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'Buy Scarcity, Sell Abundance'

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Last time, we reviewed the macro trends for Q1 2024. We noted rising bond yields, dollar and commodity prices driven higher by a stronger than expected US economy, and a manufacturing recovery in China, all conspiring to make inflation sticky. These factors tightened financial conditions as investors began to expect fewer and smaller interest rate reductions for the year ahead.

More recently, we have noted some weakening signals from the US economy and emerging signs of stress in the global financial system. Although this didn't move the FOMC (Federal Open Market Committee) to adjust US policy rates at their latest meeting, there was an important message about reducing its balance sheet. This lessening of Quantitative Tightening (QT) equates to a net boost in dollar liquidity and is QE by another name. Importantly, such loosening frees up balance sheet capacity elsewhere in the dollar system, easing financial conditions.

As liquidity watcher Mike Howell put it, The Fed and Treasury are working together to control future duration supply. The latest FOMC and QRA (Treasury Quarterly Funding Announcement) show that Fed Chair Powell and Treasury Secretary Yellen are aware of the need to preserve liquidity.

Subsequently, the dollar index (DXY), commodity prices, and US 10-year bond yields have all eased, and equity markets have risen. Crucially, for the world financial order, the value of the Yen has recovered and stabilised, and immediate fears of an Asian currency crisis have abated.

However, the Treasury and Fed working together to control future duration supply is Yield Curve Control (YCC), a policy adopted by Japan since 2016. YCC extends QE along the curve, artificially depressing longer-term yields. Usefully, we have just learned how YCC has been going for the Bank of Japan, and it isn't good.

Last week, the Bank of Japan blew an estimated $50bn of reserves to protect the value of the Yen against the burgeoning carry trade opposing it. This move put upward pressure on US bond yields and undermined Yellen's prized borrowing facility. While the immediate pressure on the Yen has declined, it has lost ~15% of its value to the dollar year to date and over 50% over the last three years; the situation remains fragile.

So, does this mean that US fiscal dominance and YCC will lead to the dollar's collapse? Probably not, at least in the short term. With its global reserve currency privilege and deep liquid debt markets, the dollar remains the yardstick against which all other currencies are measured. It is the cleanest shirt in the laundry basket. Yet, despite this, foreign central banks and other reserve asset managers have chosen to diversify into non-dollar assets, notably gold, raising the concern that dollar supremacy is not a forever certainty.

Is inflation now beaten? The answer is yes in the short term, particularly if the US slowdown gathers pace. However, structurally lower inflation requires the helping hand of productivity growth, which means accruing significant and widespread benefits from artificial intelligence (AI). Until this happens, financing government spending takes precedence over monetary policy, which means a compliant central bank with lower interest rates but elevated through the cycle inflation.

If the dollar is the least dirty shirt in the pile, then the UK pound is only slightly grubbier. Following the Truss 49-day think tank experiment, Sterling qualifies for the most improved player award among developed world currencies. It has traded in a narrow band to the dollar for 18 months and appreciated against most other major currencies.

Forecasters have consistently underestimated the UK economy's resilience and ability to fend off inflation, and the UK GDP data due after we publish this week should continue this trend of outperforming low expectations. Commentators and asset managers increasingly suggest the UK is an appealing home for capital, implying policymakers can, in theory, consider lowering rates.

Will the UK be prepared to lower interest rates ahead of the US Federal Reserve? The answer is not clear or straightforward. But if they do, and June seems the favoured time, it will further boost UK equities, particularly smaller capitalised domestically focused companies. It should also benefit other domestic assets such as Gilts and house prices.

Yet, delaying rate cuts due to fears of currency volatility could mean financial conditions remain too tight and something breaks. The last time investors lost confidence in the UK's finances, the Liability Driven Investment (LDI) blackhole within our pension funds set off a toxic doom loop in the Gilt market; this time, who knows, while history doesn't repeat itself, it could still spell trouble in rhyming couplets.

For now, improved dollar liquidity re-injects life into risk assets, including equities. Further, the UK enjoys a better than expected economic and financial toehold in the global system, which could grow into a firmer foothold as volatility spreads elsewhere. However, the ticking time bomb of ballooning government debt remains.

