



# ATLANTIC

FINANCIAL GROUP

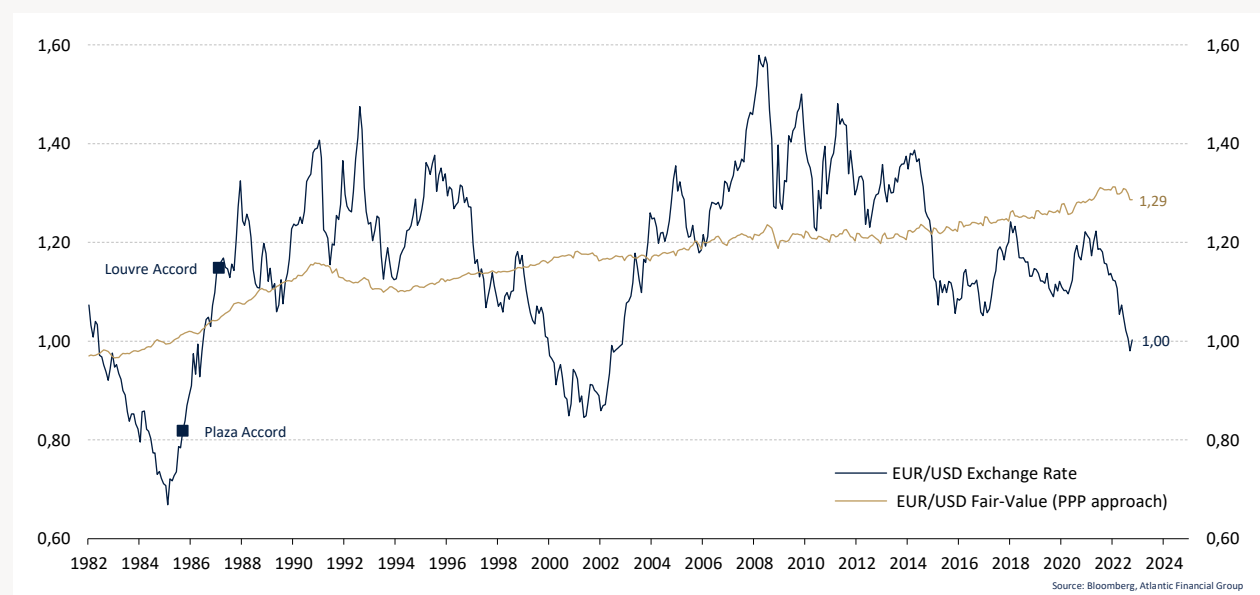
## Weekly Investment Focus

31 October 2022

### "THE GREENBACK COULD END UP SEEING RED"

- ◆ After seven years of relative stability, the dollar has literally soared
- ◆ The rise in yields orchestrated by the Fed has had a significant impact
- ◆ Buying dollars has reached consensus, with speculative positions hitting record highs
- ◆ Can the overvaluation increase, before the prospect of a new Plaza accord?

### CHART OF THE WEEK: "This is the third highest overvaluation of the dollar in modern history"



### FOREX MARKET ANALYSIS

Between 2015 and 2021, the dollar has been relatively stable against its major counterparts. Some would even say abnormally sluggish. Things are different now. **The dollar appreciated by +19% between January and September**, reaching its highest level in twenty years and an all-time high against some currencies, such as the pound sterling. The reasons for this appreciation are numerous and, for the most part, well known to investors.



### The reasons for the strength of the dollar are fundamental:

- Both the interest rate differential (see Fig. 2) and the inflation differential (see Fig. 3) are in favour of the dollar.
- Rising commodity prices in general and energy in particular, which are globally traded in dollars, have increased demand.
- International investors prefer US financial assets (stocks and bonds): these deliver the same kind of performance as local currency assets, while their face value increases as the dollar appreciates.

