MyStratWeekly
Market views and strategy

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N° 087 // **October 17, 2022**

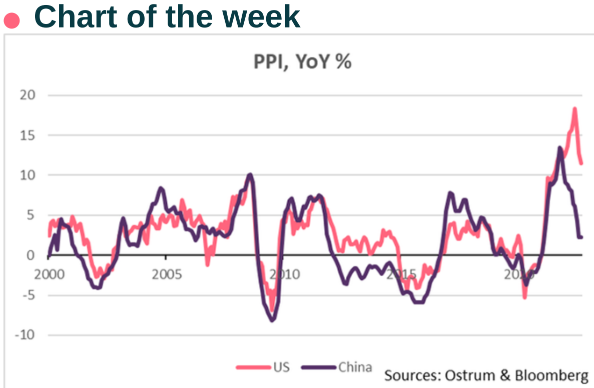
Topic of the week: Who will stop the dollar? (Or heading to a Plaza 2.0?)

- **The strength of the dollar reflects a significant structural change for energy-dependent economies;**
- **A global monetary tightening has begun trying to tame the dollar;**
- **Without China, this new form of coordinated intervention seems futile;**
- **As long as the energy crisis lasts, the greenback will benefit by penalizing asset classes outside the United States.**

Market review: Dust settles at last in the UK

- **Kwasi Kwarteng ousted, UK budget to be revamped;**
- **US inflation still above 8%;**
- **T-note yields fail to keep above 4%;**
- **Equity bounce despite mixed bank earnings releases.**

Chart of the week



Sources: Ostrum & Bloomberg

The vast majority of the inflation data are pointing to high and persistent inflation. The recent prints in the US and Europe are very much in that vein.

The chart of the week tells a different story. Producer prices inflation in China have declined very quickly. The good news is that this Chinese PPI tends to be a leading indicator of the US one which, itself, tend to lead the CPI. Patience will be needed we're very far from a significant downturn in CPI inflation. But we could see in the next few months, eventually, some pressures on goods starting to recede.

Figure of the week

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Source : Ostrum AM

The Chancellor of the Exchequer, Kwasi Kwarteng, served in his office during 38 days. The shortest time span in nearly 190 years for a finance minister to leave office alive.


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Topic of the week

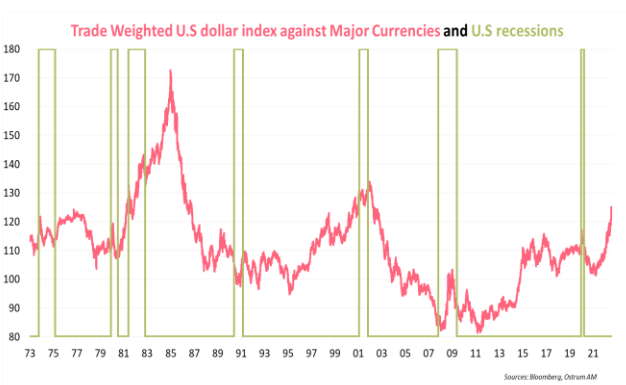
Who will stop the dollar ? (or heading to a Plaza 2.0 ?)

The strength of the dollar is starting to cause concern among the United States' economic partners. The Central Bank of Japan intervened for the first time since the Asian crisis in the foreign exchange market, to halt the yen's fall. The yuan also does not resist the strength of the greenback, despite the PBoC's attempts to stabilize. Several Fed members acknowledged that the strength of the Greenback could threaten financial stability, particularly in emerging markets. The specter of 1985, the date of the signing of the Plaza agreement, has resurfaced. In this note, we ask the following question: are conditions ripe for a Plaza 2.0?

A little bit of History

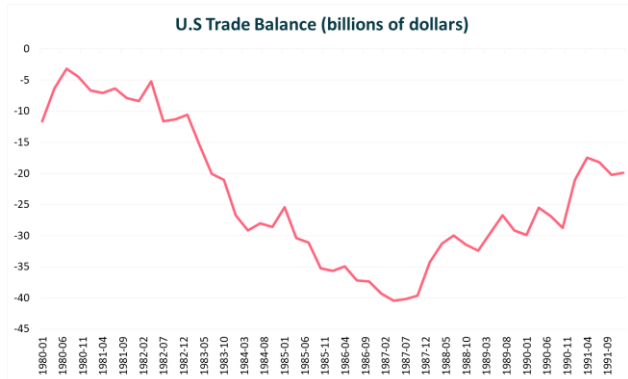
1985, an important turning point for the American policy

Over the period 1980-84, the dollar appreciated by 26% against the main currencies (chart below).



