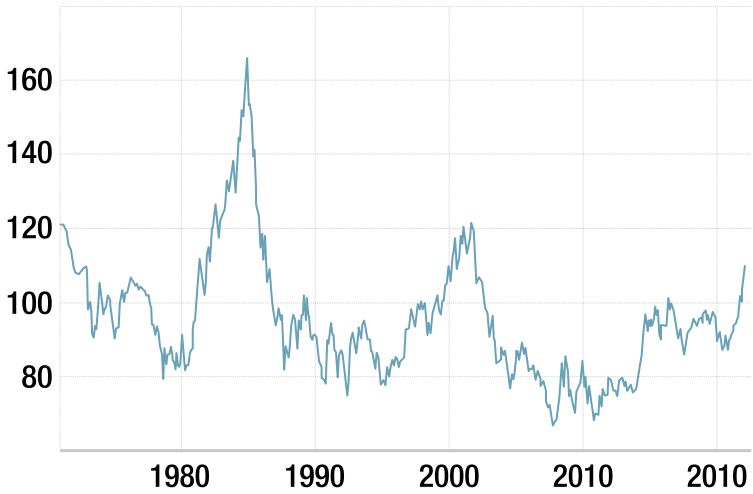
MACRO FLUX AND THE SURGING US DOLLAR

While people tend to pay more attention to things like the stock market and interest rates, it's in the currency markets where we can see the true force of macroeconomic flux. And currency markets in 2022 are on fire. Indeed, this is shaping up to be one of those years where a whole bunch of history is going to happen all at once.

The story of year is the surging US Dollar, which looks like it's on the verge of a serious break out:

Dollar Index



Source: Trading Economics.com

And when the dollar moves like this, markets start to break down. Pay close attention to the peaks on this chart. Almost all of the major stock market crises of the last 30 or 40 years have come after a period of dollar strength. Clearly, there's something important here. While everyone sort of knows that the dollar plays a unique role in our global financial system, most people don't understand just how important it is. But, trust me, the dollar is the key to everything.

You might be asking yourself:

"Wait, why the dollar is surging in the first place? Don't we have an inflation problem, a struggling stock market and an economy teetering on the edge of a recession? Wait, shouldn't the dollar be going down instead of up?"

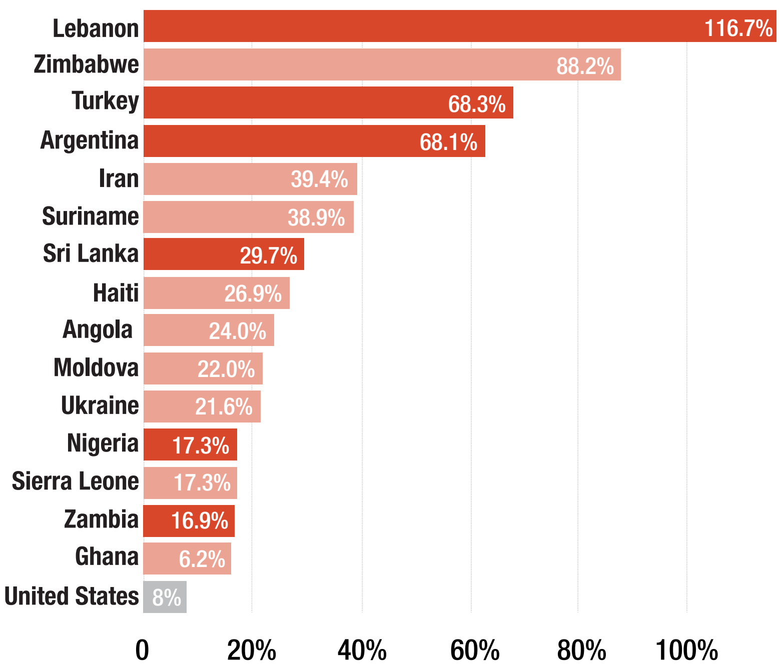
You'd think so but we live in a very complex, interconnected world and the dollar's recent move is actually pretty predictable. If that doesn't make sense yet, don't worry. I'm hoping it will by the end of this essay.

