

11/ Ifr. Trump does what he promised to do, there's no way we will get a strong US Dollar

It is our view that the single most important factor impacting global markets in 2017 will be the value of the U.S. dollar. The currency's relative valuation impacts such heavyweight constructs such as US monetary policy, US corporate earnings, global trade flows, domestic capital budgeting decisions, the flow of capital into and out of emerging economies, and yes, global GDP growth, thereby global macro stability -- all of those are heavily influenced by the changes in the valuation of the dollar. Therefore, the primary driver of performance for almost any asset class in 2017 in both the Developed and Emerging Economies will be the Dollar (see three charts below).

The overwhelming consensus view among global strategists is for another year of USD broad-based appreciation. We have trouble subscribing to this almost universal view, as that outlook primarily invokes the data set of short term interest rates and divergences in central bank monetary policy --- which

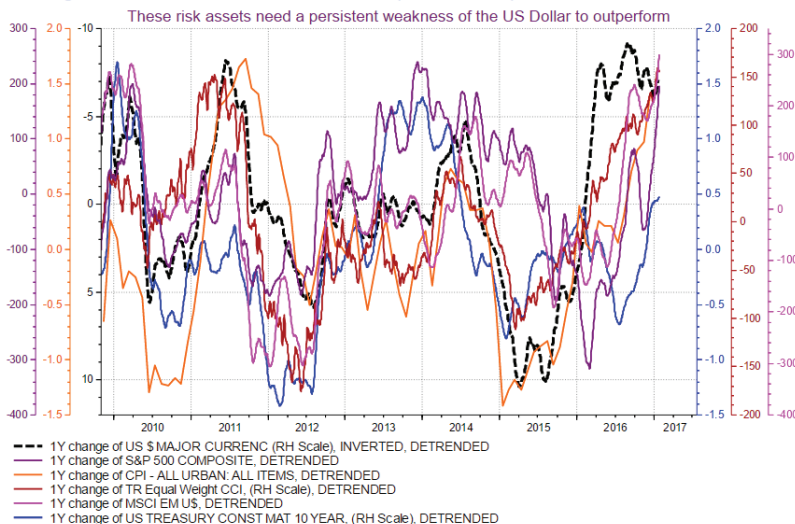
unfortunately sometimes provide long-duration, false-positive signals in correlation tests. There are other rationales invoked for a stronger US Dollar in 2017: further Federal Reserve tightening, supposedly leading to higher real interest rates in the U.S. which attracting assets away from competitor nations, the there-is-no-alternative meme (TINA), Brexit and populism weakening the standing of the pound and the euro, respectively, at a time when Japan is actively promoting a weaker yen in further attempts to boost domestic growth and inflation.

On top of all these, there's this persistent belief of some investors that the prospective effect of The Donald on the US economy (not to mention investor psychology) will continue to buoy the US currency (and other markets) against USD rivals. There are more nuanced and more sophisticated analyses, of course, and the most logical (to us) seek to provide answers to (1) what is the broader outlook for

the US economy in 2017 as Mr. Trump implements his campaign promises which he said he will all do; (2) will President Trump policies seek to raise the growth profile and thereby push up the net returns on net capital stock (NCS) in the US economy by protectionist intervention (US stock of fixed assets grow at the expense of the Rest of the World (RoW)?(3) will he try to bump up growth and return on NCS through significant tax cuts and deregulation?; (4) will GDP and NCS returns growth come through massive infrastructure spending?

NCS, in this regard, is "physical capital" or capital which is a factor of production (or input into the process of production), consisting of machinery, buildings, computers, and the like. Wikipedia describes "physical capital" as fixed capital, a kind of real physical asset that is not used up in the production of a product. In economic theory, physical capital is one of the three primary factors of production, also known as inputs in the production function. The others are natural resources (including land), and labor. "Physical" is used to distinguish physical capital from human capital (a result of investment in the human agent), circulating capital, and financial capital. Net returns on net capital stock in the economy is a metric worthwhile watching as Mr. Trump strong-arms domestic and foreign manufacturers into investing in the country in the form of factories, using the threat of significant duties for products

Changes in the valuation of the US Dollar impact a wide spectrum of financial assets, data



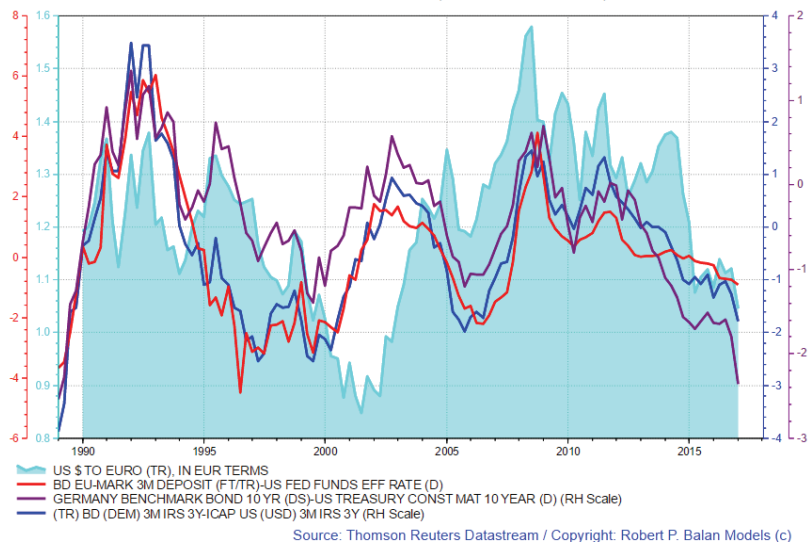
Source: Thomson Reuters Datastream / Copyright: Robert P. Balan Models (c)