The American Policy-mix, a restrictive monetary policy (Volcker 1980-1982) and Reagan's expansionary fiscal policy (1981-1984) accounted for the strength of the greenback. On the other hand, the monetary policies of the other financial centers were the opposite of those of the Fed. Like the BoJ which had lowered its key interest rate from 9% to 5%. The Bundesbank had also lowered its main interest rate from 9.5% to 5.5%. By 1982, negotiations had begun between the major powers of the time, the United States, Germany, United Kingdom, France and Japan, in order to curb the appreciation of the greenback which threatened their financial stability. The United States' foreign exchange policy was a "laissez-faire" and no agreement was reached.

In 1984 and 1985, the dollar again appreciated by 17% against the main currencies. However, the strength of the greenback was no longer explained by the fundamentals of the U.S. economy. American growth was slowing, linked to the aggressive monetary tightening, rapidly dampening inflationary pressures. The strength of the greenback then penalized American exports, especially those of its automotive sector. The US trade balance had widened rapidly, no longer supporting the greenback.

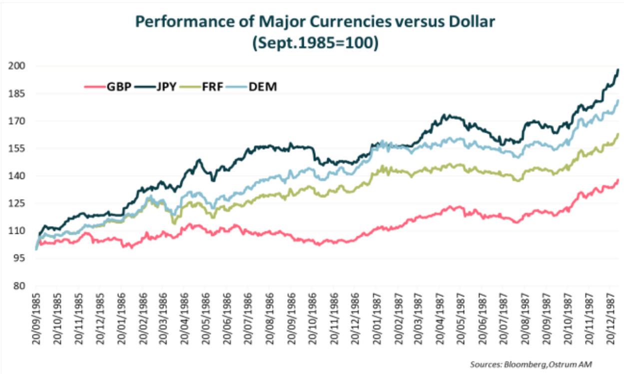


This period was also marked by a significant change in the head of the American Treasury with the appointment of James Baker in January 1985. This is an important turning point for American politics, which is shifting from "laissez-faire" to a "flexible activism" policy. This turning point was marked on September 22, 1985, by the agreement of the Plaza. The five major industrial powers of the time, the United States, Germany, France, Japan and the United Kingdom, agreed on a coordinated intervention on the foreign exchange market in order to stem the rapid rise of the dollar.

This first coordinated intervention had worked so well that, on 22 February 1987, the major economies met again. This time, the challenge of the meeting was to overcome the collapse of the greenback: these are the famous Louvre agreements. The speakers had defined secret fluctuation margins for their respective currencies, arousing the curiosity of the traders who had decided to come and test them. On top of that, the traders turned to the government bond market, selling the bonds and causing long-term interest rates to rise leading to the famous 1987 October bond crash. August 1995 was also the last coordinated intervention on the foreign exchange market, aimed at supporting the dollar against the yen and the mark.

The conspiracy thesis for the yen

Did the United States sabotage Japan's economic growth? It was the conspiracy theory that circulated in Asia. The yen was the currency that appreciated the most after the signing of the Plaza agreement, penalizing the competitiveness of Japanese exports (graph below).

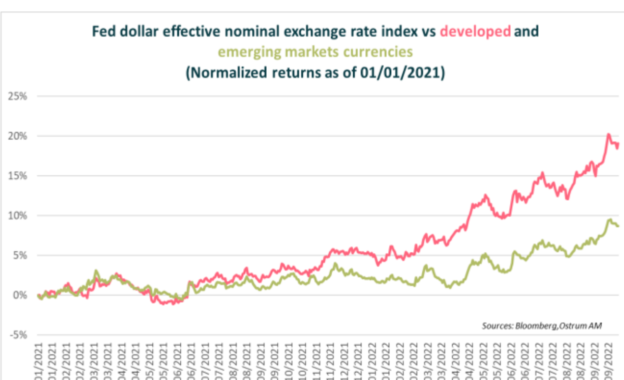


The suspicion is understandable, given the long-standing trend of US Treasury pressure on Asian countries to appreciate their currencies. Since 1990, Japanese growth has stagnated after decades of strong growth. However, between 1985-1986, when the yen appreciated, and the 1990 recession, there were the 1987-1989 bubble years, when the exchange rate policy was to support the dollar.

