ATLANTIC

FINANCIAL GROUP

Weekly Investment Focus

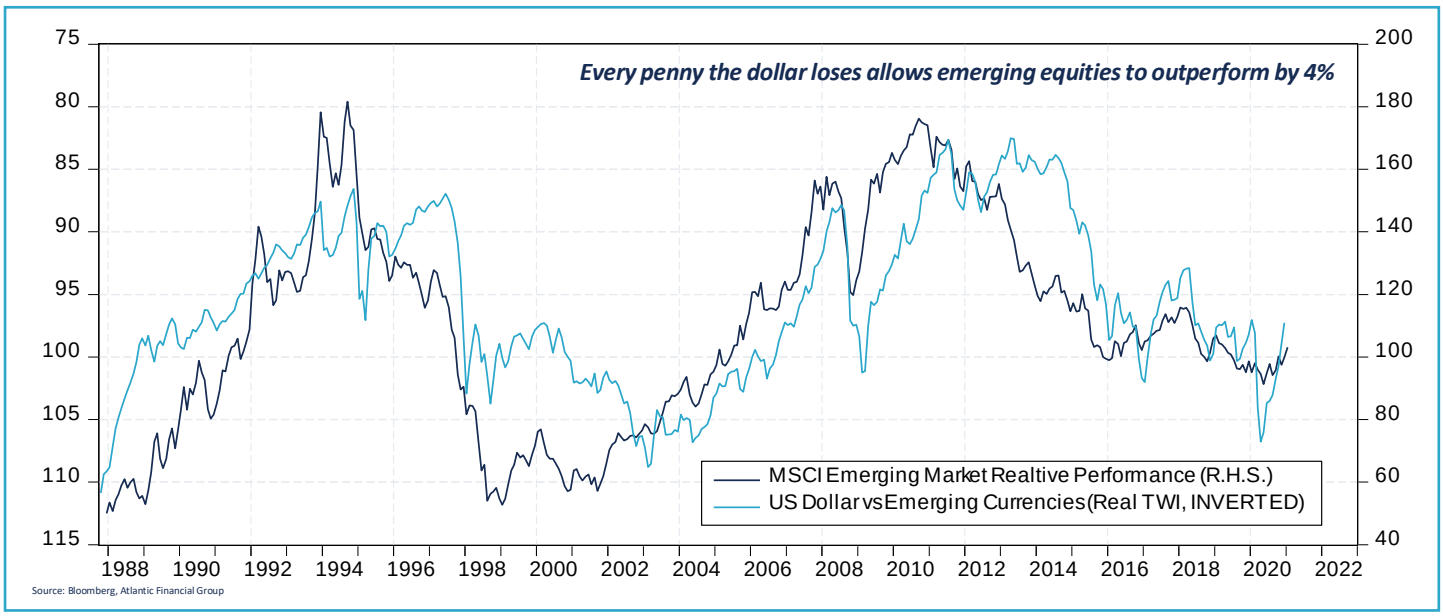
18 January 2021

Headlines

- The greenback already fell heavily last year, but this trend will continue in 2021…
- … despite Yellen's testimony today explaining the US doesn't seek a weaker currency to gain competitive advantage
- In the United States, debt monetisation is taking place at a faster pace than elsewhere
- Investors will accumulate the world's major currencies, gold, emerging markets and US exporters

Chart of the Week

"How to make the fall of the dollar profitable?"



Forex Market Analysis

"Has the drop of the greenback become too consensual?"

Prior to the covid-19 pandemic, between February 2018 and April 2020, the dollar appreciated sharply against the currencies of its major trading partners, particularly those of developed countries such as the euro, the Canadian dollar, the pound sterling, and, to a lesser extent, the franc and the yen. This surge was part of a much older trend, since its historic low in real terms (inflation-adjusted) dates back to July 2011, 9 ½ years ago. These periods of overvaluation are

rare but recurring (see chart 2). In particular, they were much more pronounced in the early 1980s before the Plaza agreements, or in 2000 during the Internet bubble, but always come to an end. **We believe that to return to its fair-value,** as defined by American economic fundamentals, **the greenback would have to give up -10% of its current value.** The overvaluation of the dollar is well known by institutional investors. It is therefore obvious that a large majority of investment banks have a negative view of the US currency. Similarly, asset managers are net sellers at 40% of open interest (see chart 3), mainly against the euro, yen and Swiss franc, but also against the New Zealand and Canadian dollars.