built by US manufacturers abroad when exported into the country. Changes in net returns on NCS had historically tended to lead US growth changes by one year, and also has great influence on the growth of US private fixed investments by domestic businesses, and consequently, on the US Dollar valuation. There has been a long negative correlation between the net returns of NCS and changes in the value of the USD. Stronger NCS net returns have been followed by weaker value of the US Dollar, and also a stronger pick up in private, domestic fixed investments (see chart below).

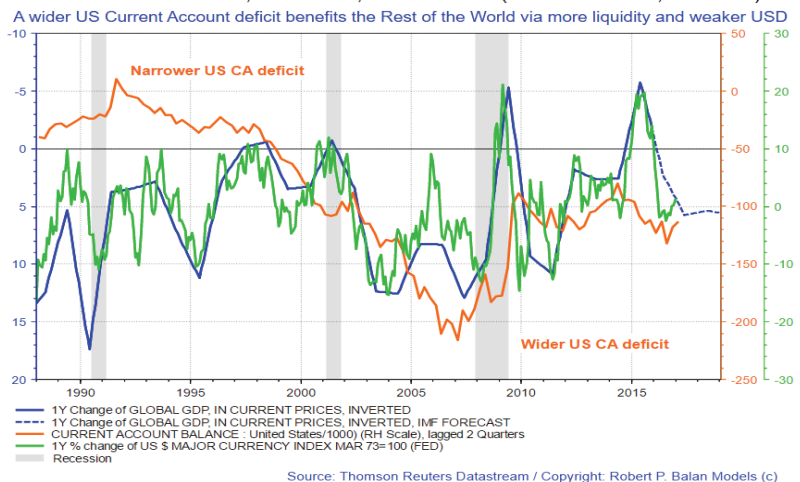
It is also important to understand which route he will take or which policy mixes he would eventually employ, as his choices can have very different impacts on asset classes. For instance, aggressive protectionist intervention rearranges the existing, post-World War II world order, as it suggests the US is no longer willing to provide excess liquidity to the Rest of the World (RoW) when needed through a wider current account deficit (and the concomitant global growth and weakening of the US Dollar that it brings).

We all know what aggressive protectionism brought in the 1930s -- a global depression. That outlook has considerable implications for the attractiveness of long-dated treasuries in case Mr. Trump decides to go this route. Will growth come via significant tax cuts and deregulation? The implications here are of robust US and global growth, and rising real rates across the globe -- that underlines the attractiveness of cyclicals and financials everywhere. It also means the likely underperformance of hedged and financially-engineered assets, private equity, and assets that owe their value to scarcity (art, collectibles). So far, (and since Mr. Trump won the election) the

US-GERMANY SPREADS: BOND YIELDS, POLICY RATES, SWAP SPREADS



US Current Account, US Dollar, Global GDP (Current Prices, Inverted)



market is clearly pricing in this particular scenario. Or will The Donald opt for that old, reliable standby -- massive infrastructure spending? This presents (to us) the most interesting option from an analytical point of view, as wider US deficit spending clearly brings about significant changes in the behavior and performance of all major asset classes, and above all, in the direction of the US Dollar.

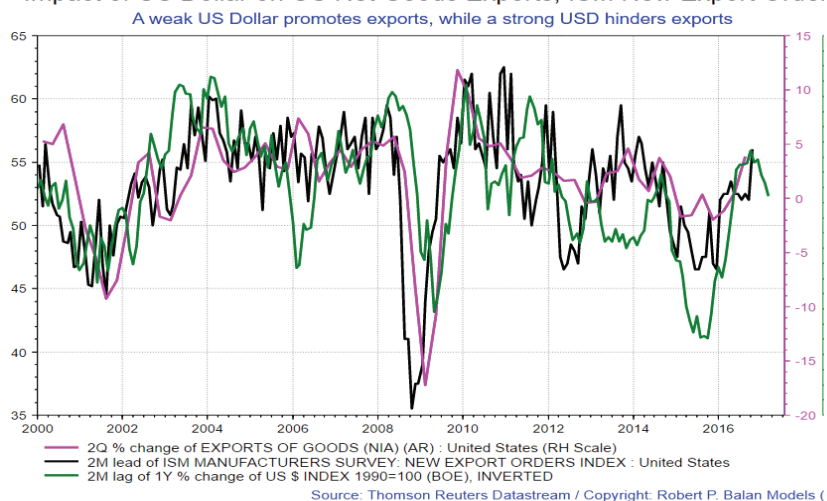
Mr. Trump recently complained about the excessive value of the US Dollar (specifically against the Chinese yuan), an initial broadside in what we believe will be a constant refrain over the coming days. Mr. Trump has chosen the repatriation and the creation of new jobs in the US as the spearhead of his government policy thrust,

