Cease Fire

By Richard Thies

The first quarter closed with a small advance for global equities and fixed income indices, as the MSCI ACWI eked out a 0.38% return and Barclay's Global Aggregate Index (Hedged) rose 3.28%. Whoever first wrote, "The journey is more important than the destination," was likely very actively invested in public asset markets in addition to their secondary career as an "inspiring framed quote" writer. Looking at just the quarterly return data for the major indices hides a punishing early-year decline and an almost immediate recovery, as well as some essential information of what took place during the period to create such a dichotomous return stream.

We will spare you a detailed recap of the previous quarter in favor of a more expansive discussion of what's coming next. But to frame our thoughts, it is important to note the first quarter was driven by three real factors and one narrative factor.

Real factors:

1. The combination of weak US data, collapsing oil, panic in the European financial sector, no signs of the Federal Reserve relenting on its planned tightening cycle, a significant widening in spreads, and tightening financial conditions from a strengthening dollar helped to create a panic in China.

2. There were several indications that the US economy was not being lead to slaughter by the industrial side or by the recession worries themselves, which was reinforced by loosening financial conditions. Similarly, the Chinese data moved from weakening to stabilizing.

3. An almost unbelievable turn of events following the G20 meeting where the Bank of Japan (BOJ) disappointed, causing the yen to strengthen, the European Central Bank (ECB) disappointed, causing the euro to strengthen, and the Fed sounded dovish in both policy and forward guidance. Even the biggest non-Fed central banks have realized that an ever-strengthening dollar is a threat to them; so is going ever deeper into negative rates as it threatens the existence of the banking sector.

Narrative factor:*

1. The start of the year was the perfect storm for those who believed that the global central banks would be able to navigate what was becoming an increasingly complex exit strategy from easy monetary policies. To summarize, a lot of bad things started happening from very little amount of actual tightening. By February, the central banks doubled down on easy policies to fix things, specifically the Fed, and asset markets reacted accordingly. Fundamentals haven't changed much and the prevailing narrative that the central banks are comfortably in charge had a scare but remains dominant.

**We use the term 'narrative' to mean the non-explicitly fundamental mindset of most market participants or, importantly, what we perceive it to be. A nod of the head to Ben Hunt at Salient Partners who helped us put words to a concept we've been internally describing for years.*

The Dynamic Divergence

Readers of our recent writings will likely remember how important we think the dollar is to explaining just about everything these days. In last quarter's commentary, we called for the dollar to run out of steam as policy divergences would start to become policy convergences and weaken the dollar accordingly. While this view has been vindicated, we would have never guessed how definitively the divergence would die or that Janet Yellen would so clearly spell out why it had to be killed. Further, we never imagined how seamlessly participants would accept the new policy direction while favoring risk assets the whole way.

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At Driehaus internal research meetings, we often ask ourselves what the single most important question is for any given issue. What's the single thing we must be right about if our view on a stock will be rewarded? What's the single thing that could change current market trends to former market trends? This basic principal applies to the formation of our top-down views as well. Currently, the single most important question is, ***"If the Fed really wants to keep the dollar anchored, will it be able to do it or is it out of their control?"*** This is the key question because there is no risk-positive outcome in the near-term if the dollar starts appreciating again, and the Fed has expressed a desire to limit USD appreciation.

In our previous writings (available here and here), we outlined why the dollar remains the primary explanatory variable in relative asset returns, absolute asset returns, and even factor returns (growth versus value) for equities, so we won't rehash that. Instead, we turn to the evidence that the Fed wants to avoid an appreciating dollar, and the likelihood of successfully achieving that goal.

What the Fed Wants…

To say that our current Fed has evolved recently would be a huge understatement. It went from all but ignoring the dollar during its meteoric rise the past few years to making it a central focus over the past few weeks. I had a one-on-one conversation with a Fed governor a year ago in which I was told that the governing board "never even discusses the currency" at meetings, primarily out of fear that people will think the Fed is becoming a central bank to the world instead of one to the United States.

As such, it was a pretty shocking to hear the Fed more or less officially become the central bank to the world last week during Janet Yellen's speech at the Economic Club of New York. Her focus on weakness abroad, oil, the oil-related countries, commodities and, most importantly, China's relationship to a strong dollar, could not be ignored.

