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The Dollar Dilemma and US Stocks

Summary

- Despite the strong performance of the US economy, we question the sustainability of US stock outperformance
- The US dollar is currently overvalued against major currencies, and tightening rate differentials could lead to a weaker dollar
- Emerging markets could benefit as capital works its way back to Japan and China

The case against US stocks

US stocks have continued to make new highs while the rest of the world has fallen behind. The S&P 500 is up over 20% YTD and over 50% since 2023. There have been few better places to put your money. We cannot dispute the rationale for this outperformance; the US economy is in a league of its own. Higher rates are supporting companies with solid balance sheets, and resilient consumers are helping smaller businesses maintain solid pricing power and, thus, profit margins. There is a strong case to be made that given the liability structure of the US economy, higher rates have proved stimulative for the economy.

Debt-laden small businesses and lower-income households reliant on debt to finance everyday purchases would rightfully dispute this claim. However, the US economy remains in great shape, and as we progress through a Fed easing cycle, US stocks can continue their momentum higher.

Today's consensus is that the US economy will undergo a soft landing and a Trump victory is automatically bullish stocks. While we may sympathise with the former, we are cautious about how aggressively markets are pricing in a bullish outcome related to a Republican victory. In 2016, many believed that a Trump victory would be bad for stocks. Markets sold off on election night as Trump looked set to win. However, markets rallied behind Trump's pro-growth policies in the following days and weeks. Markets don't want to make the same mistake again, so everyone is piling into stocks today as Trump probabilities edge higher. A Trump victory may be positive for growth, given his looser spending and tax policies, but investors should pay close attention to the bond market. The yield curve would surely steepen in the event of a Trump win, particularly if this is met with a Republican sweep.

More robust growth, widening budget deficits and higher long-run inflation expectations would all put upward pressure on longer-dated government bonds. Stocks may like pro-Trump growth policies, but they would be negatively impacted through multiple compression were 10-year yields to hit 5% again. Investors may be underestimating the risks to the bond market from a Trump win and the potential

spillover effects on US equities. We saw this unfold towards the end of Q3 last year when yields hit 5% as investors refused to pay up for duration due to elevated Treasury issuance. Stocks declined over 10% as yields widened from 4% to 5%. We are not suggesting that the same thing will happen this time as the dynamics are different, but we are attentive to the risks a Trump win poses to stocks from another bear steepening episode.

Chart 1: August 2023 bear steepening episode



The US dollar is set to weaken

The US dollar is currently overvalued against every major currency. Republicans and Democrats are seeking to reindustrialise America and restore blue-collar jobs, so they will look to find ways to devalue the currency. For argument's sake, let's just assume Trump wins. The most realistic way for him to devalue the currency would be through direct FX intervention, though this seems unlikely and a waste of resources. His policies are overwhelmingly pro-dollar, so seeing how he looks to engineer a lower dollar absent a US recession will be interesting. Even if we don't see a recession, we see several pathways to a lower dollar.

The Federal Reserve has begun its easing cycle and retains a clear easing bias, irrespective of recent data strength. Currently, 140 basis points of cuts are priced until the end of 2025, implying a terminal rate below 3.5%. This type of pricing doesn't scream recessionary but rather normalisation. Still, the dollar could weaken significantly due to tightening rate differentials. We saw this play out in August, when the BOJ hiked rates just before a weaker-than-expected US jobs report, sending USDJPY tumbling. Although USDJPY had started to decouple from rate differentials earlier; these two events triggered a sharp convergence.

Chart 2: USDJPY and US/Japan rate differential



What we saw in July and August will likely play out over a longer timeframe and in a more orderly fashion. Japanese investors have long been net buyers of US stocks and bonds, taking advantage of the higher-yielding US dollar by borrowing Yen to purchase these assets. However, with the US now easing and Japan tightening, narrowing rate differentials will make this strategy less effective. A higher-yielding Yen and a lower-yielding US dollar will likely prompt repatriation of capital back to Japan.

This is important for two reasons.

First, foreign ownership of US stocks has surged from 33% in 2010 to 58% today, an unprecedented increase. Second, Japanese investors are the largest holders of US assets. With these factors at play, foreign holdings of US stocks are more likely to fall as investors reduce US exposure and repatriate funds. This would involve selling US stocks and converting the proceeds back into Yen, causing a decline in USDJPY.

US bonds could face a similar fate. While foreign holdings of US Treasuries have declined, Japan remains a crucial buyer of US debt. A further reduction in demand from Japan—given the current and expected levels of debt issuance—could push US yields even higher. This ties back to the earlier discussion: a prolonged bear steepening of the yield curve could tighten financial conditions and compress equity valuations, meaning trouble for US stocks.

