ALPHA SOURCES

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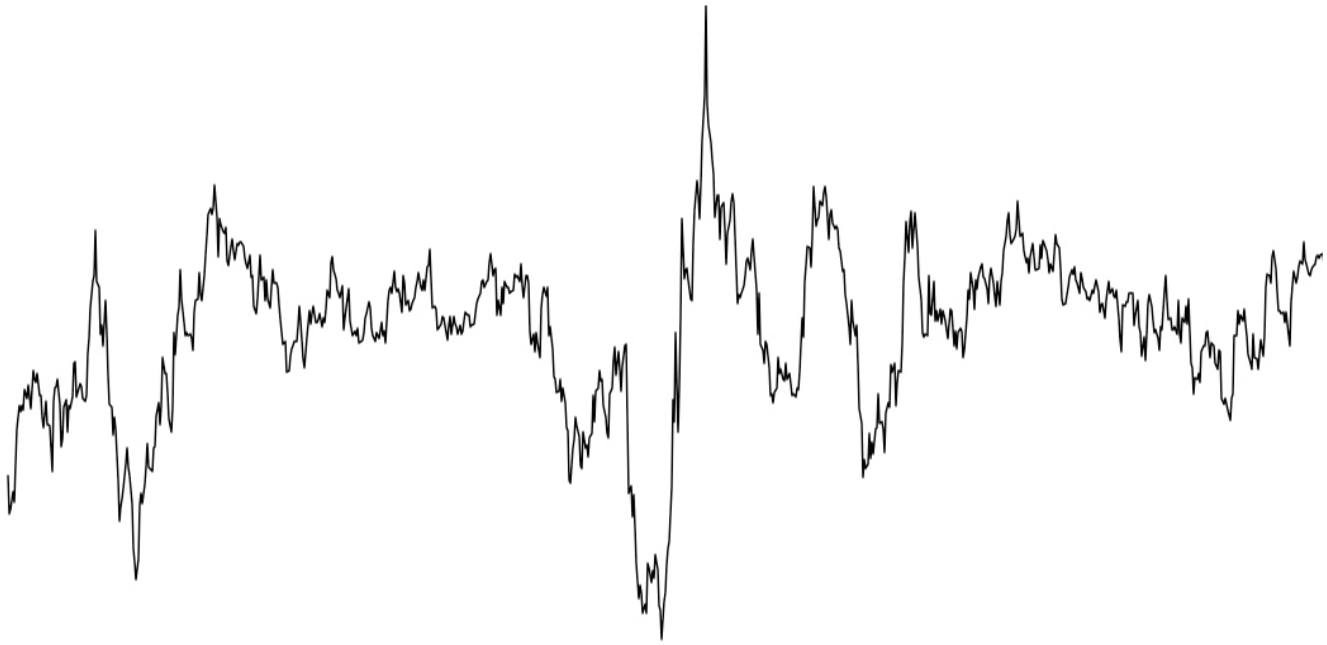

AGREEING TO DISAGREE ON DXY

One of the more interesting stories in markets last week was the disagreement about whether investors are bullish or bearish on the dollar. On the face of it, this is a silly debate. Clearly, sentiment has become significantly more positive on the dollar in the past three months, lifting the DXY index up by nearly 6% to a nine-month high of just under 95.0 at the start of Q3.

On occasion, I nail my colours to the mast and try to come up with short-term ideas in equities and bonds, but I am generally loath to do it in FX markets. Currencies have a tendency to do the exact opposite of what macroeconomists predict that they will. *Usually, the stronger the conviction of economists, the stronger the countermove.* With that warning in mind, I think it's worthwhile looking at the *stories* which currently are propelling the dollar.

The macroeconomic argument for a stronger dollar is simple. The synchronised global recovery has become de-synchronised since the beginning of the year, and the U.S. economy has emerged head-and- shoulders above the rest. Not only that; Europe and China have *slowed* while the U.S. economy appears to have gathered strength in the second quarter.

This divergence in macroeconomic performance predictably has cast a

shadow over global monetary policy. The Fed has raised rates twice this year, and recently added a fourth dot to its 2018 forecast. By contrast, the ECB has all but promised not to raise rates until the second half of next year, at the earliest, and in the U.K., the BOE is struggling to get off the mark too. In Asia, monetary policy in China is being loosened—which tends to deliver a weaker Yuan—and in Japan, the BOJ doesn't appear to be moving an inch either.

Global monetary policy divergence is a consensus story at this point, but the balance between the protagonists is interesting too. **The burden of evidence is on the Fed to convince markets that it will keep going even as the rest of the world is stationary.** The alternative, and equally plausible, narrative is one in which the Fed is a leading indicator, dragging the other major central banks along. So far, the federales have been clear in their message that they'll keep going, regardless of what others do. As long as this is the case, and the U.S. economy remains strong, this has clear implications for the dollar.

A simpler way to gauge how markets are positioned on the dollar is to look at the COT data. The first chart below shows that speculators are still net-short dollars, although they are have reduced their bets in the past 4-to-6 weeks. Based on this chart, the dollar can rise further as shorts fall by the wayside.

I have another theory. The stronger dollar is a sinister plot by the market to show Mr. Trump that he is winning and losing the trade war at the same time. The first part of this argument is simple. A tit-for-tat tariff trade spat hurts Europe and Asia more than it hurts the U.S. As long as capital is flowing freely, the dollar will be pushed higher.

The twist in this story then is that Mr. Trump and Mr. Navarro end up with the exact opposite result—a *wider* CA deficit—than what they're trying to achieve. The pessimistic view is that the White House doubles down and do something crazy, effectively slamming wholesale curbs on capital mobility. But perhaps the failure to reduce the trade deficit via tariffs could also be what is needed to flush out Mr. Navarro and co.

fig. 01 / Not all flushed out yet — fig. 02 / A clear message from rate differentials