To be clear, these are all legitimate concerns for the US central bank and the Fed's acceptance of its role in these matters is a positive development. While some within the US (and elsewhere) may not necessarily want the Fed as central bank to the world, the reality is that when the world's second biggest economy (China) has your currency and effectively your monetary policy, and when most goods are priced in your currency, you are the central bank to the world. It's better for the Fed to accept and realize that than to pretend it's not true.

In short, the Fed has adopted policy intended to avoid inflaming the greatest vulnerabilities in the global financial system, vulnerabilities which are all made more tenuous when the dollar is rising.

...What the Fed Needs

Our central question then turns to whether the Fed can keep the dollar contained while not blatantly breaching its obligations on inflation and employment. In the post-financial crisis period, we have learned to believe central bankers when they specifically tell you they're going to do something. Occasionally, however, they are wrong (e.g., Trichet, Jean-Claude), and we assume there is a point where the Fed will be forced to tighten regardless of the negative international consequences.

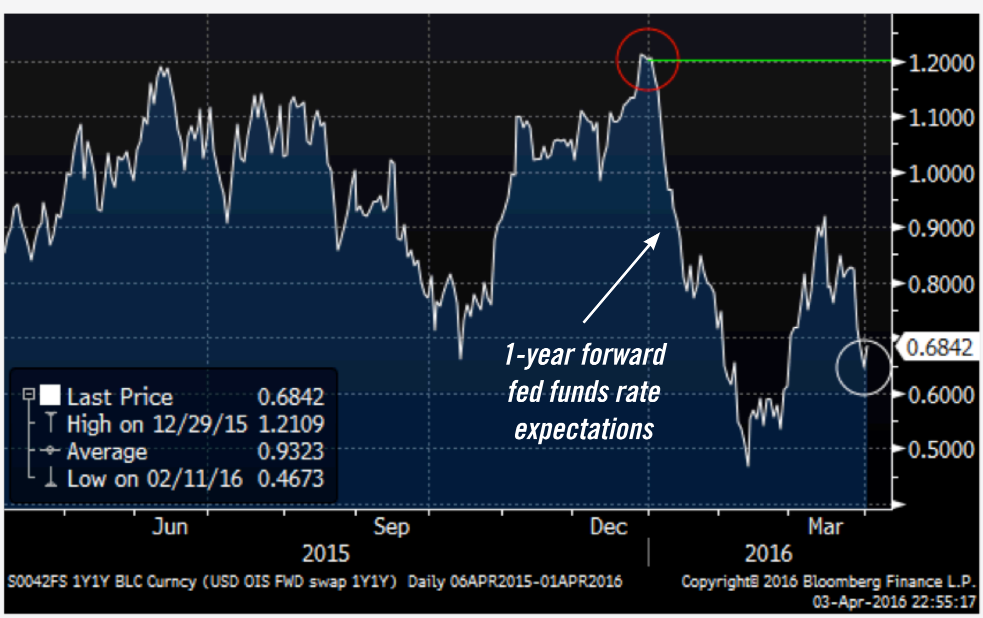
We see three main questions that warrant further exploration before opining on whether we think they can pull it off:

- » Will changes to expectations for the rate path push the dollar further down?
- » Will economic data force the Fed to abandon recent dovishness and take the dollar higher?
- » Will non-rate factors—like repayment of USD debt—strengthen the dollar against the Fed's will?

Currencies are always influenced by their underlying interest rate and in developed markets this relationship has only grown more important in recent years. When interest rates globally are so low, small changes in nominal rate differentials cause big changes to exchange rates. The dollar's fall year to date has come with rate expectations being dramatically reconsidered.

To start the year, the market was expecting roughly four total hikes and now is down to expecting half of a single increase (Exhibit 1). With roughly 15 basis points priced in for this year, there's not much more the Fed can do to reset expectations other than guide for negative rates (very unlikely any time soon, but very likely in the distant future). Pricing out even that 15 basis point increase would result in the dollar falling a few more percent. Not only has the Fed reset expectations for this year, it's also given guidance that it thinks the long-term neutral real rate is 0%. If you believe in 2% inflation, this suggests the fed funds rate must only be 2% to achieve a neutral stance. Having reset both the near-term and long-term expectations, there's not much the Fed can do verbally to weaken the dollar anymore, unless the economy turns south and all future tightening were to be priced out.

