
The Measly Dollar

Trading Wisdom

The following is an excerpt from John Percival's book, *The Way of the Dollar* (*emphasis mine*):

You will have spotted that when interest rates are leading a currency, the key to their effect on the currency lies ***in the way rate changes pan out in relation to expectations***. This does give us something to go on, because we can often gauge expectations. And if we work on the rule of thumb that expectations will be confounded, we shall be right much more often than wrong. If you spot a time when everyone is expecting US interest rates to fall, for example, buy the dollar, and you'll make out OK. A few people did, all the way from 1980 to 1985 when US rates did indeed fall.

So the fortunate truth is: ***we don't even need to forecast interest rates***. All we have to do is monitor crowd expectations (in order to go contrary, on occasions). Interest rates spend their time fluctuating, and much of the time they are confounding existing expectations. People expect rates to fall and they don't expect them to stay steady and they move down. Rates shift, and people think they will revert to earlier levels. For these reasons or otherwise, the fact is that when interest rates do lead currencies, they usually do so with a long lead time. *The currency movement tends to lag by months, often 6 months or more.*

Once again, what we are looking for is the set-up conditions for a movement in a currency. **The "key" lies in the background, not in the foreground where everyone is looking.** Here are some rules which seem to govern the relationship between interest rate shifts and currency movements.

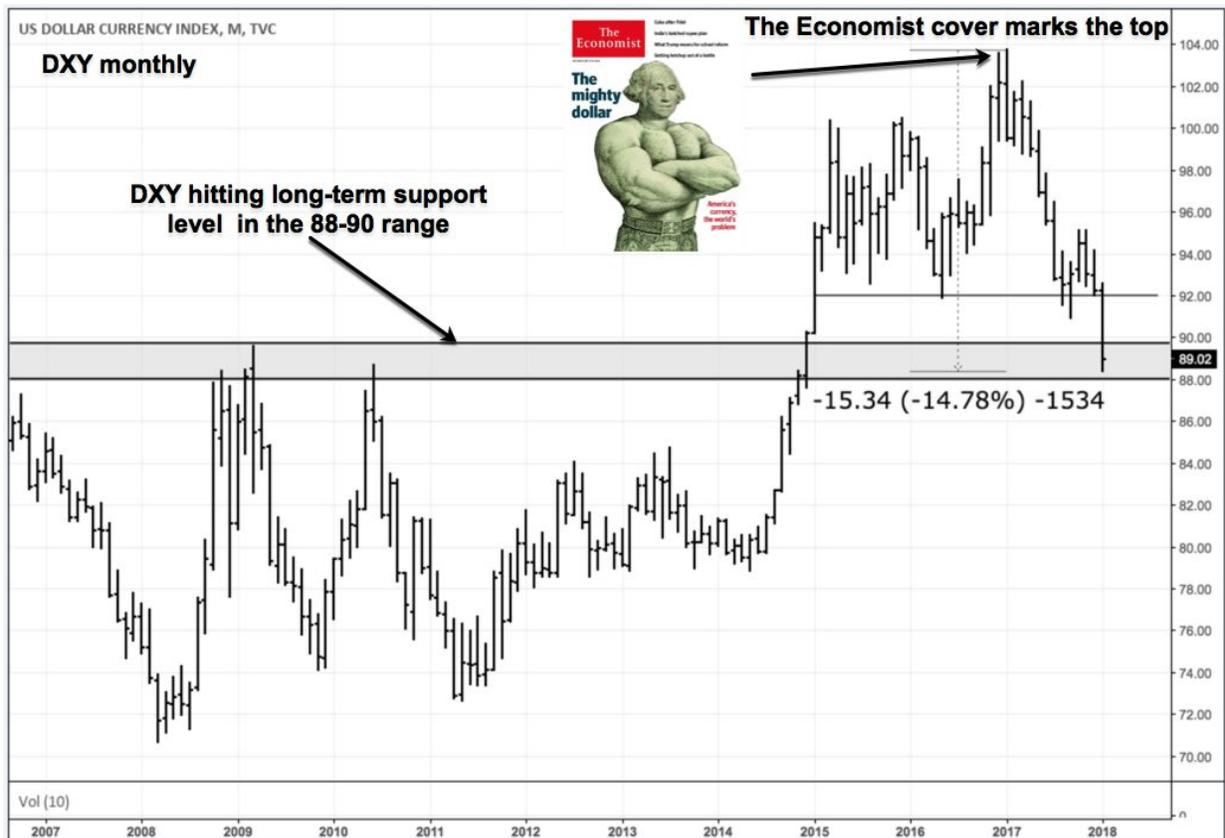
- 1) Interest rate shifts prompted by domestic pressures (an over-heating economy, for example) tend to *lead* currency movements. The lead time is measured in months rather than days.
- 2) Interest rate shifts prompted by international (and currency) pressures tend to follow currency movements and go in the opposite direction.
- 3) Following rule 2), a currency will tend to turn round and follow the lead of interest rates up: a) if/when they have risen around 4 points and especially, b) when the currency is perceived to have stabilised over several months.
- 4) In this event, interest rates will peak when the currency troughs; and *falling* interest rates will coincide with a *rising* currency. Why? Because by this time