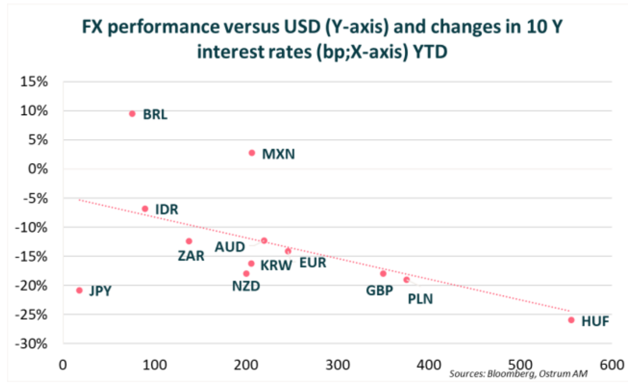
Does History repeat itself?

Strong dollar reflects weak euro…

If the dollar were so strong, it would also be strong against emerging market currencies. That is not the case. It is the developed currencies that have been most penalized by the strength of the greenback, as shown in the chart below. The dollar has appreciated by 20% against developed currencies since the beginning of 2021, while it has appreciated by only 9% against emerging market currencies.



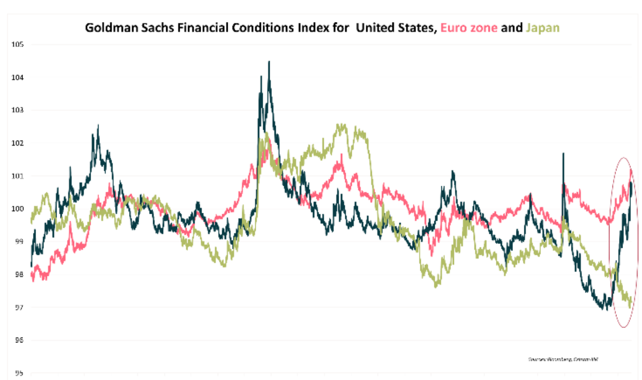
Last spring's World Bank and IMF meetings on the global economic outlook triggered a significant decline in the euro as investors realized that the fallout from the war in Ukraine was severe. Energy-dependent economies with current account surpluses, such as Germany, Japan, the United Kingdom and South Korea, are undergoing significant structural changes. The price of their energy imports has worsened their external positions, causing their currencies to fall against the dollar. This is particularly pronounced for the currencies of countries that have announced broad fiscal plans to offset rising energy prices on households and businesses, as shown in the following chart.



We can notice the resilience of the Brazilian real (BRL) and the Mexican peso (MXN). Their central banks raised their key rates before the Fed, benefiting from an interest rate cushion against the strengthening of the greenback. Latin American countries also benefit from rising commodity prices that improve their external positions, making them less vulnerable to external shocks. Eastern European countries such as Hungary (HUF) and Poland (PLN), which are at the forefront of the Ukrainian war, are also experiencing a sharp decline in their currencies reflecting the deterioration of their current and budgetary accounts, this is due to their high energy dependence.

… not Fed policy

The Fed's aggressive monetary tightening alone does not explain the strengthening of the Greenback. While financial conditions have tightened rapidly in the United States, they have also tightened in the euro area as shown in the chart below.

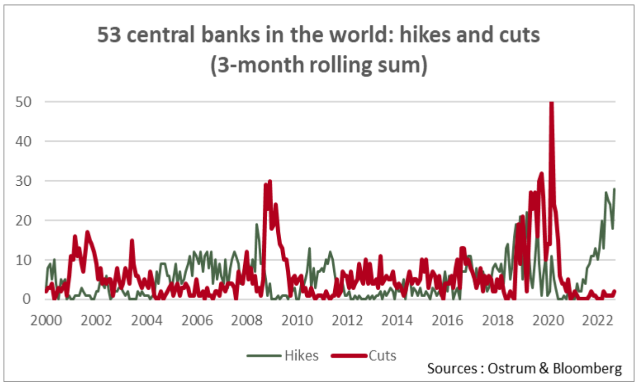


In Japan, financial conditions remain accommodative as the BoJ has decided to keep its monetary policy in contrast to that of the Fed. The memory of 1985 is probably still in people's minds… This divergence in monetary policy stance between Japan and the US explains, along with the fundamentals, the weakness of the yen relative to the greenback.