EXHIBIT 1:
Rate expectations have been completely reconsidered, weakening the dollar

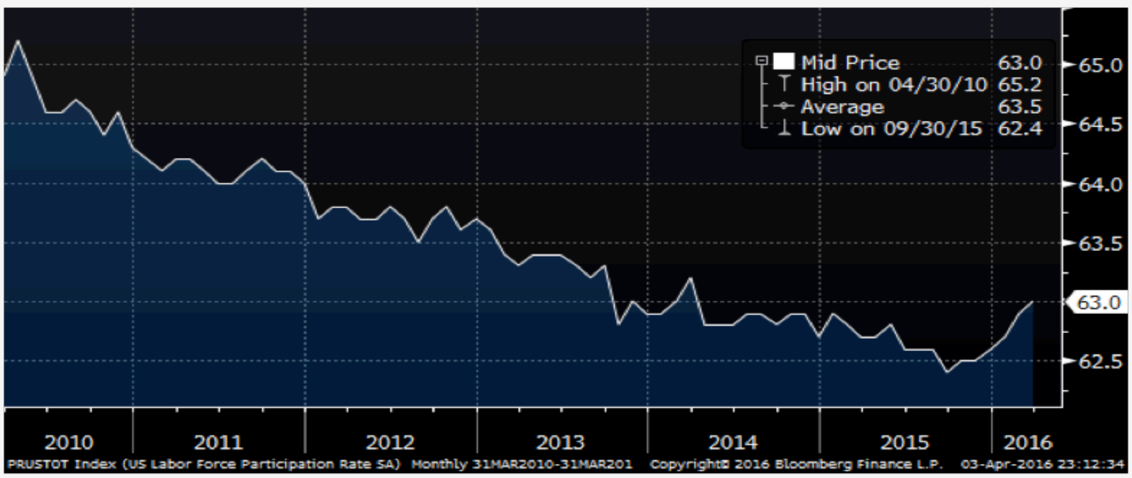


Source: Bloomberg and Driehaus Capital Management

Confusingly, most data suggests the Fed should move incrementally more hawkish and further strengthening the US dollar. The payroll data has been robust with labor force participation finally rising after years of stubbornly declining (Exhibit 2). Higher participation is an indicator of a healthier employment market that is drawing people into the labor force, as the Fed has expected. With that, core inflation is finally rising toward the 2% target. However, the recent increase in core inflation is likely transitory. If so, its decline will likely reinforce the Fed's dovish resolve. Many (ourselves included) have feared that US credit market volatility would reduce credit availability and start to weigh on growth. This has not happened at all in spite of the recent tightening in lending standards (Exhibit 3).

Finally, our biggest reason for caution during the past two years—the weight of a contracting credit impulse—is now fading (Exhibit 4). Despite this, with extremely low monetary velocity as savings rise, and still broad-based international goods price deflation, to us it does not look to be a vibrant enough cycle for the Fed to be forced to get more hawkish in the immediate term. The baseline here should be that things are good economically and, for now, there will be no glaring reasons to hike more aggressively than currently priced into the market (one hike this year).