Chart 2 - Real EUR/USD exchange rate

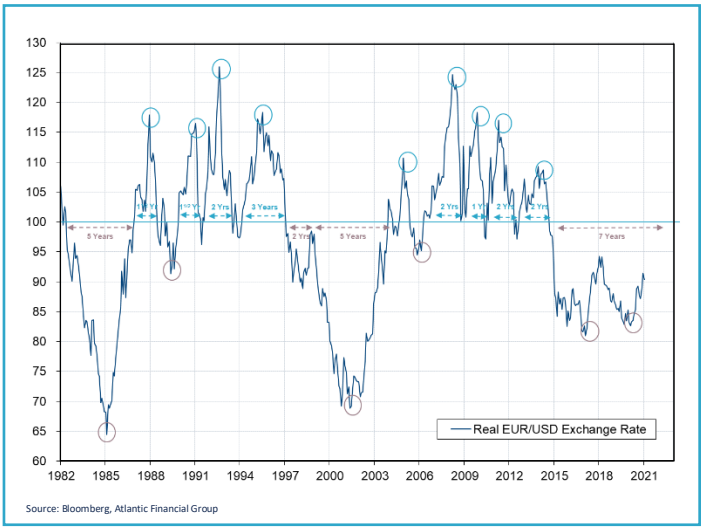
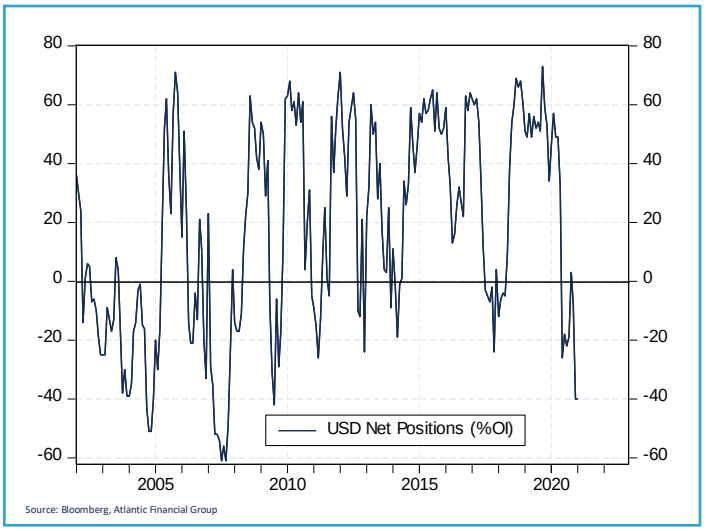


Chart 3 - Speculative positions on the US dollar



Has the fall of the dollar become too consensual to be credible? No. Admittedly, the elements justifying a further depreciation of the greenback this year are not new, but they are multiple and powerful:

- The interest rate spread with the rest of the world has narrowed considerably in 2020. **The yield differential,** which used to make it possible to take advantage of a carry trade (borrowing in euros to invest in dollars), is no longer as advantageous as it was in the past.
- **The economic recovery,** which is materializing at the pace of waves of lockdown easing, budgetary support and vaccination campaign, is prompting investors to reduce their holdings of safe haven assets, of which the dollar is one.
- **Inflation** is higher in the United States. To keep purchasing power parity constant, the dollar falls to compensate for this price increase.
- The **twin deficits** are growing faster in the United States than elsewhere: the American trade deficit is reaching records and the public deficit, already exorbitant, will increase further with the presidency of Joe Biden and the Blue Wave.
- **Trade tensions between the United States and China** will not disappear with the departure of Donald Trump. They may be less exacerbated, but Democrats and Republicans alike want to force Beijing into fair trade.
- In a more systemic, even disruptive way, **the Fed's loss of independence** from fiscal policy (US Treasury) is a historic change and **could lead to a crisis of confidence that could cause the dollar to lose its status as the international reference currency.** This hypothesis is part of a longer-term perspective, but it must be seriously considered.
- Outside the United States, **the world's major economic areas are** forging important trade links. This is the case of Asian, South American and European countries. They are thus gaining in stability and **becoming somewhat free of the dollar king.**
- In Europe, once Brexit has passed, the stirrings of a nascent budgetary union to allow **the creation of Eurobonds strengthens the single currency.**

- In China, **the creation of a digital yuan is very advanced** and could enable Beijing to impose its currency as one of the major international trading currencies.

