

## Does secular stagnation help the dollar?

The Dollar Index has broken to a new high for the year – largely on the back of weaker growth prospects overseas. If secular stagnation fears grow and asset allocation shifts towards bonds from equities, prohibitively high dollar hedging costs could mean the dollar does even better



Source: Shutterstock

### Secular stagnation fears in the ascendancy

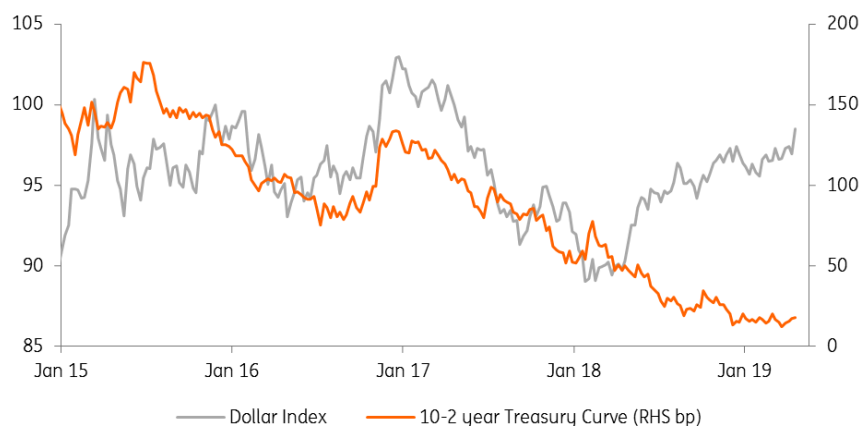
This week the trade-weighted dollar has rallied to a new high for the year. This has been driven less by US growth news, but more by sluggish activity and softer monetary policy prospects in the rest of the world. In fact, most fund managers have a growing conviction that the world economy is entering into a period of low growth and low inflation - or secular stagnation.

Fanning the fears of low growth and low inflation this week have been: [soft CPI readings in Australia](#), continued pessimism from European manufacturers ([German IFO](#)) and a [poor 1Q19 GDP release from Korea](#). We've also seen a dovish raft of central bank communication from the likes of the Bank of Canada, Sweden's Riksbank and, surprisingly, the Central Bank of Turkey.

Despite prospects of [some better US activity data near term](#), the interest rate market has struggled to shrug off fears of a slowdown. And while the jury is still out on whether a flat/inverted

yield curve foreshadows the next US recession, the dollar continues to perform well. In fact, the dollar index (DXY) has broken to a new high for the year and has now reclaimed around three-quarters of the decline since Trump took office in January 2017.

## Despite US yield curve flattening, the dollar rallies



Source: ING, Bloomberg

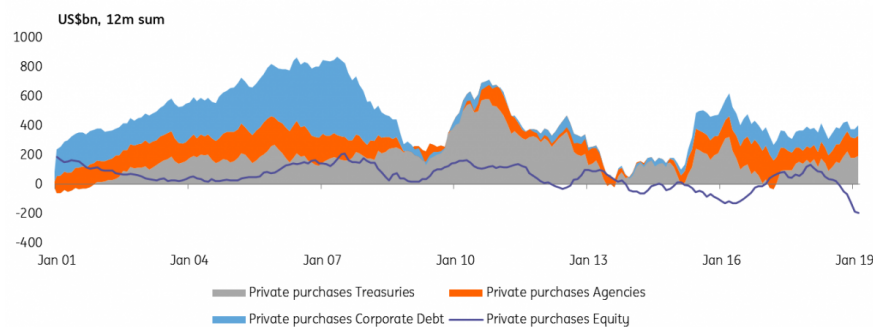
## Asset allocation shift to bonds from equities?

If increasing fears of secular stagnation are realised, we would expect to see the investment community (eg, those running balanced funds which invest in both equities and bonds) rotate away from equities and into the bond market.

Buy-side surveys suggest investors are still underweight bonds and overweight equities, although there is some evidence that the rotation (at least in US asset markets) is already underway. Here the US Treasury releases its Treasury International Capital (TIC) data series, showing foreign purchases of US securities and US purchases of foreign securities. The data (as of February 2019) shows consistent foreign private sector purchases of US bonds (Treasuries, Agencies and Corporates). In contrast, foreigners have sold US equities for the last ten months.

Were secular stagnation fears to take hold and more investments be directed towards bonds, market liquidity considerations mean that US fixed income would receive sizable inflows as a result of its large weight in global bond benchmarks. Currently, the US has the largest weight (around 30%) in the Bloomberg Barclays Global Sovereign Index.

## Foreign private sector purchases of US securities (US\$bn, 12m sum)



Source: ING, Bloomberg

### A rotation to bonds could send the dollar even higher

The recent decline in market interest rates seems to have done the dollar no harm at all. This may be because those foreign asset managers wanting to increase their exposure to the US bond market are faced with prohibitively high dollar hedging costs. For Eurozone or Japanese-based investors the annual cost of hedging FX exposure to US asset markets is now around 3.00/3.10% (using the 3 month FX forwards markets as a proxy). This cost exceeds the yields available across the entire US Treasury curve. It would be no surprise to hear that some of the Japanese Life Insurers are increasing their allocations to unhedged foreign bond positions in the new fiscal year starting this month.

Unless we see a sharp, positive re-assessment of growth overseas, or much weaker US growth to trigger a serious re-assessment of Fed policy including expectations of an imminent easing (such that the short-end of the US curve really softens and USD hedging costs cheapen), we fear that the dollar is going to be staying much stronger than our current baseline forecasts. As such our year-end 2019 EUR/USD and USD/JPY forecasts of 1.18 and 108 look like they'll have to be revised in favour of a stronger dollar.

### US Treasury yields, unhedged versus hedged into EUR and into JPY (%)



Source: ING, Bloomberg

## Author

### Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.