

# Ashdon Investment Management

## Why the US Dollar Could Weaken

August 2016

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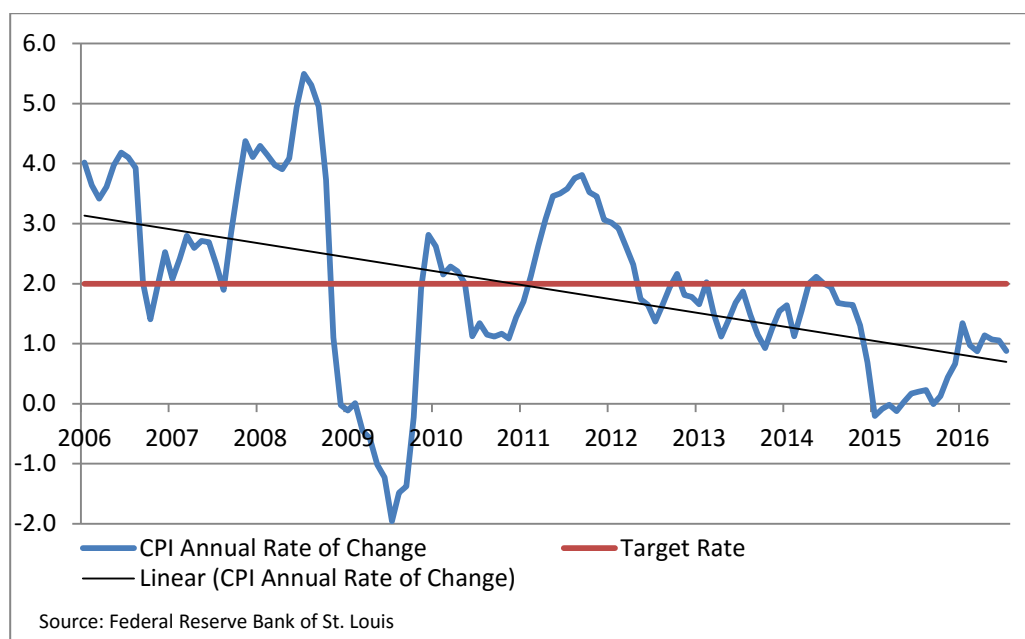
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## Why the US Dollar Could Weaken

In a recent market view, [The Case for a Strengthening Euro](#), we looked at some reasons why the Euro (EUR) was likely to strengthen overtime while the US Dollar (USD) could weaken. We cited weakness in US industrial production as a factor influencing FOMC action regarding interest rates, and why we believe US interest rates might not be raised at this time. This market view will build a case for not raising rates, and the potential of a weakening USD.

