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The strong-dollar denouement: Effects on the global economy

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For the past month, it's been hard to avoid investment commentaries with titles playing on Star Wars movies. The "something awakens" format has proved an especially popular title of late. So in planning comments about the U.S. dollar, I felt a certain pressure to look elsewhere for original title ideas. I turned momentarily away from movie plots to the current pop music landscape, sorting through possibilities like Adele, and even Justin Bieber, before naturally landing back on themes quite a bit darker-sounding — like certain Johnny Cash songs.

But all kidding aside, the concept of a dollar denouement is a great fit for my current view of currency markets. It speaks to both the end stage of dollar strength (and the carnage that it could still create), as well as our fixed income team's broad view of a long story arc.

By its dictionary definition, denouement is the final part of a play or a movie in which the strands of the plot are drawn together and matters are explained or resolved. So thank you, Webster's, for helping save me from an embarrassing title.

How markets got here

A quick review of the key plot points for the dollar strength story is in order before we reveal the chilling conclusion.

In 2014, we detailed some pitfalls that a strong dollar environment might entail, as well as some of the positive ramifications for the United States.

Among the most crucial reverberations we identified were commodity weakness as well as:

- More central bank easing
- Growth in dollar-denominated debt obligations around the world that impair balance sheets and increase global leverage in dollar terms

- Earnings pressure for U.S. multinationals and exporters
- A push lower in inflation globally.

In a large sense, each of these consequences of a strong dollar has played out in one way or another. If anything, our thinking on the fallout from a strong dollar was accurate directionally, but too optimistic. We believe the pain global markets are experiencing isn't over.

In that same commentary, we mentioned some potential positives from a stronger dollar, including further central bank easing and an effective tax break for U.S. consumers. U.S. consumers have certainly enjoyed some benefits from cheaper commodities and a strong dollar. However, the U.S. has also felt some degree of pain from job losses in the energy sector.

Perhaps more importantly, we expected central banks to react aggressively to dollar strength, and they have en masse. We thought this dollar "Catch-22" feedback loop would prompt greater and greater responses from central banks as they competitively devalued their currencies in order to keep up domestic inflation and export competitiveness. This devaluation dilemma, as we detailed in March of last year, would lead to competitive devaluations culminating in the breakdown of China's currency regime (which was managed against the dollar). Currency markets have gone through much of this process in a sequence near to what we expected. Key surprises, or things we didn't get right in terms of order, were:

- How quickly the Chinese would devalue (this came way faster than we thought)
- The European Central Bank's (ECB's) engagement in further quantitative easing, ahead of the Bank of Japan (BOJ)
- Korea's long wait to engage in devaluation of its own.

The good news is that most of what we have seen was relatively predictable up until now and that this might in fact be the end of easing for the three big devaluers: Japan, Europe, and the U.S.

An escalating threat

While the Chinese devaluation has clearly started, the dollar Catch-22 and devaluation dilemma has taken on a dramatic and perilous new dynamic, stemming from emerging markets' interventions to deal with dollar strength.

Emerging markets' currencies have weakened with other currencies against the dollar. This was all fine at the outset because initially emerging markets weren't experiencing inflation, capital flight was somewhat manageable, and emerging markets had poor growth, so a little boost in competeviness seemed fine to most emerging markets' central banks.

As the selloff in emerging markets foreign exchange has intensified, however, central banks have been forced to react by hiking rates, placing controls on the buying of dollars (or capital controls), or intervening to prevent further currency weakness and deal with capital flight (or some combination of all the prior orthodox responses).

The unfortunate implication is that, as the dollar rallies more, emerging markets' central banks are actually taking liquidity out of the system as they provide dollars to their economies and try to

prevent further currency weakness and accelerating capital flight.

If the problem isn't apparent quite yet, let me walk you through a simple step-by-step rundown, which is a modest extension of the dollar Catch-22 feedback loop and devaluation dilemma:

1. Major/developed central banks ease while the U.S. tightens monetary policy.
2. The dollar rises and other currencies fall, including emerging markets currencies.
3. Commodities fall on weak global demand, a strong dollar, and a weak Chinese economy.
4. This puts further pressure on global inflation as commodity importers and exporters experience downdrafts in their economies due to languishing commodity industries (often the main source of growth across emerging markets).
5. Inflation pressure globally leads to further reactions by central banks, driving more policy responses and driving the dollar stronger (and other currencies weaker).
6. Eventually, through commodities and weak global demand, emerging market economies suffer capital flight or signs of inflation due to imported price pressures or traditional bid to hard currencies seen when local currencies present instability (currency crisis).
7. Emerging markets' central banks are forced to stabilize capital flight, keep inflation in check, and in some more fragile cases, prevent a full-blown traditional currency crisis.8. Emerging markets' central banks stabilize through rate hikes, capital controls, intervention, or some combination of the three, reducing liquidity within local markets (dollar and overall monetary base).

Without getting overly technical, it's easy to see that as emerging markets hike rates, liquidity should be reduced both locally and globally. Capital controls are another means of preventing weaker currencies and would represent a knock to local liquidity and a likely slowing of growth and confidence within the economy in question. Importantly, and perhaps harder to see, are the effects interventions have on the global liquidity profile through the emerging markets.

Let's break this sequence of events down into a more tangible example:

1. Someone within an emerging market country wants dollars. Let's say they are selling some assets
2. They will look to engage in a transaction to sell the local emerging market currency and take dollars out.
3. The central bank is now forced to deal with a transaction that will leave more local currency for sale and take dollars out of the system.
4. The central bank can let the dollars leave and see the currency weaken (this may be fine in normal circumstances). Or, if things are tough and there is a flight of dollars, the bank may be forced to intervene, using reserves to defend its currency by selling U.S. Treasurys and then selling the dollars to buy local currency.