Let's start by examining why, in the face of everything we've seen this year, the dollar is surging higher. Here are a few plausible explanations. There's the idea of interest rate differentials. The argument here is that since the Fed has moved first and fastest among the developed world Central Banks in raising rates and investors can earn more interest here than elsewhere, there's been a natural increase in the demand by yield seeking investors to hold dollar-based investments. Then there's the commodity crunch argument. The story here is that since a huge chunk of global trade settles in dollars and commodity prices have been on a tear, importing nations have needed more and more dollars to buy the same amount of stuff. Finally, there's the idea of the dollar as the natural flight to safety trade for global investors. With the war in Ukraine, Europe's energy crisis and growing signs of trouble with the Chinese economy, this is probably one of the strongest drivers out there.

There's truth behind all these arguments but I think ultimately what this is about is just a reflection of the dollar's dominant position at the center of our global financial system. The dollar is the reserve currency, the main medium of exchange for global trade and the global investor's true measure of value. There is quite literally no real alternative to the dollar, despite what the US doom and gloom crowd, the crypto prophets and Bitcoin maxi's want you to believe. And, in my mind, the idea that the Chinese Renminbi represents a real challenge to dollar hegemony, is almost laughable. As we've seen, even the wealthy in China are basically doing anything and everything they can to get their money out of there.

Anyway, while the dollar's recent move is predictable and perhaps good for import-addicted American households, it isn't necessarily good for the global economy. I hinted at this earlier when I pointed out the interesting correlation between a surging dollar and stock market crises. Right now, it's fun for my American friends to think about travelling to Europe on a 20% discount but for the rest of the world the dollar's move higher is causing real problems. First of all, when it comes to inflation, a rising dollar is the last thing on Earth we need right now. It's akin to pouring gasoline on a blazing fire. If you look at the rest of the world, our 8% looks like a walk in the park:

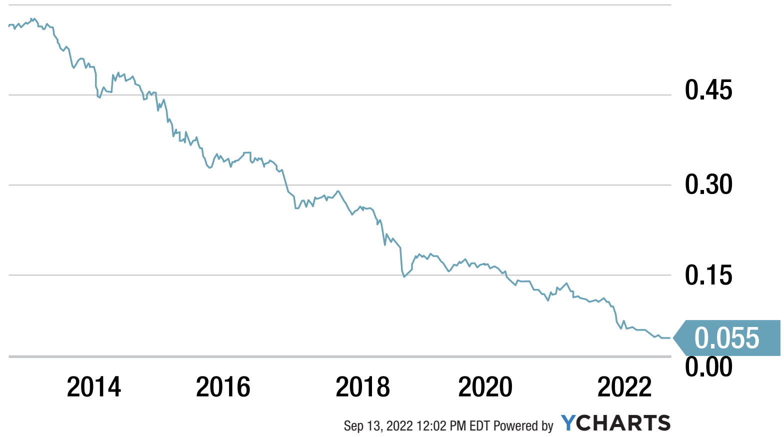
Countries with the highest inflation Rates in 2022



Most global trade today still settles in dollars (something like 67%) and many emerging economies are heavily dependent on imports, especially for necessities like food and energy. As the dollar rises, these import purchases become more expensive (i.e. each new purchase of food or oil cost more in local currency than it used to) and emerging economies get into reflexive inflationary spirals, where each move higher in the dollar introduces more inflation which then puts yet more pressure on the relative value of their currency. As you can see from the chart above, it doesn't take too long for inflation to rage out of control. And foreign central banks and governments, who find themselves in this unenviable position, are basically powerless.

Turkey, for example, has short-term interest rates set at a mere 30% and they still cannot stop the Lira from crashing. There's a lot of other things going on with Turkey but you get the point.

Turkish Lira to US Dollar Exchange Rate (I:TLUSDER)