everyone is expecting interest rates to fall tomorrow and they stay up longer than expected (ie, rate cuts tend to lag expectations in these circumstances). In other words, interest rates are higher than expected and this supports the currency.

- 5) When currencies are led by interest rates, their movement is directly related to the *unexpectedness* of interest rate levels, rather than to their rate of change.

Finally, the *cardinal rule*. **It is often the acid test of whether any given interest rate will lead a currency: it only does so when unexpected or unseen.** When observers are ignoring an important shift in interest rates for any reason — because they expect it to be short lived or because they are preoccupied with other things — you can bet it will only be a matter of time before the currency is led inexorably in the direction of the interest rate shift. What matters, as I say, is the *background*, not the foreground — because the foreground is where everyone is looking. **What matters in financial markets — and in life — is not what you see straight ahead but what you glimpse out of the corner of your eye.**

Markets and Macro



Markets work to surprise the majority of people, the majority of the time. This is because the average of everybody's expectations is already embedded in price.

Nowhere is this more true, than in the currency markets. Consensus is the ultimate killer of currency trends. The chart above is a perfect example of this, where *The Economist* magazine cover marked the top of the US dollar bull market at the end of 2016.

The dollar has since fallen 15%. A move that hardly anybody was expecting.

This is why, when analyzing currencies, we need to adopt Percival's rule of thumb and know "that expectations will be confounded."

In this week's *Brief* we're going to talk about the dollar.

We often refer to the US dollar as the lynchpin of global markets. This is because global trade is done in dollars, commodities are priced in dollars, and the greenback is the world's reserve currency and largest source of global funding... **The path of the dollar affects nearly every other asset in some way, shape, or form.** And if you can get a good handle on the dollar then you'll have a good grasp on where commodities, emerging markets, and global liquidity are headed.

To start, here are the primary models I use to think about currencies in order to understand the driving narrative (currency markets are narrative driven) and supporting fundamentals.

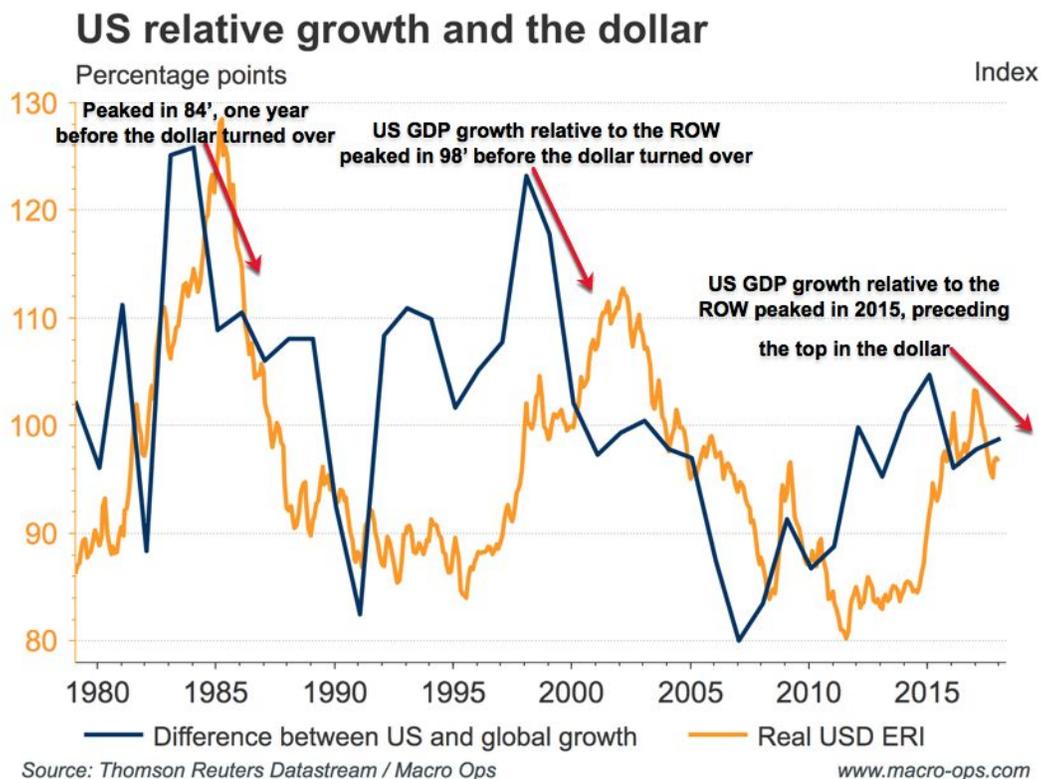
- 1) **The Core-Periphery model:** This model was used extensively by George Soros in his currency operations back in the day and discussed at length by economist Javier Gonzalez in his book *How To Make Money With Global Macro*. In this model, the US is the **core** and emerging economies are the **periphery** with other developed markets sitting in the middle. Long-term capital flows tend to cycle back and forth between concentration in the core, to strong flows to the periphery. The primary fundamentals of this model are relative growth numbers between the regions (ie, relative GDP growth and relative equity and bond market returns). When global growth is strong and broad based, risk is perceived as low, so capital flows out from the core to the periphery. The opposite holds true for when risks are perceived as being high. Put simply, **capital flows to where it's believed it'll be treated best** (ie, earn the highest stable total return relative to perceived risk). The US, along with other DMs, receives a premium over the periphery.
- 2) **Sentiment/Positioning:** Like we discussed above, we want to operate off the rule of thumb that "expectations will be confounded". So we always want to know what the popular sentiment is and how the market is positioned. To do this, we can look at anecdotal evidence such as magazine covers, news articles, and fintwit talk to get a feel

