

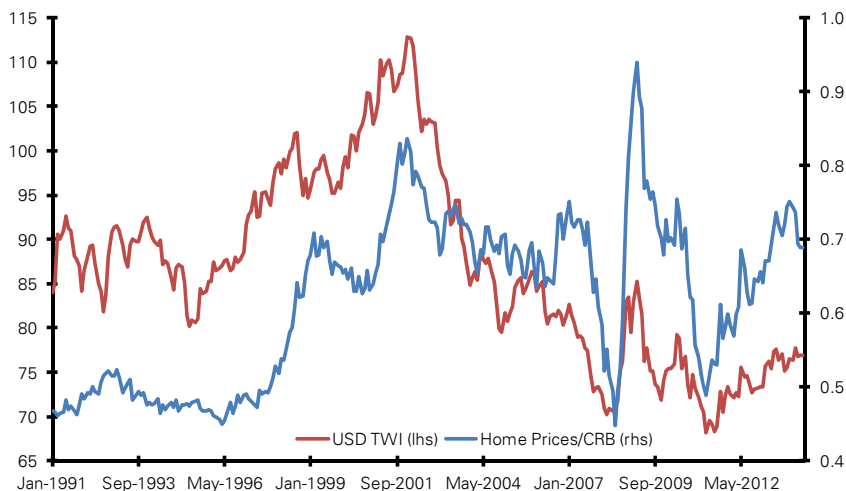


FX Daily

When USD bull runs start slow

- Current macro forces favor contrasting goods disinflation and asset inflation that resemble the backdrop to the USD rally in the second half of the 1990s. The USD is surprisingly not far off the course set in the 1990s – a period in which it is often forgotten how slowly the big USD rally evolved.

Figure 1: USD TWI vs US home prices/CRB Index ratio



Source: Deutsche Bank, EcoWin

In macro terms, similarities (and differences) with the late 1990s have particular relevance for how the big USD cycle and broader asset allocation strategies are seen evolving.

Similarities between the present and the mid - late 1990s are numerous and include:

Real Economy

1. China disinflation. CPI & PPI inflation rates slide (1996 – 98)
2. Negative US import prices (1997 - 99)
3. China GDP decelerates from 10% to 6% (1996 to 2000)
4. A reminder that EM Asia can have a recession (1997- 1999)

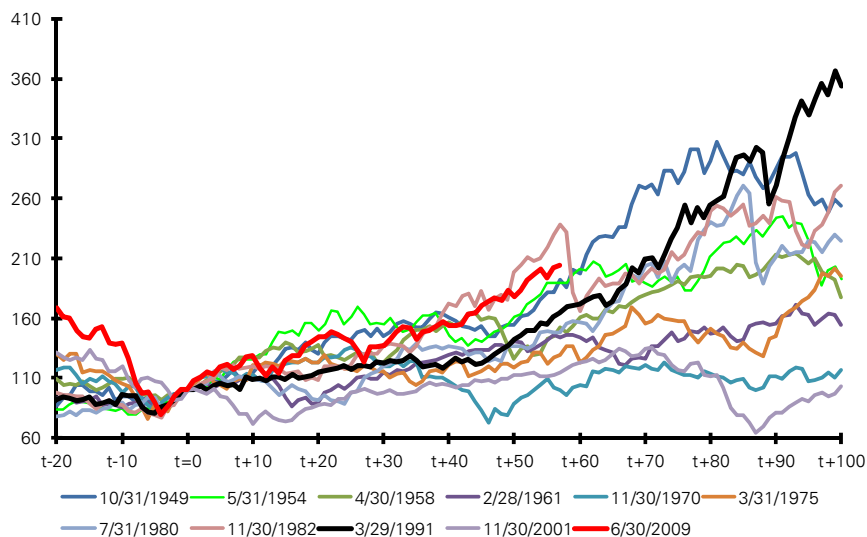


5. US growth outperformance relative to Euro zone (1996 - 2000)
6. Initially weak US recovery, but well balanced, supports upswing longevity
7. Subdued US and global wage/price growth
8. US C/A indicative of modest savings – investment imbalances
9. Strong US corporate profits upswing = strong equity cycle

