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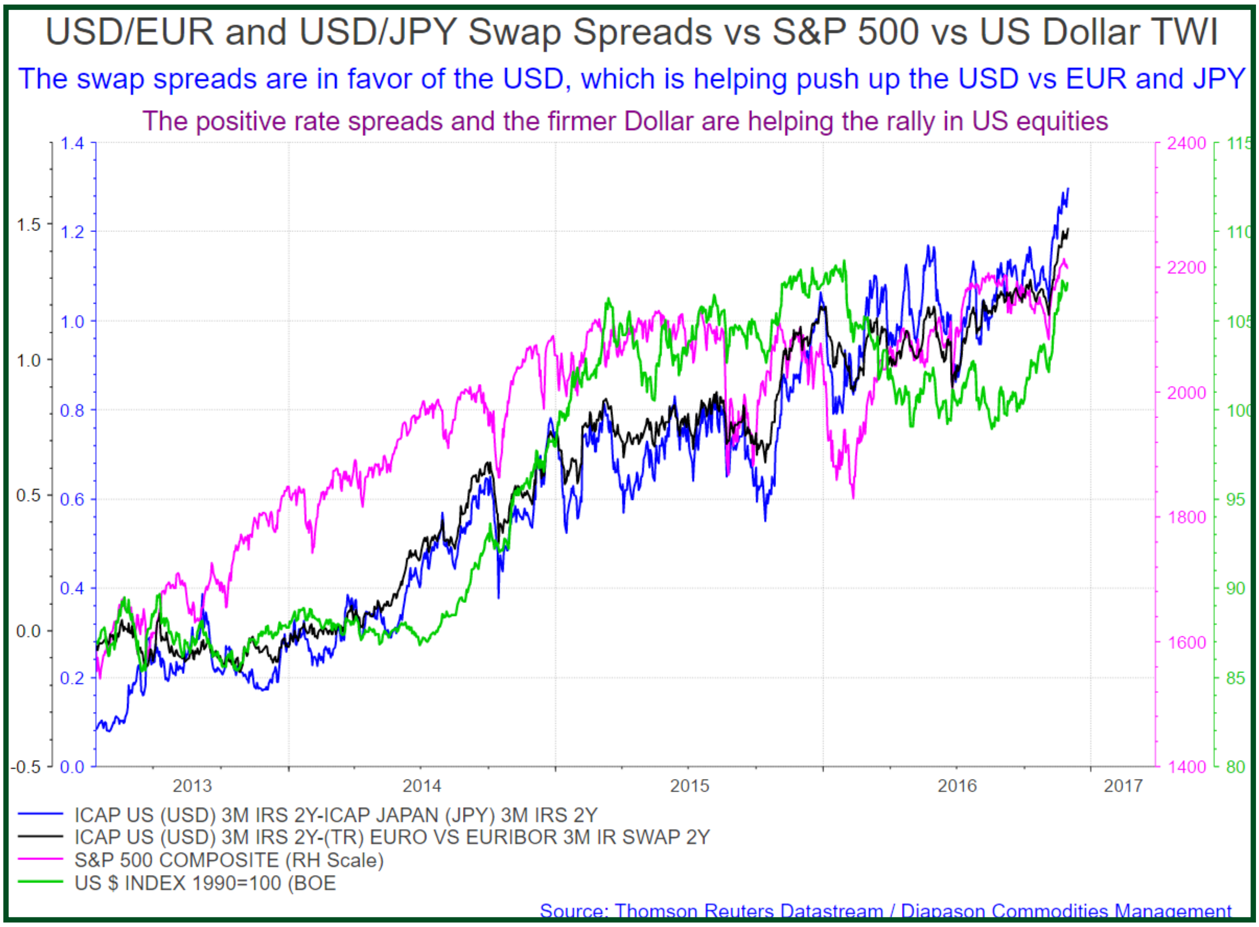
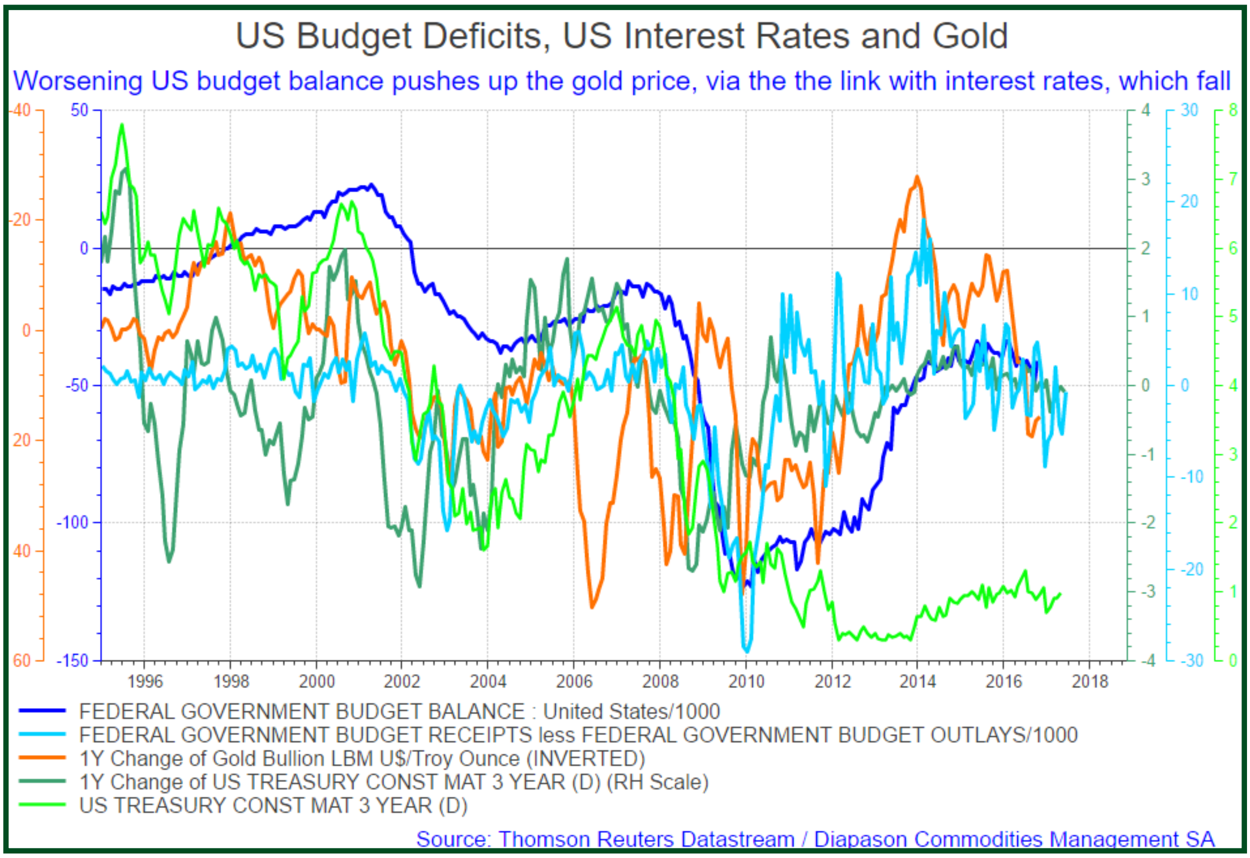
THE US DOLLAR: Enthusiasm for Trump's planned policies are positive for the USD but implementation may prove more negative.