for what narratives/belief are popular. And for positioning, we can look at the COT data and sentiment/positioning surveys like the BofA Fund Manager survey to see how investors are positioned.

- 3) Trend and Total Return:** Once a currency gets going it has a tendency to persist for long periods of time. This is because currency flows are largely speculative, meaning they chase market returns around the world. And when capital flows into a country where the equity/bond market is outperforming on a relative basis, these flows then strengthen the underlying currency. Now you have an outperforming equity/bond market + a strengthening local currency (lowering local inflation and boosting real returns). **This ups the total return for foreign investors, thus attracting more flows and creating a positive feedback loop.** So when analyzing currencies we always need to look at relative market performance, because currency pairs tend to track relative stock/bond market performance over time.

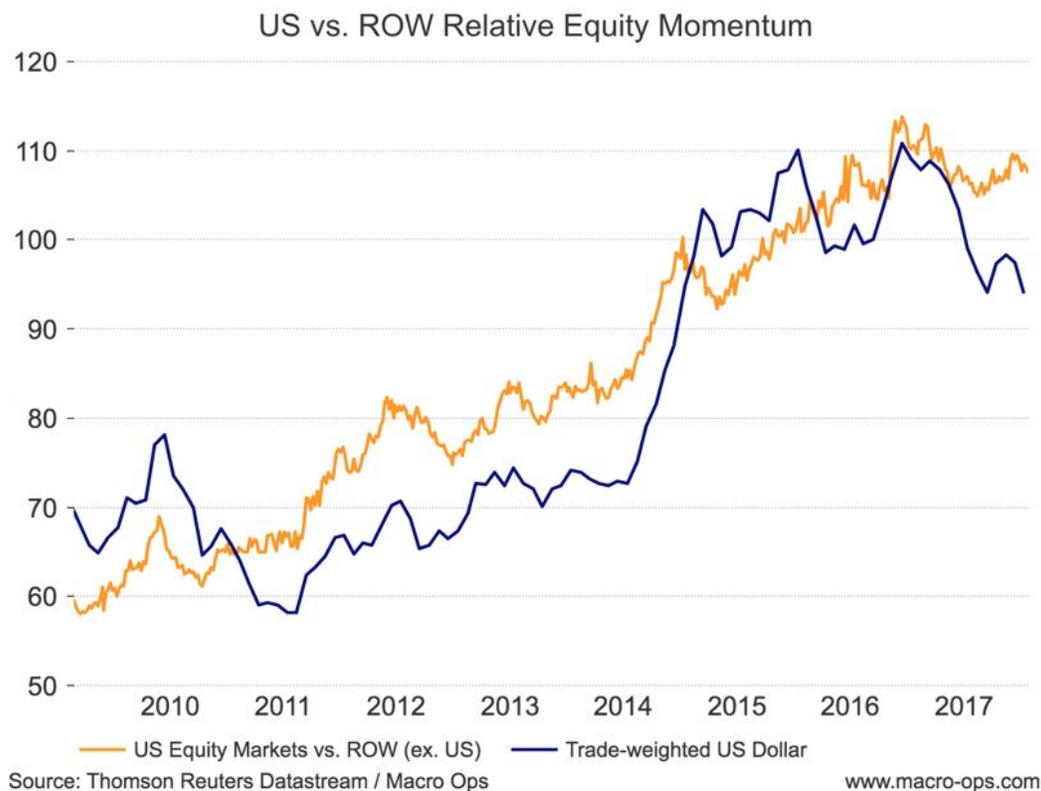
To begin our analysis of the dollar, let's take a look at relative GDP growth between the US (the core) and the rest of the world (periphery). Relative gdp growth is important because growth affects everything from investor behavior, inflation and interest rate expectations, and perceptions of risk.

