THE GREAT MONETARY DISORDER: A NEW GOLDEN AGE FOR GLOBAL MACRO

Bottom Line:

1 – Globally-coordinated efforts to suppress currency volatility since the 2008 G-20 have been mostly successful
2 – Due to ZIRP, YCC, and financial repression, yields will not be able to contain the next currency crisis
3 – The U.S. Dollar, which anchored the global monetary order, has entered a secular bear market
4 – Latin America is a great short-term trade on the weak USD as currencies should catch up with commodity prices
5 –Asian currencies will soar in the great monetary disorder as the continent embraces the virtues of strong currencies

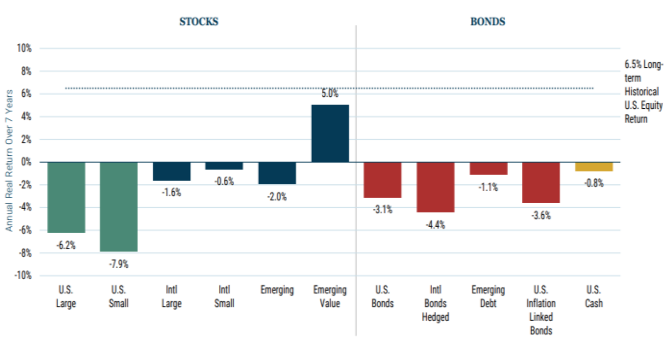
Lasciate ogne speranza, voi ch'intrate. (All hope abandon ye who enter here)
Dante Alighieri, the Divine Comedy, Canto III

The admonition on the gate to Dante's inferno nicely summarizes my capital markets expectations for the 2020s. Almost all government bonds offer return-free risk as about $14 trillion of the fixed income universe should be renamed as "fixed loss securities". Junk bond spreads have compressed to record lows despite the fact that the pandemic has stretched already dangerously-leveraged corporate balance sheets. Stocks are obscenely overvalued as retail investors gamble their stimulus checks on "meme stonks" in crazy YOLO option trades. Even commodities, which used to be the last refuge for value-minded investors, have rallied in a way that is hard to reconcile with the fact that much of the world is still under lockdowns.

As a result, it is no surprise that GMO's 7-year forecast pens negative real returns for all the major asset classes. **This report will argue that investors should turn to the zero-sum game of the currency market to offset the losses that stocks and bonds are priced to generate in the next decade**.

The first part will show that the international monetary order which emerged after the 2008 G-20 meeting is breaking down. **As all central banks have anchored curves to zero, yields can no longer be adjusted to contain currency volatility at the next crisis**.

The second part will show that the U.S. Dollar, the anchor of the global monetary order, has entered a secular bear market. The score of the greenback in my reserve currency model has deteriorated to levels last seen at the major dollar lows of 2004 and 2007.



Source: GMO's Asset Class Forecast, 31 Jan 2021

The third part will argue that **Latin America is the best short-term bet on continued dollar weakness**. Latin American currencies are undervalued by 30 to 40% compared to the prices of their commodity exports.

Asian currencies should be the long-term winners of the global monetary disorder of the 2020s. These currencies have been repressed for decades despite their strong fundamentals. This will change in the 2020s as the continent embraces the virtues of strong currencies.

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The New Global Monetary Disorder

