Fixed Income Weekly
FOR PROFESSIONAL INVESTORS

A Weakening Bias for the US Dollar

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Key takeaways

- USD strength was widely expected as we entered 2017; however, instead the USD has been weakening so far this year
- The main reasons were: 1) Global growth accelerated while US growth remained anemic; 2) Many central banks turned more hawkish while expectations for Fed tightening were reduced; 3) Eurozone politics improved after the French election while US politics continued to deteriorate and undermine Trump's economic stimulus agenda
- The USD remains at least 10% overvalued versus a range of currencies. The factors that led to weakness in 2017 are likely to remain in place for some time. We therefore expect a weakening bias for the USD to continue well into 2018

Full commentary

The US Dollar Index (DXY), made up of only G-10 currencies, has been weakening in fits and starts since the first few days of 2017, when it reached its highest level in 14 years. DXY is down about 10% since the start of the year, contrary to strong expectations that it would rise in 2017. Similarly, the Federal Reserve's US Trade Weighted Broad Dollar Index (USTWBROA), which includes emerging markets (EM) currencies, is down about 8% since late December 2016 from its highest level in 15 years.

The main factors that contributed to dollar weakness in 2017 were: (1) an acceleration of global growth while US growth remained anemic at around 2% -- US GDP was an unusual laggard within the G-3; (2) shifting monetary policy from a number of key central banks from easing to either a neutral stance or contemplating the start of a cycle of tighter policy; (3) diminishing political risks in the Eurozone after the French presidential election; and decreased confidence in the Trump administration's ability to pass its agenda of tax reform stimulus, infrastructure spending, and deregulation as politics soured in the US.

After the recent correction, the US dollar remains about 10% overvalued versus many currencies such as the euro, the Japanese yen, and the British pound based on the Organization for Economic Co-operation and Development (OECD) Purchasing Power Parity valuation measures. Using different methodologies based on the Consumer Price Index and adjusting for current account balances, the US dollar remains as much as 30% overvalued against the Japanese yen and the Swedish krone. Of course, determining fair value is difficult for currencies, and currencies can deviate by 20% or more from fair value measures for prolonged periods. Nevertheless, most studies currently show that valuation would not be an impediment to a further weakening of about 10% for the US dollar across many major currencies and a large number of emerging market currencies.

We expect the themes which undermined the US dollar so far this year to continue for some time. The major economies of the world are expected to grow for the immediate future, with recession risks at low levels barring unpredictable political or economic shocks. Most importantly, the monetary policy divergence between the US and the Eurozone firmly in place since late 2013 reached an inflection point earlier this year. The Federal Reserve is within a few hikes of reaching a neutral federal funds rate given the low growth/low inflation environment in the US (and the major economies of the world). By contrast, the European Central Bank has begun reducing its purchases of government bonds in April 2017. It is only expected to start raising rates sometime in 2018, with a cycle that will likely continue for a long time after the Federal Reserve is done raising rates. The European political process may finally have turned a corner with the French election and should gain a stronger footing after the German election in the fall; the days of the sovereign debt crisis and existential fears for the euro project now seem more distant. Unfortunately the travails of the Trump administration, by contrast, are unlikely to dissipate any time soon. The upcoming year will likely remain as politically difficult as 2017 has been, with an important set of mid-term Congressional elections in November 2018.

This week's market developments

Monday, August 21

- Japan All Industry Activity Index growth is expected to increase to 0.4% m.o.m. for June

Tuesday, August 22

- US FHFA House Price Index growth is expected to increase to 0.5% m.o.m. for June

Wednesday, August 23

- Germany Markit Manufacturing PMI growth (prelim estimate) is expected to decrease to 57.6 for August
- Germany Markit Services PMI growth (prelim estimate) is expected to increase to 53.3 for August
- Markit Eurozone Manufacturing PMI growth (prelim estimate) is expected to decrease to 56.3 for August
- Markit Eurozone Services PMI growth (prelim estimate) is expected to remain at 55.4 for August
- Markit US Manufacturing PMI growth (prelim estimate) is expected to increase to 53.5 for August
- Markit US Services PMI growth (prelim estimate) is expected to increase to 54.9 for August
- US new home sales are expected to remain at 610,000 for July