The chart below clearly shows the relationship between US GDP growth relative to the rest-of-the-world (ROW) and the subsequent trend direction in the dollar.



When growth in the core outpaces growth in the periphery (as it did from 09'-16'), capital concentrates in the core and drives the US dollar higher. When growth in the periphery outpaces the core, capital flows outwards leading to a lower dollar.

It's important to note that it's the trend in this relative growth that matters. Growth in the core (US) is almost always lower than that of high growth emerging markets. But US growth gets a premium over EMs. Which is why it's the trend in relative growth and not the absolute levels that are important.

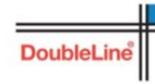


In mid 2016, beaten down equities in the ROW began outperforming the US. While at the same time, US relative GDP growth turned lower, and both sentiment and positioning reached extreme long consensus in the dollar. This led to the top in the dollar bull market.

Currently, we find ourselves with conditions that are the opposite of those that created the dollar bull market.

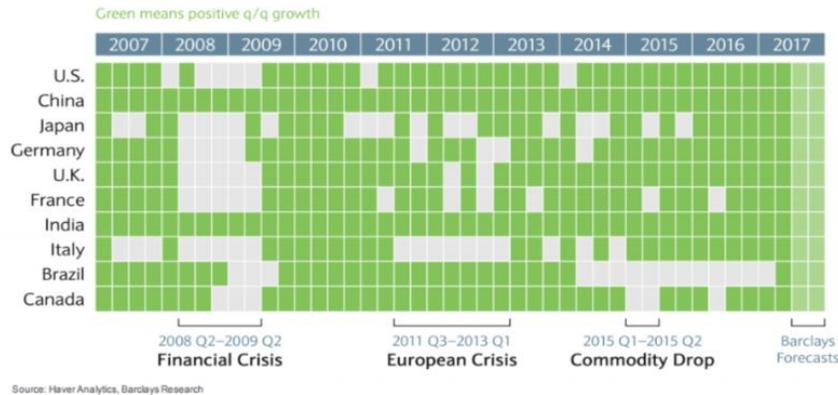
Instead of narrow and tepid growth, we have a global economy that's firing on all cylinders and seeing complete synchronized growth across the board (chart via DoubleLine).

World Growth in Sync



Growing in sync – For the first time in many years

World growth in sync



- 2011 to 2013 experienced an EU contraction, 2014 and 2015 experienced a commodity exporters hit, 2015 and 2016 experienced the China currency + growth scare, followed by a global trade slowdown

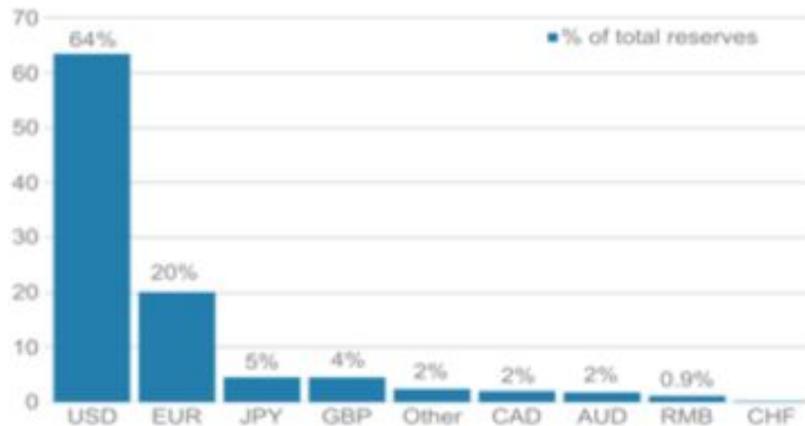
To adhere to Occam’s razor then, it’s fair to assume that the dollar is falling because we’re in the goldilocks period of the market cycle where growth is strong and risk is perceived to be low. This is leading to capital flowing out from the core and to the periphery.

