Commentary: US Dollar to Continue to Strengthen

In the immediate aftermath of the US presidential election I wrote "my instinct is that the election result is bearish for the USD in that the new administration will pursue a mercantilist trade policy and weaken it." That initial reaction was wrong. I have turned bullish on the USD and bought it against the JPY and EUR, for the following reasons;

1. I have been agnostic on the dollar for much of 2016, primarily because I felt the Federal Reserve would act against any meaningful USD strength. A stronger USD implied a shallower path of policy normalisation, other things being equal. But other things are no longer equal. "Mr Trump has proposed a $1tn infrastructure plan (5.5% of GDP) financed by historically cheap debt" (Anthony Scaramucci, Financial Times). The expected fiscal / monetary mix has shifted dramatically and interest rate yields have surged higher. Market participants are optimistic that growth can quicken in the US. Time will tell how this plays out but for now contrast those expectations with the outlook for the Euro area - stuck in austerity mode - and the relative growth and interest rate prospects for the US and Europe have suddenly diverged.

2. The dramatic shift in the monetary / policy mix means the USD is now less significant for the Federal Reserve. It has been pushed to the margins of policy considerations by the altered fiscal landscape. In addition the new administration seems likely to influence the Fed's policy bias in a hawkish direction through new appointments, including a replacement for Janet Yellen in 2018.

3. While the Trump administration may ultimately prefer to see a weaker USD - "Trump's 'America First' stance means weak dollar policies" (Eisuke Sakakibara, former senior official in the Japanese Finance Ministry) - such a policy would be difficult to achieve against a backdrop of US growth outperforming and US monetary policy tightening more than elsewhere. The administration will understand this. A weaker USD policy may emerge later but not for now.

4. In Japan, the central bank has committed to keep ten year yields 'around 0%'. Since they made that commitment, most recently on November 1st, yields elsewhere have surged. Japan is an outlier. The JPY is beginning to weaken as a consequence and I expect this to continue.

5. Technically, USDJPY has broken above its 200 day moving average for the first time in 2016 - breaking the downtrend. EURUSD had traded 1.05 - 1.15 since March 2015. A test of the lower side of this range appears likely. If the range breaks I would expect the move lower to be substantial.

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November 14, 2016