Financial Markets

10. USD (initial) underperformance after T.Bond sell-off (1994)
11. Yen weakens sharply (1995 – 1998) after surprising strength
12. EM equity underperformance relative to DM (1995 - 1998)
13. Tech stock ebullience (Nasdaq P/E today is above P/E levels through 1998)
14. Spain periphery convergence trade (1995 - 1997)
15. A Russia 'problem' (1998)
16. Equity vol initially low (1995 - 1996) thereafter transitioning to a higher vol regime, led by EM
17. Very soft FX Vol (1996), before G10 vol normalized with Asia crisis and yen vol above 20!
18. Soft commodities (1996 – 2001)

Figure 2: Equities performance during US business cycles (rebased to start of cycle = 100)



Source: Deutsche Bank, EcoWin, NBER

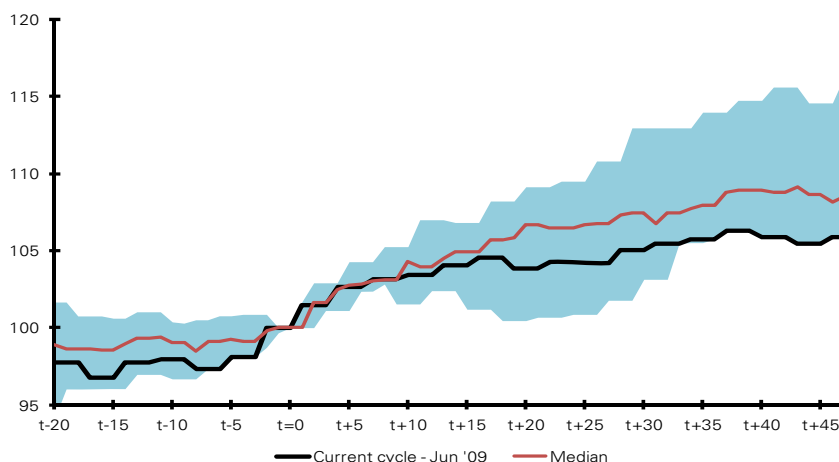


A few big differences:

Monetary authorities in 2014 may recognize the early stages of a return to the 1990s quandary posed by ebullient asset prices that contrast with goods disinflation. In the 1990s, globalization limited wage pressures, while strong US productivity encouraged Alan Greenspan to think in terms of 'a new economy'. A lack of goods inflation pressures prompted accommodative policies that looked beyond asset inflation, encouraging stronger growth, leading to upward revisions to estimates of US potential growth rates.

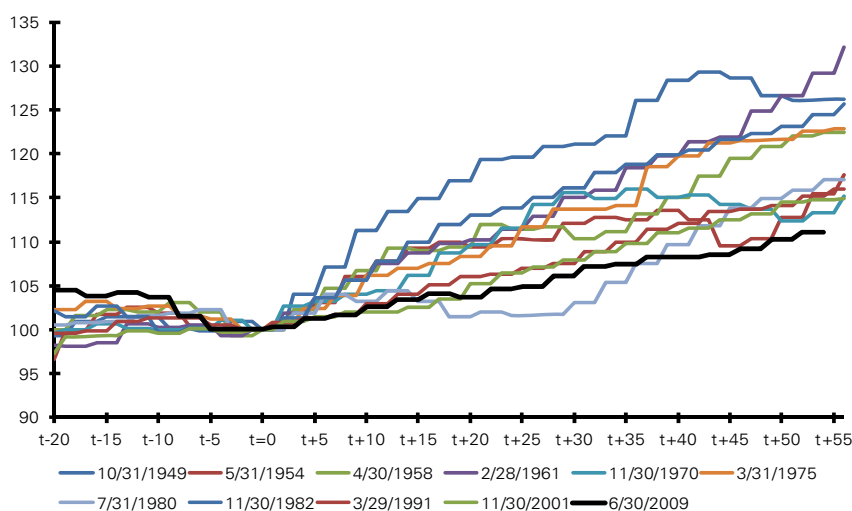
The current cycle also has asset inflation and goods disinflation, but with much weaker productivity growth and relatively subdued investment growth, such that estimates of the US natural rate of growth are if anything being revised down rather than up!

Figure 3: Productivity: nonfarm business output per hour during US business cycles (rebased to start of cycle=100). Slow start in this cycle



Source: Deutsche Bank, EcoWin NBER

Figure 4: US real GDP during US business cycles (rebased to start of cycle=100). Slowest post WW2 cycle.



