MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 025 // **May 31, 2021**

Topic of the week: Why is the dollar down?

- **The dollar has depreciated since last year against a wide range of currencies.**
- **The long-term equilibrium rate for the EURUSD is 1.24, so the dollar has only come closer to its fundamental value. The dominant cyclical factor appears to be the very rapid expansion of twin deficits.**
- **The massive inflow of liquidity into the U.S. money market has also played a role. This effect is transitory in nature.**

Market review: Growth underpins risk assets

- **Strong growth in the US, recovery in the euro area**
- **Biden sees $6T budget next year**
- **T-note unmoved by projected deficits**
- **Equities higher, stable credit spreads**

Chart of the week

The global EPS revision ratio (computed as the net upgrade divided by total revisions) is at a 30-years high.

This suggests that trailing earnings growth will likewise reach very elevated levels. The growth rate could even reach 40%, a level unseen over the past 30 years.

The rebound of profits, from a very depleted level, is hardly a surprise. The scale and the pace of the rebound however has caught analysts by surprise.

Figure of the week

5.8

Source : OECD

5.8%. This is the OECD's global growth forecast for 2021. It has been revised sharply upwards (4.2% expected in December) following the vaccination campaign and the massive American stimulus plan.

Stéphane Déo
Head of markets strategy

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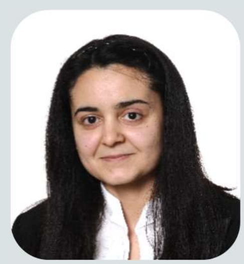
Global strategist



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Emerging countries strategist

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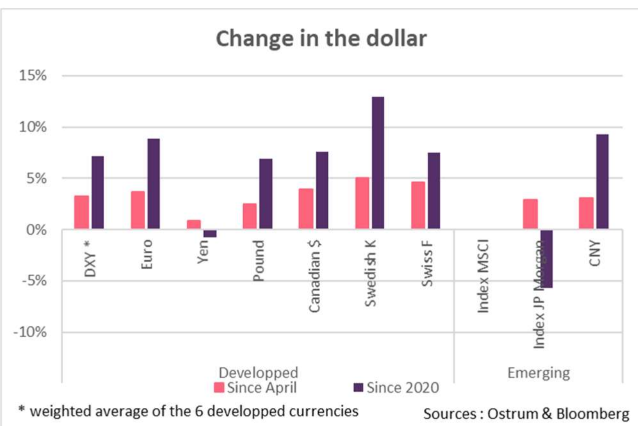
Developed countries strategist

● Topic of the week

Why is the dollar down?

The dollar has depreciated since last year against a wide range of currencies. The very strong US recovery has not changed anything, on the contrary, the depreciation has been accentuated since the beginning of April. We propose a three-step explanation, first with a structural view that sets the long-term equilibrium valuation. Then a more cyclical approach to take into account the variations around this long-term fair-value. Finally, a short view on the huge recent liquidity movements that have necessarily contributed to the depreciation of the dollar.

Despite very strong growth figures and an unprecedented economic recovery, the dollar is headed downwards. It has lost 3.8% against the Euro since the beginning of April and 9.0% since the beginning of last year. This weakness is not limited to the cross against the euro, the chart below shows that the weakness of the dollar is very widely shared among the major currencies of developed countries. While the situation for emerging countries is, as usual, much more contrasted, the strength of the Renminbi has continued and, overall, the emerging currency indices have also tended to appreciate.

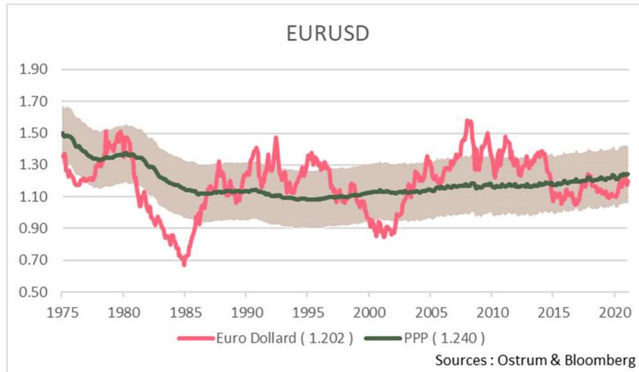


How can we explain this weakness in the greenback? We propose a three-step approach: first a long-term, structural approach, then a more cyclical approach to take into account medium-term developments, and finally a short-term approach based essentially on cash flows[1].