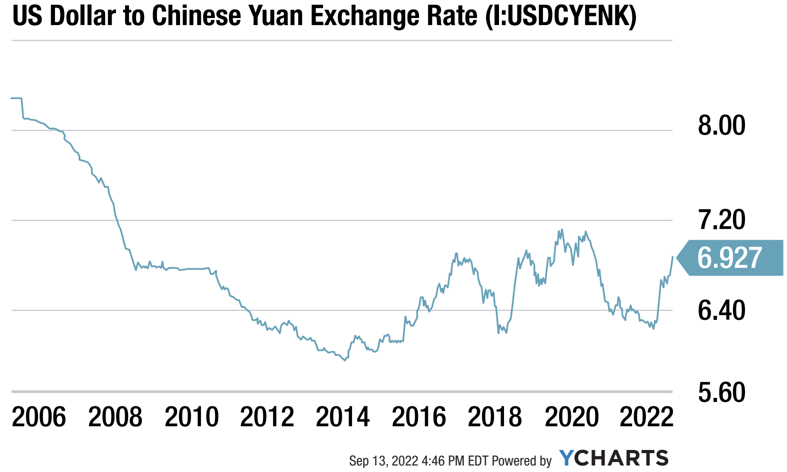


To make matters worse many emerging market governments and companies have borrowed heavily in dollars. According to the BIS, there's over $4T of outstanding dollar denominated debt. This is problematic because, like with imports, as the dollar rises these debt payments become more and more expensive (i.e. it takes more local currency to convert to pay the same amount of dollars due). Imagine you are a company earning your revenues in Turkish Lira but needing dollars to service your debt! You can get upside down in a hurry.

Dollar denominated debt problems are putting serious pressure on governments and businesses already struggling in the face of runaway inflation. That's why we're seeing protests and unrest all over the emerging world. This probably gets worse before it gets better, introducing yet more uncertainty into our world.

Currency markets around the world are flashing massive red warning signs. With CPI still above 8% and the Powell Fed signaling clearly that they are not done hiking, things could get worse quickly. I have to believe that the Chinese are starting to get worried about the viability of their peg, which many astute investors have been betting against unsuccessfully for years.

US Dollar to Chinese Yuan Exchange Rate (I:USDCYENK)

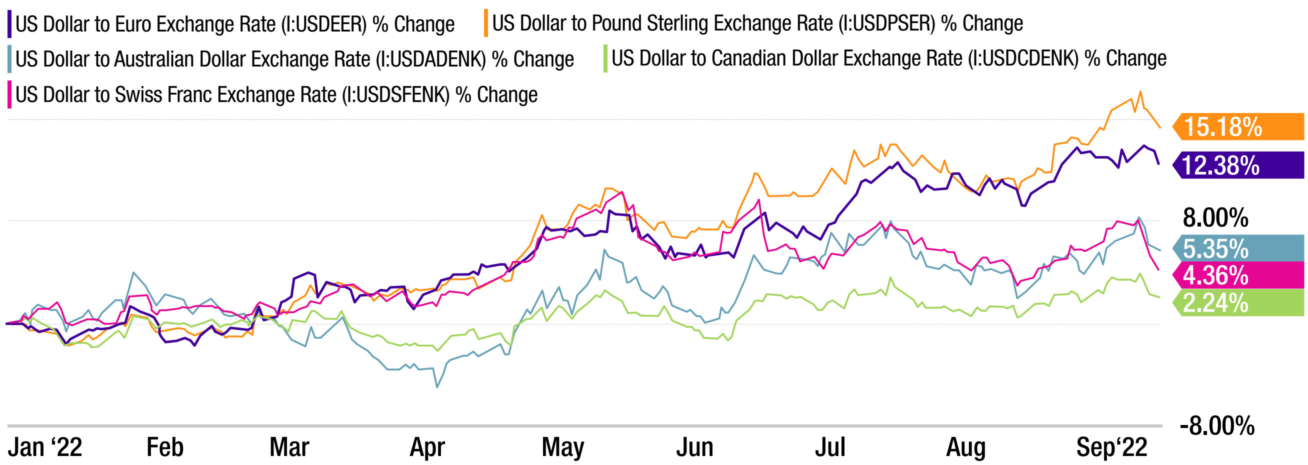


This might be their moment. By the way, this is why Trump was calling the Chinese a currency manipulator. The peg essentially makes Chinese exports cheaper than they perhaps otherwise would've been with a freely floating currency.

I don't trade currency markets too often but I do like to follow them as there's no better place to see the seeds of big changes coming in the global economy. A lot of times there's nothing to see—just routine speculative noise and the minor ebbs and flows of geopolitical evolution. Sometimes though they can tell us a lot. This is one of those moments.