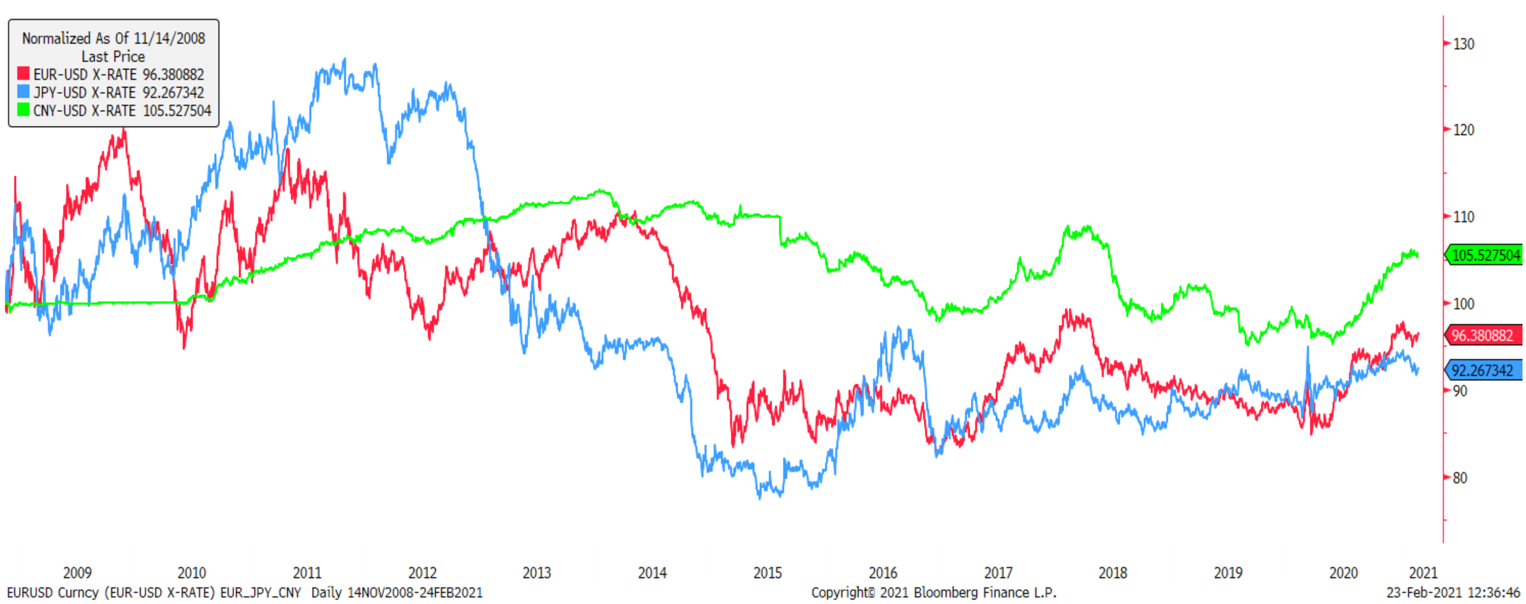
France and England rarely see eye-to-eye, but their alliance has changed the fate of the world at several crucial historical junctions. The latest big Franco-British initiative took place at the height of the Great Financial Crisis when N. Sarkozy and G. Brown called for "a new Bretton Woods system" and pushed for the first G-20 summit, held in Washington DC on November 14, 2008.

The French President and British Prime Minister eventually suffered humiliating electoral defeats but their creation lived on. In the past decade, the G-20 has been the most efficient forum for world leaders to tackle global economic and monetary issues.

Curtailing currency volatility has been a recurring goal of the G-20: as a result of the 2008 meeting, the Federal Reserve extended swap lines to four emerging markets central banks. The February 2018 G-20 meeting of finance ministers and central bank governors in Shanghai called for an end of the "currency wars' unleashed by China's botched devaluation of the RMB in August 2015. The "Sintra pact" of 2017 organized an attempt to collaboratively normalize monetary policies around the world.

Although there were plenty of hiccups along the way (European debt crisis, Chinese devaluations, Abenomics, etc), the G-20's efforts to curtail currency volatility have been generally successful. The three most important exchange rates (the Euro, the Yen, and the Chinese Yuan) have stayed within a 20% band against the U.S. Dollar. **The fact that these three currencies are more or less back to their November 2008 levels is perhaps the best testimony of the success of this era of collaboratively-managed exchange rates.**

