US DOLLAR SLIDE CONTINUES **AMID POLITICAL GRIDLOCK AND DOVISH FED**

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ABOUT **THE AUTHOR**

Tinyiko is our young, up-and-coming and dynamic economist, working alongside Johann Els and Rian le Roux. It is her fresh take on everything to do with economics that adds original insight to our macroeconomic analysis.

KEY TAKEOUTS:

- GLOBAL MONETARY SUPPORT EXPECTED TO TAPER
- US DOLLAR SUFFERS AS TAX REFORM HOPES FADE
- WEAK US DOLLAR GOOD FOR EMERGING MARKETS

While the global economy ended the second quarter on a solid footing, supporting investor sentiment, a stream of more hawkish comments by a number of central banks served as a reminder that the extended period of broad-based and extreme monetary support is coming to an end.

Another global feature has been the relentless weakening of the US dollar, despite the US Federal Reserve (Fed) leading the global policy normalisation cycle. A soft US dollar is, of course, a boon to emerging markets as it tends to support commodity prices and reduce pressure on emerging market currencies. As a result, capital flows into developing countries have remained buoyant in recent months. The key factors undermining the US dollar are the political gridlock in Washington (raising concerns over the timing and size of the long-awaited stimulatory tax reform), reduced concern over a more aggressive Fed (as US inflation remains tame amid a tight labour market), and the European Central Bank (ECB) indicating that it, too, is considering tapering asset purchases perhaps from early next year.

TRUMP PROMISES FAIL TO MATERIALISE

It's no secret that US President Donald Trump has had a disappointing start to his presidential term, with the failure of the latest Obamacare repeal raising doubts as to whether the administration will, in fact, be able to implement much of its promised policies, particularly on the fiscal policy front. The US dollar surge late last year was mainly on the back of the perceived positive impact that proposed fiscal stimulus would have on both growth and company earnings, as analysts made upward revisions to their US growth forecasts. Consequently, as optimism over tax reform faded, the US dollar came under pressure.

INFLATION AND RETAIL SALES DISAPPOINT

The US dollar was also negatively affected by growing doubt over whether the Fed will raise interest rates again this year. A combination of the Fed's plan to start slowing asset purchases later in the year and subdued macroeconomic data are driving the softening interest rate view. With the closely watched core PCE (personal consumption expenditure) deflator measure (inflation excluding food and energy) at only 1.4%, weak US inflation implies that the Fed is not achieving its 2% inflation target. In addition, annualised GDP growth during the first half of 2017 was just less than 2%, indicating that the economy is not overheating – warranting a less aggressive Fed. With the unemployment rate at a historically low 4.4%, it appears that the labour market is the only strong signal at present keeping the Fed on course to hike rates one more time this year – even though labour market strength has not convincingly translated into a pick-up in wage growth and consumer demand. Retail sales have been flat since the start of the year and vehicle sales have been trending weaker in recent months. If the market is right about the Fed's likely course of action, then the key case for a strong US dollar (i.e. rising interest rates) is considerably weakened.

EUROPE RECOVERY SPELLS AN END TO QE

Growing expectations that the ECB will soon announce plans to begin paring back monetary stimulus in January 2018 has also played a role in explaining the US dollar's recent weakness. The underlying improvement in the Eurozone economy is clearly reflected in the June unemployment rate falling to an eight-year low of 9.1%. While the Eurozone remains on a recovery path, inflation is pretty subdued, with the core CPI hovering around 1.2% for July and well below the ECB's 2% target. Still, the firming and spreading Eurozone recovery is paving the way for the ECB to follow the US Fed in starting to roll back monetary stimulus through a slowdown in the pace of asset purchases.

We ended last month's review with the conclusion that a better Europe and a less aggressive US Fed would bode well for emerging markets through a softer US dollar – a view that we have held for some time now. While this view is clearly playing out, market focus is shifting to the inevitable tightening in global liquidity conditions – as first the US Fed and then the ECB starts to wind down asset purchases in coming months. While this indeed holds risks to relatively elevated asset prices, we do not think it portends a premature end to the global equity bull market, largely because global growth is firming, which will support corporate profitability.

Inflation and GDP data sourced from FactSet