Source: Deutsche Bank, EcoWin NBER



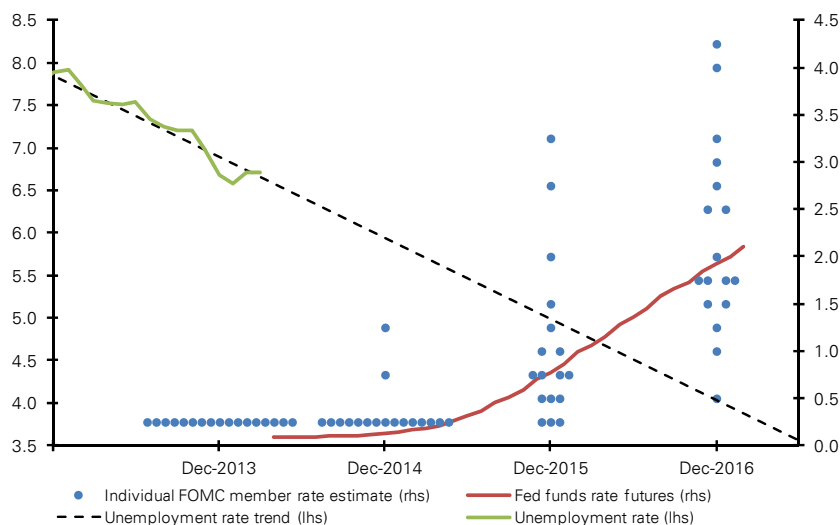
For much of this upswing, G4 Central Banks have struggled to close output gaps because of zero bound policy constraints, and have actively sought to reflate assets to correct legacy balance sheet issues. Optimists (count this author in the more sanguine camp) see the potential for a long US upswing after a slow start, much as the 1991 upswing only really got going after 1995. The constructive view suggests we currently stand at the equivalent of 1995 or 1996 with say 5 years of upswing to come. In contrast, secular 'stagnationists' see risks that the economy can only reach full employment objectives with financial excesses and emphasize the eventual vulnerabilities from a high amplitude asset cycle amid limited policy flexibility. Note both camps are inclined to see strong cyclical upswings for select asset prices, including housing and equities.

Similarities and differences with the last USD bull cycle: USD implications

For the USD, there are a number of important differences between the current cycle and the 1990's USD bull run:

1. Four years into the 1990s recovery, the funds rate had already been raised 300bps from an unusually low rate of 3%, to 6% - a mid-cycle peak that was not exceeded for another 5 years. In contrast, in the current cycle all the Fed has done is trim QE, suppressing long-term rates a little less than before. The bad news signal for the USD, is that the USD needed quite a push from sizable Fed tightening before the currency responded in the 1990s. The good news for the USD is there is plenty of Fed catch up tightening to come for the markets are still pricing in a very dovish Fed scenario.

Figure 5: Fed funds futures versus FOMC 'dots'

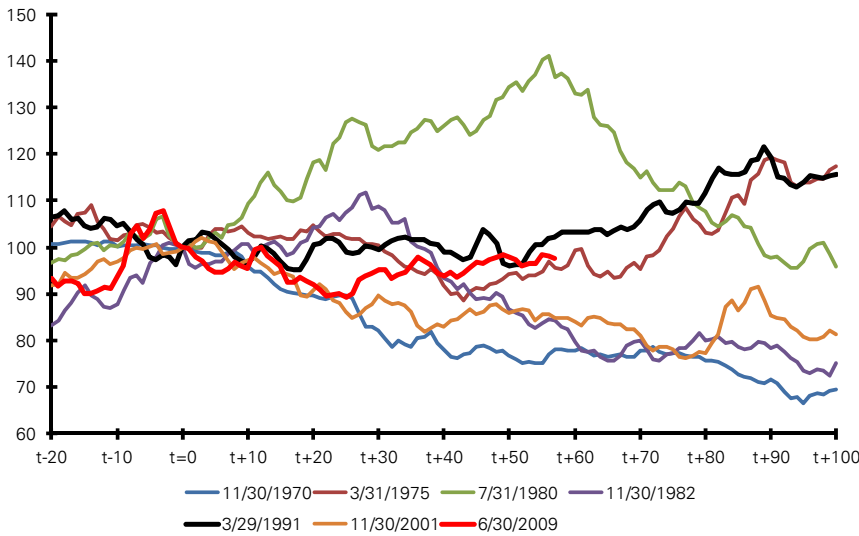


Source: Deutsche Bank, EcoWin, Bloomberg Finance LP, Federal Reserve Board

2. In the 1990s US upswing, the USD based in 1995, but only started to make a concerted break into new terrain over 6 years into the recovery in 1997, when the contrast between the travails in EM and the resilience of the new US economy became more obvious. This only emphasizes the extent to which patience is needed in trading large currency cycles and for that matter the difficulties of trading a big currency cycle in one direction.