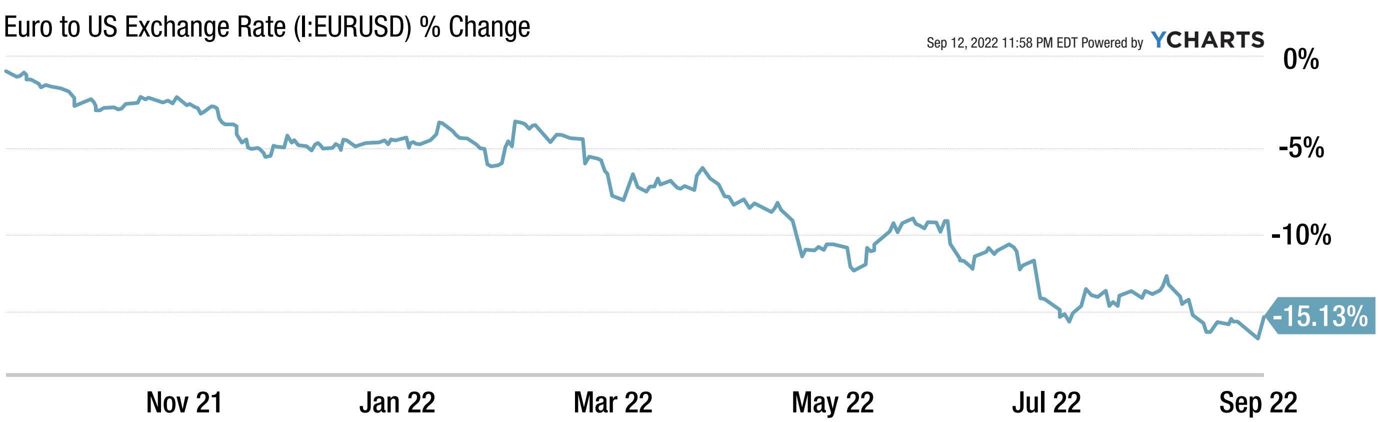
Here's what I think the currency markets are telling us:

1. The US is still the safest and best place to invest



The more uncertainty in the world, the stronger the US dollar is going to get. This is a manifestation of an important truth: The US still represents the best of capitalism in the world, mostly because, even with all our problems, we are the gold standard when it comes to rule of law in the world but also because we actually have a pretty dynamic and very innovative economy. I think we're about to enter another big period of US outperformance.

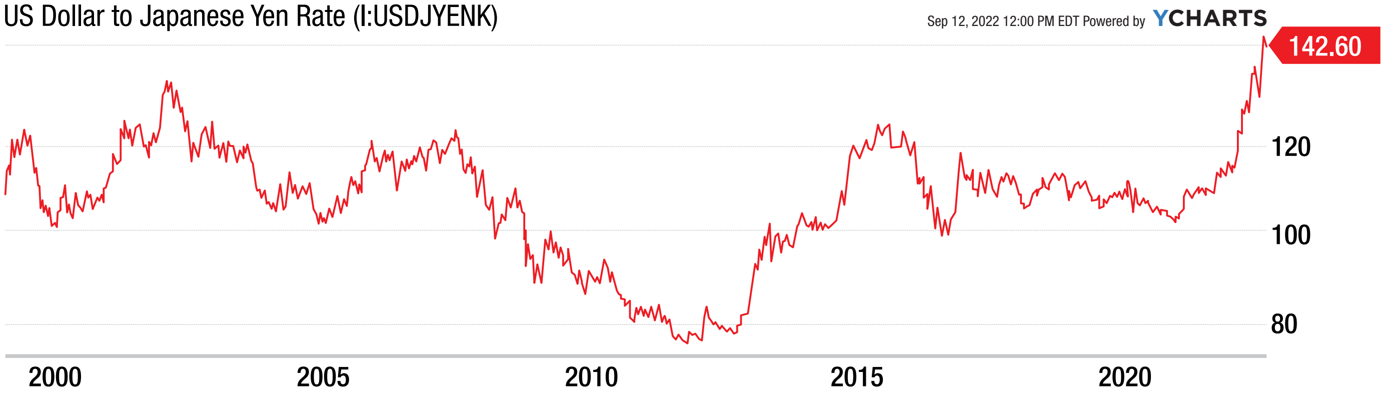
2. Europe is in real trouble



The strategic foolishness of European energy policy is on full display and, in a time like this, the inherent flaw of the EU system (the inability to coordinate fiscal policy) could become existential.