A Decade of Stability: Euro, Yen, and Chinese Yuan since the 2008 G-20



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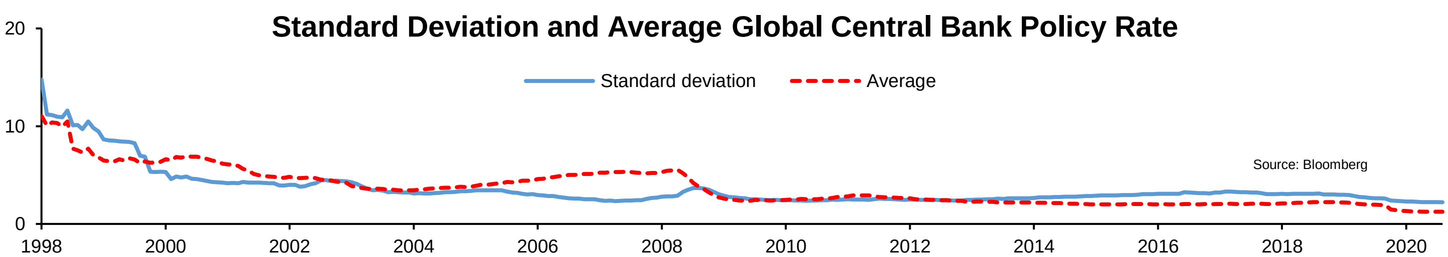
Mundell's trilemma states that countries with open capital markets can either target the external value of their currencies or the level of their domestic interest rates. **The G-20's commitment to currency stability meant that central bankers had to occasionally deviate from their favored monetary policy options**: for example, the 2013 taper tantrum forced the Federal Reserve to postpone balance sheet normalization in order to limit the damage of the soaring U.S. dollar on emerging economies. The European Central Bank would have preferred to keep European rates at zero or below in 2017 but it had to accept a 100 basis points rise in *bund* yields to maintain a relatively stable EUR/USD exchange rate during the Fed's hiking cycle.

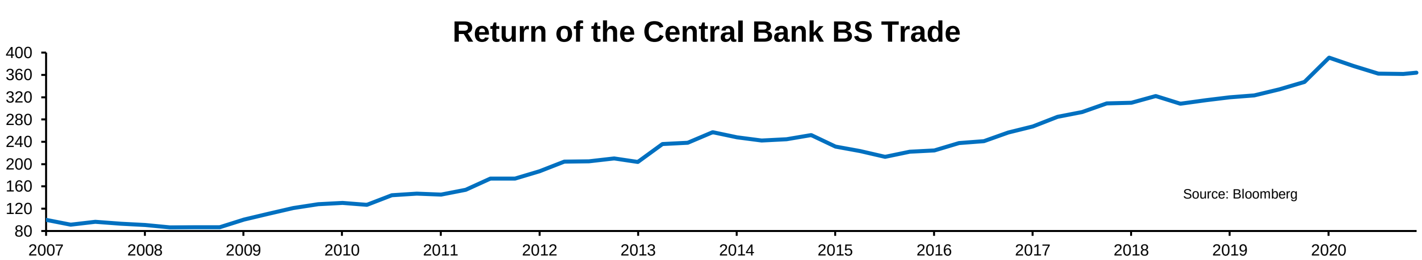
In the G-20 monetary order, currency stability was the objective and interest rates were the tools.

In the new monetary disorder, controlling interest rates, and especially long-term ones, has become central bankers' most important mandate: the Bank of Japan explicitly targets term premia with its yield curve control policies. The Fed targets borrowing costs for low-quality issuers with its purchases of junk bonds. The European Central Bank Pandemic Emergency Purchase Program (PEPP) effectively targets the spread between Italian BTPs and German *bunds*.

Given current levels of indebtedness and economies' reliance on these programs, central banks are unlikely to deviate from this domestic objective even at the cost of major spikes in currencies' volatility. **Once all rates are durably anchored at zero, monetary policy can no longer stabilize the external value of currencies**. As shown in the chart below, the world is getting close to this theoretical limit: the average policy rates of the 60 largest central banks is 1.25%. with a standard deviation of just 2% - the lowest levels ever for both measure.