Fig. 2 - Interest rate differential

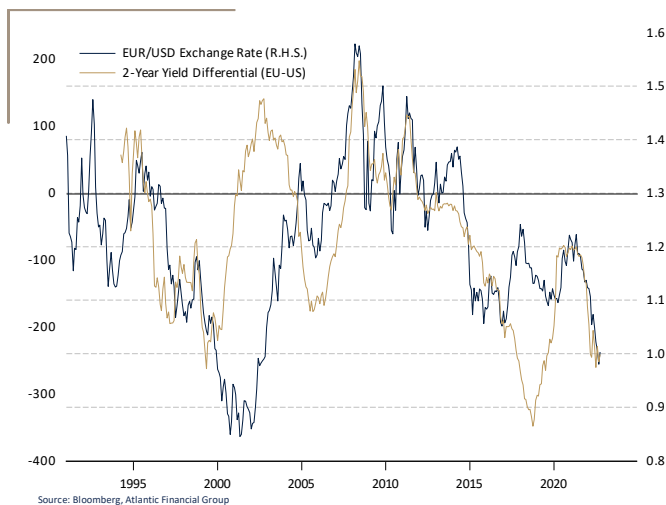
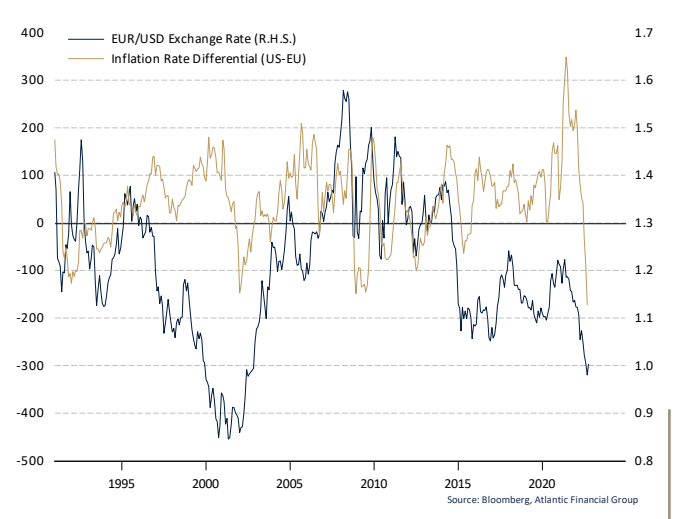


Fig. 3 - Inflation rate differential



### They are also political and behavioural:

- Russia's recent entry into the war has been on European soil, putting pressure on European governments, corporates, and households, not least through rising energy prices. Moreover, the risks of a geopolitical slippage or a nuclear accident cannot be ruled out.
- The debt crisis, both public and private, is back on the agenda. Europe, through its political construction, will probably be less effective than the United States in managing it effectively.
- The dollar's "smile", popularised by Stephen Jen when he was chief currency economist at Morgan Stanley, states that the US currency tends to appreciate above fundamentals when the economic and financial environment is doing very badly or very well. Conversely, the dollar weakens when the overall environment is weak (see Fig. 4).
- Investors are almost all positioned in the same direction: buyers of dollars. Speculative positions recently reached 77% of open interest. This is the highest level in over 17 years (see Fig. 5). Paradoxically, if these flows support the dollar's appreciation trend in the short term, they will underpin the fall in the medium term. When the dollar starts to fall, traders will be forced to unwind their long positions in order to manage their risk. By doing so, they will exacerbate the next downtrend.