Fiscally dominant governments in an increasingly fractured world mean elevated inflation will persist beyond the current cycle without dramatically improved productivity measures or serious attempts to tackle debt-bloated government exchequers. As investment strategist Lyn Alden said in her latest public newsletter, *most successful investing can be summed up as "go short abundant things and go long scarce things." In an era of fiscal dominance, bonds are among the most abundant things around.*

Meanwhile, equities remain an attractive long-term asset class. But in a world of increasing fiscal dominance, the stock-picking skills of active management become more critical in a changing risk environment, and weightings to real assets might be preferable to bonds.

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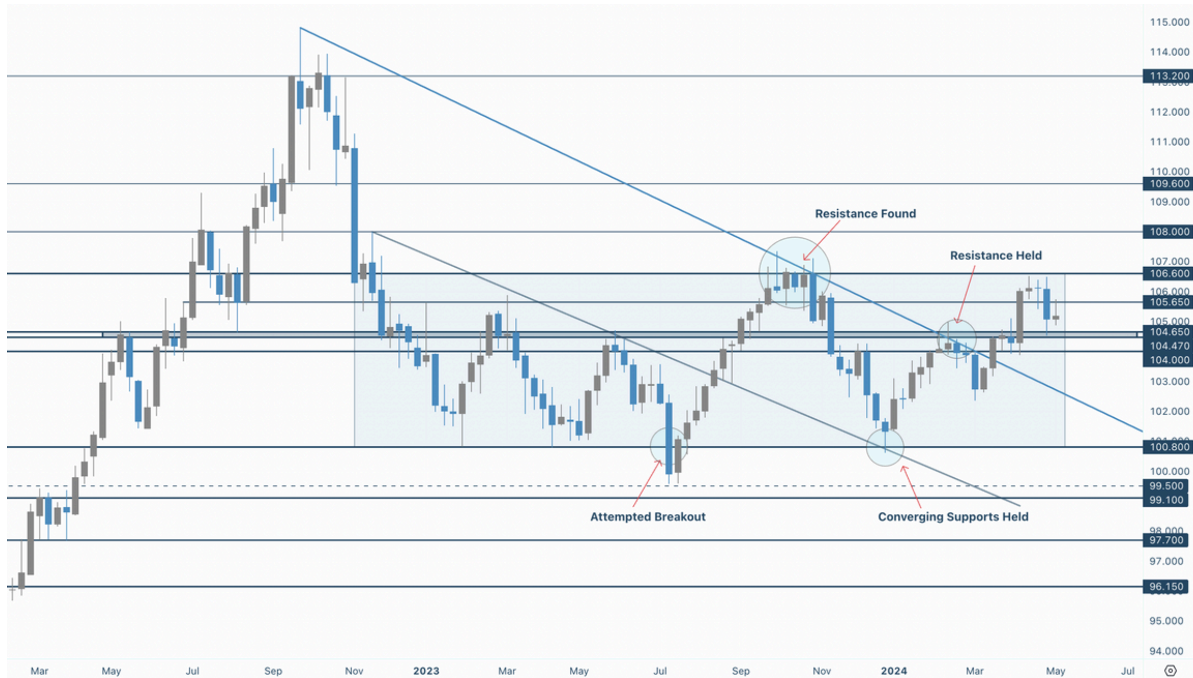
JACKSON'S CHART - DOLLAR (WEEKLY)

An analysis by Jackson Wray



Source: TradingView.com

EXPLANATION

DXY (Weekly) - It has been almost 10 months since we covered the Dollar Index when an attempted breakout of 100.800 unfolded. In the days following that issue, the DXY reclaimed this critical level and continued the momentum by printing 10 consecutive weeks of bullish candles. Clearing the descending trend line highlighted previous resistance levels in the 104.000 area and 105.650, finally pausing at 106.600, where a battle commenced. Weakness in the dollar's relative strength pushed the price back lower, breaking multiple supports until the price hit the crucial 100.800 again. The convergence of two key supports proved to be very strong, and a move north followed back up to a newly formed trend line and the 104.470-104.650 zone; both resistances put up a good fight but finally broke after 9 weeks of price action. From this perspective, there have been significant moves since November 22, but ultimately, the DXY has remained rangebound in the 100.800-106.600 region.

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FURTHER READING & LISTENING

- Balanced Portfolio Construction
- Mindless compassion is leading us towards the end of our civilisation
- How the US controls the world
- Dollar Milkshake Update

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