ClearBridge Investments

Falling Dollar Could Speed Economic Normalization

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"The best way to destroy the capitalist system is to debauch the currency."

- Vladimir Lenin

"Obviously a weaker dollar is good for us as it relates to trade and opportunities."

- U.S. Treasury Secretary Steven Mnuchin

Key Takeaways

- Failure to support a strong U.S. dollar could lead to significant losses for foreign holders of Treasury securities.
- The recent dollar decline started from overvalued levels and reflects improving economic growth outside the U.S. Continued weakness should be supportive of global GDP growth.
- A weak dollar should accelerate a "Great Reversion" in inflation, interest rates and bond yields, a scenario beneficial to cyclical and financial stocks.

For the first time in over 25 years, a U.S. Treasury Secretary backed away from publicly endorsing a strong U.S. dollar (USD). The greenback quickly dropped by about 2% over the subsequent 48 hours as the yen, euro and British pound soared higher. U.S. bond yields also rose by about 2%, accelerating the pain for Chinese and European investors in U.S. 10-year Treasurys, which are now down 5% to 6% year-to-date in local currency terms. Secretary Mnuchin may find this unhelpful just as he needs to begin selling record amounts of new debt without the help of the Federal Reserve (Exhibit 1).

Now the world knows that the U.S. desires a weaker dollar at the same time that the Trump administration is focusing on pro-growth policy initiatives like recently passed tax cuts and deficit spending.

For us, the key question is how does this growing realization over currency policy impact our belief that we are moving into a "Great Reversion" over the coming years? To review, we expect global inflation and nominal GDP growth to rise more than is generally expected, which will lead to a normalization of interest rates and the yield curve. Due to a geographically broadening expansion, profit growth outside of the U.S. will be relatively strong and we expect stocks will continue to outperform bonds. This will lead to a shift in asset price behavior that favors many long-suffering investments including cyclical and financial stocks.

Clearly, an escalation of the recently announced U.S. tariffs on washing machines and steel to a broader trade war would undermine the current synchronized global economic recovery. Also, a rapid shift in relative currency

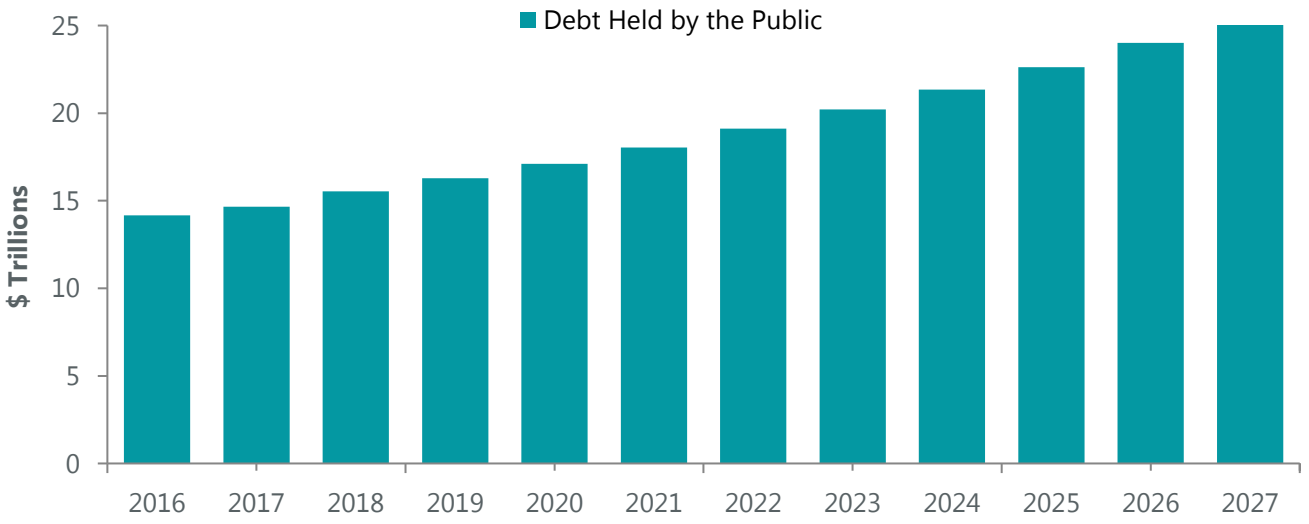
valuations would elicit potentially disruptive reactions from central bankers and increase bond and stock price volatility. Thus far, the response from the rest of the world has been critical but measured, with most nations continuing to advocate a focus on market-opening reforms and avoiding competitive devaluations.

Also, it is important to note that the recent decline in the USD started from overvalued levels and therefore just reflects improving economic growth outside of the U.S. Neither the euro, pound or yen are at economically harmful values.

A falling greenback will tend to raise global nominal GDP growth by increasing inflation in USD-denominated goods while supporting stronger consumer buying power overseas, especially in emerging markets. Production in the U.S. will become cheaper, which could lead to an improvement in capital investment, greater foreign consumer demand and increased imports of U.S. products. This will tend to reduce global imbalances and create a more sustainable economic expansion. Bond investors demanding greater compensation to offset rising inflation will steepen the yield curve and boost the profits of lenders and insurance companies.

While the recent pace of the USD drop is unsettling, the impact thus far just serves to accelerate the positive rebalancing trends already in place. Increasing trade frictions and a sudden jump in U.S. interest rates could prove disruptive, but we expect the Great Reversion to continue.

Exhibit 1: U.S. Debt Issuance Expected to Surge



Source: Bloomberg, Congressional Budget Office.

About the Author

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- 34 years of investment industry experience
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