The budding narrative is: **The horizon looks clear and foreign markets offer better relative value to expensive US stocks and bonds.**

In addition, there’s a lot of capital concentration which accumulated in the core over the last 7-years. This capital is likely to be converted out of dollars and into other currencies over the coming year(s). This will put further downward pressure on the dollar and risk creating a bearish feedback loop.

For example, the dollar currently makes up an unnecessarily large percentage (64%) of global foreign reserves, as shown on the chart below *via Morgan Stanley*.

Exhibit 4: USD makes up 64% of global FX reserves...



Source: Macrobond, Morgan Stanley Research

Hedge fund manager, Ray Dalio, recently noted (emphasis mine), “the dollar’s role as the dominant world currency are anachronisms and **large relative to what one would want to hold to be balanced**, so rebalancings should be expected over time, especially when **U.S. dollar bonds look unattractive** and trade tensions with dollar creditors intensify.”

Morgan Stanley commented on the vulnerability of the dollar in a note, saying (emphasis mine):

*Our key point here is that foreign holdings of USD-denominated debt have increased, while foreign holdings of European debt instruments have declined. A similar dynamic has taken place for equities, where foreign ownership of US equities has more than doubled, which contrasts with trends in the foreign ownership of European equities. An important implication is that, **should US assets lose their relative attractiveness (e.g., widening credit spreads, declining equities), then there could be a substantial amount of foreign-held USD-denominated assets for sale.***

With the US deficit set to widen because of the recent tax cuts and expected increases in fiscal spending (coming infrastructure plan), we’re set to see a rise in the supply of USD assets at a time when investors are moving their capital out of dollars and into other markets.

That’s not the kind a backdrop that’s supportive of a stronger dollar.

On top of this, no matter which means of valuation you use, the dollar is overvalued, especially against emerging market currencies.

Chart 3: USD still appears expensive vs its FEER



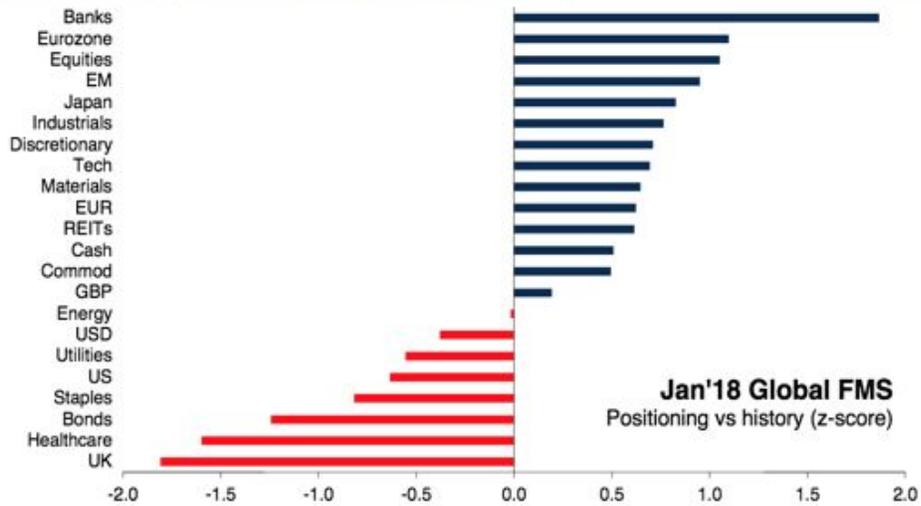
When looking at the dollar, we have to include the euro. The EURUSD pair makes up well over half of the trade-weighted dollar basket, so it has a large influence on where DXY goes.

You can see on the chart below that the euro has completely retraced the breakdown from its previous multi-year trading range. If price holds this month, it would mean that **this was a major multi-year bear trap**.



Sentiment and positioning in the euro and european assets have ticked up, as shown in the chart below via the BofA FMS.