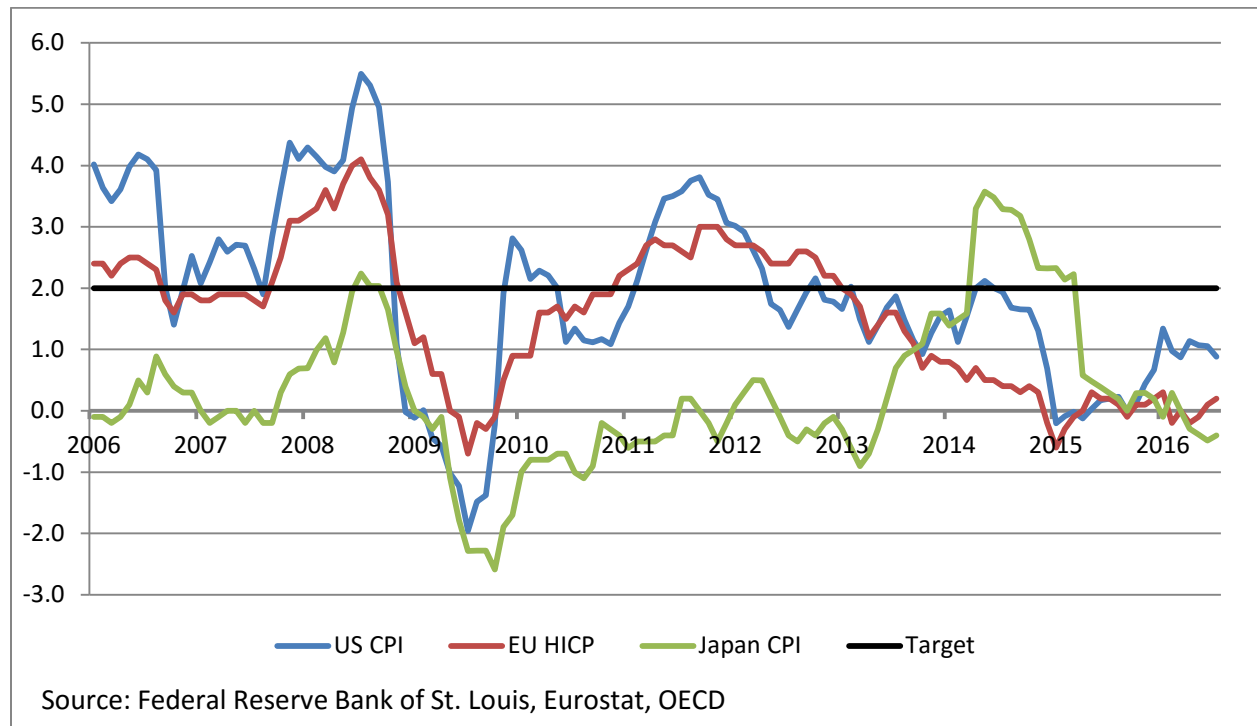
One of the Federal Reserve's (FED) directives is to maintain stability in prices, which is measured by the Consumer Prices Index, or CPI. The current FED target for inflation is 2% per year.



Despite the wild deflation swing during the Global Financial Crisis (2008-09), the objective of 2% has largely been achieved. However, the basic long term trend (black line) has been notably lowered due to the drop in CPI that occurred in late 2014. The long term trend now indicates that CPI is headed closer to zero.

- The recent decline in US inflation is driven by recent USD strength – a lesson learned from observing other economies.
- Raising rates could further strengthen the USD, putting unwanted pressure on growth and inflation.
- We believe the FOMC, currently not achieving its inflation target, will not follow through on plans to raise rates in the near term.

