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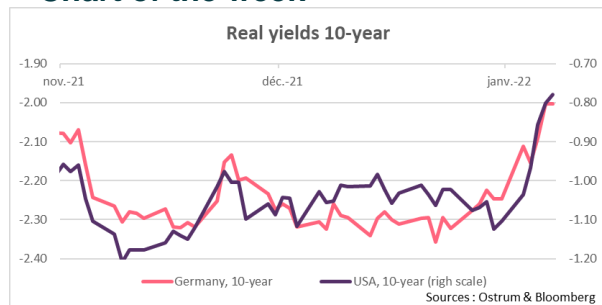
• Topic of the week: What if the dollar plunges?

- In the short term, cyclical elements seem to take precedence over the dollar's trajectory. In particular, the fact that the Fed dug up the axe and boosted the yield differential;
- In the medium term, however, the cocktail that is developing is much more negative for the dollar: extremely pronounced funding imbalances that do not seem to lead to a rapid decline. On the other hand, foreign investors are tired of buying the dollar;
- Historical precedents show that adjustment, when it finally happens, can be violent.

• Market review: Fed: the timetable is accelerating

- FOMC minutes hint at balance sheet contraction;
- T-note yields at April 21 highs;
- Pullback on Nasdaq, growth stocks;
- Sovereign spreads widen slightly.

• Chart of the week



The rebound in rates since the FOMC minutes is quite impressive. Already almost 30 bps on the 10-year-old American since the beginning of the year, and the 10-year-old German who gains 15 bps in sympathy.

But perhaps the most impressive is elsewhere, the typology of the increase. It's basically the real rates that have shifted: in fact the inflation expectations have actually gone down. That is completely contrary to what we have seen so far.

It seems that this time the Fed is really taking inflation seriously: hence a more restrictive monetary policy and reactive real rates.

• Figure of the week

554

Source : Ostrum AM

This is the carbon intensity (gCO₂/kWh) this morning in Germany. A new record! Since the closure of two atomic power plants the figures are alarming. France is at 98g this morning.



Stéphane Déo

Head of markets strategy
stephane.deo@ostrum.com



Axel Botte

Global strategist
axel.botte@ostrum.com



Zouhoure Bousbih

Emerging countries strategist
zouhoure.bousbih@ostrum.com



Aline Goupil- Raguénès

Developed countries strategist
aline.goupil-raguenes@ostrum.com

• Topic of the week

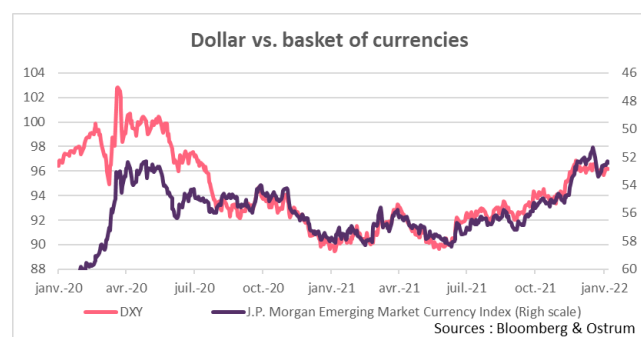
What if the dollar plunges?

The dollar had a very good year 2021 and appreciated sharply against almost all world currencies. The fact that the Fed dug up the hatchet helped a lot in appreciation. A priori there is little reason for this to change in the coming weeks or months. In the medium term, however, the cocktail that is brewing is much more negative for the dollar: extremely pronounced funding imbalances that do not seem to lead to a rapid decline. On the other hand, foreign investors are tired of buying the dollar. This could affect the parity of the greenback.