For 2021, the most important argument is the following:

- To control the level of bond yields, **the US Federal Reserve (Fed)** buys huge volumes of US debt. To do so, it **prints dollars at a frantic pace,** enough to make *Nairobi*, *Rio* or *Denver* in *Casa de Papel* pale in envy. **This monetisation** is beneficial from an economic point of view, because it supports economic activity, inflation and makes the debt sustainable, but it **is unfavourable to the greenback.** Like all tradable goods, the price of the dollar (its exchange rate) is subject to the balance between supply and demand. It appreciates when it is rare and falls if it is abundant. Even though all the major central banks have injected liquidity into the markets, the Federal Reserve (Fed) has done so unparalleled and, in particular, faster than the European Central Bank over the past 12 months.

  According to this approach, admittedly incomplete, it would be possible to see the euro exchange against 1.30 dollars in the near future (see chart 4). This will be even more obvious against currencies whose central banks print less money, such as the Swiss franc and the Chinese yuan, or against precious metals such as gold or silver, whose supply is "stable". Thanks to this argument, some will rightly mention certain cryptocurrencies with a predefined supply, such as Bitcoin, whose exchange rate recently exceeded $40,000.

Chart 4 - Money printing differential

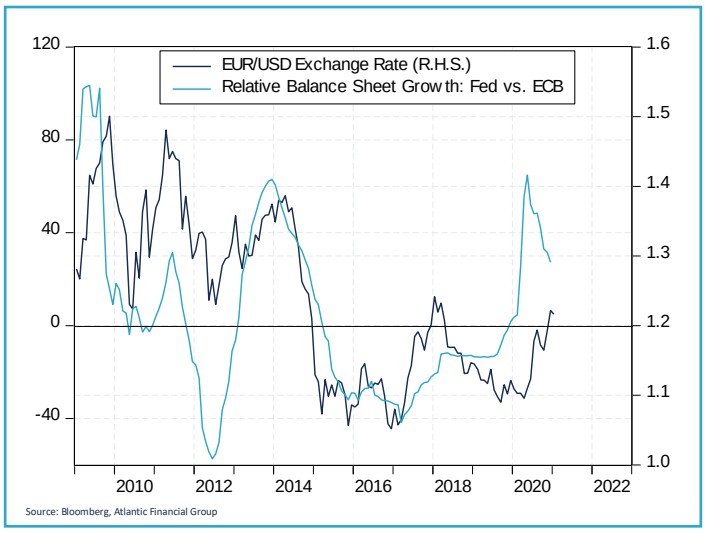
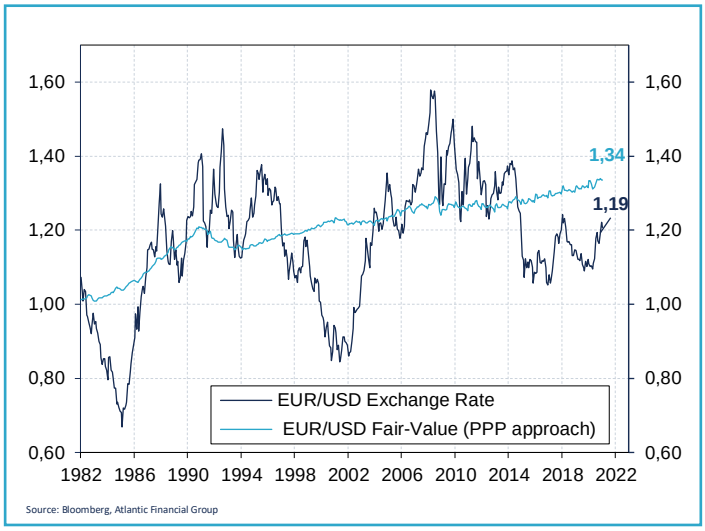


Chart 5 - Purchasing Power Parity (PPP)