When all interest rates are anchored at zero, currencies should no longer be driven by differences in carry, but by central liquidity. As I explained in "The Carry Trade Is Dead … Long Live The Central Bank BS Trade!", the winning strategy has been to buy the currency with the least balance sheet expansion again the currency with the highest liquidity injections. Much to my pleasure, the strategy has gained 4.7% last year, mostly by being long the Chinese Yuan against the Loonie and the Aussie



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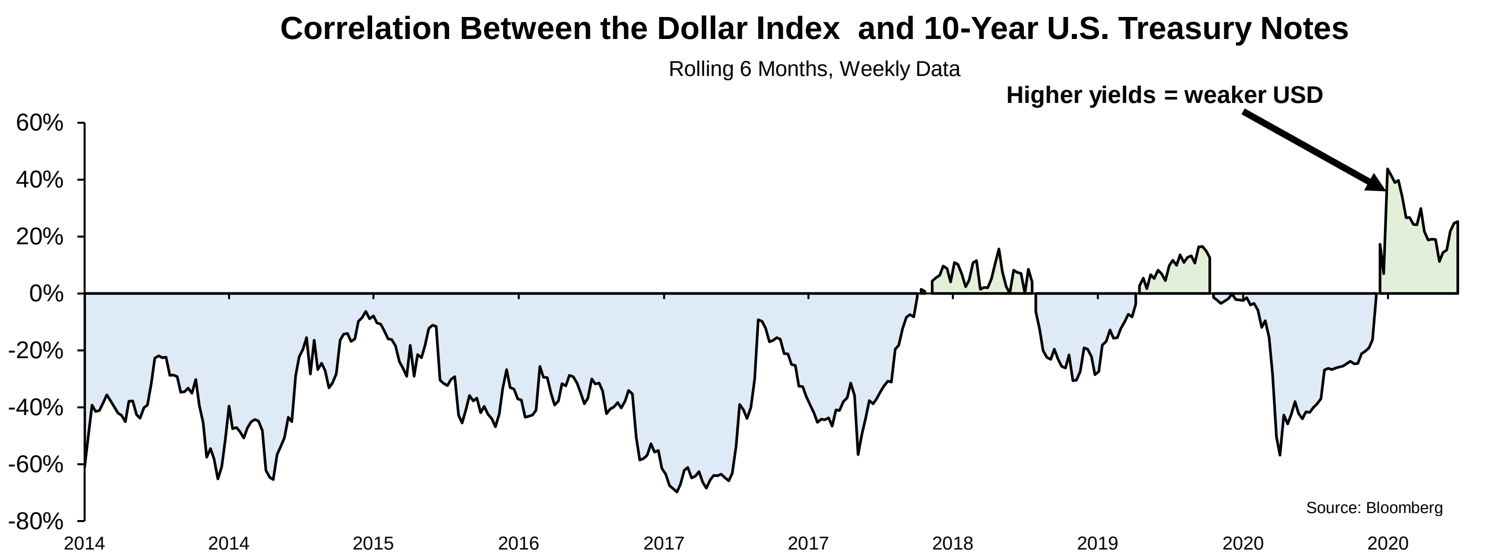
The De-Anchoring of the USD

Currency volatility could be manageable if the anchor of the global monetary order remained stable. Alas, the U.S. Dollar is becoming the catalyst for this new era of monetary disorder. I believe that the chart below is the most important macro chart for 2021: it shows that the U.S. dollar is now positively correlated to 10-year Treasuries prices, i.e., **rising rates (and thus lower bond prices) are associated with currency weakness.** In other words, foreign investors are so concerned with inflation and political risk that they sell USD assets despite rising yields.

When this pattern is observed in emerging markets, foreign investors bail out, central bankers organize hasty press conferences, and finance ministers resign. Of course, the U.S. is not Turkey and this unusual relation between the dollar index and Treasury yields may just be the result of economic normalization: as the Covid panic receded and global growth expectations recovered, investors sold the two safe haven assets (the U.S. dollar and U.S. treasuries) at the same time. But this explanation becomes less convincing with every passing day. For example, **the Dollar index has lost 3% since the election despite a 54 basis point increase in 10-year yields**, which is hard to reconcile with the normalization hypothesis.