Fig. 4 - The dollar smile

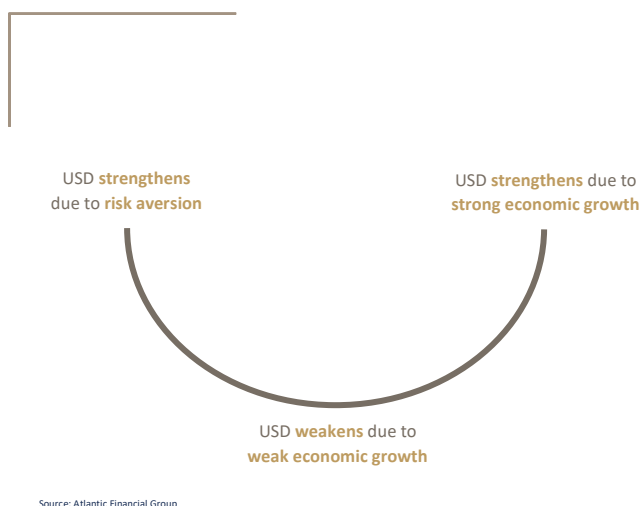
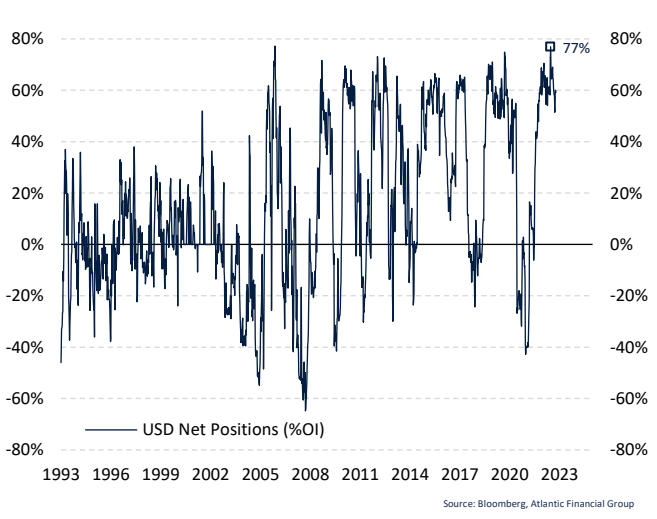


Fig. 5 - Speculative positions



The flip side of the greenback's recent strength is that it is moving further away from its economic fundamentals. On a Purchasing Power Parity basis, it is now +34% overvalued against the euro, for example (see Chart of the Week and Fig. 6). Against the yen, the strength of the dollar is such that it prompted a reaction from the Japanese government, which intervened directly in the foreign exchange markets on 22 September to support the Japanese currency. **Despite the excesses, the dollar's overvaluation could increase.** In 2001, during the dotcom bubble, the dollar was +40% "overpriced" and in 1985, before the Plaza Accord, +50%. It could therefore take "some time" **for the major states to coordinate their efforts to stabilise foreign exchange rates...** and avoid provoking or exacerbating a crisis like the last seven times the dollar soared (see Fig. 7).

Fig. 6 - EUR/USD over/undervaluation

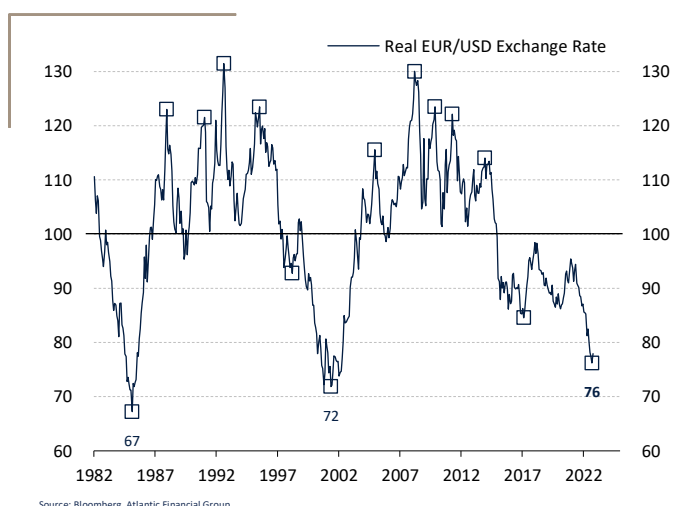
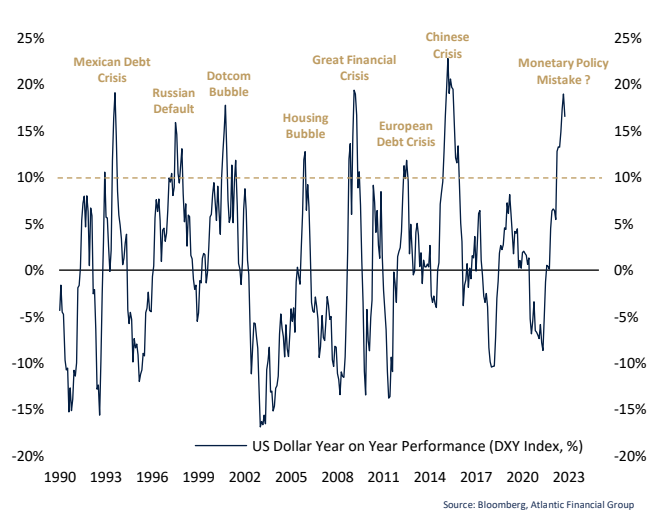