EXHIBIT 2: Labor force participation is finally on the rise again

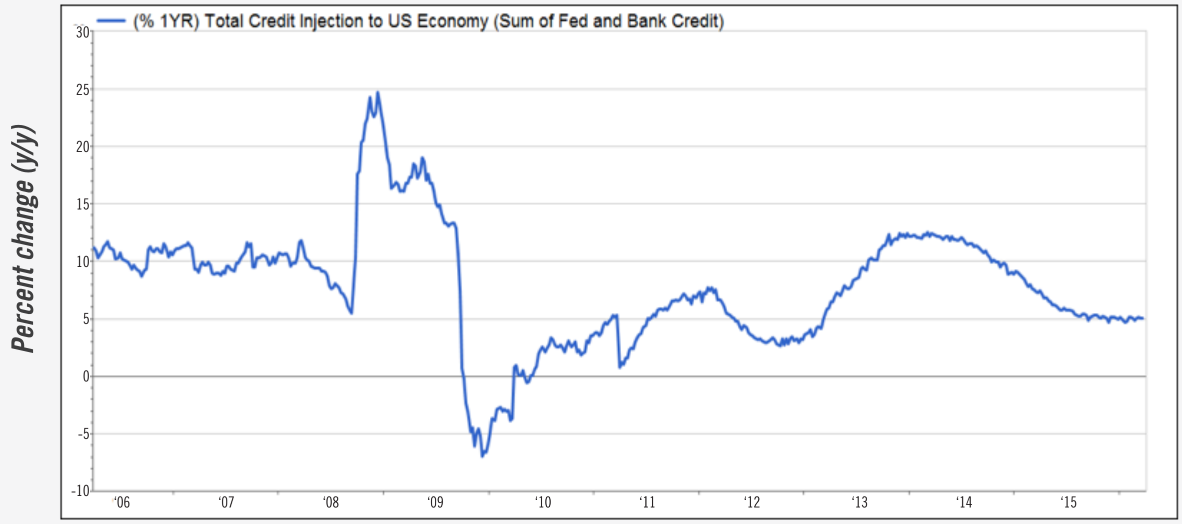


Source: Bloomberg

EXHIBIT 3: Bank credit growth has not slowed in the recent period, running counter to recent Fed dovishness

Source: FactSet

EXHIBIT 4: The total credit injection into the US economy is stabilizing as the year-over-year contraction of the Fed's balance sheet fades



Source: FactSet

The hardest determination to make is what will be the non-rate drivers of the dollar's direction and, ultimately, which driver will be the most powerful. We've explained why rate expectations are unlikely to fall much further and why the data, while good recently, won't be enough to force more tightening. Assuming that's true, the dollar's direction will revert to being driven by country balance sheet effects. These include relative central bank balance sheet sizes and credit growth rates, countries' different external positions, and the repayment of FX-denominated borrowings. It's effectively impossible to aggregate all the moving pieces here, but we'll give it our best effort.

The two biggest sources of dollar liquidity creation are the current account deficit and the US banking system. At current run-rates, together they are creating roughly $1.1 trillion per year (about $550 billion through the external deficit, $650 billion through the banks, and zero from the Fed). By contrast, the ECB is creating roughly $1.2 trillion (in euros) through its QE program, flat contribution from the banks, and losing the equivalent of about $650 billion due to its huge current account surplus, meaning the natural direction, assuming no changes to US rates, should be a very slightly stronger euro.

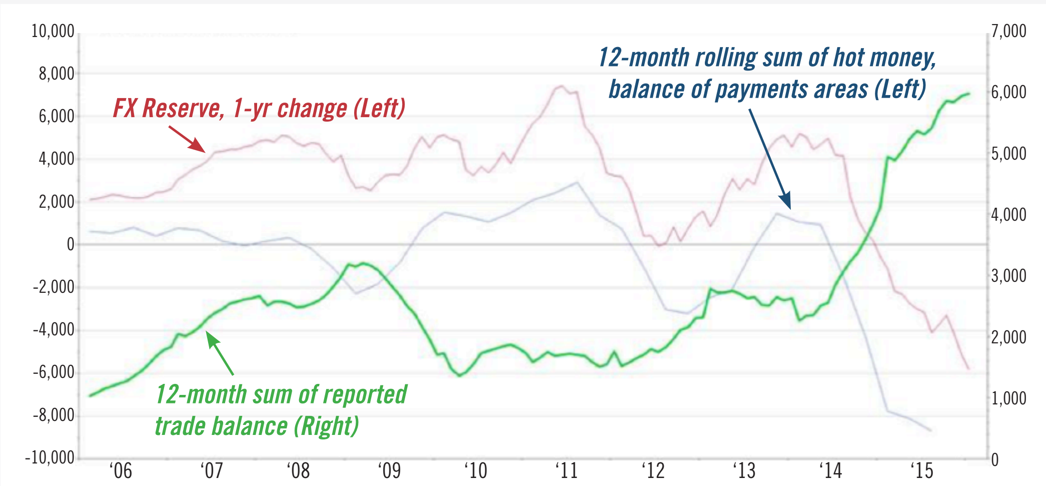
Similarly, Japan has an ambitious QE program but with little liquidity generated by the banks and a growing current account surplus from repatriation, Japan only creates $600 billion (in yen) in additional currency supply. The conclusion is that against the major developed markets, there is no reason the dollar cannot continue to fall and should continue to move with rate differentials, leaving the Fed in charge for now.

