Appendix

Note: Reflecting on the outlook for the US$

Introduction:

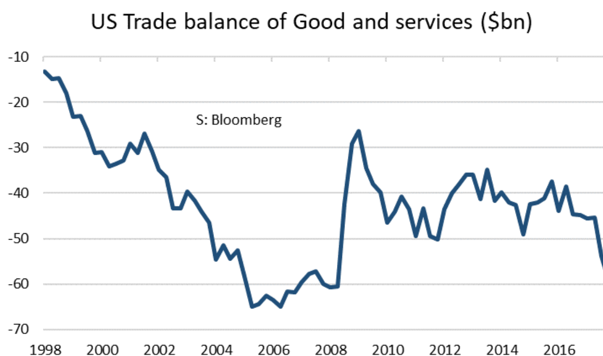
Deutsche Bank (DB) recently produced a material piece of economic/ currency research focusing on the outlook for the US$. They concluded that the US$ needs to fall, perhaps significantly, if the US is to fund its growing external and budget deficits.

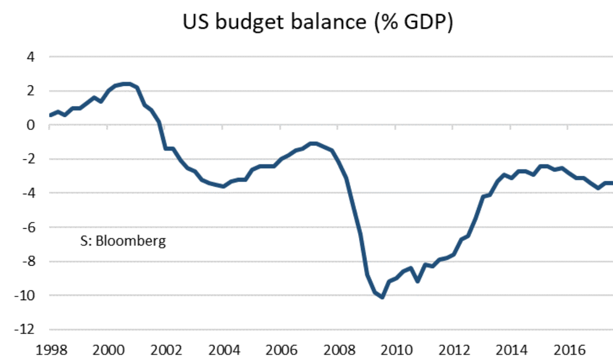
The Leicestershire County Council Pension Fund maintains significant exposure to the US$ across various asset classes. It also operates a discretionary foreign currency hedging programme managed by Kames Capital to a twin risk reduction/ profit mandate. This programme currently spans the direct equity investments; significant other exposures exist including infrastructure and private equity. The aim of this note is to summarise and review the DB thesis and also to consider whether action is appropriate including broadening the coverage of the hedging programme.

Background:

President Trump has fulfilled one of his campaign promises by embarking on a significant expansion of US fiscal policy. The current US budget deficit is 3.4% (as at end 2017). Under the new fiscal stance, the US version of the UK's Office of Budget Responsibility, the US Congressional Budget Office (CBO), estimate that the deficit will rise beyond 5% in 2020 (amounting to a deficit of $1trillion)[1].

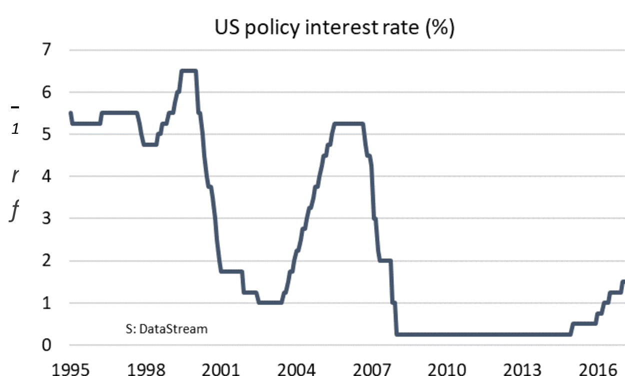
Historically a significant proportion of US consumption spending leaks overseas and DB, and others, estimate that the fiscal stimulus will led to a deterioration in the trade balance of $150bn (the monthly trade imbalance recently deteriorated to $58bn (February)). This will probably see the trade deficit breach historic lows.

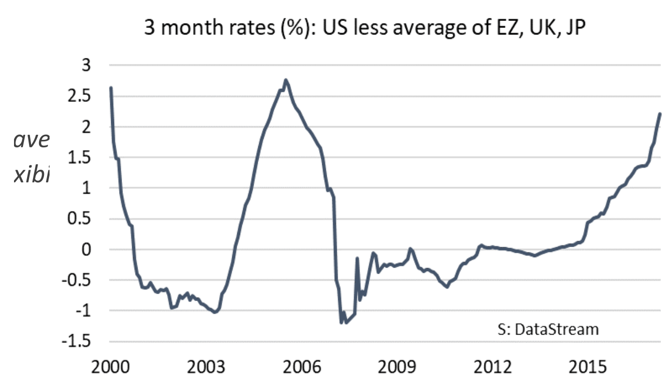




At the same time, the US Federal Reserve is proceeding with its efforts to normalise US monetary policy by increasing its interest rate. Although the absolute level remains low, the scale of the increases announced over the past two years is now starting to become significant - especially in a global context. See overleaf for charts of the US policy rate and the gap between US 3-month interest rates against the UK, Eurozone and Japanese average; the interest rate premium for owning US$s is returning to historic highs.