For now it's the other way round

The situation

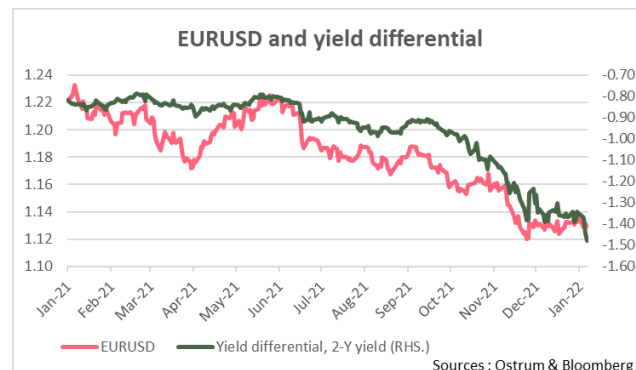
Overall, the dollar has appreciated over the past year. The chart below summarizes the trend. The DXY, an index that shows the evolution of the dollar against the six majors (EUR, JPY, GBP, CAD, SEK and CHF) gained 6.4% over last year. The "J.P. Morgan Emerging Market Currency" index had a very similar trend with an average EM currency depreciation of 8.9% over the year.



In general, all world currencies depreciated against the dollar at the same time, which tends to support the idea that it was not a question of the weakness of certain countries or regions, but rather of a renewed strength of the dollar.

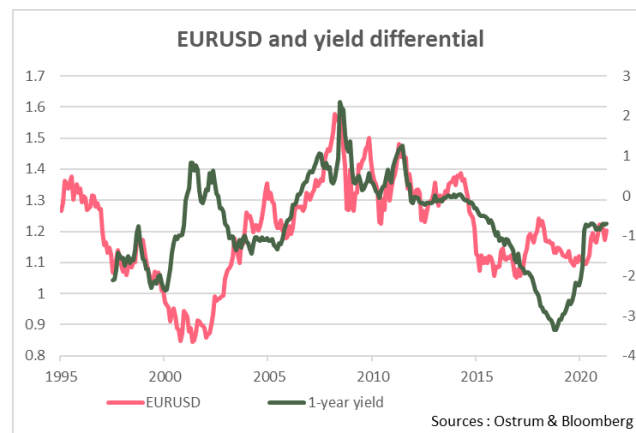
Mechanism, essentially the rate differential

The interest rate differential seems to be one of the main causes of this trend. The chart below shows the evolution for EURUSD in comparison with short rates. Empirically, the interest rate differential most related to the exchange rate evolution is that on the short part of the curve because it is an approximation of the relative cost of funding between two currencies. On the chart below, we took the two-year rate gap.



The story therefore seems to be simply that the increase in the Fed's expectations of rising rates, which materialized especially from the summer onwards, attracted liquidity investments and raised the dollar.

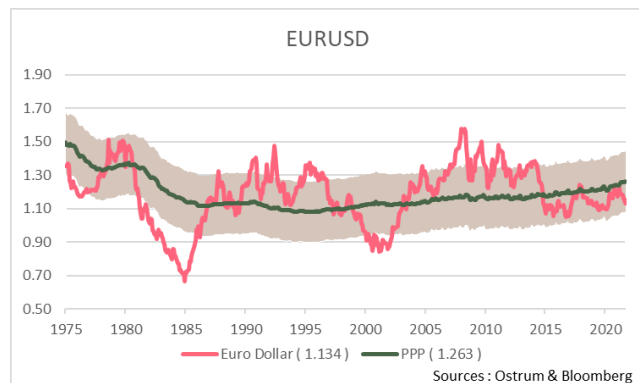
It should be noted, however, that this explanation, indisputably valid and relevant for 2021, is not as obvious as it seems. The chart below shows the same dynamic, but over a much longer period, several decades. The rate differential is indeed very useful in explaining short-term changes in exchange rates, but only intermittently. For long periods, the relationship is distant or even disappearing. So we should not extrapolate too much the trend of last year, the relationship is much less lasting than it seems at first sight.



As a result, an expensive dollar

The consequence of this strong increase of the dollar is that its valuation is now strained. Here too, to be clear, we take MyStratWeekly – 11/01/22 - 2

the EURUSD parity as an example. A classic model of PPP (Purchasing Power Parity) leads to estimate the equilibrium value of the dollar at 1.26, while it is at the time we write, close to 1.13. Using this approach, it would therefore be 10.5% overvalued against the Euro.



Small downside, however, here too currency valuation models must be taken with a pinch of salt. The PPP approach, which takes into account the inflation differential between the two areas, is a long-term approach. As the graph shows, the observed rate tends to switch to PPP, but the process is long and slow, and can last a decade. The divergence in the rate observed at the “break-even” rate can also be significant.