Taking a broader perspective, I like to think of the U.S. dollar as not one, but four currencies:

- **The domestic currency of the United States**

By this metric, a strong dollar should be associated with strong real growth and stable prices. Indeed, the three strong USD cycles (early 80s, late 90s, late 2010s) coincided with rapid real growth and dis-inflation. By contrast, the International Monetary Fund estimates that US GDP will not have recovered its pre-Covid level by the end of 2021 and inflation expectations (as measured by the 10-year breakeven rate for TIIPS) have shot up to a seven-year high of 2.2%.

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- **A funding currency for emerging markets**

Strong dollar cycles usually squeeze weak emerging markets borrowers. Most of Latin America went bust when the U.S. dollar soared in the early 80s, Asian currencies collapsed in the late 90s, and Argentina and Turkey were destroyed by the dollar rally of the late 2010s. By contrast, the world's ugliest currencies (Turkish Lira, South African Rand and Argentine Peso) have been the best performers in the past five months.

Furthermore, emerging markets' reliance on USD funding may be fading: China's last sale of Euro bonds drew a record €17 billion of bids and Russia's latest foreign currency bond sales have been denominated in Euros.

Total Return of Currencies in USD since Nov 3

Period Custom | Basket All Countries | Base USD
Range 11/03/20 - 02/18/21

Best Total Returns (%)

1)	Turkish Lira	TRY	26.51
2)	South African Rand	ZAR	11.50
3)	Norwegian Krone	NOK	11.02
4)	Argentine Peso	ARS	9.60
5)	Russian Ruble	RUB	8.73
6)	Iceland Krona	ISK	8.48
7)	Colombian Peso	COP	8.43
8)	Australian Dollar	AUD	8.41
9)	New Zealand Dollar	NZD	8.08
10)	British Pound	GBP	7.05

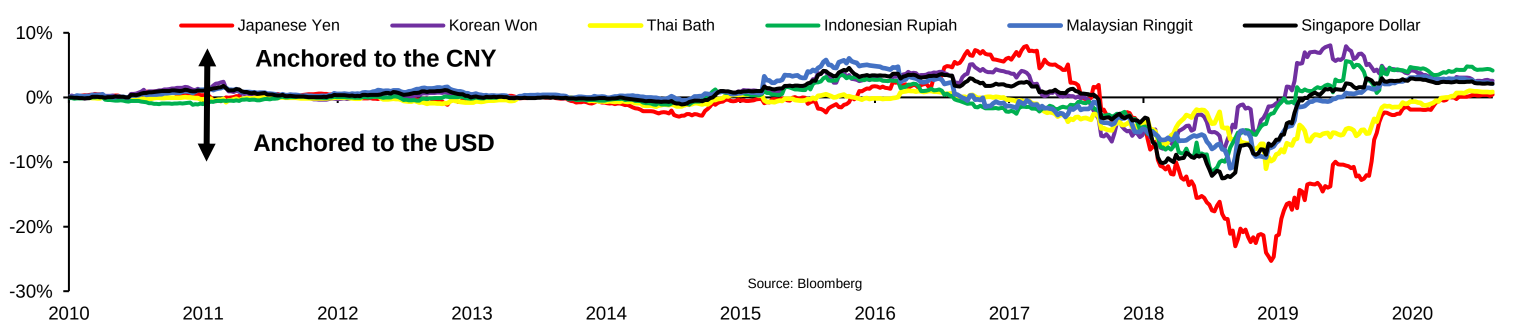
- **The price of commodities**

Almost all commodities are denominated in U.S. dollar: dollar strength is synonymous with weak commodity prices, and vice versa. Gold and oil have lost 50% or more in the strong dollar cycles of the early 80s and late 90s. By contrast, almost all commodities have rallied by 30% or more in the past six months.

- **The world's reserve currency**

Dollar strength usually leads to more central banks pegging to the dollar and outright dollarization in the most extreme cases, which creates more demand for U.S. dollars. We are witnessing the exact opposite: as I pointed in "the Year of Living Dangerously", all Asian currencies, Yen included, are now more correlated to the Chinese Yuan than they are to the U.S. Dollar. If, as I expect, China leads the Asian continent away from USD pegs or quasi-pegs, Asian central banks will no longer need to hold large reserves of USD assets and will no longer sterilize their surpluses in the Treasury market, reducing the long-term demand for greenbacks.