The long term view: back to fair value

Let's start by setting the long-term framework, the canonical model in this case is the "purchasing power parity" or PPP. The intuition is simple: imagine that inflation is at 10% in the United States and 0% in Europe. It implies, if the exchange rate remains unchanged, that American goods are 10% more expensive than European ones. In order to rebalance, the dollar must depreciate by 10%. Formally, the PPP therefore assumes that the exchange rate evolves in parallel with the difference in inflation between two countries.

The good news, as shown in the chart below which uses almost half a century of data, is that this approach is very effective in describing long-term trends in Euro/Dollar parity.



However, there are two practical problems with this approach.

- The first is that the actual exchange rate can deviate significantly from the PPP: in 2008 the Euro was overvalued by 35% compared to the PPP, it was undervalued by 42% in 1985. More generally, the exchange rate observed diverged by at least 10% from the PPP in the majority of cases since 1975. So, the model lacks a lot of precision.
- The second problem is that PPP provides a valuable estimate towards which the exchange rate reverts back. But while differences in PPP tend to be erased over time, they are erased on a decade-long scale. So, the divergence is very slow to correct itself.

We must therefore use this approach for what it is: an estimate of a long-term anchor point but with very limited relevance to describe volatility and short-term developments.

However, it is interesting to note that our estimate of the present value of PPP is 1.24. The level of the EURUSD is currently 1.22.

[1] For the dedicated ones, this approach is a simplification of the « NATREX » models which include a structural equation to capture long term fundamental value, a cyclical one to capture the medium term movements, and a third one based essentially on flows of funds.

Conclusion

This "structural" or "long-term" approach therefore shows that recent changes in the dollar only bring it very close to its long-term equilibrium value. A return to normal in some ways and certainly not an aberration.

The medium-term view: twin deficits

As we have said, while PPP is useful, it does not capture medium-term changes in exchange rates. The variations around PPP are essentially cyclical. There are several approaches that can help us better understand these variations.

Essentially, there are three most preferred approaches to capture the cyclical aspect:

1. Interest rate differentials:
2. Growth differential:
3. Twin deficits:

Which one is best? The answer is essentially empirical. Let's have a look at the data.

Interest rate differentials

This is one of the explanations favored by the markets. The intuition is simple: if rates are higher in the United States, they will attract investors and thus contribute to the appreciation of the dollar. This idea was validated by the latest data on purchases by Treasury's foreigners (the famous «TIC») which were at the most historical for the month of March.

However, this approach poses a problem: which rates to choose? Short or long? It is usually the short rates that provide the best signal for exchange rates. The table below shows the correlation of the rate differential with the EURUSD since 1995 and shows that the best results are actually found for the one-year rates.

Correlation between the exchange rate and the yield differential

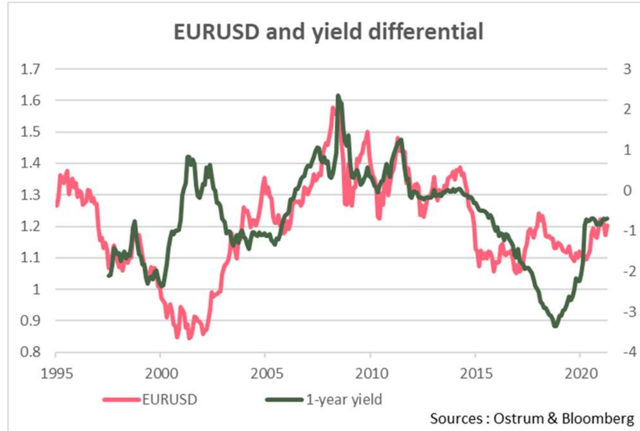
	1-year yields	2-year yields	10-year yields	1-year in 1-year	Slope 1Y-10Y
EURUSD	47%	29%	27%	19%	-43%
PPP	-7%	-4%	-58%	-32%	-47%
Deviation	50%	29%	41%	25%	-35%

Source : Ostrum & Bloomberg

It is easy to understand, however, that cash flows on the foreign exchange market are dominated by short-term ones, and thus by the money market. It is logical to think therefore that the short part of the curve plays a predominant role.