Thursday, August 24

- UK second quarter GDP growth (prelim estimate) is expected to remain at 0.3% q.o.q.
- US existing home sales growth is expected to increase to 5,550,000 for July

Friday, August 25

- Germany second quarter GDP growth (final estimate) is expected to remain at 0.6% q.o.q

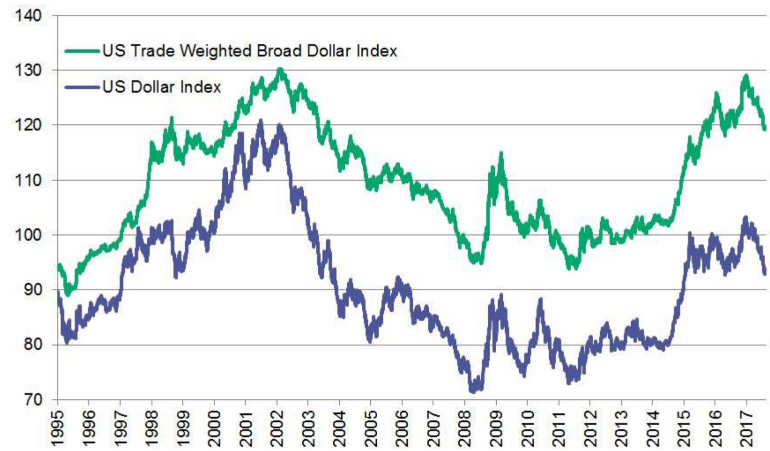
Source: Bloomberg, data as of August 28, 2017

In light of the shifting dynamics of economic growth, monetary policy divergence, and domestic politics in the US vs. Europe, as well as the fact that the US dollar still remains overvalued by most measures, we would favor a weakening bias for the US currency well into 2018. The days of exceptionalism for the US economy, monetary policy, and politics appear to be behind us for the medium term.

Due to the public holiday in the US, the Fixed Income Weekly will not be published on Monday, September 4. The next issue will be delivered on Monday, September 11.

Chart of the Week

US Dollar and US Trade Weighted Broad Dollar Indices



Source: Bloomberg; data as of August 28, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on September 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	June 14, 2017	1.00% - 1.25%	1.15%	September 20
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	September 7
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.06%	September 21
BoE	-25 basis points	August 4, 2016	0.25%	0.29%	September 14

Source: Bloomberg; data as of August 28, 2017

Next week's market developments

Monday, August 28

- Japan unemployment rate is expected to remain at 2.8% s.a. for July

Tuesday, August 29

- UK Nationwide House Price Index is expected to decrease to 0.0% m.o.m. s.a. for August
- •US Conference Board Consumer Confidence Index is expected to decrease to 120.6 s.a. for August

Wednesday, August 30

- Eurozone Consumer Confidence Index (final estimate) is expected to remain at -1.5 for August
- Germany CPI (prelim estimate) is expected to decrease to 0.1% m.o.m. for August
- US ADP national employment change is expected to increase to 185,000 s.s. for August
- US annualized quarterly GDP growth is expected to increase to 2.7% q.o.q. s.a.a.r. for 2Q
- Japan industrial production (preliminary estimate) is expected to decrease to -0.3% m.o.m. s.a. for July

Thursday, August 31

- US personal income growth is expected to increase to 0.3% m.o.m. s.a. for July
- US personal spending growth is expected to increase to 0.4% m.o.m. s.a. for July
- US existing home sales growth is expected to increase to 5,550,000 for July

Friday, September 1

- Germany Markit/BME Manufacturing PMI (final estimate) is expected to remain at 59.4 s.a. for August
- Markit Eurozone Manufacturing PMI (final estimate) is expected to remain at 57.4 s.a. for August
- Markit UK Manufacturing PMI is expected to decrease to 55.0 s.a. for August

Source: Bloomberg, data as of August 28, 2017