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“The Big Long,” US-Dollar Cycles and their Painful Extremes.

Welcome to 2016 (please see our Outlook "late cycle investing").

Investors faced a disparate performance across global markets in 2015. Euphoria in the first half was followed by a summer “growth panic” led by China, emerging markets (EM) currency fears and then subsequent recovery. Finally, acute policy disappointments were felt in the final quarter of the year. Some of the policy disappointments came so late in December that many investors didn’t care to consider the implications ahead of holidays. (I*t’s true professor, markets are not so perfectly efficient*). Thus, “thin markets” and turn-of-the-year illiquidity has exacerbated impact.

The policy disappointments are helping shape the global market response to renewed challenges, including turbulent Chinese equities and renewed weakening in China's currency after a window of stability from September through November 2015.

Following strong pronouncements in October, the disappointment following ECB president Draghi's powerful words and the ECB council's parsimonious actions is most easily articulated. The Bank of Japan also tinkered with its QE program, which effectively seemed worse than leaving the possibility of future action to lie ahead. However, both the Eurozone and Japanese central banks remain in long-term easing campaigns with economies in incipient recovery. Staying on the present easing course will have its setbacks, but the path is likely to produce gradual strengthening in economies and weaker local currencies in the absence of large external shocks.

The case of the Federal Reserve is both more critical and subtle. In times past, the current level of the key U.S. policy rate, 0.37% with mere “gradual” increases lying ahead would hardly seem a threat. Subtly, however, the Fed’s policy statement noting “gradual adjustments,” as the path forward seems *not* so different from a traditional policy tightening cycle. Prior to the Fed’s December 16 action, key Fed policymakers strained to say how different the Fed’s course would be from past when pre-formulated tightening cycles aimed at bringing an accommodative policy back to neutral, one meeting at a time. The Fed will of course re-emphasize it’s “data dependent” view for each meeting decision ahead and will likely try and dissuade notions of a “cycle” by skipping action on January 27. Yet the historical proclivity for the U.S. economy to grow employment at an above-trend pace through *nearly the very end* of economic recoveries should keep markets on guard about a “data-dependent” Fed.

Variable Risk Premiums Around Policy By Country

It is within this backdrop that we see the renewed weakening of the Chinese currency in the final month of 2015, a large swoon in the first trading day of 2016, and local Chinese share market panic amid untested steps to control market volatility. To remind, with a 14% share of global exports, China’s currency is the important economic variable, not local shares which have little greater correlation to even Hong Kong markets than other global equities. China's economy, the exchange rate's impact on external debt, and perhaps even importantly, the competitive currency dynamics of *other*, more-open emerging markets are the key variables to watch.

The fact that China had pursued an forex policy of gradual appreciation for most of the past decade (after earlier pegs and previous depreciation) has left its currency out of step with the depreciation seen in other EMs (see figure 1). This is a key vulnerability for world markets this year. China's large size, significant export strength (current account surplus) and large foreign reserves suggest the CNY should *not* have been on the same depreciation path of some petrol-oriented currencies such as the Russian Ruble in recent years. China would achieve little net benefit from depreciating deliberately if other freely traded currencies move down in lock step and broader global demand were shocked in the process. **Much as last year, however, broad global markets will need to see the Chinese currency as a market mover in the large basket of factors determining asset prices.**

Figure 1. Index of Emerging Market Currencies (Inflation Adjusted) and USD vs Yuan

Source: Haver Analytics as of January 4, 2015. Note: Other important trading partners include Mexico, China, Taiwan, Korea, Singapore, Hong Kong, Malaysia, Brazil, Thailand, Philippines, Indonesia, India, Israel, Saudi Arabia, Russia, Argentina, Venezuela, Chile and Columbia.

Figure 2. U.S. Broad Real Trade Weighted Dollar

Sources: Bloomberg as of January 4, 2015.

Chinese depreciation of at least some modest scope fits an ongoing multi-year trend of U.S. dollar appreciation. Yet one pattern we see as quite likely to repeat in 2016 is the sharp sustained counter-trend rallies and sell offs in "challenged asset classes." Crude oil both fell 65% and rallied 45% last year. The Euro fell 12% and rallied 10%. In each case, the larger move represented the underlying, fundamental trend. OPEC continues to pump oil at near record output levels right into the face of lingering US oversupply. The ECB is adding €60 billion every month to base money through March 2017, but likely longer.

The "bounces" may come to these same assets and a range of others in 2016, such as US-dollar sensitive emerging markets equities and credit. These are well positioned for contrarian bounces after an abysmal 2015. After today, "trading curbs" won't be the final word on Chinese macroeconomic policy. However, the big picture is one in which U.S. dollar bull and bear market cycles go on to lasting extremes that the economic profession seems very uncomfortable to explain.

The broad trade-weighted dollar adjusted for inflation - and thus a loosely indicative measure of purchasing power parity for the world's reference currency – surged to far higher levels when U.S. inflation waned in the 1980s. It peaked at significantly higher levels than today's level in 2002. **This was two years after U.S. asset markets peaked and a half year after the 2001 recession ended.**

External investors are not as keen as in the past to expand cross border asset holdings to levels reached in 2006. The Federal Reserve will also keep the exchange rate story we tell above in mind. But policymakers have limited success with multiple economic policy targets. With increasing importance, exchange rates have a proven tendency to overshoot finely modeled fair value targets despite the efforts of central bankers.

As we noted in our Outlook for 2016. We indeed worry some that exchange rates and related asset markets will move counter to the longer-run trends this year despite a “widening” of U.S. dollar appreciation led by China today. Yet a key message should be, the U.S. dollar bull market will only find it’s true lasting peak when the Fed is deeply engaged in a new easing cycle. However meagre, a new tightening cycle only began last month.

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