Net Correlation of Asian Currencies with the Yuan & USD



A New Global Macro Golden Age

If the analysis above is correct, the current decline of the Dollar Index (down 10% since the March 2020 high) is only the beginning of a *secular* bear market for the dollar. For comparison, the Dollar index lost 33% in the 70s, 52% in the 80s, and 41% in the 2000s.

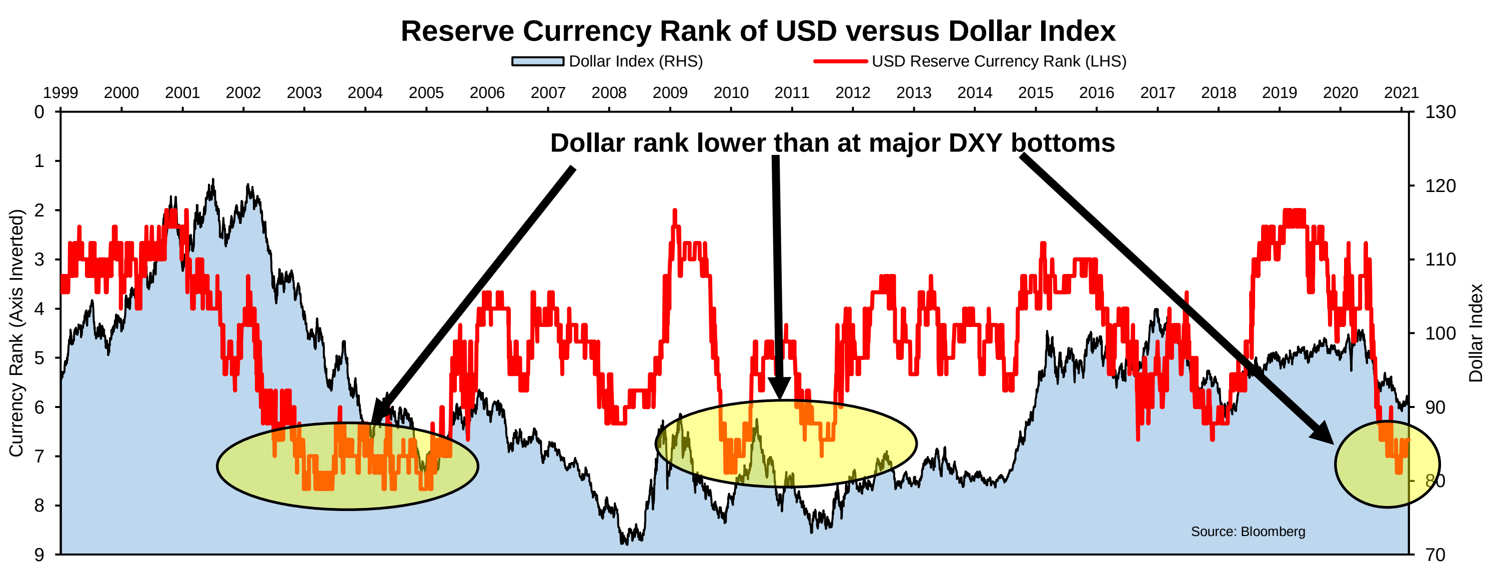
The currency model I developed in March 2018 can help us assess how low the US dollar could fall in this cycle. The model ranks the world's major currencies according to the traditional three functions of money:

- *A unit of account:* this is the "ledger" aspect of money. Currency is a system that allows us to convert wheat into cows, work into food, and future promises into financial assets. Stability is the most important quality of the "ledger" aspect of money. I measured it by the one-year standard deviation of their exchange rates against a GDP-weighted basket of the world's currencies.

- *A store of value:* this is the "savings" aspect of money. Ideally, currency should allow its users to move consumption across time. I have used the real interest rate, defined as central bank's short-term target annual rate, minus the current domestic rate of inflation as a measure of how well currencies store value.

