest further weakness ahead.

Regarding *sentiment*, USD has ever since WW2 played the role of the world's safe haven in times of trouble (together with gold, that is). But not this time. After 21 February when the stock markets tanked, USD has actually weakened by more than 10%.

This caused USD to break through a trendline since 2008 where USD had fallen to 1.58 Against the EUR. This was followed by nearly 12 years of strengthening, at some point in 2017 reaching 1.03. There is nothing magic about breaking a trend line, but it attracts attention from market players when a trend has been in pace for a long time.

Incompetent

An important causality factor in this picture is the catastrophic CoViD-19 handling in the United States. Europe is currently witnessing progress in its approach to stop the "second wave", while the USA is nowhere near getting the pandemic under control and it only seems that social distancing measures will become more intense.

Combined with the gradual automatic expiry of various economic stimulus packages it looks as if the USA will trail all other significant countries in respect of economic growth. We first noticed anomaly this back in May 2020.

Currently some international growth forecasts are being updated, but significantly, they all assume a significant new package of help to be introduced. We are more sanguine about this. Majority Republicans seem to be intent of limiting such help.

It is only too easy to conclude that USD's safe haven status currently is undermined by the incompetent handling of CoViD-19 and its economic consequences. This may not be a lasting situation, but for now it is rather palpable.

Secular factors or current events

Other secular factors are also at play and they also point in the direction of a weaker dollar. The US economy is still the world's largest and the USD is still the world's most important reserve currency. But recently we have received some news that can easily be taken for signs that the importance of the USD is declining.

USD has been overtaken by EUR as the currency for cross border transactions - as SWIFT could report last week.

Last week also saw the most tangible consequence of Trumps economic isolationism. The Obama administration invested 7 years of negotiations to create a new free trade zone in the Pacific Ocean called TPP. Trump withdrew USA from the project in January 2017 following his inauguration, with unsubstantiated claims of it being a bad deal.

This left the barn door open for China who continued the efforts to build a large free trade zone. Mid November we received news of the Regional Comprehensive Economic Partnership (RCEP). It is a free trade zone with 15 members and covers 30% of global trade. There is little doubt that China will use this vehicle to further reduce the influence of the USD in the region.

How to use this for your portfolio

One thing is to believe in a weakening trend of the USD. It is a different game to use it for practical investing.

Obviously, currency traders will know what to do, but portfolio investors are in a different situation.

The USA stock market comprise some 52% of the global listed stock market, including CAD, AUD, NZD, Arab countries, we get over 65% weight of USD denominated stocks. USD denominated bonds comprise some 2/3 of the global bond market - a large portion of which are corporate bonds.

It means that any global portfolio will be influenced by a USD weakening and this should be played using currency hedging of the portfolio.

Finally, for individual stocks it is always tricky to discern the importance of a weaker dollar. It requires detailed knowledge of the company's total exposure to USD and to the hedging strategies used by the finance arm of the company.*02 December 2020.*