Fig. 7 - Annual growth of the dollar & crises



**Forty years ago, agreements were not reached quickly.** Japan and Germany, in coordination with the United States, sought to strengthen the yen and the deutsche mark to counterbalance the greenback.



While 22 September 1985 is remembered, investors sometimes forget that the discussions started in 1982, requiring more than three years of preparation (see Fig. 8).

Fig. 8 - The context that led to the Plaza Accord

- Until August 1971, the US dollar was exchangeable for gold, when President Nixon closed the window of convertibility. As the dollar exchange rate became a floating rate, inflation expectations soared.
- In 1973, with the end of the Bretton-Woods agreements, the dollar devalued sharply, and the first oil shock took place. In this period of recession and inflation, key rates were kept too low.
- In 1975, despite the fact that the US was recovering from recession, accommodative monetary and fiscal policies were maintained. Moreover, the labour market dynamics of the time allowed wages to keep pace with inflation.
- In 1979, under the combined effects of the Iranian revolution, the Iran-Iraq war and the resumption of world demand, the second oil shock aggravated the situation.
- When Volcker became chairman of the Federal Reserve in 1979, inflation and inflation expectations were high, and the monetary institution lacked credibility. In order to counteract these negative phenomena, he decided to vigorously raise the key interest rates from 10% to 20%. As the dollar paid more than other currencies, it appreciated excessively.
- As early as 1982, at the G7 conference in Versailles, the United States was singled out because of the strength of the dollar. The subject was raised again in 1983 at the G7 meeting in Williamsburg.
- In 1985, Ronald Reagan was re-elected President of the United States. James Baker moved from the White House to the Secretary of the Treasury. At an OECD meeting in April 1985, he opened the door to global monetary policy coordination. Negotiations intensified thereafter and the Plaza Accord was signed on 22 September 1985.
- The main objective of the Plaza Accord is to depreciate the dollar by -10%, presumably on top of the -10% to -15% it already lost between February and September. It is likely that the timing of the coordination was conducive to its success.
- To the contrary, in February 1987, the Louvre Accord looked like a failure. While it aimed to halt the fall of the dollar, the greenback continued to drop.

Source: Atlantic Financial Group

**Today, the ability of governments and central banks to coordinate is greater. However, there are several factors that counteract this:**

- **The interests of the countries concerned are not all aligned.** A weaker dollar would run against what the Federal Reserve (Fed) and the US Treasury are trying to achieve: lower inflation. In the very short term, it seems difficult to envisage Uncle Sam opting for a dollar inflationary policy. Without the



involvement of the US, an agreement is unlikely to succeed. The strength of the greenback would have to be perceived as intolerable, either because it suffocates American exporters or because it poses a risk to global financial stability, particularly in emerging markets. As emerging countries finance themselves in dollars, the cost of debt and the risk of insolvency increase as the dollar appreciates.

- **The currency market is extremely deep.** The daily volume of foreign exchange transactions is USD 8,300 billion, compared to around USD 200 billion in 1985. It is now 40 times larger than it was 40 years ago. By comparison, the Group of 10 major economies (G10) collectively has \$2.8 trillion in foreign reserve assets (deposits and securities). If investors believe that this stock is too small to have a lasting impact on currency prices, they may be tempted to test the determination of the countries involved in an agreement.

**Finally, to weaken the dollar, it would be far more effective for the Fed to "pivot"** away from its strategy of raising policy rates, or for other central banks to quickly join it on the restrictive side of monetary policy.