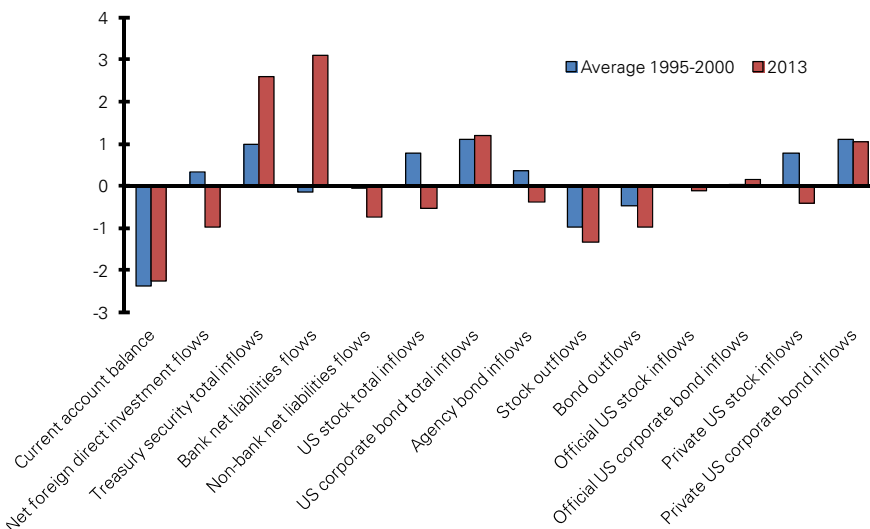
Figure 6: US real exchange rate during US business cycles (rebased to start of cycle=100). Look at the slow start to the 1990s USD bull run



Source: Deutsche Bank, EcoWin NBER

3. The balance of payments comparison in Figure 7 below, shows a comparable C/A deficit as a share of GDP currently to what the average deficit in the late 1990s. However the financing of the C/A deficit in the last 2 years lacks the net FDI and net equity inflows of the late 1990s, and has primarily been replaced by short-term bank liability and Treasury bond inflows. It is also clear that net FDI and equity inflows of the 1990s will have to be made up for with 2 key features: (i) reduced FX hedge ratios (equals USD buying) on foreigners holdings of US assets as short-term US rates rise, and (ii) increased holdings of US Treasuries either for flight to quality reasons, and/or because long-term rates are nearer normal and there is reduced duration risk.

Figure 7: How the C/A deficit been financed: US BOP components as a % of GDP – comparison of 2013 with average for 1995-2000.

