THE US DOLLAR BULL MARKET WILL RESUME

It has been my view for some time that US denominated assets will prove to be the best performing asset class for the balance of the decade. Notwithstanding the recent strength in the euro and the yen, I continue to believe that the secular bull market in the greenback will reassert itself.

Central banks around the world are clearly engaging in competitive currency devaluations, although none will own up to the fact. It is the policy that "dare not speak its name." That both the euro and the yen have rallied of late despite the adoption of QE and/or negative interest rates is not only surprising, but somewhat troubling. The European banking industry is under extreme stress and the continent's economic and political issues have been well documented. I have written that I believe that there is a significant chance that the euro, as it is now constituted, may not last another decade. I continue to hold that view.

The Bank of Japan recently adopted a negative interest rate policy largely to facilitate a weaker yen. Yet the yen has continued to move sharply higher. The countertrend rally of the euro and the yen has surprised many, not least of which the European Central Bank and the Bank of Japan. What can account for this development?

I believe that both currencies are responding to a combination of short covering and the unwinding of carry trade positions. I suspect that the yen, in particular, is being strongly influenced by the carry trade because of Japan's recent adoption of negative interest rates. The dramatic nature of the moves especially that of the yen, suggests to me that one or more very large hedge funds may be under severe pressure. If this is the case, both currencies should resume their decline once the issues have been resolved.

The only major nation that has made an effort to defend its currency of late is China. China has spent a not inconsiderable amount of funds recently to maintain an orderly decline in the yuan. I believe that China wants a less expensive currency, but is not prepared to see it beaten down overnight by hedge funds. China has sufficient reserves to defend the yuan for some time. My expectation is that we will see a gradual devaluation by adjusting down the trading bands with the US dollar.

It appears that the latest weapon being unleashed by central banks is negative interest rates. Many countries, including Canada, have expressed a willingness to at least contemplate negative rates. Bond markets around the world seem to anticipating negative rates as yield curves flatten or invert. The United States seems the most reluctant to resort to negative rates, which is another reason to favour the greenback going forward.

The global economy is in a tenuous state. Negative interest rates are primarily a theoretical tool, having limited real world application until recently. The intent is obviously to stimulate an economy by making the holding of cash undesirable and devaluing the local currency. I suspect the law of unintended consequences will assert itself, producing dramatic and volatile markets.

I have never experienced more purely macro driven markets than we are now experiencing. I expect this to continue at least through the balance of the decade.

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