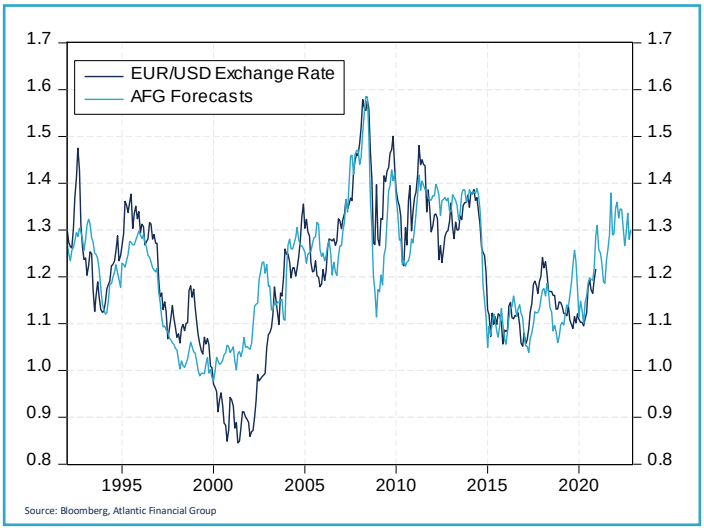
For once, the different fundamental analytical approaches converge:

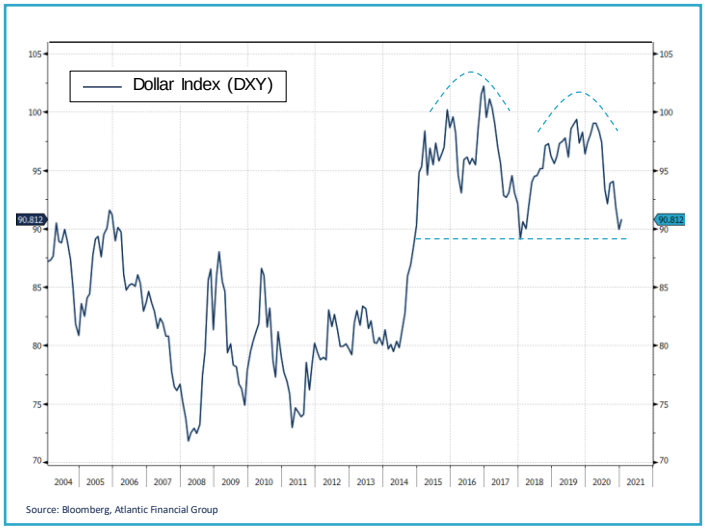
- In the very long term, the models based on Purchasing Power Parity (PPP) and mentioned above, justify an equilibrium value of 1.34 between the euro and the dollar (see chart 5).
- In the medium term, **our econometric model,** which is based in particular on growth, inflation, corporate pricing power, public deficits and interest rates on both sides of the Atlantic, **anticipates an exchange rate between the euro and the dollar above 1.30 from the fourth quarter of 2021,** then stabilising between 1.27 and 1.36 in 2022 (see chart 6).

These analyses, based on macroeconomic variables, have the advantage of being extremely reliable in indicating the trend. On the other hand, they have very little predictive power in terms of timing. For this, it is better to rely on technical

analysis. However, **the Dollar Index (DXY) is approaching an important support. If it yields, the bearish move will accelerate** (see chart 7). The signal is similar for the EUR/USD exchange rate: 1.25 is a key resistance. A break at this level would open the door for 1.35-1.40.

Chart 6 - Forecast €/$ exchange rate Chart 7 - Dollar Index





Investing in the world's major currencies or in gold, to protect against a depreciation of the dollar, is entirely feasible. But there are also other options:

- Usually, when the dollar weakens, **emerging market equities outperform by 4 to 1: they post a relative performance of +40% every time the dollar loses 10%** (see Chart of the Week). There are several explanations for this relationship, but the main one is that emerging market companies are seeing the cost of servicing their debt fall. This debt, which is mainly issued in dollars, becomes less onerous as the dollar depreciates and interest rates fall. This is often the case simultaneously, creating a much more favourable financial environment for companies in emerging countries.
- **In the United States, international companies** that make a significant part of their sales outside the dollar zone do much better than others. They gain in competitiveness and thus see their revenues increase.
- **In Europe, the phenomenon is reversed. Small caps** and companies with a domestic bias are relatively insensitive to a fall in the dollar. Among the large capitalisations, those which produce internationally will also have an advantage. Some also manage to benefit from a reduction in their energy bill.