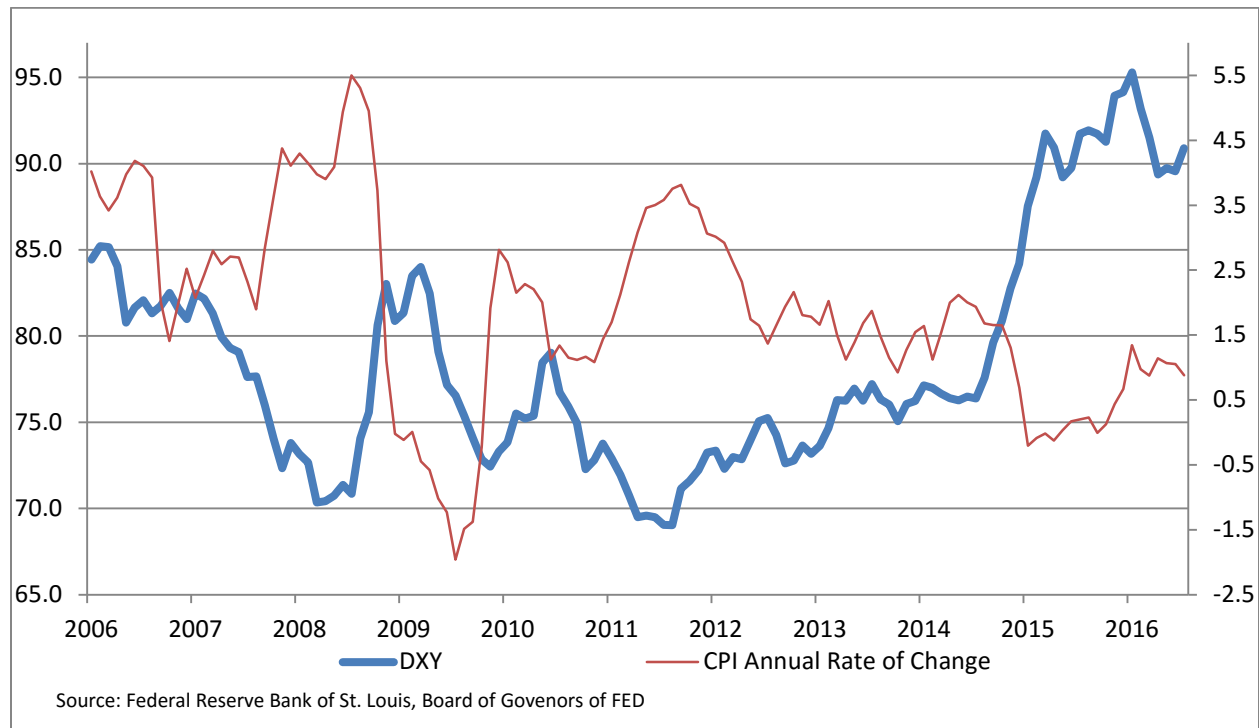
This has been a global phenomenon. The three developed market regions in the chart below all have the same 2% inflation target.



There are two things that jump out to us from this chart. The first is Japan's massive, but ultimately transitory swing into inflation starting in 2013. This bump highly correlates with the massive injection of money from the Central Bank of Japan (BOJ) during its beginning rounds of [Abenomics](#). Unfortunately, the price increases weren't sticky, and headline inflation came back down towards disinflation.

The second event (discussed with the first chart) is the large decline in US inflation starting in late 2014. This trend followed the timely prediction by one macro-focused manager (hired for some Ashdon clients) discussed in a write-up released late 2014. The manager cited two preceding events as evidence the US wasn't immune to a disinflationary trend. The first event was Sweden's attempt at raising interest rates in 2011-2012, and the second event was the UK's attempt at raising interest rates in late 2013-2014. In both cases, higher yields were followed by higher exchange rates, which were a result of investors seeking a higher-yielding currency. Consequently, the higher exchange rates were attributable to slowing economic growth in those countries, primarily due to higher export prices making domestic producers less competitive in global markets. Slow domestic growth caused inflation rates to reverse and trend lower, forcing both countries to lower rates back to zero. Today, both economies are experiencing low inflation similar to the Euro area and the US. They have also been forced to remain at the zero-bound with their policy interest rates, and in the case of Sweden, have set negative rates.