Chart 3 illustrates how closely tied the US dollar and US equity outperformance have been. Non-US investors have consistently bought dollars for decades to gain exposure to the big US tech and innovation story. However, were the dollar to break down from today's levels, driven by tightening rate differentials, we would then enter a period where the risks to an over-owned US equity market would require investors to hedge with other assets. Alongside the possible bursting of the AI bubble and a hard landing, this repatriation dynamic is one of the most significant risks to continued US equity outperformance, likely playing out over the next 12-18 months.

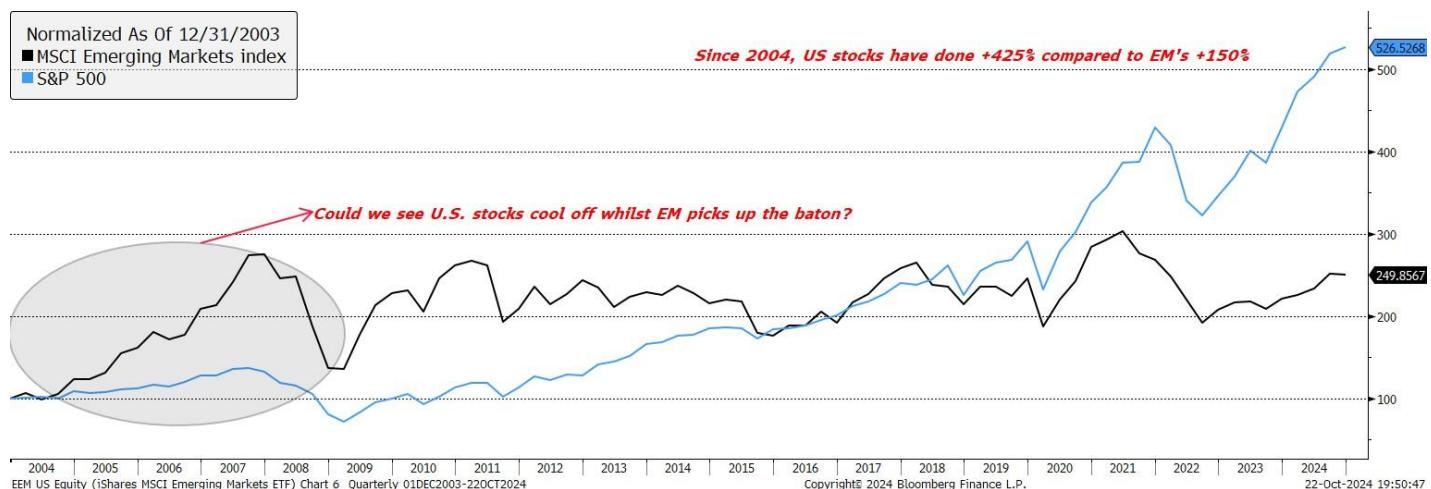
Chart 3: Non-US investors have been buying dollars to buy US stocks



Emerging markets may have their moment

The repatriation thesis could also play out in China. Although access to US markets for Chinese investors is difficult, many have increased exposure to US equities. This isn't just a function of a strong US economy or the allure of AI but more so the wealth destruction at home due to declining property and stock market values. Were economic conditions and market sentiment in China to improve, Chinese investors could take some US chips off the table and reallocate to domestic markets. Although the bar for repatriation may be higher in China than in Japan due to its structural challenges, there is considerable scope for capital to flow back into Asia. This shift could exert downward pressure on the dollar, creating a negative feedback loop that strains US stocks and the dollar. With the US dollar more likely to weaken than strengthen from here due to the reasons posited, emerging market currencies could stand to benefit, enhancing the appeal of EM assets.

Chart 4: Will the gap between US and EM converge?



Today, investor enthusiasm for emerging markets is thin. As reported by Bloomberg, since 2020, the ETFs that invest in developed countries have attracted 19 times more capital than those focused on developing ones. That's nearly a four-fold increase from the period between 2005-2009. This shift marks a stark contrast from the 2000s when EM was the place to be. In 2007, the EM index traded at a 25% premium to the S&P 500 as a multiple of average earnings. Today, emerging markets are trading at a 44% discount. Given this valuation gap, it's tough to see EM assets remaining this undervalued for much longer.

Making a case against the US equity market is difficult. It's been the clear winner for over a decade, and it's natural for investors to flock towards the winners. However, from a portfolio rebalancing perspective, with rising term premia driving US yields higher and tightening rate differentials triggering capital repatriation into Asia, we think investors should be thinking seriously about how they can hedge against US underperformance. Emerging markets, in particular, stand to benefit in this scenario.

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