#### **Conclusion:**

Most currencies have fallen heavily against the dollar. The US could end up suffering from an overly strong currency, which certainly helps to contain imported inflation but also penalises its export competitiveness. Investors must remain patient. Rather than trying to catch a falling knife, it is often better to wait until the trend is clearly reversed before buying currencies against Uncle Sam's currency.



## RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
<b>Equities</b>							
World (MSCI)	589.0	58.12	3.4%	4.3%	-20.5%	19.0%	16.9%
USA (S&P 500)	3 901	59.49	4.0%	5.0%	-17.1%	28.7%	18.4%
USA (Dow Jones)	32 862	71.34	5.7%	10.8%	-8.1%	20.9%	9.7%
USA (Nasdaq)	11 102	52.85	2.2%	0.5%	-28.6%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	392.8	63.23	3.7%	7.3%	-15.5%	23.5%	0.8%
UK (FTSE 100)	7 048	52.25	1.8%	0.8%	-1.6%	18.4%	-11.4%
Switzerland (SMI)	10 772	60.02	3.8%	5.4%	-13.9%	23.7%	4.3%
Japan (Nikkei)	27 546	49.89	0.8%	4.4%	-4.0%	6.7%	18.3%
Emerging (MSCI)	846	34.82	-2.2%	-3.4%	-29.4%	-2.3%	18.8%
Brasil (IBOVESPA)	114 539	51.09	-4.5%	5.6%	9.3%	-11.9%	2.9%
Russia (MOEX)	2 168	60.04	6.1%	16.4%	-38.1%	21.9%	14.8%
India (SENSEX)	60 646	62.20	1.2%	6.1%	4.2%	23.2%	17.2%
China (CSI)	3 509	24.99	-3.4%	-7.4%	-26.8%	-3.5%	29.9%
Communication Serv. (MSCI World)	68.77	41.72	-1.7%	-3.1%	-36.9%	10.9%	24.2%
Consumer Discret. (MSCI World)	279.8	44.43	0.8%	-3.7%	-31.1%	9.2%	37.0%
Consumer Staples (MSCI World)	253.3	61.17	4.8%	3.6%	-11.3%	11.7%	8.8%
Energy (MSCI World)	243.0	69.36	2.8%	17.9%	34.3%	37.5%	-27.7%
Financials (MSCI World)	125.4	62.03	3.8%	7.1%	-14.2%	25.1%	-3.1%
Health Care (MSCI World)	327.8	64.38	4.8%	6.8%	-9.9%	18.0%	15.4%
Industrials (MSCI World)	266.6	63.78	5.6%	8.6%	-18.2%	16.6%	11.8%
Info. Tech. (MSCI World)	401.2	57.33	4.8%	3.8%	-29.5%	27.6%	46.2%
Materials (MSCI World)	283.6	54.28	1.9%	6.0%	-19.3%	15.4%	21.6%
Real Estate (MSCI World)	164.0	48.89	4.2%	-0.7%	-28.2%	23.6%	-5.7%
Utilities (MSCI World)	142.1	53.85	5.8%	-0.9%	-10.3%	11.1%	4.8%
<b>Bonds (FTSE)</b>							
USA (7-10 Yr)	4.03%	40.00	1.3%	-2.9%	-16.7%	-2.4%	9.3%
Euro Area (7-10 Yr)	2.74%	55.37	3.8%	1.7%	-16.4%	-2.9%	4.5%
Germany (7-10 Yr)	2.10%	50.80	2.5%	0.1%	-15.3%	-2.7%	3.0%
UK (7-10 Yr)	3.48%	60.25	4.6%	4.9%	-16.4%	-4.9%	5.4%
Switzerland (7-10 Yr)	1.11%	57.80	2.8%	2.3%	-10.5%	-2.3%	0.4%