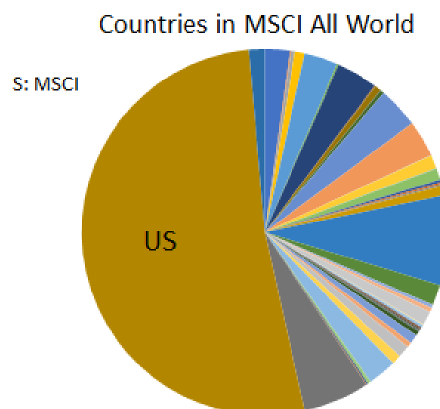
Classically, the policy mix of tighter monetary policy and easier fiscal policy is supportive of a currency. Fiscal expansion should improve the domestic economy making it more attractive for people to invest in that country while a higher interest rate increases the 'reward' for investing in the currency (or the penalty for hedging). This was certainly case when President Reagan expanded fiscal policy in the early 1980s and after German reunification.





The kernel of DB's argument is not to challenge this classical relationship but that the scale of the external funding needed by the US exceeds the rest of the world's capacity to provide. DB suggest that only private investors in the EZ and Japan or central banks in Asia can provide the capital that the US requires.

European and Japanese private investors have been investing more overseas in response to the operation of QE (quantitative in their respective domestic economies); QE is being wound down. Official investors in Asia have been heavy buyers of US$ assets for many years as the direct counterpart to the trade surpluses they have operated with the US. DB argue that with Trump targeting lower surpluses with Asia and, more importantly Asia, led by China, evolving their economic model towards more domestically driven demand then the Asian 'bid' for US$s will fade.



What differs between today and the situation in the 1980s is the degree to which the rest of the world already owns US$ assets. Perhaps nowhere is this more obvious than in the country mix of MSCI global equity market index where the US weighting is 52%. Many investors believe that they have seen this situation before – when Japan dominated the world's equity markets – and it didn't end well; they are reluctant to push the US weighting (in world equities) higher.

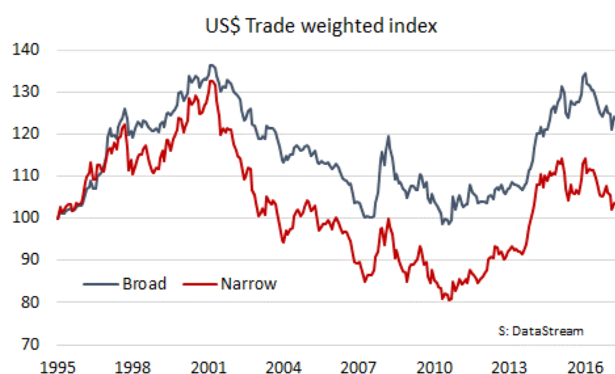
DB bring these arguments together to conclude that unless there is a sharp rise in US bond yields, judged unlikely, the price of the US$ needs to fall. In their words:

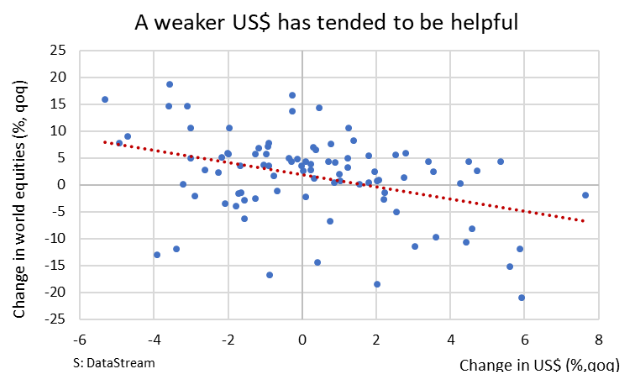
'…even the US cannot have its cake and eat it. Absent a let up in Trump's protectionist zeal or a decisive hawkish turn from the Fed, funding the twin deficits would require a material depreciation of the $ to make US assets more attractive for private investors in Europe and Asia. It will not come cheap'.

Comment

Measured on a trade-weighted basis, the US$ has, in recent months and on a narrow or broad basis[2], reversed some of the gains of 2011 – 2016. In large part, this reflects the rehabilitation of the Eurozone as an investible area after last year's French general elections.

Historically, a falling US$ has tended to be associated with periods of rising equity markets (chart) and global equity markets have risen returned 11% over the past year.





