27th March 2020

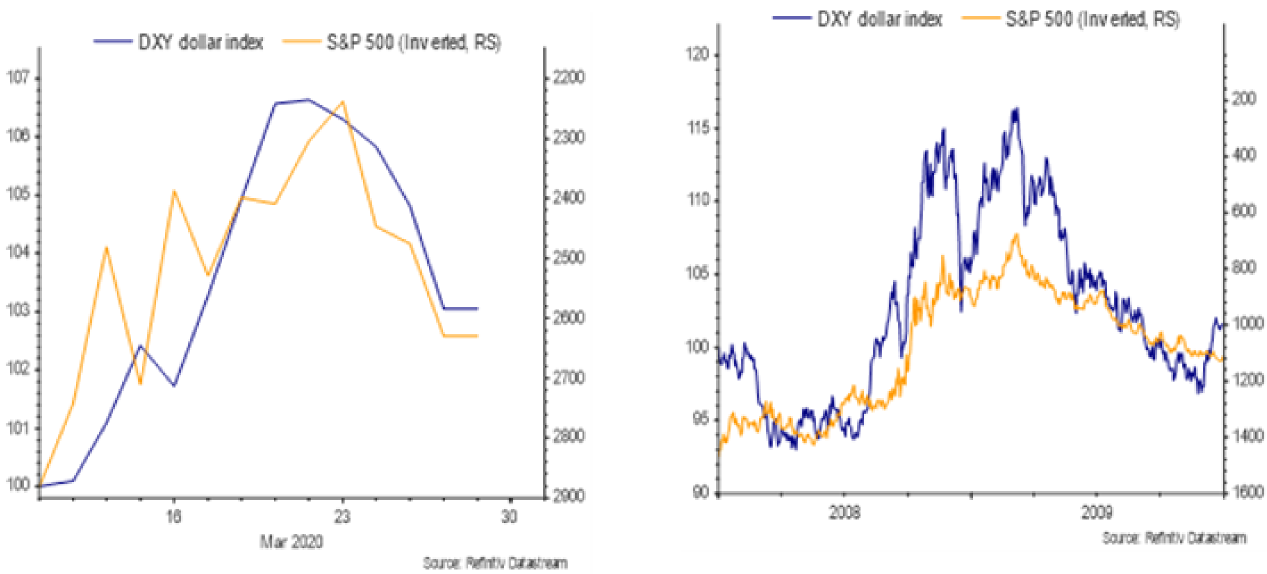
Market Update

Dollar outlook

The dollar is the world's major funding currency. Earlier this month, as the coronavirus crisis intensified, companies began to get worried about a sharp drop in revenues and a seizing up in funding markets - both which would impact their access to dollars. As a result, companies started max out their dollar credit lines, which pushed the dollar sharply higher earlier this month.

This week, we are seeing the dollar pull back. There are a couple things causing this. First, the Fed stepped in by offering swap lines to the world's central banks, which has eased dollar funding concerns. Second, risk assets have bounced the last few days. As the chart shows, the dollar has been moving inversely with stock prices, as it did during the GFC, as the chart on the right shows.

Like during the GFC, the dollar is moving in line with risk on sentiment



It's too soon to say the dollar rally is over, but on a 12m view, even after the sharp decline of the last few days, the dollar probably has more downside, for three main reasons.

1. The first reason is that we should spend most of the next year in risk on mode. Although the economic pain will be severe and this crisis will leave scars, the global economy is most likely going to snap back strongly in Q3 this year. This backdrop, combined with ultra accommodative monetary policy settings and currently depressed risk appetite suggests we spend most of the next 12m in risk on mode, which benefits higher risk currencies.

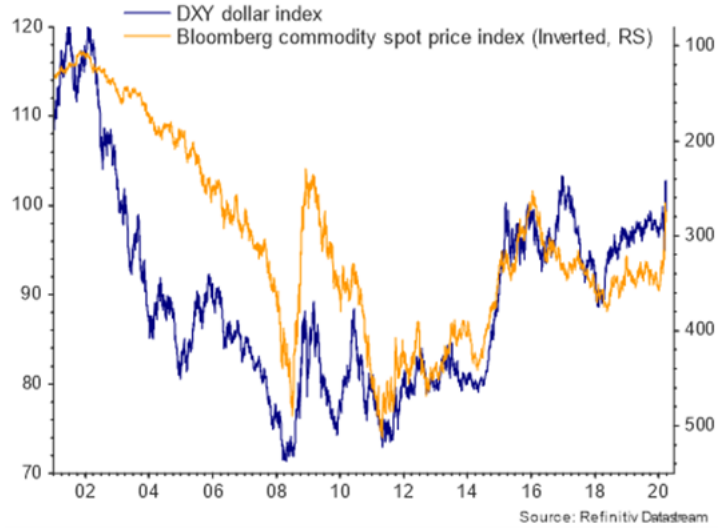
2. The second reason to expect downside in the dollar is interest rate differentials. The 2 year rate spread in the UK, Eurozone, Japan and China have all moved sharply against the dollar. This didn't matter when markets were tanking, but it should matter more once the volatility stabilizes. The four charts show that the pound, euro, yen and RMB all have upside versus the dollar based on the historical correlation with interest rate spreads, which are unlikely to move much over the next 12 months.