- *A medium of exchange*: we agree to offer our work and belongings for colorful pieces of paper (or rather digital book-keeping entries) because we know that others would be willing to provide their work and belongings for the same colorful pieces of paper. The model uses the one-year change in the price of each major currency in terms of gold as a measure of this last function of money.

The USD's current score of 6.7 is about the worst in history. It is comparable to the levels observed at the 2004 and 2008 lows for the Dollar index, suggesting much more dollar weakness in the coming years.



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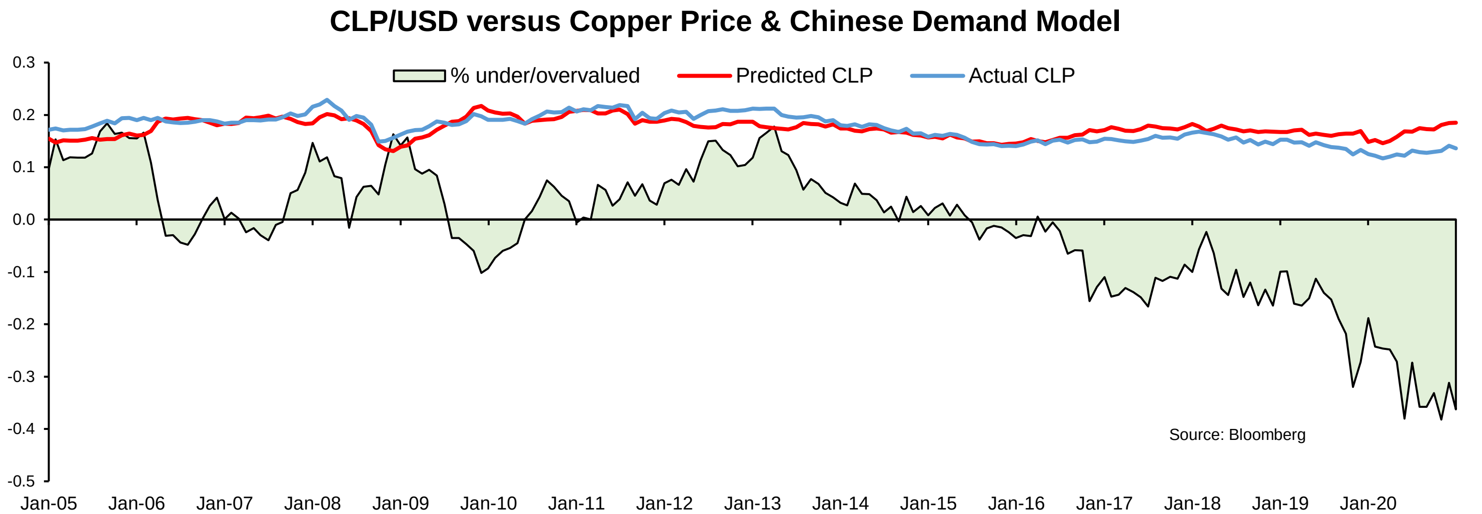
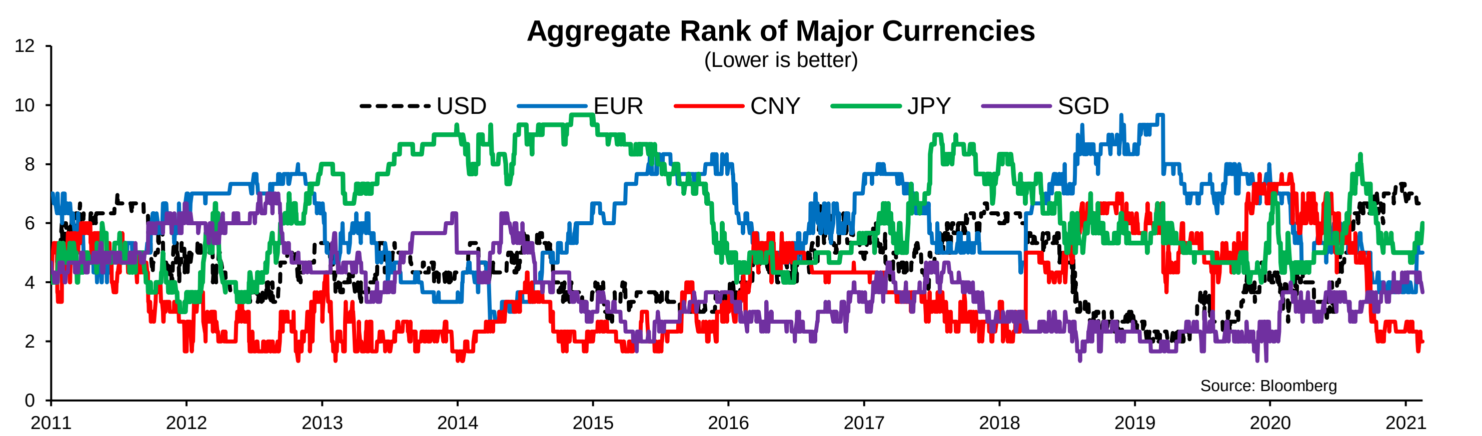
If the U.S. dollar keeps declining, Latin America, whose liabilities are mostly denominated in (falling) U.S. dollars and whose export revenues are tied to (rising) commodities prices should be the obvious beneficiary. Last week's report presented my commodity-price regression model for the Brazilian Real, which concluded that the Brazilian currency is 37% too cheap compared to the prices of its major commodity exports.