For a new form of coordinated (monetary) intervention?

Global monetary tightening to try to tame the dollar

The chart below shows that over the past two decades, the number of Central Banks with rate hikes has reached an all-time high (chart below).

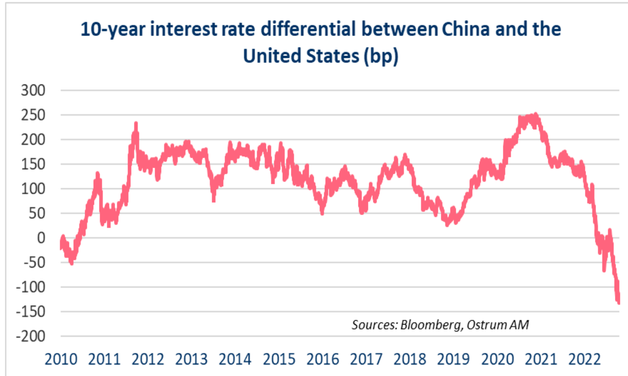


However, it should be noted that the Central Banks had, on the whole, paused during summer which coincided with the stabilization of the ICE dollar index. Then, after the summer break, the global monetary tightening resumed, in the wake of the greenback's rise. The central banks of other countries are forced to raise their key interest rates, regardless of the economic consequences, to preserve their financial stability. Is this a new form of coordinated intervention to try to curb the appreciation of the dollar?

The world has changed since 1985 with the emergence of China

For the coordinated monetary tightening to tame the greenback, all Central Banks must play the game. However, the Chinese Central Bank (PBoC), along with the BoJ, is one of the two main central banks to have kept its monetary policy in total opposition to that of the Fed.

The long period of low interest rates in the United States had benefited China. Chinese interest rates were between 3% and 5% higher than their US counterparts, attracting foreign capital to the country in a quasi-fixed exchange rate system. This configuration has suddenly changed. The interest rate differential between China and the United States has declined rapidly, as has the 10-year differential of over -120 bps, a rather unusual pattern, as shown in the chart below.



The deterioration of the growth prospects, together with the rapid tightening of the interest rate differential, led to the depreciation of the yuan against the dollar, which exceeded the psychological threshold of 7, a threshold that had forced in the past PBoC to intervene in the foreign exchange market. The consequence has been the outflow of capital from China, probably amplified by fears of US sanctions because of China's proximity to the Russian regime. Another consequence of the strong dollar is the decline in Chinese foreign reserves linked to the valuation effect. They reached $3.005 billion in September, their lowest level since 2007. When foreign capital leaves the United Kingdom, it takes the Sterling in its wake. In the case of China, the decline in the yuan is more limited because of its large foreign exchange reserves. This comfortable position could quickly change as well.

The PBoC is facing a dilemma. Raising interest rates in a deteriorating economy and real estate crisis could exacerbate the economic crisis. However, doing nothing could also lead to large outflows of capital that would further weaken its economic situation, particularly its property crisis. How can China keep its almost fixed yuan exchange rate against the dollar without raising its interest rates? For now, the Chinese authorities are avoiding answering the question by trying to manipulate the exchange rates set by commercial banks. However, if US interest rates remain on this upward trend for the long term, it will be difficult for China to postpone answering the question. In terms of investment strategy, this means that Chinese interest rates have probably reached their low points.

Markets Strategy : the dollar sets the tone for other to other asset classes

Determining the greenback trend is the base of any investment strategy. The table below shows, for each dollar environment (down/up), the performance of other asset classes.