Exhibit 3: The Longs & Shorts, relative to Global FMS history*

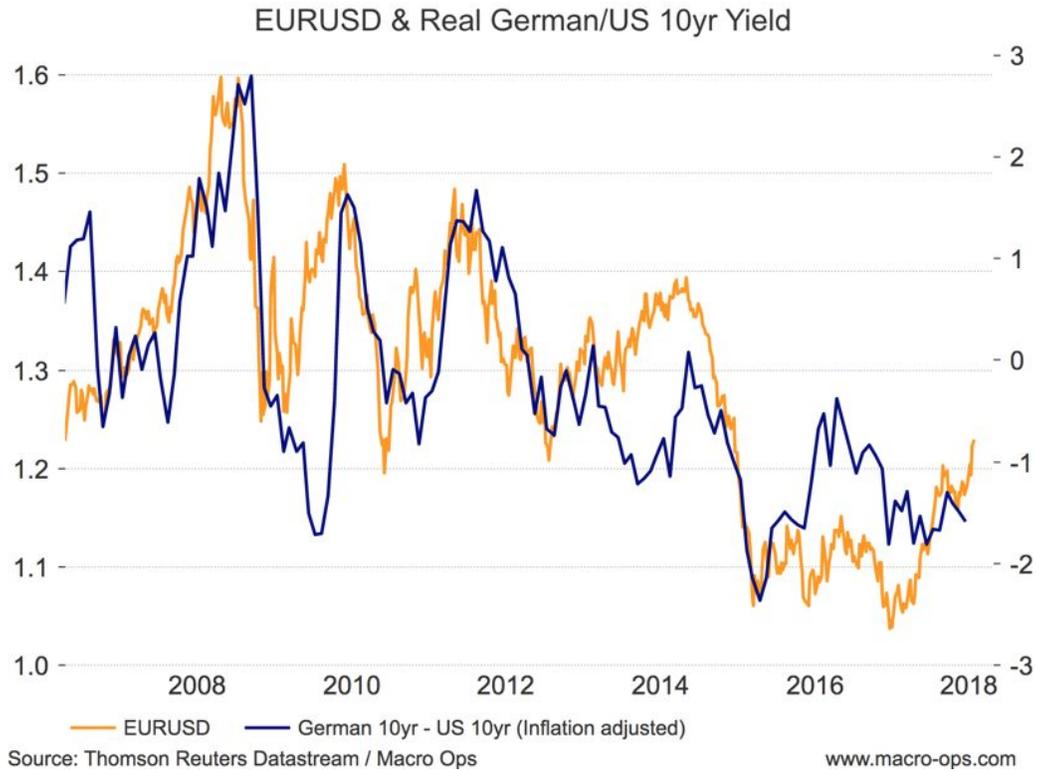


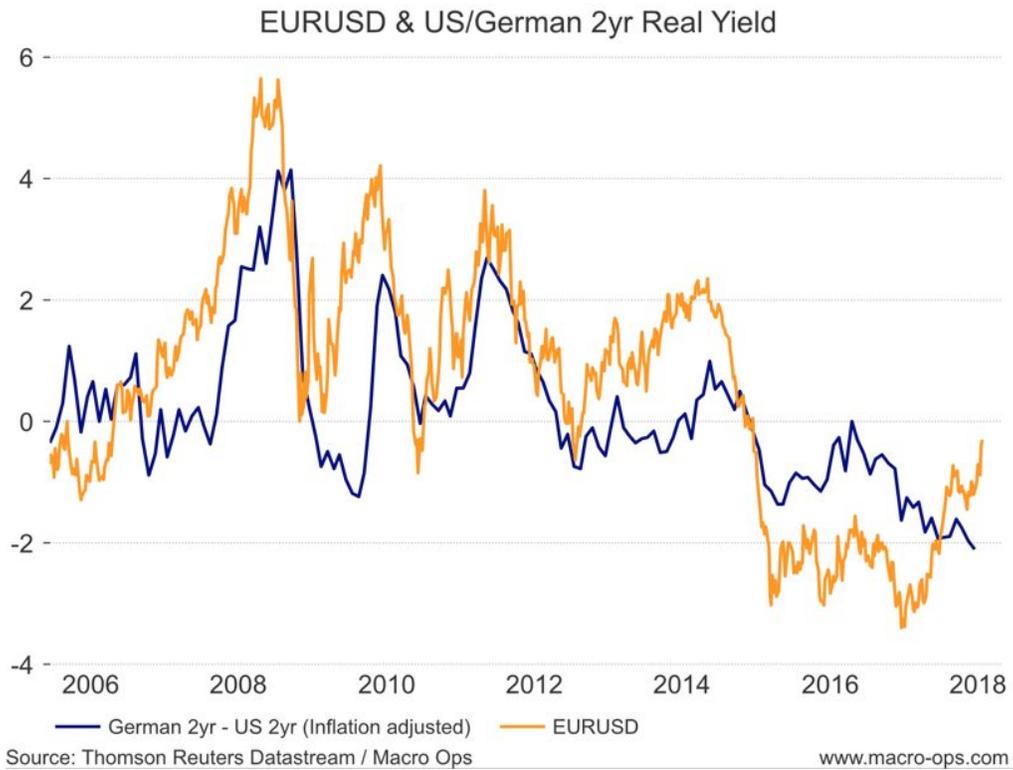
Source: BofA Merrill Lynch Global Fund Manager Survey. *data since 2006 for commodities & real estate; since 2001 for everything else

Spec COT positioning is stretched and is now a headwind over the near-term.