We say "for now" very intentionally. In the numbers above, we assumed a stable Fed balance sheet. This is potentially the difference between a dollar that can still weaken if rate differentials are steady and one that could skyrocket if the Fed's balance sheet begins to return to pre-financial crisis levels. We suspect some members of the central bank realize this. The next two years will see peak maturities in the Fed's security portfolio and there will be pressure to let the balance sheet finally shrink. Between now and 2018, holdings of more than $700 billion of US Treasury and mortgage-backed securities come due. A contraction of that size will not only put massive upward pressure on the dollar, it would tighten domestic financial conditions far more than would a few rate hikes. Hiking rates much in advance of this is not necessary and would only exacerbate the negative outcomes.

China and Emerging Markets

The elephant in the room, and most interesting dynamic at work, is in the emerging markets. According to the Bank for International Settlements, there was $2 trillion in total cross-border USD-denominated debt in emerging markets at its peak last year. Contrary to many common perceptions, the biggest USD borrowers have been Chinese financial companies. While it is impossible to know the tenor of the USD debt on the whole, for the Chinese borrowers the majority is short-term and is being repaid very quickly now that FX expectations have changed. This is also the reason that capital outflows from China have been so massive in recent months. Given that borrowers' decisions to repay are largely a reflection of market conditions and expectations, we can't forecast the level to which they will be repaid. When Chinese repayments start to slow, it'll be a good indication that the worst has passed.

EXHIBIT 5: Hot money outflows have accelerated, mitigating the growing trade surplus. We expect the pace of outflows to slow this year.



Source: FactSet, Driehaus Capital Management

Other theories…

Something else to keep in mind as it pertains to the US dollar, asset allocations, and a possible reason for the abrupt shift in the Fed's verbiage, is that outflows from China are extremely important to asset markets. Their pace dictates the level to which the People's Bank of China (PBOC) can ease monetary policy, their pace dictates the immediate risks of the China renminbi (CNY) devaluation, and their pace plays a hand in credit quality in China. As such, it directly or indirectly affects most global markets. Of the roughly $700 billion in USD debt from China that must be repaid, most of it is due before the end of this year and the pace of outflows already appears to be slowing down. The point is that there is a very real benefit to China, the CNY and to global financial stability for the Fed to wait even a few more quarters before resuming its hawkishness. Of course risks will remain from the massive leveraging cycle for a long time, but once more of the USD debt has been paid off, China's downside beta to a stronger dollar will decrease. Perhaps the Fed even realizes this.

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Looking ahead

In many ways, an already confusing outlook is now even muddier. The reaction function of the central banker to the world has changed and participants will struggle to react to incoming data, likely increasing volatility. Conversely, we have a new target to monitor and a new stabilizer. Until recently, there was no evidence that the Fed even cared about the dollar's destructive global role. The tacit acknowledgment of that care is a positive for risk assets, especially for those areas that have the highest risk premium attached to them as a result of the dollar's ascent (commodities, EM, US credit, etc.). That was the same impulse that led us to recommend increasing exposure to emerging markets the past few quarters, but admittedly the case is less strong after the recent rally.

Lately, it's been easy to know what to do if you just know what the dollar is going to do. As we've outlined, there may be small additional downside if the market continues to price fewer hikes in the near term, but it's not massive downside until an easing cycle comes back into the realm of possibility, which is something we are nowhere near. Similarly, the risks of a dollar spiking for other reasons in this environment have significantly lessened with the Fed's renewed focus on the currency's value, which should have some staying power.

For both equities and credit, it also matters what you think this dovish shift ultimately means for the economy and inflation. With long duration bonds looking very expensive to us tactically (Exhibit 6) and the Fed wanting more inflation, bonds and their equity proxies look riskier to us. "Long duration" equities, like utilities, have led this latest cycle, so there will likely be some rotation.

Most importantly, when something as compelling as the strong-dollar narrative begins to change, it is likely the relationships it created will also change. As such, we are paying close attention to whether European stocks can start to do ok when the euro is strengthening, whether the Nikkei can start to survive a stronger yen, whether the oil price can sustain a move up on something other than a weaker dollar, and whether the beta that emerging markets have to the dollar can change. Over time, actual relationships do change: external deficits in emerging markets are much smaller so there is less need for US dollars, much USD-debt has already been repaid, European services activity is growing strongly with the euro at 1.05 and also at 1.12, etc. Despite these realities, the dollar has remained in charge of the stock market but there's a good chance this slowly starts to change.

EXHIBIT 6: US term premium already extremely low near pre-taper tantrum levels, a risk for bonds and their proxies

Source: Bloomberg and Driehaus Capital Management

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Richard Thies is an assistant portfolio manager. He provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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