Dollar Environment			DXY	S&P 500	MSCI World	MSCI EM	EMBIGD	GBI-EM	WTI	Bloomberg Commodity Index	Copper	Bloomberg Euro aggregate
Down	1998-08-14	1998-10-08	-9.09%	-9.72%	-9.93%	-13.00%	-13.36%	na	8.01%	0.91%	-0.86%	1.80%
Up	1998-10-08	2002-01-28	28.92%	18.10%	7.32%	35.06%	70.76%	na	39.04%	-0.53%	-4.77%	15.20%
Down	2002-01-28	2004-12-30	-32.91%	7.10%	19.31%	63.47%	51.79%	na	116.71%	65.29%	104.30%	23.90%
Up	2004-12-30	2005-11-15	14.35%	1.27%	3.27%	19.79%	7.53%	8.41%	31.14%	13.41%	31.80%	3.20%
Down	2005-11-15	2008-03-17	-22.34%	3.87%	14.10%	61.84%	19.80%	18.80%	85.47%	24.82%	94.66%	2.10%
Up	2008-03-17	2008-11-20	23.10%	-41.06%	-44.03%	-55.55%	-21.53%	0.50%	-53.05%	-43.02%	-56.78%	-4.80%
Down	2008-11-20	2008-12-18	-9.66%	17.65%	19.17%	27.13%	10.52%	9.50%	-27.01%	-4.41%	-17.24%	0.10%
Up	2008-12-18	04/03/2009	11.00%	-19.48%	-21.43%	-16.40%	1.00%	-1.50%	25.29%	-4.87%	30.03%	-0.20%
Down	2009-03-04	2009-11-25	-16.15%	55.80%	62.06%	-25.83%	30.90%	12.40%	71.79%	28.49%	86.52%	16.00%
Up	2009-11-25	2010-06-07	19.06%	-5.42%	-11.05%	-9.09%	2.91%	5.80%	-8.36%	-10.89%	-12.66%	3.70%
Down	2010-06-07	2011-05-04	-17.39%	28.26%	31.68%	31.62%	11.54%	28.26%	52.91%	38.11%	49.55%	2.00%
Up	2011-05-04	2017-01-03	41.19%	67.58%	28.19%	-25.83%	39.52%	47.53%	-52.10%	-49.05%	-39.72%	32.00%
Down	2017-01-03	2018-02-16	-13.67%	21.01%	21.61%	38.15%	7.75%	21.01%	17.87%	2.48%	31.51%	2.10%
Up	2018-02-16	2020-03-19	15.08%	-11.82%	-20.74%	-36.12%	-8.78%	9.39%	-59.11%	-30.36%	-33.29%	-2.10%
Down	2020-03-19	2020-12-30	-12.72%	54.90%	58.52%	68.19%	29.68%	13.50%	91.91%	26.32%	62.64%	10.60%
Up	2021-06-15	2022-09-28	24.37%	-12.42%	-19.17%	-36.45%	-24.58%	-12.42%	13.91%	20.54%	-22.44%	-15.10%
Average Performance-Down			-16.74%	22.36%	27.07%	31.45%	18.58%	17.24%	52.21%	22.75%	51.38%	7.33%
Average Performance-Up			21.82%	1.31%	-8.35%	-12.59%	13.06%	11.69%	-11.02%	-17.90%	-12.20%	6.71%

Sources: Bloomberg,Ostrum AM

The results are intuitive. In a period of falling dollar, non-US and commodity asset classes outperform US assets. Like the emerging MSCI equity index, which has an average performance of 31.4%, oil (WTI) and industrial metals (copper) which have an average performance of more than 50%. Emerging equity markets and commodities suffer the most from the strength of the Greenback.

We can notice the consistency of the results for the emerging market external debt (EMBIGD), local debt (GBI-EM) indexes and the Bloomberg Euro aggregate index (European credit). For emerging market debt, this can be explained by the change in the composition of the indexes since 1998. Today, the JPM EMBIGD Index is highly balanced between countries rated "Investment Grade" at 51% and high yield countries at 48.5% of the index. The other explanation is probably related to the long period of low interest rates at the international level that prompted investors to seek higher returns in external and local emerging market debt. For European credit, the support of the major central banks through the various private debt purchase programs probably explains the good performance, whatever the period of rise or fall of the dollar. It can be noticed also that the performance of the asset classes over the current period (last line of the table in purple) are all negative, reflecting a generalized "sell-off", except for energy, which reflects an important structural change.