The result is also similar, according to our calculations, for the entire basket of currencies that make up the DXY. Cf. the table below.

	Spot	PPA	Deviation *
EUR	1.13	1.26	11.4%
JPY	0.01	0.01	38.1%
GBP	1.33	1.63	22.9%
CAD	0.78	0.88	12.1%
SEK	0.11	0.16	43.6%
CHF	1.09	1.12	2.6%
DXY	95.67	81.43	17.5%

* positive == USD overvalued

A persistent trend

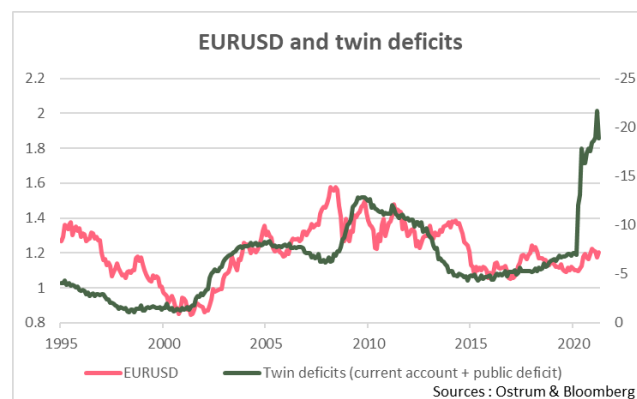
The observation is therefore clear, at least over the past year: the dollar, mainly aided by the rise in US rates, appreciated against all world currencies to the point of becoming overvalued (to an extent certainly reasonable). So there is little reason to think that this could change.

Mammoth imbalances

Why then ask the question of a drop in the dollar? In the long

run, one of the most stable relationships to explain the variations in the EURUSD is to look at the funding imbalances in the United States. More specifically, the “twin deficits” (current account + government deficit) have been very well correlated with the EURUSD for more than a quarter of a century.

The explosion during the Covid period hurt this relationship, the dollar should have gone to ... 2 against the Euro!



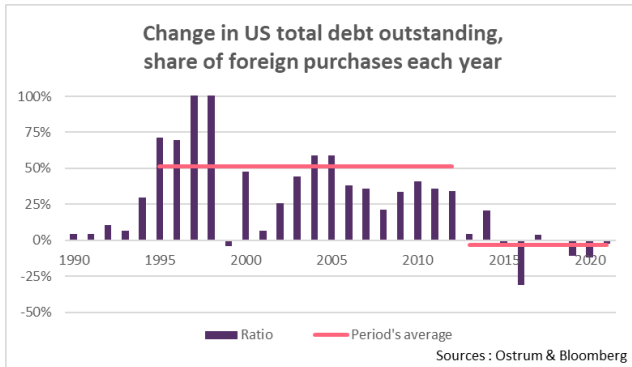
The fact remains that the level of imbalance in the United States is impressive and could eventually weigh on the currency.

The public deficit

Let's start with the government deficit: 12.6% deficit last year. A colossal figure but the Eurozone was at 7.3% the same year which is not bad either.

What is shocking is the financing typology of this deficit. The American Treasury publishes monthly the holding of the American debt and this allows to get statistics on foreign purchases.

Over the period from 1995 to 2012, foreigners, as shown in our calculations on the following chart, purchased about half of the US debt issued. In other words, they financed half of the US deficit over this period, year after year. Since 2013, the proportion has gone to 0%! To be precise, they have even been net sellers of \$818 billion accumulated over the past nine years. The external financing of this deficit has therefore completely dried up.



The external deficit

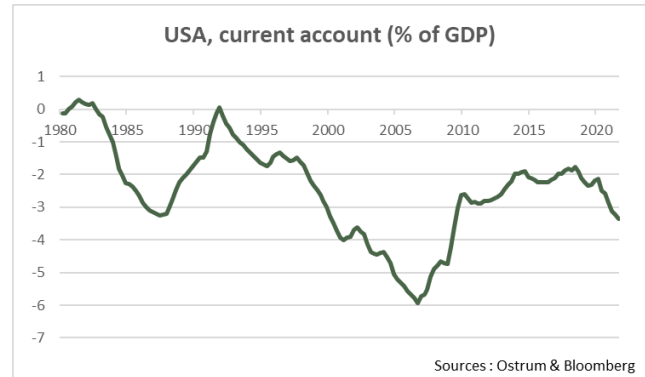
The net foreign position of a country is the difference between what that country owes abroad and what the foreigner owes to that country. In the case of the United States the situation has deteriorated extremely rapidly over the past decade as shown in the graph below.