3. Japan is Terminal

US Dollar to Japanese Yen Rate (I:USDJYENK)

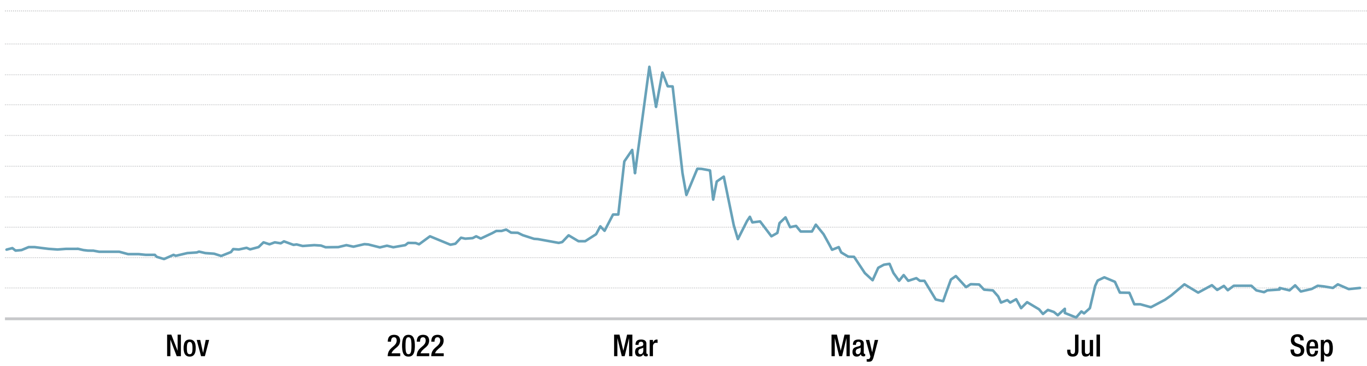


After years of radical central bank activism, the BOJ is going to finally get the inflation they've been seeking. This might help them deal with the problem of their 3x debt-to-GDP situation.

4. Russia's invasion looks like it's not as reckless as it seemed

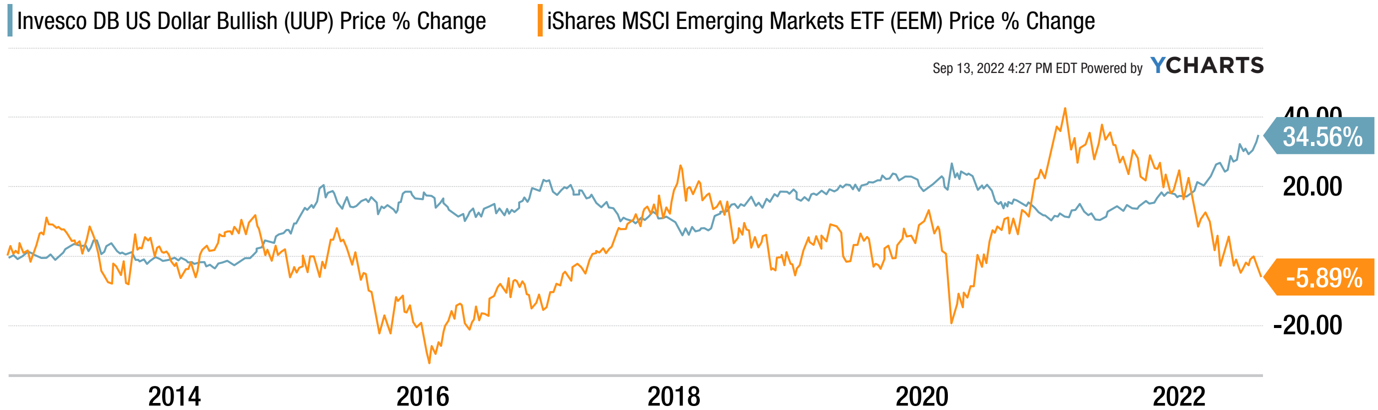
US Dollar | Russian Ruble

Source: Trading Economics.com



This is one of the most depressing charts I've seen. Obviously, the sanctions aren't working. Hopefully the Ukrainian offensive can bring an end to this war and Putin's mad military adventurism.

5. Emerging markets have become completely un-investable



For developed world investors, emerging markets will have to crush it in absolute terms just to make up for the losses on the currency side. It's going to be hard for heavily indebted (often in dollars), import dependent emerging economies to break out of this reflexive inflationary spiral. Watch this situation closely as it's fast becoming the fault line for geopolitical risk. ▫