However, the problem with this approach is that the relationship is far from stable as shown in the graph below. If the rate differential did indeed provide a very relevant signal between 2003 and 2015 (72% correlation, which is a high level for an exchange rate) the performance since then is more than mediocre (only a 6% correlation).

Unfortunately, this approach is much more unstable than its widespread use suggests.



A small caveat to be complete. We must be careful however not to throw this approach completely out the window: by taking only this year's data, we obtain a much closer relationship between the EURUSD and the interest rate differential as shown in the graph below. The relationship, if it has been very unstable over the past decade, seems to be back in vogue.

The growth differential

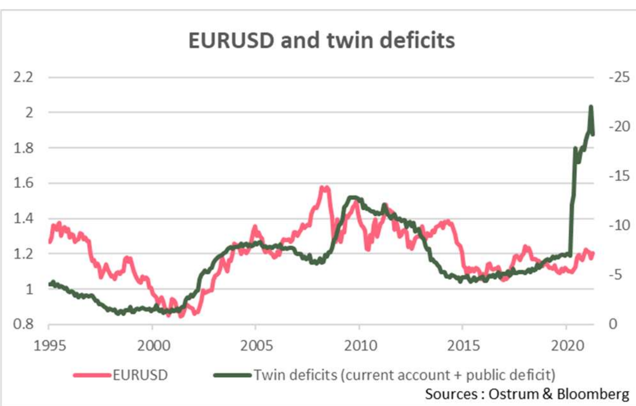
The idea is simple: a more dynamic economy will attract more investors and thus capture international flows, resulting in an appreciation of its currency.

Unfortunately, this approach is far from being validated by the facts as shown in the graph below. Not only is the correlation between the two variables low, but it is even more unstable than in the case of the rate differential: very clearly negative for 10 years (between 1995 and 2005), it has become more positive since, although recent years show that there really is no meaningful relationship.

This variable therefore does not seem, contrary to the intuition, to provide any relevant information.

Twin deficits

The sum of the current account deficit and the government deficit are called twin deficits. The results are more than encouraging. It is, moreover, among all the variables we have tried, the one that has the strongest correlation with the exchange rate. More interestingly, the chart below shows that the correlation is stable, there are no periods of sharp divergence, as in the case of the rate differential. This is particularly important for predicting a variable: a strong exchange rate relationship with a variable, which would be intermittent, carries the risk that it will not be relevant in the future. And so the model would be obsolete. So, the stability of the relationship is a very positive point.



The problem with this approach is the unprecedented explosion of twin deficits would suggest that the dollar should approach 2.0 against the Euro. Level, it is unnecessary to specify, with very little credibility.

The signal is unambiguous, however, and it is difficult to refute the idea that twin deficits have had an impact on the depreciation of the dollar.

Conclusion

Modelling the cyclical part of EURUSD movements is difficult, without obvious solution. However, the best approach seems to be that of twin deficits because it is the most stable and therefore the most reliable relationship. This explains the depreciation of the dollar but also suggests that the trend is not over. Could this be counterbalanced by other factors that argue in the opposite direction for an appreciation of the dollar, notably the interest rate differential? An econometric approach shows that the magnitude of the twin deficits is such that this is the predominant factor.