The appendices to this note repeat comment provided by the Fund's two currency managers: Kames Capital and Millennium Global. Both agree with DB's analysis and expect the weakening of US$ to continue. Both doubt that this will adversely impact emerging markets (by 'starving' the rest of the world of capital).

There is little doubt that the current US policy mix should be lending support to the $. The question is the scale of external funding required and the appetite and capacity of non-US investors to provide it. That said,

[2] 'narrow' refers to major currencies, 'broad' refers to all tradeable currencies

the US$ has been weakening despite a rising interest rate differential with other major economies and the boost to domestic growth from a more expansionary fiscal setting has yet to emerge (the latest real time estimate of US economic growth, produced by the Atlanta Fed, suggests a pace of 1.9% - on trend but no more).

It is also true that the rise in the US$ in the years to 2016 was due, in part, to a shortage of viable opportunities elsewhere (the € was blighted by existential worries and deflation has gripped Japan afresh). Significant amounts of capital found its way to the US by default. With the rest of the world demonstrating clear economic improvement, these flows have been unwinding; unless something unforeseen happens, there seems no reason to suppose that they will flow back into the US$.

Macro-economic policy changes continuously impact currency markets and the Fund's currency managers are well placed to assess the opportunities they present (only Kames' has an explicit risk reduction feature to their mandate). In decades past, there have been relatively few policy changes of the scale of those currently underway in the US and it is to be expected that they will shape currency markets and the world economy for several years. A generalised and sustained weak US$ environment should there be guarded against. The current hedge programme creates the ability to protect some of the Fund's US$ exposures, not all of them.

On this basis and given the Fund's significant exposure to US$ assets, consideration should be given to increasing the span of the currency hedging programme to cover foreign currency exposure in all growth oriented investments not explicitly managed by the asset manager; for the most part, these will be US$ exposures.

Things to consider:

1. The hedge manager (Kames) will apply their current hedge ratios to whatever scale of exposures the Fund provides. Currently they are operating a neutral 50% hedge on the US$. Accordingly, the Manager is likely to be a seller of $s robotically on the day on the revised instruction; there is an element of chance (in the prevailing £/US$ spot rate) on that day.

2. A bigger programme will generate larger swings in daily P&L and hence collateral required; this needs to be assessed in the context of the Fund's available cash balances etc. (In extreme conditions Kames can, on approval, access the index-linked bond portfolios).

3. A point is likely to be reached when the US$ finds a floor and becomes attractive. At this point and absent a materially improved outlook on the US's twin deficits a strong US$ could 'suck' capital out of the global economy. This could challenge the Fund's current overall asset mix.

4. The Fund has the option of lowering the neutral hedge ratio set for Kames. This is not considered appropriate because this would apply solely to the US$ (and not be common across all £ foreign exchange rates). Kames has the discretion – and perspective – to adroitly alter the individual hedge ratios. If (when) crisis hits financial markets, then the US$ will always be a preferred 'last resort' investment.

5. If Hymans' *end of LDI gilt distortion* thesis is accepted then, eventually, higher gilt yields should, all else equal, lend support to £ (particularly once the yield transition is nearing completion).

6. It is several weeks until the next Local Pension Committee. While the behaviour of the US$ between now and then cannot be determined with great certainty there is scope for the 'short' US$ view to acquire a greater market prominence. Given the views of Kames and Millennium, there seems no reason to delay any required action until the LPC (and risk missing further $ weakness).

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17/04/2018

Appendix One: Comment from Kames Capital

The Deutsche Bank research highlights the risk to the US Dollar, and US assets very well.

To our mind the key points are;

- Recent US domestic economic policies increase both deficits, fiscal and external, to levels that question the sustainability of funding those deficits.
- The deficits have been funded recently by QE policies in Japan and Europe, and over the years from Asia via reserve accumulation.
- Developments in these regions suggest that the appetite to continue to fund is declining and recent US Trade policy developments are exacerbating that trend.

This leads to a scenario that would imply higher funding rates (bond yields) and lower real asset prices (as financial conditions tighten). This year Fed Funds rates have increased by 25 basis points but funding rates (as measured by LIBOR, FRA or CP rates) have risen by nearer 60 basis points, even T-bill rates have increased by more than Fed funds. As such this has made the US Dollar more expensive to hedge. For example, for a Japanese investor the cost of hedging is largely determined by the Fed and the rate hikes in this cycle have already made new purchases of hedged US Treasuries unattractive (10-year USTs have only a 20 basis point pickup on JGBs if hedged for 3m).