In the third quarter of 2021, Americans owed \$16 trillion more to the rest of the world than the rest of the world owed to the United States, according to the latest Bureau of Economic Analysis (BEA) Net International Investment Position (NIIP) publication. This is 69% of US GDP, up from about 50% at the end of 2019 and well above the 16% of GDP recorded a decade ago.



This deterioration is essentially a reflection of the balance of payments, which is once again very weak as shown in the graph below. A current account deficit means that the country is indebted to the rest of the world, and therefore its net external position is deteriorating.

It should be noted, however, that the deficit was worse in the period 2005-2010, but at the time the revaluation of US assets abroad had partly offset the current account deficit flows (the dollar was sinking, and therefore the dollar value of assets abroad was improving). That is no longer the case.



How bad is it?

The problem is “external sustainability”. In most countries, the increase in external liabilities implies an increasing burden of debt servicing. This may ultimately require a significant adjustment in the exchange rate, but above all a compression of domestic demand to generate the trade surplus needed to service the debt. Indeed, historical data suggest that large net external liabilities significantly increase the risk of external crises.

The case of the United States is different since it borrows exclusively in dollars, and therefore does not carry currency risk. On the contrary, as we mentioned earlier, a weaker dollar improves the United States' external position in accounting terms by revaluing its external assets. Unlike an emerging country, for example, where a depreciation of the currency quickly becomes destabilizing, it is on the contrary salutary in the singular case of the United States. As the issuer of the global reserve currency, two positive factors mitigate the need for the United States to have a trade surplus:

1. The return on U.S. external liabilities over the past two decades has been below the GDP growth rate. This reflects the decline in Treasuries and rates on the credit market.
2. The performance of its assets has consistently outperformed its liabilities to the point that the U.S. investment income balance remains positive despite its high net debit position.

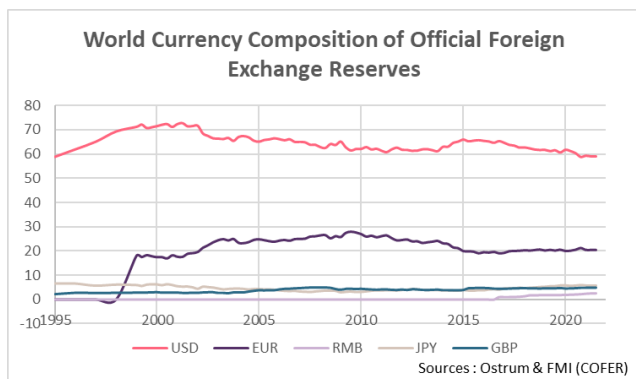
Lack of appetite

So it would be wrong to panic about numbers, as impressive as they are. This is what General De Gaulle called in his time the “exorbitant privilege”: the United States can print its currency to pay its deficit.

The logic, however, only applies to the extent that trading partners are willing to accept these dollars, for example to increase their foreign exchange reserves. That is where the

problem lies. Treasury purchases, as we've said, have been very weak over the last decade, and the appetite for this paper is not significant.

On the other hand, as shown in the chart below, the share of the dollar in world reserves has fallen to the lowest in a quarter of a century. Here too, it seems that the appetite of investors is not really at the rendezvous, the IMF was even touched recently, see "The share of the dollar in global foreign reserves reaches its lowest level in 25 years", available on: <https://blogs.imf.org/2021/05/05/us-dollar-share-of-global-foreign-exchange-reserves-drops-to-25-year-low/> and there is no collapse, nor any strong alternative for the moment. The Chinese electronic currency could, in the long term, present an important regional alternative, the Euro also has this role in part in some regions of Eastern Europe or Africa. But these efforts are, for the moment, limited.