Conclusion:

The dollar has been overvalued for many years. Its depreciation started 8 months ago but is expected to accelerate in 2021, despite Yellen's testimony explaining the US doesn't seek a weaker currency to gain competitive advantage. The signals to justify a further fall are accumulating, not only against the euro but also against most other currencies. The greenback could thus trade at 1.32 dollars to the euro by the end of the year. On the stock market, not only is it mainly the emerging indexes that will benefit, but also the large US exporters and European companies that produce internationally. Investors will have many ways to take advantage of the falling dollar. The movement has only just begun.

Returns on Financial Assets

Total return performance by asset class

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2021 Year-to-Date (%)	2020 (%)	2019 (%)
Equities							
World (MSCI)	655.9	63.71	-1.2%	3.6%	1.5%	16.8%	27.3%
USA (S&P 500)	3 768	57.06	-1.5%	2.1%	0.4%	18.4%	31.5%
USA (Dow Jones)	30 814	59.00	-0.9%	2.1%	0.7%	9.7%	25.3%
USA (Nasdaq)	12 999	59.22	-1.5%	3.2%	0.9%	45.1%	36.7%
Euro Area (DJ EuroStoxx)	403.8	57.70	-1.2%	3.0%	1.7%	0.8%	27.3%
UK (FTSE 100)	6 736	58.22	-2.0%	3.6%	4.3%	-11.4%	17.2%
Switzerland (SMI)	10 877	69.48	0.7%	5.2%	1.6%	4.3%	30.2%
Japan (Nikkei)	28 242	73.73	1.4%	7.0%	3.9%	18.2%	20.7%
Emerging (MSCI)	1 358	74.48	0.3%	8.7%	5.2%	18.5%	18.8%
Brasil (IBOVESPA)	120 349	56.15	-3.8%	3.6%	1.1%	2.9%	31.6%
Russia (MOEX)	3 451	70.00	-0.1%	6.9%	5.1%	14.8%	38.4%
India (SENSEX)	48 633	68.97	0.5%	6.0%	2.7%	17.2%	15.7%
China (CSI)	5 523	64.88	-0.7%	10.4%	4.7%	29.9%	39.2%
Energy (MSCI World)	158.5	66.12	1.4%	6.4%	9.7%	-27.7%	13.9%
Com. Serv. (MSCI World)	100.33	54.26	-1.4%	0.4%	-0.3%	24.2%	25.1%
Materials (MSCI World)	340.9	62.15	-2.7%	6.3%	3.7%	21.5%	20.8%
Info. Tech. (MSCI World)	455.2	56.63	-1.8%	3.7%	0.2%	46.1%	47.5%
Utilities (MSCI World)	153.6	58.63	-0.9%	3.1%	1.2%	4.8%	22.3%
Financials (MSCI World)	128.6	68.65	-0.2%	6.1%	3.9%	-3.2%	24.1%
Cons. Staples (MSCI World)	262.6	41.55	-2.0%	-0.2%	-2.0%	3.8%	22.4%
Health Care (MSCI World)	326.7	74.04	0.1%	4.7%	2.7%	15.4%	23.3%
Cons. Discret. (MSCI World)	385.1	59.19	-1.8%	4.0%	1.6%	37.0%	28.2%
Industrials (MSCI World)	293.5	57.83	-1.5%	2.5%	1.4%	11.8%	27.2%
Bonds (FTSE)							
USA (7-10 Yr)	1.08%	37.38	0.1%	-1.3%	-1.4%	9.3%	7.4%
Euro Area (7-10 Yr)	-0.24%	48.62	-0.1%	-0.5%	-0.2%	4.5%	6.7%