The short-term view: liquidity flows

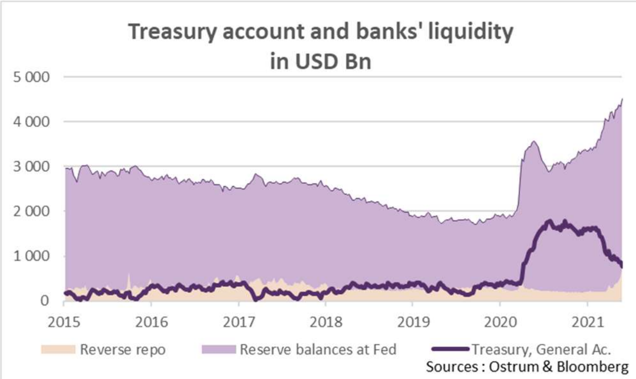
Of course, the fundamental variables are not enough to explain all the foreign exchange movements. Short-term liquidity flows may also explain some short-term deviation movements. This is particularly the case at the moment because the policy of the Fed but also that of the US Treasury contribute to provide the market with unprecedented levels of liquidity, which have weighed on the dollar.

We need to go back to the beginning of the story and look at the details of the Fed's accounts. When the US Treasury has cash, for example when it collects taxes, it deposits it with the Fed. This is therefore a liquidity drain on the financial system since this liquidity is de facto drawn by the Fed.

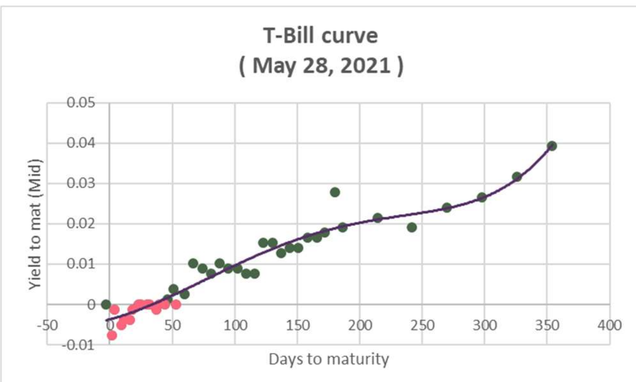
That Treasury account at the Fed was in the range of $200 billion to $400 billion in the last decade, and it went up to $1,792 billion at the end of January this year. It's a much higher level than what's needed, and in fact the Secretary of the Treasury, Janet Yellen, said she wanted to use that liquidity. As a result, the treasury account fell to $778 billion, a decrease of $1,013 billion.

Without going into too many technical details, when the Treasury uses its cash in its account, this is liquidity that is injected into the financial system and available to the banks. In concrete terms, an American citizen who receives a cheque as part of the stimulus package will draw this cheque into the Treasury account at the Fed and deposit it into his bank account. This liquidity therefore appears in the banks' reserves statistics, so it is logical that the two move in parallel as shown in the chart below.

It should also be noted that this liquidity has grown so rapidly that the Fed has reopened repo facilities for banks that have returned to very high levels of investment. That's another way of taking those cash flows into a repurchase agreement.

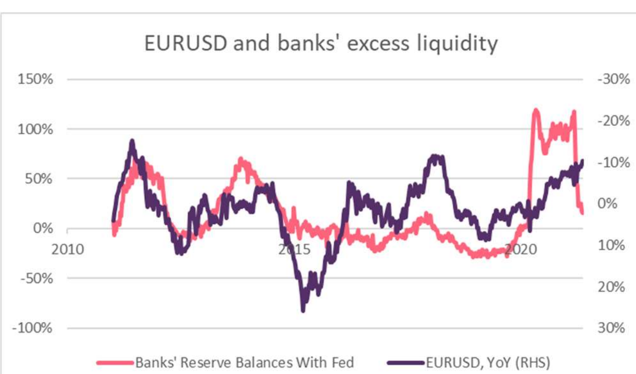


Why is this important? When the money market is flooded with liquidity there are typically two effects. On the one hand, short rates are under pressure. And indeed, as we write, 12 of the 42 T-Bills listed have a rate less than or equal to 0%.



Another effect, of course, is that this inflow of liquidity has an impact on the exchange rate. Indeed, the chart below shows that periods of bank liquidity growth are generally associated with periods of depreciation of the dollar.

The intuition is simple, a too strong abundance of liquidity on the money market therefore leads to a depreciation of the currency.