rates across the globe -- that underlines the attractiveness of cyclicals and financials everywhere. It also means the likely underperformance of hedged and financially-engineered assets, private equity, and assets that owe their value to scarcity (art, collectibles). So far, (and since Mr. Trump won the election) the market is clearly pricing in this particular scenario. Or will The Donald opt for that old, reliable standby -- massive infrastructure spending? This presents (to us) the most interesting option from an analytical point of view, as wider US deficit spending clearly brings about significant changes in the behavior and performance of all major asset classes, and above all, in the direction of the US Dollar.

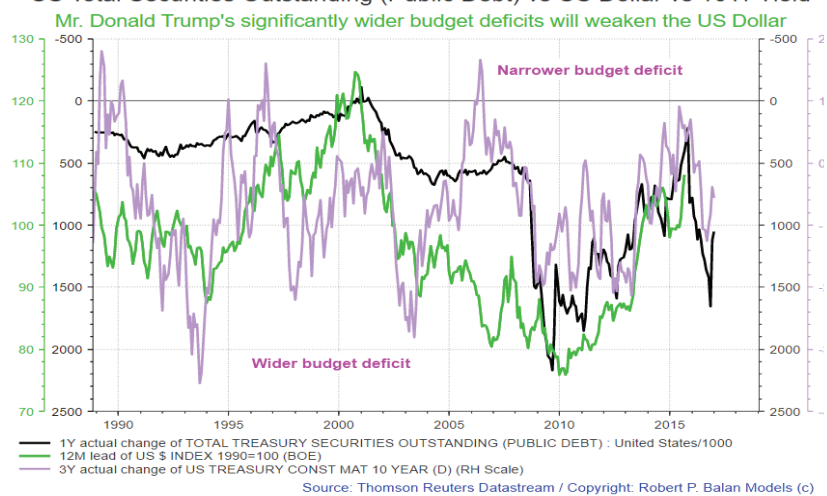
and his recent Twitter tweets brings this beyond doubt. Now, if we are to believe Mr. Trump's mantra of bringing jobs back to the US, then his recent broadside (and more to come) against a strong US Dollar, totally makes sense. There is no way he can make that promise of bringing back those jobs to the US come true with a strong US Dollar. A manufacturing renaissance in the US is simply not sustainable with a strong currency, like the one we have now. The fact is, a strong USD kills exports growth in the US (see chart below), so Mr. Trump's government will want to engineer a weaker currency; and as we can see, he and his ministers have already taken steps to undercut the US unit's strength. By killing exports, a stronger Dollar also negatively impacts GDP growth. The transmission of a strong US Dollar's effect runs through US net exports which are negatively impacted by a strong US Dollar, as we said. Weaker net exports therefore weaken US GDP growth. The negative effect flows from the US Dollar to GDP, not the other way around.

The market believes that tax cuts and deregulation will be the primary tools Mr. Trump will deploy to kick-start US growth. The market is still far from convinced that a Trump government, owing to a Republican-held US Congress, will go via the route of significantly wider budget deficits. This market belief could be misguided. There is this persistent post-financial-crisis myth that austerity-minded conservative governments always, or at least tend to, favor fiscal prudence. The myth also goes on to claim that on the other hand, redistribution-oriented progressives view large deficits as "free lunch" on a "tax-and-spend" agenda. This simplistic perspective, while perhaps containing a grain of truth, badly misses the true underlying political economy

Impact of US Dollar on US Net Goods Exports, ISM New Export Order



US Total Securities Outstanding (Public Debt) vs US Dollar vs 10Yr Yield



of deficits, according to the economist Kenneth Rogoff. Mr. Rogoff further claims that the truth is whenever one party has firm control of government, it has a powerful incentive to borrow to finance its priorities, knowing that it won't necessarily be the one to foot the bill. Significantly, if Mr. Trump makes true his promise to increase deficit spending for massive infrastructure rebuild, there is no way for the US Dollar to remain strong with that massive addition of US Dollars in the global system (the latest talk among Republican Congress leaders point to prospective 9 Trillion\$ addition to the budget deficits over several years). Massive increases in US debt (resulting in wider deficits) kills the US currency, as a very large supply of US Dollars will reduce the currency's relative value (see chart below). This is almost a given, if seen from

this perspective. Therefore, we suspect that the reason for some manufacturers are promising to take jobs back to the US is that they also see a future USD devaluation by massive deficits, thereby making goods manufactured in the US price-competitive again by a significantly weaker US currency. As we said, we already know the winner in a tussle between Mr. Trump and a strong US Dollar. Whoever believes that Mr. Trump's allusion to a strong US Dollar killing US companies in competing globally (especially against China) is just another impulsive rant, is totally missing the big picture.