US bond yields have stabilised after selling off in the first month of the year and are showing little signs of a funding crisis despite the rise in money market rates. Kames' Fixed Income team continue to expect US yields to rise later in 2018 as bond supply, inflation and interest rates are all expected to rise. US risk assets (equities) have been volatile and are showing negative returns in 2018 but at a broad index level (using the S&P 500) are still nigh on 30% higher than 3 years ago and still relatively highly valued compared with other global risk markets.

It is likely that the USD weakness scenario that DB paints would be accompanied by higher bond yields (as a result of the need to fund the fiscal deficit) and lower risk asset prices thus the currency, having shown a negative correlation with risk assets over the last year, becomes positively correlated with US risk assets. For example, looking at 2018 over a short time period (3 month) the USD is positively correlated with world equities; although over the longer one and five years the correlation remains negative. If the current relationship is sustained for Leicester County Council Pension Fund this becomes a significant risk given the other dollar assets within the fund (other than the global equity portfolio). The currency programme has already moved from an overweight USD position to neutral in 2018 in view of the evolving US economic policy.

Sterling of course is also a currency that is prone to battle against twin deficits so it is likely that if there is an increased focus on deficits sterling will suffer as well. However, the UK has a different funding base and has a reasonably healthy positive income balance so you would expect sterling to outperform the US Dollar. Politics have been a negative factor for the UK for some time, though recently that has changed with the hard-line Brexiteers within the government refraining from destabilising the increasing 'soft' Brexit process or the government itself.

In conclusion, we have retained a neutral position re the GBPUSD cross rate on the currency hedging programme although we remain overweight many EM and Asian currencies which one might expect to appreciate against the USD if the scenario that DB paints comes to fruition. What is becoming evident though is that the risk of a synchronised underperformance of all US assets is becoming greater which implies the risk profile of the Leicester County Council Pension Fund is also increasing. This factor should be taken into account when considering whether a currency hedge of these assets is appropriate.

Appendix Two: Comment from Millennium Global

We view the widening of US twin deficits against the backdrop of still synchronised global growth and steady Fed tightening, which results into a flattening yield curve, as underpinning a trend of broad USD weakness over the medium term. In that respect the global backdrop remains favourable for EM, all else equal: EM currencies would be most vulnerable to a sharp rise in US real yields, either reflecting acceleration of tightening by the Fed or higher growth potential, which we do not foresee (the Fed balances the need to avoid inflation overshoot with the willingness not to cause recession at this late stage of the business cycle; the fiscal package is not designed in a way to sufficiently improve the supply side of the economy, both infrastructure or education spending would be required).

We agree with the analysis that the size of the US twin deficits over the next few years and the reliance of the US on foreign capital flows, mostly debt flows, points to downward pressures on the USD and/or much higher interest rates as highlighted in the USD section of the attached Quarterly Outlook. The end of QE by the ECB or the effective tapering by the BoJ contribute to reducing one key source of surplus savings that were available to fund US external deficits. All the more so as the flat US yield curve make FX-hedged investment in US Treasuries by Japanese or Euro area investors.

USD index valuation (vs. advanced economies) adds to the view as the USD is still expensive on our PPP metrics. Of course, at some point USD overvaluation will be removed and the rest of the world will be more advanced in the economic cycle, perhaps slowing compared to the US, which will eventually pave the way for a bottom of the USD over the next few years.

We do not see therefore the US as detracting capital flows from EM in the near term. Indeed, we find that foreign private capital flows to EM are driven by the growth differential between EM and DM (developed markets), which we expect to pick up further. Already the momentum of forecasts revisions and relative economic surprises have favoured EM over DM. Big EM economies have come out of recession (Brazil, Russia) or are accelerating (India) while the credit tightening in China remains contained enough not to trigger a hard landing and spillover to broader EM.

In terms of broader impact on risky assets, we view the deterioration in US fundamentals (sovereign balance sheet, net IIP, twin deficits…) as more likely to prove USD-negative than risk negative. The main negative channel to global risk appetite remains US trade policy – for now we see this is negatively impacting sentiment but not evolving into a global trade war that would impact global growth and risk appetite. Our base case is that geopolitical risks, trade tensions and major central banks' tapering contribute to higher financial market volatility but that a massive rise in global risk aversion is avoided.

More fundamentally the question relates to the outlook for global imbalances: as the US net dis-savings increase, will EM net savings have to rise? I think the key here is that higher US external deficits come alongside with wider current account surpluses in Japan and the Euro area, while EM balance of payment positions have improved over the last few years (partly for structural reasons, including fiscal adjustment). There is little sign of external constraint to growth for EM at this stage. So global imbalances are on the rise but it is more likely to add to FX volatility in G3 and China than broader EM in the near term.

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