WILL THE US DOLLAR RISE OR FALL IN 2017?

The election of Donald Trump as President of the United States will continue to influence markets, not least currency markets, given his protectionist views on trade. I have been of the view that the U.S. dollar is in a long-term bull market. The U.S. Dollar Index (DXY) began its current rise a few days prior to the election and has continued to demonstrate post-election strength. As of this writing, the DXY is near an important long-term breakout point at 100.15. A new U.S. president and the DXY at an important price point would suggest that a review of the prospects for the U.S. dollar is appropriate. An analysis of the U.S. dollar versus the currencies of its major trading partners would seem an effective means of determining the likely direction of the DXY.

The yuan is the major currency that has garnered the most press attention lately due to President-Elect Trump's threat to impose punitive import tariffs on Chinese made goods and the weakness of the yuan year to date. Back in April, I wrote that I expected yuan weakness and perhaps even a large one-time devaluation. The yuan has now weakened to its lowest level versus the U.S. dollar in 8 years. The Peoples Bank of China (PBOC) has publicly endorsed a strong yuan and has attempted to smooth its descent through open market intervention. The PBOC spent $45.7 billion defending the yuan in October, raising the amount spent on intervention in the past year to circa $500 billion. As a result, China's foreign exchange reserves have fallen to $3.12 trillion. The use of foreign exchange reserves, which could arguably be more effectively used for other purposes, to defend the yuan shrinks China's monetary base. The Chinese economy has cooled considerably, with exports and imports declining 7.7% and 7.5%, respectively, over the past year. The third quarter economic growth rate of 6.7% reported by the Chinese arouses suspicion because it is identical to the growth rates reported for the previous two quarters. The Chinese have either been able to bring extraordinary precision to bear on an enormous economy or the numbers are being massaged to appear more robust. The Chinese public themselves believe that the yuan will weaken, producing large outflows of capital, some of which gets directed to real estate in cities such as Vancouver and Toronto. In the face of ongoing downward pressure on the yuan, I believe the Chinese may yet resort to a large one-time devaluation. Such a devaluation would simultaneously make Chinese exports more competitive, drastically reduce or eliminate intervention costs and establish a hard "line in the sand" in terms of yuan valuation. The trade and/or tariff threats from the Trump administration should not have a significant influence on Chinese policy. Firstly, the United States is just one of a number of large Chinese trading partners. Secondly, the ultimate actions of the Trump administration will be designed to cater to the taste of its electoral base rather than respond to Chinese policy. In sum, the ongoing downward pressure on the yuan is expected to continue for some time and will likely only relent with a sharp one-time devaluation.

I have also been a skeptic of the euro for some time. In July of last year, I wrote that I didn't think the euro would last a decade. The surprising Brexit vote in June has likely shortened that time frame. The economic and cultural fissures within the European Union (EU) are under increasing stress. The European banking industry is fragile at best, with the current policy of negative interest rates making life for the banks ever more difficult. The EU economy is struggling with anemic growth rates despite an unprecedented level of central bank intervention. The euro has fallen sharply against the U.S. dollar in 2016 because of its economic woes, negative interest rates and Brexit. It is expected that pressure on the euro versus the U.S. dollar will continue. Indeed, upcoming votes in Italy and France may put additional pressure on the euro in the next six months. The euro trading at par with the U.S. dollar would not be surprising in 2017.

The British pound was obviously a casualty of the Brexit vote, suffering a substantial decline after the referendum. It is expected that pressure on the pound sterling will remain, particularly after negotiations begin in 2017 with the triggering of article 50.

The Japanese yen is the only major currency to exhibit strength in dollar terms over the past couple of years. However, even the yen has weakened of late, trading at its lowest level since last June at end of trade today. The yen will likely remain the strongest major currency versus the dollar in relative terms, but is unlikely to demonstrate real absolute strength.

In conclusion, the absence of a strong competing currency suggests that the U.S. dollar will continue to perform strongly. The prospect of a Fed interest rate increase in December, in a world beset with negative interest rates, adds more fuel to the U.S. dollar bull market. We have been living in a world of tacit competitive currency devaluations, a situation which shows no signs of abating. A major risk to the global economy is the potential adoption by the Trump administration of 1930s era protectionist trade and tariff policies, which would precipitate a global recession. Somewhat ironically, such policies may well produce an even stronger U.S. dollar as competitive devaluation policies by competing nations are exacerbated to take advantage of reduced trade opportunities. The DXY may retreat from its breakout point in the shorter term but I expect the DXY to trade well over 100 over time.

By Jonathan Baird CFA