When the emerging market central bank buys its local currency, it effectively tightens the monetary base locally. This leads to central banks spending reserves and reducing liquidity from the system. The more alarming part is that more dollar strength means more tightening of liquidity conditions globally in addition to the slew of other negative factors a strong dollar might have on the global economy. This is a new element to the Catch-22 and brings us to our dollar denouement, where all

the stories tie together and the complete plot is fully understood.

Approaching the final scene

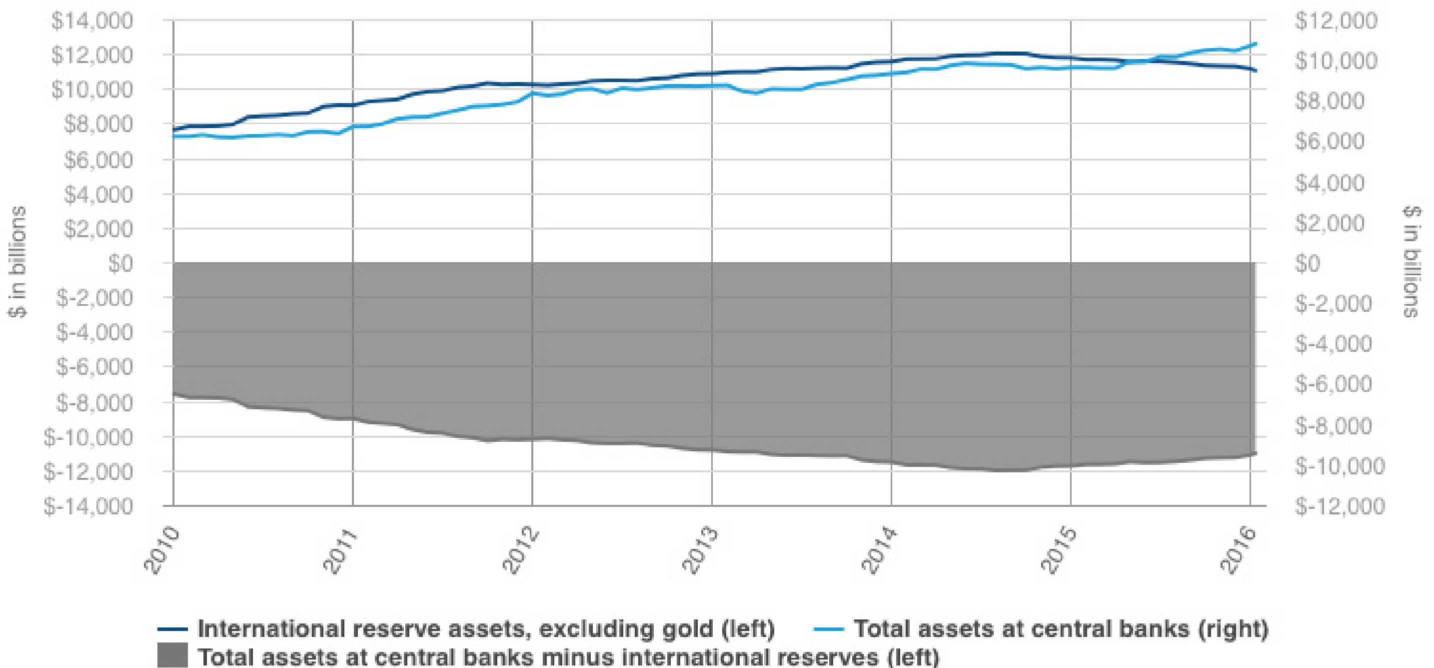
In our plot's resolution, each time a central bank attempts to weaken its currency, the dollar strengthens and global growth and liquidity slow even more through the numerous factors we've mentioned above (in addition to emerging markets' rate hikes, capital controls, and interventions).

> In our view, the growth engines of the global economy are on the ropes due to dollar strength, and each central bank creating more dollar strength will damage emerging market growth even more.

In short, this is checkmate for the ECB and BOJ. They cannot ease anymore if it creates dollar strength and consequent foreign exchange and commodity weakness in emerging markets. This trade-off of liquidity within the system is very evident in the chart below, which shows that global reserves rose initially but have since reversed into a mirror image of the balance sheets of the ECB, the BOJ, and the U.S. ECB and BOJ easing have led to dollar strength and further emerging markets' foreign exchange and commodity weakness. Each quantitative-easing adventure in the developed world has added to more tightening in the emerging world through the dollar and commodities.

Is this the end of the story? Perhaps. I think it is more likely that the ECB and BOJ are no longer able to ease and weaken versus the dollar, given how they affect global currencies. This is good news only if the ECB and BOJ get the joke. They may not yet.

A trade-off in liquidity



Data: Bloomberg.

Chart is for illustrative purposes only.

Tying the strong dollar story together, our denouement leads to a not-so-happy conclusion:

1. The BOJ and the ECB seem not capable of creating meaningful liquidity for the system without pushing up the dollar and damaging the commodity complex and inflation.
2. To the extent that more liquidity adds to more dollar strength, growth weakens globally as liquidity and growth are sucked out of the emerging markets.

The good news is that the Federal Reserve likely understands and cannot ignore these forces. To the extent that risk markets globally continue to soften and there is more stress on China (and further potential devaluations within Asia), we should start to see light at the end of the tunnel. The dollar has in effect capped its strength through the carnage it has created globally.

This doesn't mean there isn't more carnage coming, but eventually the damage will come back to the U.S. and make the dollar less attractive, relatively speaking, than other assets, dampening dollar strength. There is still a lot of game to be played, but the conclusion to the story is that dollar strength ended because dollar strength was the dollar strength's undoing.

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