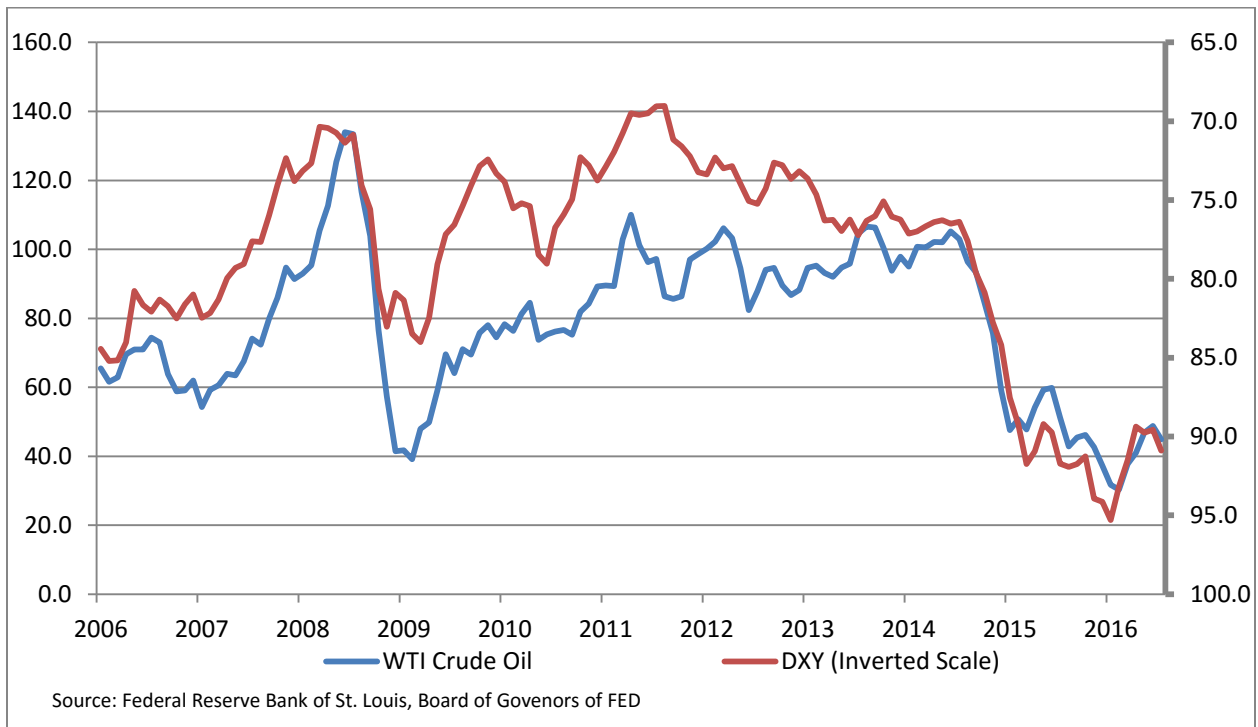
This situation is unfolding in the US economy. Below is a trade-weighted index of the USD (DXY), compared with US CPI (annualized rate of inflation).



As highlighted previously, the direction of a currency's exchange rate is largely driven by local interest rate policy. Notice on the chart above the USD began its drive higher in late 2014. At that time, the FOMC became "hawkish" on the growing strength of the US economy, and communicated to investors the *expectation* of a series of interest rate increases. Inflation grinded to a halt during the resultant breakout rally in the USD, and only modestly began to increase after the USD retraced some of its gains since December 2015.

For Sweden and the UK, a strengthening currency manifested as export weakness. For the US, an economy where exports are a lesser percentage of the economy, inflation decreased because of a different force.