Japan (5-10 Yr)	0.24%	56.75	0.5%	0.3%	-1.3%	0.0%	-0.1%
Emerging (5-10 Yr)	8.77%	50.53	3.1%	0.5%	-23.3%	-2.3%	5.2%
USA (IG Corp.)	5.87%	44.29	1.9%	-0.8%	-19.3%	-1.0%	9.9%
Euro Area (IG Corp.)	4.30%	49.89	1.2%	0.2%	-14.4%	-1.0%	2.8%
Emerging (IG Corp.)	9.57%	24.49	0.5%	-2.5%	-21.8%	-3.0%	8.1%
USA (HY Corp.)	8.99%	61.51	2.2%	3.0%	-12.2%	5.3%	7.1%
Euro Area (HY Corp.)	8.65%	55.80	1.6%	1.3%	-13.5%	3.4%	2.3%
Emerging (HY Corp.)	12.62%	50.65	2.2%	1.1%	-20.0%	-3.2%	4.3%
World (Convertibles)	352.5	54.27	1.9%	1.5%	-19.6%	2.4%	38.8%
USA (Convertibles)	477.0	55.09	2.1%	1.4%	-19.6%	3.1%	54.5%
Euro Area (Convertibles)	3 443	57.00	1.2%	2.4%	-16.1%	-0.3%	6.1%
Switzerland (Convertibles)	171.1	59.14	0.8%	1.3%	-8.0%	-0.5%	0.5%
Japan (Convertibles)	198.0	45.27	-0.3%	0.4%	-1.3%	3.3%	2.8%
<b>Hedge Funds (Crédit Suisse)</b>							
Hedge Funds Indus.	728	59.40	n.a.	-0.7%	0.1%	8.2%	6.4%
Distressed	935	57.68	n.a.	-0.5%	-3.3%	12.5%	3.8%
Event Driven	744	48.38	n.a.	-2.5%	-8.4%	12.9%	7.0%
Fixed Income	381	51.18	n.a.	-0.8%	-3.1%	5.2%	3.6%
Global Macro	1498	80.69	n.a.	2.0%	24.3%	9.6%	6.5%
Long/Short	828	43.37	n.a.	-2.7%	-10.8%	8.3%	7.9%
CTA's	421	79.54	n.a.	3.5%	23.4%	8.2%	1.9%
Market Neutral	284	53.95	n.a.	-1.0%	-2.2%	6.2%	1.7%
Multi-Strategy	691	57.78	n.a.	-0.4%	-0.8%	7.0%	5.6%
<b>Volatility</b>							
VIX	25.75	35.46	-13.3%	-14.7%	49.5%	-24.3%	65.1%
VSTOXX	24.89	33.83	-10.6%	-20.6%	29.2%	-17.6%	67.5%
<b>Commodities</b>							
Commodities (CRB)	552.4	n.a.	-1.2%	-1.1%	-4.5%	30.3%	10.5%
Gold (Troy Ounce)	1 642	42.14	-0.5%	-1.1%	-10.2%	-3.6%	25.1%
Oil (WTI, Barrel)	87.90	52.81	1.9%	7.0%	14.2%	58.7%	-20.5%
Oil (Brent, Barrel)	93.88	52.65	3.6%	6.8%	22.8%	51.4%	-23.0%
<b>Currencies (vs USD)</b>							
USD (Dollar Index)	110.90	46.45	-1.0%	-1.1%	15.9%	6.4%	-6.7%
EUR	0.9951	54.73	0.8%	1.5%	-12.5%	-7.5%	9.7%
JPY	147.85	42.37	0.7%	-2.1%	-22.2%	-10.2%	5.1%
GBP	1.1597	59.27	2.8%	3.8%	-14.3%	-1.0%	3.1%
AUD	0.6419	48.95	1.7%	0.3%	-11.6%	-5.6%	9.6%
CAD	1.3621	48.84	0.8%	1.5%	-7.2%	0.7%	2.1%
CHF	0.9972	45.07	0.4%	-1.0%	-8.5%	-3.0%	9.4%
CNY	7.2728	32.73	-0.1%	-2.2%	-12.6%	2.7%	6.7%
MXN	19.836	57.87	0.5%	1.5%	3.5%	-3.0%	-5.0%
EM (Emerging Index)	1 581.4	40.32	0.2%	0.3%	-8.8%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)



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