17/ Inflation and its implications for the US Dollar and Euro relationship

Will the inflation uptick be sustainable if energy prices are taken down a notch, as we expect in Q1 2017? Given the single universal price of crude oil, will inflation rise faster in Europe relative to the US, or is it the other way around? These questions are being asked as comparative inflation rates often plays large roles in the USD-EUR relationship. During certain periods in the immediate past, inflation differentials were instrumental in driving the valuation of the USD versus the euro, as much as interest rate differentials did (see graph 1 next page).

Inflation has been relatively higher in the US since early 2015, but the lower EU inflation rate since then did not help the common currency as swap and yield spreads predominantly favored the US Dollar over the euro at that time, a condition which still persist today. But as the chart above shows, relative inflation rates played a major role in the EUR-USD relationship during the period up to Q2 2014. During those earlier periods, the higher inflation rates in the US were part of the reasons why the US currency was weaker versus its EU counterpart (see graph 1 next page).

Then by late 2014, the interest rate spreads turned massively in favor of the US Dollar as the ECB aggressively eased monetary policy. In fact, it was the sharp decline in inflation (actual and expected) which drove the ECB to engineer a rapid decline in interest rates, which subsequently brought about a persistent decline in the valuation of the common currency. Nonetheless, there is now a growing gap between the inflation rates of the two regions as US inflation rates rise sharply. Although inflation as valuation factor has been overshadowed by the overwhelming impact of rate differentials favoring the US unit, there would come a point where significantly higher inflation rates in the US would start to hurt the USD and weaken its valuation against the euro. It also helps that with domestic inflation rising quickly, the change rate of Germany's bond yields is stabilizing. Germany CapitalAccount is also starting to rise, suggesting that investment capital which fled the Eurozone is starting to be repatriated, and should help strengthen the common currency in the near future (see graph 2 next page).

There is this persistent belief in the markets that higher long term interest rates (the 10yr yield as proxy) pushes up the value of the US dollar. This belief is misguided. That has not been true since global finance came out of the Great Financial Crisis (GFC) of 2007/2008 during Q2 of 2009. Since then, changes in the US Headline CPI have been ahead of the changes in the 10-year yield and the US dollar. The new comovements: changes in CPI are positively correlated with, and lead the changes in the long bond yield, and changes in both CPI and 10yr yield lead the negative changes in the US dollar. These relationships have held true even in the periods before, during, and after the Fed tightened policy in December 2015; it remained the case until late August 2016, when the US Dollar started to strengthen even as the CPI and the 10yr yield rose (see graph 3 next page). The inflation situation in the US is, and has been, significantly different from that of the eurozone's. US Core CPI has been sideways since February last year, after a sharp push in most of 2015, bringing the index above 2.0%. The Fed targets the Core PCE's change rate, which is still slightly below the Fed's target of 2%, but the recent high energy prices will soon percolate into the PCE, and we expect the Fed's inflation target to be met by 3Q 2017. This outlooks contrasts sharply with that of the Eurozone – the ECB predicts euro-area core inflation won't reach their 2% target until at least 2019. Normally, we do not invoke the Fed's and ECB's inflation targets in a discussion of relative currency valuations, as both central bank's core inflation targets have been similar in recent years.

But the recent schism shown in the US Headline CPI-long bond yield-US Dollar relationships may have its origin in developments in the core inflation universe. It turned out that there is a new player in the inflation Index, long-term rates, and US Dollar triangle – the US Core PCE Index (less Food and Energy components).

Unlike the leading function of the US Headline CPI on US rates and the US Dollar, the Core PCE tende to lag behind developments in rates and the US currency. But that changed starting in July when the Core PCE monthly changes started to fall sharply even as corresponding monthly changes in rates and the US Dollar rose sharply .
The divergences we saw in the Headline CPI relationships, and now in the Core PCE comovements, led us to believe that the long bond yield rally was driven primarily by the sharp rise

in CPI, while the sharp ascent in the US Dollar was impelled primarily by the aggressive decline in Core PCS inflation. Those developments make sense if considered separately, but based in the context of recent relationships, they don't if taken together. The most puzzling of all – the positive correlation between the long bond yield and the Core PCE has completely broken down

Conclusion:
There is evidence from academic work that the negative correlation between crude oil and the US Dollar flows from the former to the latter. We can also show empirical evidence that this is indeed the case, and we have shown that in previous publications.In fact, we believe this is the linkage leading to the negative correlation between the US Dollar and CPI inflation, headline or core. As we showed in previous charts, inflation negatively leads the US Dollar, and since crude oil leads CPI, then the proper conclusion is that higher oil produces higher inflation which tends to weaken the US currency.

The outlook for near-term oil prices, on account of the OPEC and Non-OPEC agreements to cut oil production, is significantly bullish, as can be expected. However, we believe that there are short-term negatives in the oil fundamentals which may depress oil prices in early Q1 2017, but by mid-year, the production cuts should start to push prices higher.
It may also be that severe Capex cuts in the past two years, and over the next coming years (up to 2020) should prime higher oil prices, with negative consequences to the US currency for some time .

Therefore, our outlook is for the US Dollar to strengthen until mid-February, after which the US currency should weaken significantly against the euro and other major currencies.