Conclusion

In the short term, cyclical elements seem to take precedence over the dollar's trajectory. In particular, the fact that the Fed dug up the hatchet helped greatly in the appreciation. A priori there is little reason for this to change in the coming weeks or months.

In the longer term, the cocktail brewing is much more negative for the dollar: extremely pronounced funding imbalances that do not seem to lead to a rapid reduction, on the other hand a fatigue of foreign investors to buy the dollar.

The solution in this case is to change the dollar parity to return to more "reasonable" imbalances (it is no longer clear what "reasonable" means today).

Recall that the last period of very strong deterioration of the US current account was in the third quarter of 2006 with an external deficit that was close to 6%. At the time the dollar was at 1,275 on average over the quarter, a year later it was at 1,367 or 7.2% lower, two years later at 1.536 or 20.4% lower folds.

Stéphane Déo

• Market review

Fed: the timetable is accelerating

The Fed is discussing balance sheet reduction, which will be necessary to raise long-term rates

The withdrawal of monetary stimulus in the United States remains a central issue for financial markets. The December FOMC minutes revealed that the contraction of the Fed balance sheet is already under consideration. This prospect triggered a strong upward movement in Treasuries yields amid curve steepening pressure. The Fed's change of tone weighed on breakeven inflation rates and initially added support to the greenback. Equities and growth stocks fell. The speculative asset complex (cryptocurrencies, small cap values) also adjusted to the new monetary situation. The Bund (-0.05%) follows the uptrend in T-note yields (1.76%) which eventually triggered widening in Greek spreads, and, to a lesser extent, Italian bond spreads as the Presidential election looms later this month. Credit is stable while European high yield is catching up with its dollar equivalent. Emerging spreads were up somewhat.

The geopolitical situation remains uncertain. The unrest in Kazakhstan resulted in the fall of the government and Russian military intervention. The events, caused by the rise in the price of energy, question the country's oil production capacities. In a context made difficult by the fall in Libyan production, the increase in OPEC production (+ 400kbpd in February) has not convinced the markets. Brent prices shot up above \$82 a barrel. In addition, the Kazakh crisis is causing tensions in the price of uranium, which also explains Russian interests in stability in the region. Gas prices in Europe has fallen thanks to LNG cargo ships re-routing from Asia to Europe but Russian gas remain unavailable pending the approval of Nord Stream 2. The threat of Russian invasion of Ukraine is delaying the European green light, whilst Biden demands tangible signs of de-escalation in the East. North Korean ballistic missile testing would go almost unnoticed in this context.

The Fed's monetary policy is the key determining factor for financial markets. The minutes of the last FOMC show a clear change of heart from policymakers. High inflation is the main concern and requires a significant adjustment to monetary policy, including ending asset purchases, three rate hikes in 2022 and a winding down of the balance sheet. This last point had not been mentioned until now. The Fed will cut the amount of its bond proceed reinvestments once the cycle of rate hikes begins. In 2017, the balance sheet reduction began after Fed Funds had reached 1%. Inflation is high (6.8% in December) so a contraction in the balance sheet can be brought forward. Cutbacks in mortgage bond

holdings seems fully justified by the rise in property prices and rents, the contribution of which to the cost of living will increase in 2022. In terms of activity, surveys appear resilient to the resurgence of the epidemic. Tensions in the supply chain also appear to be easing somewhat. Employment increased by 199k in December and revisions to the previous two months added 141k jobs. The unemployment rate decreased to 3.9% with a stable participation (61.9%). Central bankers will certainly pay attention to the increase in wages (4.7%). In the Eurozone, the German economy continues to be held back by rising energy costs and health measures. Industrial production contracted in November in both Germany and France, in contrast to favorable surveys. Eurozone inflation reached 5% in December.

