

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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The Dollar – the Best of a Bad Bunch

- Dollar – few alternatives to the currency at present
 - Euro – too few positives
 - Sterling – under pressure from politics and inflation
 - Yen – likely downside risk until the Fed baulks at recession risk
 - Swiss franc – has safe haven status backed by a likely positive interest rate by September
 - When the dollar rally ends, gold will be in the ascendency
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The dollar's recent inexorable rise has appeared to show no bounds and has made asset allocators inevitably believe that it may be too risky to bet against the currency. We think it is

essential for investors to be discerning in taking that bet. We believe that the US dollar still has upside against the euro and sterling, but it is much less obvious to take the bet against the Swiss franc or potentially against the yen.

As geopolitical challenges continue to overwhelm countries, the US dollar has only gained in strength, reinforcing the currency's – and the United States' – safe haven status. President of Yardeni Research, Ed Yardeni's assertion that "there is no alternative country" or "TINAC" is built on that strength—and some solid data. Net capital flows into the US amounted to \$1.3 trillion in the year to May, just falling short of the record inflow of \$1.4 trillion annual inflow registered in February. Very few currencies have been able to compete with the dollar. This has felt very much the case in recent months, with most major countries finding themselves in an inferior position to the US.

EUR/USD – Limited near-term chance of euro weakness reversing and with marked downside risk

Spot USD/EUR 1.02

Q4 consensus 1.06

Q4 GCIO forecast range 0.95 -1.05

We see little let-up in the weakness in euro against the dollar given the confluence of a myriad of challenges. The ECB had an opportunity last week to draw something of a line under the euro weakness; however, even after a surprising 50bps rate hike, the euro appears to have remained biased towards weakness. The ECB may have hoped that a larger-than-expected rate hike and a framework for controlling bond spreads between the government bond yields of periphery countries would help. However, the poor outlook for eurozone growth and the uncertainty about how easy it would be for the ECB to enact its TPI programme to control spreads only aggravated negative sentiments. We doubt that the euro could materially turn around ahead of a potential halt in gas supplies by Russia.

Only time will tell whether Russia will follow through on its threats. Estimates suggest that such Russian action, if it materialises, could cut eurozone GDP by two to three percentage points. However, investors often forget that Russia would also be a loser if it closed off the gas supplies since it can't simply redirect the gas to other parts of the world. The gas has to move through a pipeline – and not shipped – and there simply isn't the infrastructure to redirect the gas to another part of the world. Russia would lose out on significant revenues.

Chart 1: EUR/USD

Source: Bloomberg

JPY/USD

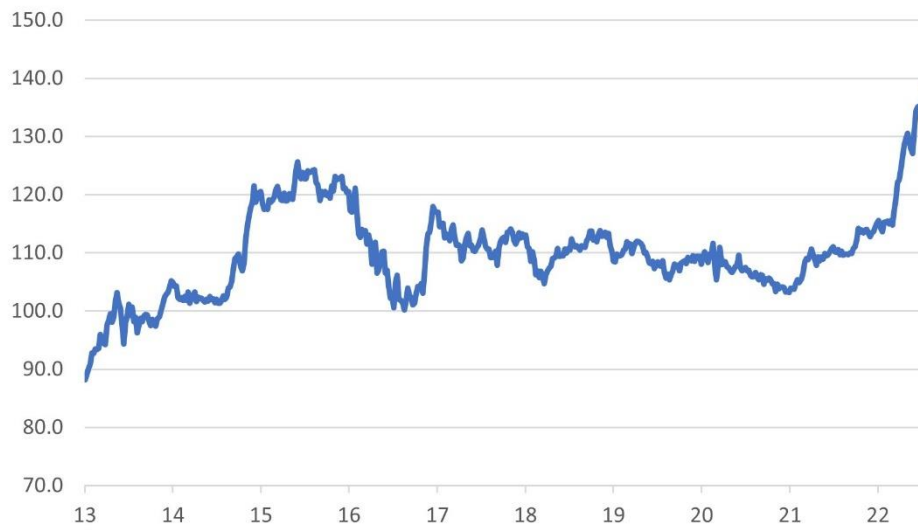
Fundamentals argue for further yen weakness but the Japanese currency is primed for a smart recovery if the Fed runs shy of weak US growth.

Spot Yen/USD 136

Q4 consensus 132

Q4 GCIO forecast range 120-140

The Bank of Japan has continued with its ultra-loose monetary policy. Unlike the ECB's current pivot, there appears to be little appetite at the Bank of Japan for a tighter monetary policy. Despite recently increasing its inflation forecasts, the Japanese central bank is focused on supporting growth; hence, a significant shift in policy looks unlikely. The yen, consequently, has weakened by about 18% since the start of the year, the weakest level in some time. Nevertheless, were the Fed to change its view on the outlook for US growth and shift its monetary stance to moderate from hawkish, in such circumstances, the yen/dollar could be primed for a sharp recovery.

Chart 2: Yen/USD

Source: Bloomberg

GBP/USD

A pending new prime minister and inflation still on a rip do not bode well for sterling unless the Bank of England signals more aggressive tightening...as it must.

Spot USD/GBP 1.20

Q4 consensus 1.20

Q4 GCIO forecast range 1.15-1.20

With the leading candidate for the prime ministership advocating tax cuts, and inflation surprising to the upside, sterling has its challenges. However, we suspect that the grave nature of the UK's inflation challenges may result in a more robust phase of tightening from the Bank of England. Last week, UK inflation shot up to a 40-year high of 9.4%, while the GfK Consumer Confidence Index fell to its lowest level since records began in 1974.

Ironically, sterling firmed up above the \$1.20 level last week. It might be that after the bad economic news, investors were thinking about how much worse could it get? We sense that sterling still has more downside, although we also believe that the currency is in value territory.

Chart 3: USD/GBP

Source: Bloomberg

CHF/USD – found a base and with CHF strength potential**Spot CHF/USD 0.96****Q4 consensus 0.96****Q4 GCIO forecast range 0.94 - 0.96**

The Swiss National Bank's (SNB) surprising decision to protect the Swiss franc with a 50bps rate hike has helped the Swiss franc firm up somewhat from March through to the middle of the year. We believe that the SNB will likely reinforce its inflation-fighting credentials with a further 50bps rate hike at its next meeting in September. At 3.4%, Swiss inflation marks a multi-year high and is quite a shock to the system in Switzerland. Current negative policy rates don't sit easily with such high inflation.

The prospect of a positive interest rate should reinforce the Swiss franc's safe haven status.

Chart 4: USD/CHF

Source: Bloomberg

Longer term dollar gold rather than dollar paper

We have talked above much about the outlook in the short and medium term for the dollar. We do still have our longer-term concerns about the greenback. If by the end of this year the US economy slips into recession and inflation still remains high, investors may have less confidence in the dollar's status as a safe haven asset. We expect the mid-term elections in the US to somewhat expose the vulnerabilities of the US government, which is unlikely to be able to react with an effective fiscal policy. In such a scenario, we would be advocating gold as a safer way of hedging against risks than holding US dollars.

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