Conclusion

So, heading to a Plaza 2.0? The answer is NO, because: 1/ the strength of the dollar is due to the weakness of the euro, reflecting a significant structural change for energy-dependent economies. 2/ if agreement occurred; an intervention would take time to intervene. The negotiations of the Plaza agreement had lasted three years! 3/ the new form of coordinated intervention, the generalized monetary tightening, requires the participation of the BoJ and the PBoC to be able to tame the dollar. But the two central banks are not inclined to change the direction of their monetary policy. Who will stop the dollar, then? As long as the energy crisis lasts, this should benefit the greenback.

Zouhoure Bousbih

Market review

Dust settles at last in the UK

Kwasi Kwarteng is replaced by Hunt, Gilt yields ease on budget U-turn. US inflation still tops 8%.

US inflation and the UK budget continue to drive the short-term trend in financial markets. The Truss government finally seems to be taking stock of the financial instability following the September 24 announcements. The initial denial of reality gives way to a full-fledged fiscal U-turn. In the United States, the persistence of inflation validates the continuation of Fed monetary tightening. A 75bp rate hike is expected at the upcoming FOMC meeting. These two opposing forces – the easing of UK bond yields and the confirmation of the Fed's restrictive bias – have caused bouts of extreme yield volatility. The T-note briefly breached the 4% threshold as the German Bund traded above 2.4%. Gilt is moving in a wide 60 bp wide corridor. This level of volatility is proving harmful on credit markets as new corporate bond issues find buyers after large yield concessions (20-25bp premium compared to the secondary market yields). Major CDS indices (iTraxx, CDX) exhibit considerable volatility. Equity markets are also confused. The US CPI release caused an instant 3.6% plunge in the S&P future before short covering (sales of puts) sparked a sharp intraday rebound of more than 5% to close at the session high on October 13th. In this context, the US greenback, which appears overvalued due to a lack of safe alternatives, remains a reliable barometer of risk aversion, moving in the opposite direction to risky assets. The BoJ's stubbornness to keep easing policy sends the dollar-yen parity ever higher beyond 148.

The British government seems willing to amend the mini budget presented at the end of September. Kwasi Kwarteng was ousted and replaced by Jeremy Hunt. It was the sine qua non for an easing in UK bond market tensions. After the reintroduction of the 45% tax bracket, spending cuts and corporate tax increases may reduce the unfunded amount. In this context, the BoE's emergency intervention on Gilt may end even if the standing repo facility will remain available. The Central Bank has won the tig of war with the UK government and may now be able to refocus on its fight against inflation. Market expectations point to a rate hike of 100 to 125 bp on November 3 and a repo rate of almost 5.5% by the middle of next year.

In the United States, headline inflation reached 8.2% in September and 6.6% excluding energy and food products. The inertia of inflation is quite impressive. Goods and services whose prices change infrequently (so-called “sticky prices”) show an annual increase of 6.5%. Rents are still rising at a sustained pace of 8-9% per year. In addition, the producer prices of goods continue to point upwards. Pressure on production costs remains strong despite foreign competition and the strong dollar, which both weigh on the prices of imported goods. In addition, the rebound in oil prices since the OPEC decision to cut output by 2mbpd represents an upside risk in the short term.

Interest rate volatility remains considerable. The 4% threshold on the T-note yield, broken briefly after the CPI, represents a psychological level for many investors. The US curve remains strongly inverted with a 2s10s spread at -50 bp. The memory of high inflation will likely force the Fed to keep interest rates high and neglect the - illusory – inflation base effects of next spring. The negative term premium remains an enigma given the high level of inflation at a level inconsistent with the 2% Fed goal. Inflation breakevens represent a great opportunity in this context. MBS spreads (77 bps) have been widening steadily since the middle of August. The downturn in housing prices and the rise in long-term interest rates are unfavorable to the asset class. In the euro area, the Bund traded above 2.40% with an easing (below 2.20%) in the wake of the Gilt rally. The decline in the German 10-year yield is accompanied by a steepening in the 10s30s spread, which turned positive again. Swap spreads are trading at banking crisis levels, above 100bp on all maturities. Sovereign bond spreads are broadly stable but market liquidity measures show a deterioration. The 10-year OAT is trading around 60 bp. The market awaits the appointment of the Italian government which should be announced around October 20th. Giancarlo Giorgetti, Minister for Economic Development under Mario Draghi, now seems the frontrunner for the Minister of Finance position.