The US Dollar Trade Weighted Index is threatening to break out to new bull market highs after trading in a reasonably well defined range over the past couple of years. The previous motive force has been the policy divergences between the US and the other major developed economies (e.g., Eurozone, Japan); the election of Mr. Donald Trump who wants to employ significant deficit spending to kick-start the moribund US economy has added to the upside momentum for the US unit. However, unlike the movement of paper assets, long-term changes in the value of currencies often provoke feedback loops that impact the course of currency valuations in unpredictable ways, by virtue of their linkages to growth (via net exports) and to the rise and fall of inflation. So, it is necessary for us to make distinctions between short term and long term drivers, which may not necessarily be complementary.

Our immediate short term concern about the USD: is the threatened breakout sustainable? On some measures the US dollar is starting to look slightly over-valued, over-bought, even over-hyped, so it makes sense that we should expect some degree of consolidation sometime soon. But with the market still focused on a Fed tightening in December, and on bond yields recently bumped higher by investor exuberance post the Trump election, interest rate differentials favour the US currency, as the US cash rate stays bid (see graph USD/EUR & USD/JPY Swap spread). This spread factor support may even may even grow as the Fed restarts its



tightening cycle. Thus from a portfolio perspective it will probably pay to have a long dollar bias in the short-term. Based on this argument, it also pays to stay long on US equities in the short-term.

However, investors who bought the US Dollar on the presumption that Mr. Trump can deliver on his campaign promise of massive infrastructure spending, may want to reassess the long-term implications of that deficit spending policy plan.
Debt and deficit spending are really no big deal (but the lack of correct perspective makes them such contentious subjects) -- they are lagged functions of the economy (and so is the US Dollar)- Those linkages are shown in the graph (Us budget deficits, US Interest rates, USD) which we explain further:

Federal Budget Balance (the delta between Receipts and Expenditures), is positively correlated with US GDP growth (after a lag). It is very easy to explain that correlation - that is, the FDB becomes less negative when GDP growth rises and vice versa. In other words, budget balance is a lagged function of GDP. Apply the math and you will see that government debt is a negative function of GDP. To keep their living standards at the same level, individuals, corporations and the government borrow when GDP slows down. For the government, it is the automatic (spending) stabilizers that keep borrowings high (thereby making debt rise) when GDP slows down (reduction of tax revenues). Those automatic stabilizers are there by law, even if spending for them increases the debt over GDP ratio. The other complication is that GDP growth is also, to a large extent, dependent on government spending, especially during GDP growth recessions. And for a government to do that during a recession, they have to borrow, which further adds to the US aggregate debt. Strongly rising US aggregate debt has provided some of the most spectacular US Dollar bear markets (and the inverse, spectacular gold bull markets).

Given these contradictory vectors, we will characterise the outlook for the US Dollar as positive in the short-term, probably even in the medium-term, though with limited potential but negative further out.