As regards financial markets, current debates within the FOMC leaves little doubt about the stance of policy going forward. James Bullard argued for a hike in March while Neel Kashkari, arguably the most dovish FOMC participant, sees two increases this year. The balance sheet policy is mentioned as a tool to avoid an excessive flattening of the yield curve, such as Greenspan's 'conundrum' which contributed to inflate the real estate bubble and led to the ensuing devastating financial crisis in 2008. Against this backdrop, the strike price of the alleged Fed put may be much lower than investors think. The S&P 500 gained fully 27% in 2021. This leaves the Fed a lot of room before intervening, especially as the inflationary backdrop is very different from 2018. Asset allocation shifts have been accelerating. The US 10-year yields rose last week by more than 20bp above their 2021 peak. However, markets still do not fully price in the potential for higher Fed Fund rates years out. Real yields are nevertheless recovering from very depressed levels whilst breakeven inflation rates shrank despite oil prices rising above \$80 a barrel. The steepening of the yield curve went hand in hand with significant outflows from Treasury bond funds (-\$2 billion, the largest weekly outflow in a year). A busy primary IG credit market, with more than \$60 billion issued in this first week of 2022, also generated hedging flows adding to selling pressure.

In the euro area, Bund yields followed on from the US Treasury bond market. The upside surprise on inflation in Germany and then in the Eurozone contributed to the rise in yields. The German 10-year bond yield closed at -0.04%. Peripheral bonds however underperformed, especially Greece as long-term GGB syndication looms at the end of the month. Italy is trading around 135bp at 10 years. Draghi will likely run for President. There is considerable uncertainty regarding the new PM as the government is about to announce a budget extension of €15-20 billion for this year.

Axel Botte
Global strategist

● Main market indicators

G4 Government Bonds	10-Jan-22	1w k (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.59%	+1	+11	+3
EUR Bunds 10y	-0.03%	+8	+31	+14
EUR Bunds 2s10s	54.8bp	+7	+21	+11
USD Treasuries 2y	0.89%	+12	+23	+16
USD Treasuries 10y	1.77%	+14	+29	+26
USD Treasuries 2s10s	88.2bp	+3	+6	+11
GBP Gilt 10y	1.19%	+22	+45	+22
JPY JGB 10y	0.14%	+7	-7	+3
€ Sovereign Spreads (10y)	10-Jan-22	1w k (bp)	1m (bp)	2022 (bp)
France	31.88bp	-5	-6	-6
Italy	132.08bp	-1	-3	-3
Spain	67.96bp	-4	-6	-6
Inflation Break-evens (10y)	10-Jan-22	1w k (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2%	-2	+2	-10
USD 10y Inflation Swap	2.67%	-15	-3	-11
GBP 10y Inflation Swap	4.19%	+2	-23	+2
EUR Credit Indices	10-Jan-22	1w k (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	94bp	-1	-4	-1
EUR Agencies OAS	46bp	-3	-3	-3
EUR Securitized - Covered OAS	43bp	-3	-4	-3
EUR Pan-European High Yield OAS	306bp	-12	-26	-12
EUR/USD CDS Indices 5y	10-Jan-22	1w k (bp)	1m (bp)	2022 (bp)
iTraxx IG	52bp	+4	-1	+4
iTraxx Crossover	257bp	+16	-3	+15
CDX IG	53bp	+3	-1	+4
CDX High Yield	311bp	+17	+4	+18
Emerging Markets	10-Jan-22	1w k (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	369bp	+0	+1	+0
Currencies	03-Jan-22	1w k (%)	1m (%)	2022 (%)
EUR/USD	\$1.133	0.274	0.133	-0.4
GBP/USD	\$1.357	0.638	2.208	0.3
USD/JPY	JPY 115	0.182	-1.451	0.0
Commodity Futures	10-Jan-22	-1w k (\$)	-1m (\$)	2022 (%)
Crude Brent	\$81.0	\$2.0	\$6.1	4.09
Gold	\$1 800.3	-\$1.1	\$17.5	-1.58
Equity Market Indices	03-Jan-22	-1w k (%)	-1m (%)	2022 (%)
S&P 500	4 602	-4.06	-2.34	-3.5
EuroStoxx 50	4 240	-2.13	0.96	-1.4
CAC 40	7 116	-1.41	1.77	-0.5
Nikkei 225	28 479	-1.48	0.14	-1.1
Shanghai Composite	3 594	-1.27	-1.99	-1.3
VIX - Implied Volatility Index	22.35	34.64	19.58	29.8

Source: Bloomberg, Ostrum AM

Additional notes

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