Germany (7-10 Yr)	-0.54%	48.63	0.1%	-0.5%	-0.2%	3.0%	3.0%
UK (7-10 Yr)	0.29%	47.17	0.0%	-0.2%	-0.7%	5.4%	4.8%
Switzerland (7-10 Yr)	-0.47%	44.74	-0.3%	-0.5%	-0.2%	0.4%	2.0%
Japan (5-10 Yr)	0.05%	45.37	0.1%	-0.2%	0.0%	-0.1%	0.0%
Emerging (5-10 Yr)	4.05%	36.27	-0.4%	-1.4%	-1.8%	5.2%	13.3%
USA (IG Corp.)	1.85%	47.65	0.5%	-0.4%	-1.1%	9.9%	14.5%
Euro Area (IG Corp.)	0.24%	55.08	0.0%	0.1%	0.1%	2.8%	6.2%
Emerging (IG Corp.)	3.73%	57.15	0.2%	-0.1%	-0.4%	8.1%	13.1%
USA (HY Corp.)	4.18%	80.22	0.2%	0.9%	0.4%	7.1%	14.3%
Euro Area (HY Corp.)	3.22%	73.38	-0.2%	0.4%	0.4%	2.3%	11.3%
Emerging (HY Corp.)	6.08%	45.12	-0.6%	-0.8%	-1.4%	4.3%	11.5%
World (Convertibles)	443.2	71.64	-0.4%	6.2%	3.5%	38.8%	17.3%
USA (Convertibles)	600.5	70.78	-0.3%	7.1%	4.4%	54.5%	22.8%
Euro Area (Convertibles)	4 099	49.97	-1.2%	1.1%	-0.4%	6.1%	7.6%
Switzerland (Convertibles)	186.8	56.68	-0.1%	-0.1%	0.0%	0.5%	2.4%
Japan (Convertibles)	196.5	65.87	0.1%	1.4%	1.1%	2.8%	2.6%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	671.4	68.23	n.a.	3.8%	n.a.	2.5%	9.3%
Distressed	859.5	63.57	n.a.	2.3%	n.a.	1.5%	1.4%
Event Driven	719.4	64.75	n.a.	3.8%	n.a.	3.1%	8.2%
Fixed Income	374.0	70.13	n.a.	1.4%	n.a.	2.2%	6.1%
Global Macro	1 099.5	69.72	n.a.	4.5%	n.a.	2.0%	10.4%
Long/Short	856.1	68.59	n.a.	4.1%	n.a.	3.6%	12.2%
CTA's	315.8	58.00	n.a.	5.3%	n.a.	-3.2%	9.0%
Market Neutral	273.3	54.27	n.a.	1.8%	n.a.	-0.1%	1.6%
Multi-Strategy	651.5	62.59	n.a.	4.2%	n.a.	1.4%	7.3%
Volatility							
VIX	24.34	52.90	12.9%	6.3%	7.0%	65.1%	-45.8%
VSTOXX	22.43	50.40	9.3%	3.2%	-4.0%	67.5%	-41.5%
Commodities							
Commodities (CRB)	472.5	71.13	1.6%	6.8%	2.7%	9.4%	7.6%
Gold (Troy Ounce)	1 839	42.25	-0.3%	-2.3%	-3.2%	24.9%	18.3%
Oil (WTI, Barrel)	52.36	66.96	0.2%	10.0%	7.9%	-20.5%	34.5%
Oil (Brent, Barrel)	54.19	59.33	-2.5%	8.1%	6.5%	-23.0%	24.9%
Currencies (vs USD)							
USD (Dollar Index)	90.818	55.62	0.4%	0.9%	1.0%	-6.7%	0.2%
EUR	1.2076	41.25	-0.6%	-1.5%	-1.1%	9.7%	-2.2%
JPY	103.74	49.63	0.5%	-0.4%	-0.5%	5.3%	0.9%
GBP	1.3569	52.14	0.4%	0.3%	-0.7%	2.8%	3.9%
AUD	0.7686	54.05	-0.1%	0.8%	-0.1%	9.5%	-0.4%
CAD	1.2775	49.93	0.1%	0.1%	-0.4%	1.8%	5.0%
CHF	0.8914	45.48	-0.1%	-0.9%	-0.7%	9.8%	1.4%
CNY	6.4871	58.29	-0.1%	0.8%	0.6%	6.7%	-1.2%
MXN	19.833	53.64	1.2%	0.6%	0.4%	-4.9%	3.8%
EM (Emerging Index)	1 721.7	57.50	0.0%	0.4%	0.1%	3.3%	3.1%

Source: Bloomberg, Atlantic Financial Group

Performance (Negative \ Positive)

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