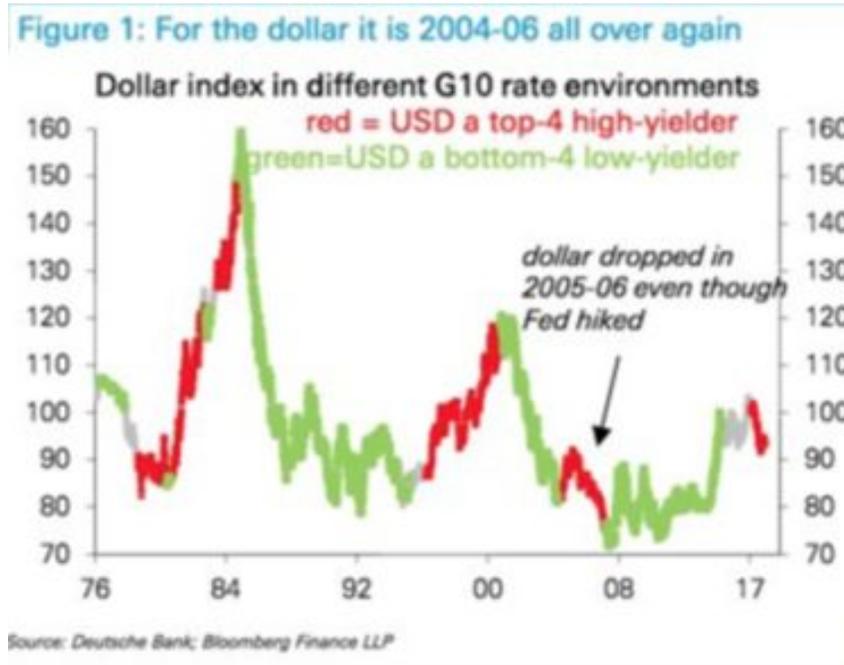


The real yield differential between the US and Europe hasn't supported the move up in the euro. But the market is driving the EURUSD pair higher on the *expectations* that european rates have more room to move up from current levels, than US rates do.





In fact, the dollar is currently a top-4 yielder out of the G10 (chart below via DB).



While yield differentials are important, currencies can move against logical yield relationships for long periods of time. And it's the **expectations over future yield differentials that tend to matter more than the current spreads.**

The most important chart for the dollar in my opinion is this one. The S&P versus emerging markets. Even with US stocks going on an endless tear, EMs are performing even better.



If EM outperformance continues, it's going to attract more capital flows which will help to drive the dollar lower.

A falling dollar creates a number of positive tailwinds for EMs besides raising foreign investor's total returns.

It leads to higher commodity prices, which benefits commodity producing countries. And it leads to lower funding costs (many EM corporates and countries borrow in USD, so a lower dollar equates to lower debt costs).

With liquidity as loose as it is today, there's little on the near-term horizon that could significantly reverse these dollar bearish flows outside of a major shock that raises investor's perceptions of risk. Sentiment and positioning is now bearish the dollar but far from extreme levels that tend to mark significant reversal points.



I don't expect the dollar to continue falling straight down. Many DM-USD pairs appear to be stretched over the short term and are nearing significant resistance levels. So we're likely to see a pullback soon. But as traders we have to respect the tape and acknowledge the possibility that the dollar bull market which started in 11' is now over.

Dollar history, 7-year cycles?



If this is the case, it will have big implications for markets moving forward. And it'll be great for our long energy and financials trade.

Let's keep an eye on the relative equity charts adjust our fire going forward.

Target List & Portfolio Review

This is a big week for earnings. Lots of major names reporting so there's the potential we'll see an uptick in volatility.



Earnings Whispers @eWhispers · Jan 27

#earnings for the week

\$AAPL \$BABA \$FB \$AMZN \$AMD \$MSFT \$BA \$PYPL \$LMT \$GOOGL \$V \$STX
 \$MCD \$T \$PFE \$ALGN \$MA \$AKS \$UPS \$X \$SEA \$BX \$S \$XOM \$NUE \$QCOM
 \$EBAY \$HOG \$SIRI \$GLW \$GPRO \$AET \$KEM \$PHM \$D \$NOK \$CVX \$SAP
 \$AMGN \$AMG \$ADNT \$PII \$LLY \$ANTM \$DHR \$MO

eps.sh/cal



Alibaba Group, Amazon.com, AMD and 4 others

Tuesday Morning Corp (TUES), which we have a small position in, reports on Thursday. We'll be going through their numbers to see if we want to build it into a larger position or cut completely.

If there's a big surprise in BABA's earnings it'll likely impact JD. So we'll be tracking their report closely.