It is important to note, however, that this argument is, by its nature, short-term. The US Treasury will certainly want to bring its account to the Fed under 500 billion, a drop of another 300-400 billion, and therefore a similar amount of liquidity that will inflate the balance sheet of the banks. If this is the case, about two-thirds of the adjustment has already been made. This mechanism may contribute to an additional depreciation of the dollar, but it will remain marginal.

Conclusion

The depreciation of the dollar may seem precipitous, and even surprising when we look at the rebound of the US economy. A very long-term view, using the parity of purchasing power relativizes this view, ultimately the EURUSD parity only came closer to its fundamental equilibrium value which we estimate at 1.24.

There seem to be two main forces driving this depreciation. On the one hand, there has been a stable relationship in the past between the evolution of the EURUSD and the twin deficits in the US. The explosion of the budget deficit and the balance of payments would then largely explain the downward pressures. If the diagnosis is correct, this is a factor that is not going to disappear, and the weakness of the dollar could continue. Nevertheless, it should also be noted that the unprecedented inflow of liquidity, linked to the management of the Treasury account, necessarily played a role as well. This factor, on the other hand, is transitory in nature and is expected to disappear in the coming months. In this case a significant part of the dollar adjustment would have passed.

As mentioned above, the EURUSD rate deviates by 10% or more from its fundamental value more than half the time. This is not the case at present, and the rate could then stabilize in a range close to this equilibrium value.

Stéphane Déo

Market review

Growth underpins risk assets

Risky assets remain positive on the back of growth ahead of central bank meetings in June.

The Fed's rhetoric has become inaudible to the markets. The tone of the April 28 FOMC minutes turned out to be quite different from Jerome Powell's message at the last Fed press conference. Trimming bond purchases will indeed be debated at upcoming FOMC meetings. In addition, a backstop via a standing repo facility will be set up by the Fed. US growth in the first quarter was confirmed at 6.4% on an annualized basis. The growth estimate of domestic demand was revised upwards. Private consumption and investment posted double-digit growth. Inventory drawdown in the first quarter points to a strong recovery in output, despite elevated input costs and shortages of components including semiconductors. As an example, GM just announced the imminent resumption of activity at five of its production facilities. Inflation is on the rise, no doubt beyond the transitory effects of the reopening of the economy. For example, maritime freight costs are up considerably. The cost of a container on the Shanghai-Rotterdam route indeed increased fivefold in the past year. The contribution of housing will rise as past increases in house prices (+13% from a year ago) feed gradual into higher rents. The private consumption deflator excluding volatile items stood at 3.1% in April, its highest level in 30 years. Household inflation expectations over the 5- to 10-year horizon now stand at 3%.

In this context of inflationary economic growth, President Biden presents a $ 6 trillion federal budget for fiscal year 2022. The forecasted deficit fetches $ 1.8 trillion in 2022 and the policies measures penciled in the proposal will keep annual public deficits above $ 1.3 trillion over the next ten years. According to OMB projections, the federal debt will reach 117% in ten years' time. The federal deficit outlook entails crucial information for the Fed when it comes to asset purchase tapering. However, the Fed has full latitude to stop its support to the mortgage market ($ 40 billion per month) given the prevailing risks of a real estate bubble.

In the euro zone, the latest surveys show renewed optimism. The extent of the expected rebound in economic growth is commensurate with the winter contraction, as evidenced by the sharp downward revision in French GDP growth in Q1 2021 (from +0.4% to -0.1%). The run-up in inflation will remain subpar relative to the United States. Short-time working arrangements have effectively frozen wage inflation. Domestic cost-push inflation will remain minimal. However, producer prices are at their highest for more than 10 years in France, Germany or Italy. Low inflation has been Philip Lane and Fabio Panetta's main argument against Council members (Weidmann, Schnabel, Knot) who already see the reasons for a decrease in emergency monetary support. At the end of the day, Christine Lagarde may have to convey a somewhat confusing message.