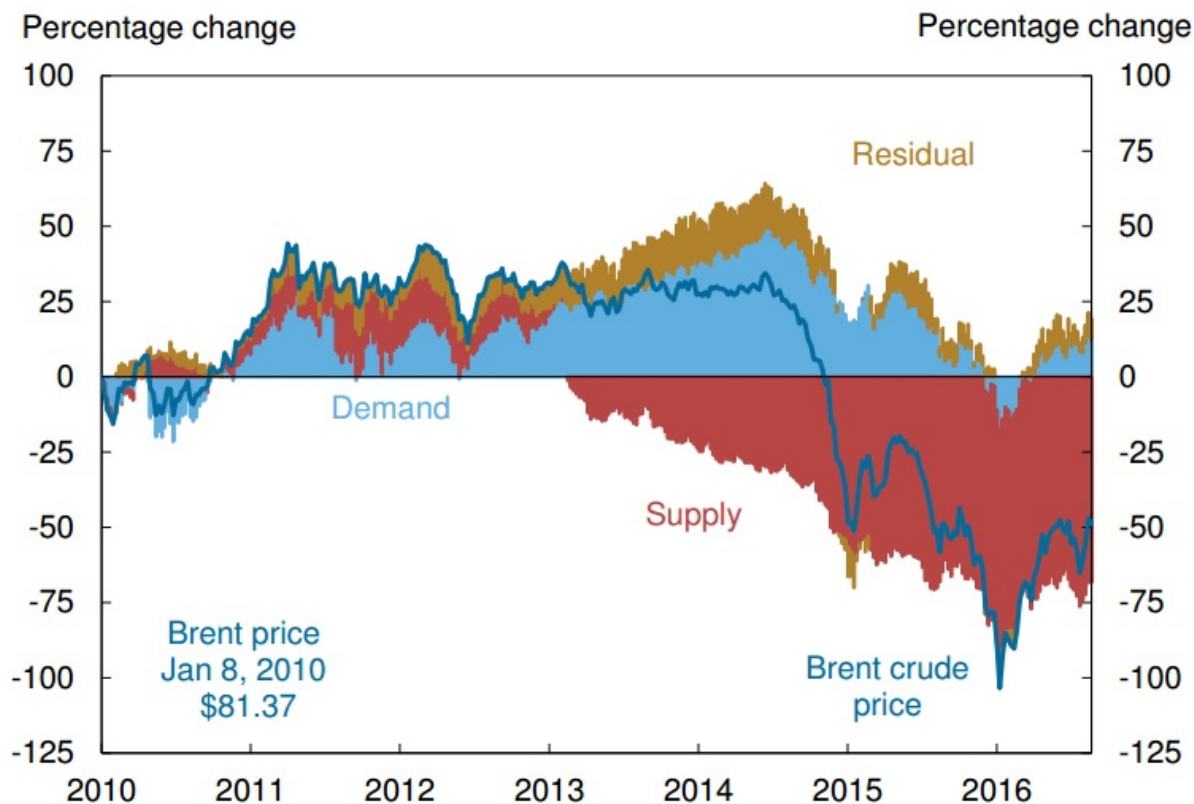
Below is a chart of the inverse of DXY overlaid on a chart of WTI Crude Oil.



In periods where the USD strengthens, oil tends to trade lower in price. The logic behind the correlation is a stronger currency is able to purchase more of a commodity, in this case oil. We can chart the USD against many other commodities and see similar trends. Something important to note is that most commodities in the world are traded and denominated in USD.

Although significantly influenced by the strength of the USD, WTI crude prices have been, and continue to be, heavily influenced by new supplies of US shale oil, which peaked in production around the same time as the breakout rally in the USD. Since the significant drop in prices, the increase in oil supply has only slightly receded.

The chart below is a weekly release from the New York FED. They take the price of Brent crude and break it down into factors influencing the price per barrel. This helps the analysis by allowing us to separate the currency effects from the supply and demand effects.



Sources: Authors' calculations; Haver Analytics; Thomson Reuters; Bloomberg.

Notes: Residual reflects price movements unexplained by supply and demand factors. Supply, demand, and residual sum to Brent crude price.

A stronger USD and the oversupplied commodity complex are both deflationary forces. It is not a coincidence that in near real-time, inflation rates in Japan, Europe and the US began to decline once the USD began to strengthen. In a world of excess supply of nearly any good or service, fierce competition creates price drops when input costs go down, such as energy becoming cheaper. The global competitive landscape also explains why Sweden and the UK were so sensitive to their exchange rates trading higher. While large economies like the US are more complex and diversified, the fundamental drivers that were so clearly witnessed in the case of Sweden and the UK are also in play in the EU, Japan and the US.

The FOMC is signaling rate increases in the near term. However, past market events as previously shown, displays how raising rates into global weakness can have unwanted deflationary effects. To raise the policy rate now could strengthen the USD and lower the inflation rate considerably more, and that would work against the FOMC's target inflation rate of 2%. We don't see the FOMC continuing on this path. However, to abandon the communication of this path could send financial markets into a tailspin (USD into a freefall), and could have negative implications for the real economy. The most likely course of action is to do nothing. And in that scenario, the USD should weaken overtime, which would provide a tailwind to higher oil prices, and provide some much needed relief for the export sectors.



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