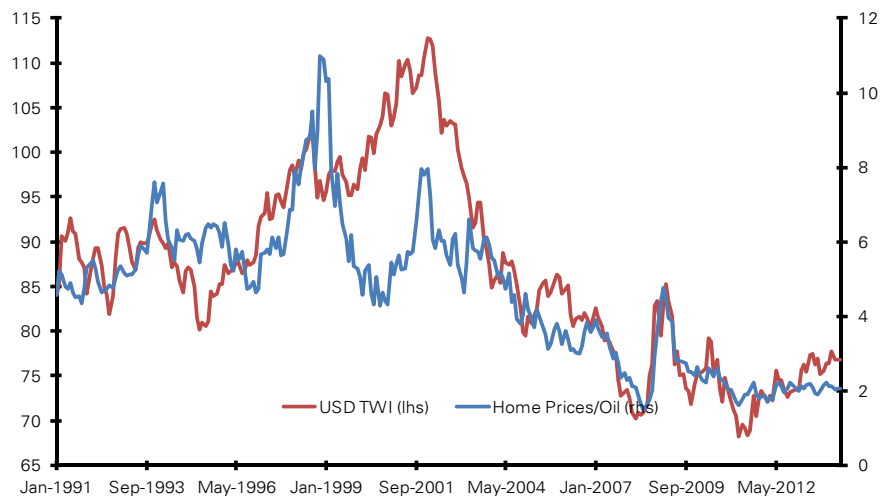


Source: Deutsche Bank, EcoWin



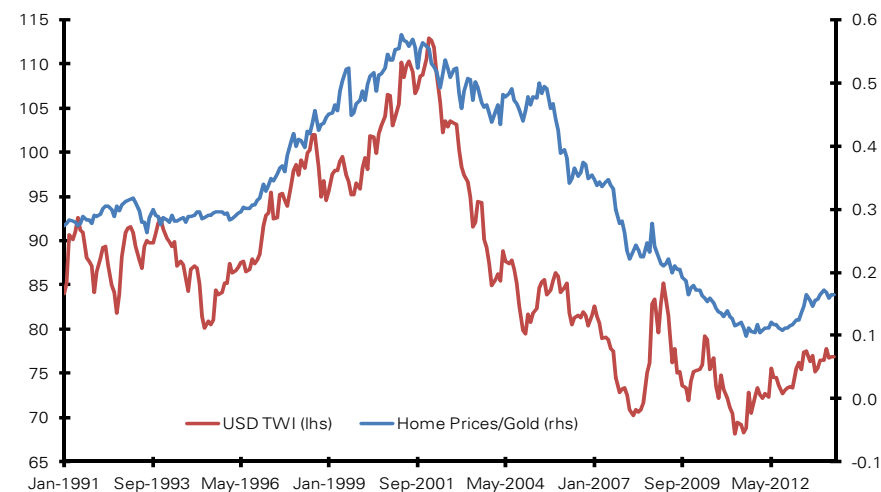
- The 1990s experience suggest that higher US rates, that add to the divide between US and EM asset market prospects would be extremely helpful for the dollar's revival. A proxy measure for this state of the world is the ratio of US home prices (indicative of domestic demand and the Fed rate cycle); and the CRB (US terms of trade improve with lower commodity prices) – See Figure 1.

Figure 8: USD TWI vs home prices/oil ratio



Source: Deutsche Bank, EcoWin

Figure 9: USD TWI vs home prices/gold ratio



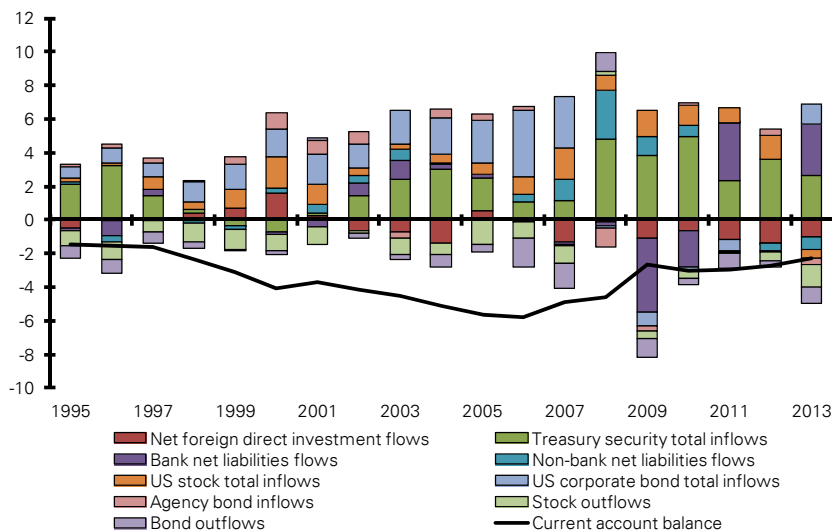
Source: Deutsche Bank, EcoWin

- The ratio has tended to pick out most of the bigger USD trends. This is consistent with a world of strong US asset inflation, and soft EM led commodities and goods inflation forces which is largely described in 'the similarities' to 1990s above. This is happening, but not with the vigor of the late 1990s, not least because of concerns about a weaker US natural rate of growth, and therefore a lower equilibrium natural rate of interest. The USD can still go up with a lower USD (long-term equilibrium) natural rate of interest, if the Fed moves earlier than most other Central Banks. Circumstances are evolving in this direction, albeit on a very slow path, but then it is easily forgotten how



slowly the USD rally evolved in the 1990s. An unusually slow but balanced US recovery likely has multiple years to provide additional USD support in an elongated but moderate USD bull cycle.

Figure 10: US current account balance vs financial flows (% of GDP)



Source: Deutsche Bank, EcoWin