Interest rate volatility is somewhat disruptive for the primary credit market. New issue premiums are substantial and lead to a repricing of secondary market spreads. Euro IG corporate credit is trading at spreads of 235 bp against Bund, which looks excessive in the context of an economic downturn but still insufficient to revive the interest of final investors. High yield remains quite illiquid but the absence of primary issuance mitigates the impact of high yield fund outflows. The iTraxx Crossover (616 bps) moves on risk aversion between 691 bps at its widest on September 28 and 585 bps 5 trading days later. Selling protection on the XO is also the only way to quickly gain exposure to European high yield.

Equity markets remain fragile despite Thursday's spectacular rebound. The first banking publications in the United States for the third quarter were mixed. The Euro Stoxx 50 rallied 1.5% this week.

Axel Botte
Global strategist

Main market indicators

Emprunts d'Etats	17-oct.-22	-1sem (pb)	-1m(pb)	2022 (bp)
EUR Bunds 2a	1.9%	-1	+37	+252
EUR Bunds 10a	2.22%	-12	+47	+240
EUR Bunds 2s10s	31.3bp	-11	+10	-12
USD Treasuries 2a	4.43%	+12	+56	+370
USD Treasuries 10a	3.93%	+5	+48	+242
USD Treasuries 2s10s	-50bp	-7	-8	-127
GBP Gilt 10a	3.98%	-50	+84	+300
JPY JGB 10a	0.26%	+0	+2	-8
EUR Spreads Souverains (10a)	**17-oct.-22**	**-1sem (pb)**	**-1m(pb)**	**2022 (bp)**
France	59.08bp	+2	-2	+22
Italie	244.75bp	+16	+4	+110
Espagne	117.77bp	+4	+0	+43
Inflation Points-morts (10a)	**17-oct.-22**	**-1sem (pb)**	**-1m(pb)**	**2022 (bp)**
EUR 10a Inflation Swap	2.47%	+2	-10	+40
USD 10a Inflation Swap	2.63%	+12	-7	-14
GBP 10y Inflation Swap	3.98%	+29	-29	-19
EUR Indices Crédit	**17-oct.-22**	**-1sem (pb)**	**-1m(pb)**	**2022 (bp)**
EUR Credit IG OAS	231bp	+9	+31	+136
EUR Agences OAS	95bp	+0	+7	+46
EUR Obligations sécurisées OAS	111bp	-4	+3	+65
EUR High Yield Pan-européen OAS	640bp	+27	+83	+322
EUR/USD Indices CDS 5a	**17-oct.-22**	**-1sem (pb)**	**-1m(pb)**	**2022 (bp)**
iTraxx IG	128bp	-6	+16	+80
iTraxx Crossover	612bp	-33	+59	+370
CDX IG	104bp	+2	+15	+55
CDX High Yield	595bp	+13	+69	+302
Marchés émergents	**17-oct.-22**	**-1sem (pb)**	**-1m(pb)**	**2022 (bp)**
USD JPM EMBI Global Div. Spread	569bp	+23	+74	+200
Devises	**17-oct.-22**	**-1sem (%)**	**-1m(%)**	**2022 (%)**
EUR/USD	$0.976	0.598	-2.634	-14.2
GBP/USD	$1.131	2.261	-1.102	-16.5
USD/JPY	JPY 149	-1.978	-3.666	-22.6
Matières Premières	**17-oct.-22**	**-1sem ($)**	**-1m($)**	**2022 (%)**
Brent	$92.2	-$4.0	$2.1	25.65780504
Or	$1 657.8	-$10.8	-$18.1	-9.3713
Indices Actions	**17-oct.-22**	**-1sem (%)**	**-1m(%)**	**2022 (%)**
S&P 500	3 583	-1.55	-7.49	-24.8
EuroStoxx 50	3 407	1.48	-2.68	-20.7
CAC 40	5 980	2.39	-1.60	-16.4
Nikkei 225	26 776	-1.26	-2.87	-7.0
Shanghai Composite	3 085	3.73	-1.33	-15.2
VIX - Volatilité implicite	32.22	-0.71	22.51	87.1

Source: Bloomberg, Ostrum AM

Additional notes

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