Interest rate differentials have turned against the dollar in Europe...

...and Asia

3. The third reason to be cautious on the dollar is commodity prices. Commodity prices are depressed now, but should move higher over the next 12 months as the economy starts to pick up. It's true that the US has higher commodity exposure now given the rise in shale, and UK, Euro area, China and Japan have very little commodity exposure. But the rise in commodity prices should give much more of a boost to the Russias, South Africa's, Brazils, Norway's, Canada's and Australias of the world.

A rebound in commodity prices should lead to flows out of the dollar

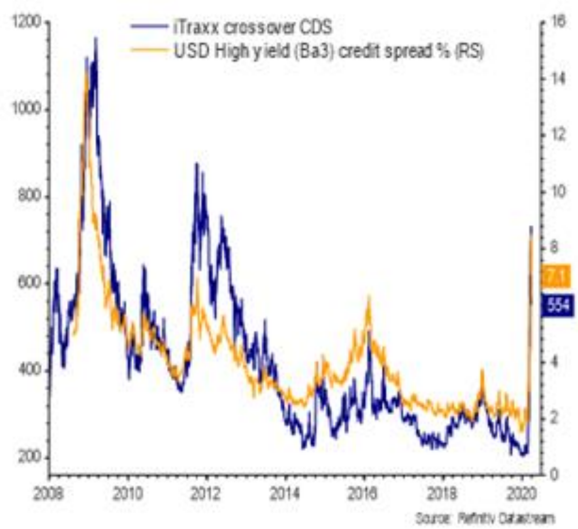


In addition to these 3 drivers, the dollar is also expensive, market sentiment on the dollar is bullish, which has negative implications from a contrarian perspective, and its already massive current account and budget deficits are set to balloon even further.

Economic Update

We had a parabolic move higher in US initial jobless claims yesterday. The consensus expected them to rise to 1m, they rose to 3.28 million. This makes the rise we saw in during the GFC look miniscule and speaks to just how quickly this crisis has hit.

Parabolic move higher in initial claims



We would make two observations:

1. It appears that the market has already come to grips with how bad the economic fallout will be. The real time gauges of market expectations of the economic fallout actually improved yesterday - one example is the US high yield corporate bond spread narrowed by 83 basis points yesterday.

2. All of these new claimants will be much better looked after than in the past. On this front, the Senate has unanimously passed a $2.2 trillion stimulus package, that is expected to be approved by the House today. Contained in the package is an the unprecedented expansion of unemployment insurance - the Federal government will give jobless workers an extra $600/week for four months, on top of their state benefits, which range from $200-$550/week, depending on the state. Also, the US government is creating of a new pandemic assistance program, which provides jobless benefits to those who don't qualify for traditional benefits. This includes independent contractors, the self-employed and gig economy workers.

So these newly unemployed workers are going to be looked after.

US Senate Passes (unanimously) $2.2tr Fiscal Package

- An unprecedented expansion of unemployment insurance - the Federal government will give jobless workers an extra $600/week for four months, on top of their state benefits, which range from $200-$550/week, depending on the state.

- The creation of a new pandemic assistance program, which provides jobless benefits to those who don't qualify for traditional benefits. This includes independent contractors, the self-employed and gig economy workers.

- Direct payments worth up to $1,200 per adult for those earning less than 75k per year (phased out to zero for those making more than $99k).

- $500bn in loans, loan guarantees and investments to help hard hit sectors. Businesses who take loans must not issue dividends for a year after the loan is no longer outstanding, and must retain 90% of employment levels as of March 24 through September 30.

- $350bn in loans to small business, $150bn in aid to hospitals, $32 billion in grants to airlines.

- Student loan payments suspended through Sept 30

- Protections on mortgage foreclosures and evictions

Finally, although economic growth is collapsing in the West, China is getting back to work. Activity levels are still well below where they should be, but the daily data on real estate sales and coal consumption are moving clearly in the right direction. This provides some hope for what we could see in the west after the lockdown's here are finished, and we move into the warmer summer months.

China getting slowly back to work