The chart below repeats the same analysis for the Chilean Peso, using the copper price and the Li Keqiang index - a proxy for Chinese growth which does not rely on manipulated statistics. **The Chilean Peso is also undervalued by a record 36%.** The same analysis for the Peruvian Sol, the Colombian Peso, and the Mexican Peso yielded similar results: Latin American currencies have overcorrected during the Covid crisis and should be one of the best trades of 2021 as they catch up with buoyant commodities prices.



Latin American currencies can be a great trade, but they are never a good long-term investment. For that, investors should turn to the Asian continent. The Chinese Yuan is best ranked currency in my model, followed by the Singapore Dollar.



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This model's reading is consistent with a qualitative assessment of the region.

- Asia handled the Covid crisis much better than the rest of the world and has recovered faster
- Central banks have generally not followed the crazy MMT experiments of their Western counterparts
- Deficits are contained
- Real rates are positive
- Current account surpluses are at or near records
- Currency reserves are abundant
- Potential growth and demographics are much more favorable (at least in Southeast Asia)
- Currencies remain cheap on a purchasing power basis

The main argument against Asian currencies used to be that upside was capped by currency manipulation. However, I believe that China's decision to allow the Yuan to rise against the U.S. dollar will cascade through the region. The Malaysian Ringgit, the Thai Bath, and the Korean Won were manipulated to maintain competitiveness with China – a concern which has been alleviated by the recent rise of the Yuan. Due to its economic weight and trade importance, China can probably bully its smaller neighbors if they attempted to resume the competitive devaluation game.

But I do not think this scenario is likely as the benefits of a strong currency will become more obvious in an era of soaring food prices and US$ 65 + Brent prices. Ensuring affordable prices at grocery stores and gas stations is an essential part of the social contract for governments which often lack democratic legitimacy. **Since most Southeast Asian countries are net importers of energy and agricultural products, a strong currency will become a political imperative**. Stronger currencies will also help the transition from their traditional export-oriented model to more sustainable domestic and regional sources of demand.

The completion of Asia's demographic transition also argues for a stronger currency: growth was paramount when Asian countries needed to provide millions of jobs for massive youth bulges entering the labor market. Artificially cheap currencies boosted the job-intensive industries in the export sector. However, **working-age populations are peaking across the Asian continent, unemployment rates are extremely low, and ageing populations will be happy sacrifice a few points of unsustainable GDP growth for the benefits of strong and stable currencies**.

As Asians embrace the virtues of strong currencies, financially-repressed institutions in the West will allocate a greater share of their savings to the region, which will feed a virtuous loop of currency strength and capital inflows. **In a world of obscenely overpriced assets, Asian currencies and fixed income instruments are a rare bright spot for long-term investors**.

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