Ahead of Memorial Day weekend, trading volumes in fixed income markets remained subdued. The T-note failed to react to Joe Biden's announcements hovering in a narrow range between 1.56 and 1.62%. There is significant excess dollar liquidity. The Fed's reverse repo facility is now absorbing $ 330bn (accumulated since mid-March) as private-market repo rates dropped into negative territory. The Fed could decide to intervene by raising the IoER. This excess liquidity also ensures a smooth functioning of the primary Treasury market, which is crucial before considering a reduction in quantitative easing. This market backdrop also favors emerging market bonds, whose spreads remain stuck within a narrow range.

In the euro area, Bund yields bounced off the -0.20% support closing a week of volatility around -0.18%. Investor appetite for peripheral sovereign bonds remains high. The Italian 10-year spread declined to 110bp compared with 124bp in April. The Italian bond issuance worth € 9bn this week were well received by the market. The enthusiasm for "green" bonds is not waning, with transactions by French agencies in particular (BPI, CDC, etc.) being largely oversubscribed after the slight widening of spreads at the start of the month. This window of opportunity had to be taken advantage of before the launch of EU bonds at the end of June. The first payments from the European plan are now expected in early July.

The spread compression trend in credit markets resumed last week, with iTraxx Crossover tightening below the 250bp threshold. Gross corporate bond issues are down by 36% to € 146 billion between January and May compared to the same period in 2020. Net of bond redemptions, total issuance came to € 59 billion, half of it being absorbed by the ECB. The excess demand for corporate credit keeps IG spreads stable around 85bp vs. Bund. The more active primary market in high yield space, however, appears to have little impact on speculative-grade bond spreads. Unattractive valuations nonetheless argue for a reduction in exposure to high beta market segments.

European indices gained 1.2% last week. Defensive sectors are struggling while the reopening theme (leisure, consumer cycles) outperforms. Flows remain favorable to the asset class, particularly in Europe. Luxury goods continue to benefit from China and US spending, resulting in increased dividends. The real estate sector is consolidating in Germany. In Asia, Shanghai rebounded strongly in connection with the continuous rise of the yuan.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	31-May-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.66 %	0	+2	+4
EUR Bunds 10y	-0.18%	-4	+3	+39
EUR Bunds 2s10s	48 bp	-3	+0	+35
USD Treasuries 2y	0.14 %	-1	-2	+2
USD Treasuries 10y	1.59 %	-1	-3	+68
USD Treasuries 2s10s	145 bp	+0	-1	+66
GBP Gilt 10y	0.8 %	-4	0	+60
JPY JGB 10y	0.09 %	+1	-1	+7
€ Sovereign Spreads (10y)	**31-May-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	36 bp	-2	0	+13
Italy	110 bp	-7	-1	-1
Spain	65 bp	-4	-3	+3
Inflation Break-evens (10y)	**31-May-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	138 bp	+2	-1	-
USD TIPS	245 bp	-1	+4	+46
GBP Gilt Index-Linked	358 bp	-4	+11	+58
EUR Credit Indices	**31-May-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	85 bp	-1	+1	-7
EUR Agencies OAS	39 bp	+0	+1	-2
EUR Securitized - Covered OAS	31 bp	+1	0	-2
EUR Pan-European High Yield OAS	299 bp	-5	-2	-59
EUR/USD CDS Indices 5y	**31-May-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	50 bp	-2	+0	+2
iTraxx Crossover	248 bp	-10	-1	+6
CDX IG	51 bp	-1	+0	+0
CDX High Yield	287 bp	-5	0	-6
Emerging Markets	**31-May-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	333 bp	-2	-11	-19
Currencies	**31-May-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.220	-0.11	+1.51	-0.19
GBP/USD	$1.417	+0.11	+2.54	+3.82
USD/JPY	¥109.63	-0.77	-0.29	-5.77
Commodity Futures	**31-May-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$69.5	$1.1	$3.2	$18.2
Gold	$1 904.8	$20.8	$135.6	$10.4
Equity Market Indices	**31-May-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 204	1.16	0.55	11.93
EuroStoxx 50	4 055	0.48	2.02	14.14
CAC 40	6 471	0.97	3.21	16.56
Nikkei 225	28 860	1.75	0.16	5.16
Shanghai Composite	3 615	3.38	4.89	4.10
VIX - Implied Volatility Index	16.76	-16.82	-9.94	-26.33

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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