Speaking of JD, it had a strong weekly close at new all-time highs. This is our highest conviction trade and we think this move is just getting started.



Our long energy basket is doing well and I'm considering adding to some of the stronger names. I particularly like W&T Offshore (WTI). It's up close to 140% since our entry back in September. It just had a weekly close above its 200-week moving average. If price looks like it'll hold above the MA then we'll add to the position this week.



I'm also considering buying some DOTM calls in either Antero Resources (AR) and Petrobras (PBR) this week. The calls for both are pretty cheap. I'll be digging into both companies this week.

Lastly, I've been taking a close look at gold and silver miners. Their charts look very constructive but the macro picture for them is more muddled. I can see precious metals going in either direction, but it does appear a large move is coming and I would currently put the odds in favor of that move being up.

We can buy some inexpensive DOTM calls on a few of these miners that offer us great asymmetry should gold move higher from here. I'll be discussing that trade more in depth in the February *MIR* which comes out next week.

That's all I've got for now. Expect some trade alerts and research to come your way this week.

Have a great week in the markets and see you in the CC!

Your Macro Operator,

Alex

Macro Ops Portfolio		YTD	Inception (16')				
NAV	\$2,869,574	6.40%	42.84%				
Big Bet Macro							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Equity	Limbach LMB	2,750	\$13.66	\$12.00	\$5,775.00	\$18.00	\$14.10
Equity	JD	5,867	\$44.74	\$36.00	\$85,364.85	\$72.00	\$50.55
Equity	Interactive Brokers IBKR	1,800	\$41.71	\$58.50	\$10,512.00	\$55.50	\$64.34
Equity	W&T Offshore WTI	16,000	\$2.18	\$3.30	\$26,880.00	\$4.50	\$4.98
Equity	EnSCO ESV	3,700	\$5.15	\$5.75	\$3,145.00	\$6.50	\$6.60
Equity	Transocean RIG	2,900	\$9.32	\$10.30	\$2,523.00	\$15.00	\$11.17
Equity	Cabot COG	1,350	\$26.28	\$26.30	\$2,065.50	\$34.00	\$27.83
Equity	Tuesday Morning TUES	7,500	\$2.60	\$2.60	\$4,875.00	\$5.00	\$3.25
Equity	United Insurance UIHC	13,000	\$16.98	\$17.00	\$34,970.00	\$20.00	\$19.69
Equity	Trip Advisor TRIP	7,754	\$36.46	\$33.80	\$23,106.92	\$50.00	\$37
Equity	Nikkei Mar 18 Future	6	\$23,300	\$22,803	\$24,810.00	\$26,000	\$23,630
Equity	BCS Jan '19 15 Call	574	\$0.35	\$0.00	\$22,960.00	\$3.50	\$0.40
Equity	DB Jan '19 30 Call	670	\$0.30	\$0.00	\$20,100.00	\$3.00	\$0.30
Equity	CCJ Jan '19 17 Call	236	\$0.41	\$0.00	\$7,080.00	\$5.00	\$0.30
Equity	FCAU Jan '19 25 Call	108	\$0.90	\$0.00	\$42,120.00	\$5.00	\$3.90
Equity	JD Jan '19 70 Call	108	\$0.92	\$0.00	\$28,080.00	\$7.00	\$2.60
Equity	TRIP Jan '19 75 Call	108	\$0.89	\$0.00	\$3,240.00	\$7.00	\$0.30
Equity	CHK Jan '19 10 Call	750	\$0.14	\$0.00	\$8,250.00	\$1.00	\$0.11
Equity	Tesla Mar '18 240 Put	28	\$8.80	\$0.00	\$2,604.00	\$24.00	\$0.93
Equity	MS June '18 65 Call	126	\$0.46	\$0.00	\$8,442.00	\$3.00	\$0.67
Equity	WMT June '18 120 Call	126	\$0.51	\$0.00	\$22,302.00	\$3.00	\$1.77
Volatility							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Volatility	SVXY	2,257	\$132.60	\$0.00	\$289,392.54	~	\$128.22
Rates	IEF March 2018 104/109 St	150	\$1.31	\$0.00	\$7,950.00	\$7.00	\$0.53
Commodity	SLV June 2018 17 Straddle	130	\$2.84	\$0.00	\$21,840.00	\$5.00	\$1.68
Commodity	GLD Sep 2018 128 Straddle	24	\$15.10	\$0.00	\$23,112.00	\$30.00	\$9.63

Risk Budget				
	Total Allowed (in Bps)	Total Used	Total Available	Percentage Used
Master	2500	2,549	-49	101.97%
Big Bet Macro	1250	1356	-106	108.51%
Volatility	1250	1193	57	95.43%

**Updated 1/26