

Rising political risks in the US and the dollar

Dec 26, 2018

Barely two weeks ago, the dollar index reached its highest level since June-2017 and now the investors seem to be cutting their exposure to the American assets, amid a partial government shutdown in the US and signs of confrontation between the Trump-administration and the Federal Reserve. So far this week, the safe haven currencies like the JPY and the CHF have appreciated by 0.8% (on average) against the dollar. Meanwhile, the emerging market currencies like the INR, the CNY and the RBL have appreciated by around 0.4%.

The Washington Drama: What's the plot?

- **Partial government shutdown:** In the US, a government shutdown occurs when Congress fails to pass the appropriations bill - the legislation funding for federal government operations and agencies. For the budget year 2019, about 75% of the government funding (defense, education, veteran's affairs, energy etc.) was already approved before the midterm elections, while the funding for the remaining 25% of the federal budget was left for approval and expired last Saturday. Thus, the "partial shutdown", which seems to be affecting the key parts of the federal government including the Department of Homeland Security, the Justice Department, the Interior Department, the State Department and the Department of Housing and Urban Development. More than 420,000 essential federal employees are now working without pay and another 380,000 are put on temporary leave.
- **Unending negotiation:** what's the sticking point? The seven remaining appropriations bills that Congress couldn't finish before the midterms were packaged together as a short-term continuing resolution. However, the discussion on passing this resolution, between the congressional Democrats and the Trump-administration has so far not yielded any result, primarily because of the President's demands for a border wall funding. To prevent the halt in government activities, the Senate approved a stop-gap measure (before the shutdown deadline), keeping the spending for the remaining 25% of the federal programs

unchanged. However, President Trump has insisted on USD 5bn as funding for the Wall-project, and has rejected the stop-gap bill. Thus, the negotiations are still going on.

- Escalation of risks: Of late, the high frequency data in the US has been somewhat weak. Non-farm payrolls for example increased by just 155,000 in November, missing market expectations of around 200,000. Similarly, wage growth has been softer-than-expected. The trade spat with China has been another point of concern for the markets. According to the IMF, the growth rate for the US economy could slow down from 2.9% in 2018 to 2.5% next year because of such trade conflicts. Thus, a shutdown coming on the heels of a major sell-off in the equity market (since early October) and slowdown risks seems to have added to the concerns of the investors.
- Trump vs. Fed: What's making the matter worse is the conflict between the Trump-administration and the US Federal Reserve. Early this week, on Monday, US President Donald Trump criticized the Federal Reserve, describing it as the "only problem" for the US economy. This was after the media reports surfaced, over the weekend, that Trump had discussed replacing Federal Reserve Chairman Jerome Powell.
- What does Treasury know that we don't? US Treasury Secretary Steven Mnuchin recently hosted a meeting with the president's Working Group on Financial Markets, a body known as the 'Plunge Protection team'. As per media reports, Steven Mnuchin also held a series of conversations with top American bankers in a bid to calm the financial markets. However, since the meeting has come in between a bout of market volatility, investors seems to be taking it as yet another sign that things are not normal.

Dollar Outlook: What to expect?

All in all, the mounting political risks in Washington are making investors bearish about the dollar. However, we are not as pessimistic as the markets in general and consider this as a USD buying opportunity. We believe that once the knee-jerk reaction to the government shutdown is over, assuming that a resolution is imminent, USD bids could come back. For

H1-2019, we do not see any major setback in the dollar index. In our view, the US-China trade spat and Brexit related concerns could re-emerge as the major themes for the global markets. If the past behavior of the markets is a gauge, this should keep the USD supported.

Thus, while we do not see a rally in the dollar index, at the same time we do not expect a sharp correction either, primarily on account of the following assumptions:

- For one, the Treasury secretary, Steven Mnuchin, has already dismissed any rumors regarding the exit of Fed Chair Jerome Powell. Thus, we believe that the US Fed would hike one more time in 2019 and this could prevent a sharp downfall in the USD in the near-term.
- Two, with regards to the shutdown, we believe that the issue is likely to drag on until early-January. However, as Democrats take control over the Senate (3rd January onwards) the Trump-administration might end up postponing the funding bill for the Wall, in order to reach an agreement. Ultimately, we believe that an interim bipartisan support would be agreed at around USD 1.6 bn for border security, similar to the earlier version of the Homeland Security bill.
- Three, even as US growth rate is likely to slowdown in 2019, as the effects of Trump administration's fiscal measures fade and trade concerns weigh to some degree, any fears of a recession are far outstretched and exaggerated in our view. The US economy is still likely to be an outperformer in the developed world and this is what could prevent a sharp fall in the dollar index.

We expect the dollar index to gradually weaken against other G3 currencies only in 2H-CY2019. This is because we expect the BoE and the ECB to gain confidence (on back of momentum in the economy) and start normalizing monetary policies. Once the markets start pricing in interest rate hikes in the euro zone and the UK, the dollar could take a back-seat.

- Having said that, if the shutdown lasts longer and in case there is a sudden change of guard at the US Fed, we could see a significant weakness in the dollar. That is, the scenario that we expect for 2H-2019 could kick-start much earlier. The inability

to compromise for both the parties (Democrats and the GOP) could become a major cause of concern ahead of the Debt ceiling. Just to recall, in February-2018, President Trump made the decision to suspend the debt ceiling until March 1st, 2019, which essentially allowed the government to borrow an unlimited amount of money over that time period. Now that the Committee for a Responsible Fiscal Budget (CRFB) estimates that the debt would surpass USD 22 trn by March of 2019, new measures to curtail spending and cap the overall debt would have to be considered. This could make the negotiations over the appropriations bill tougher going forward. Read below for more on US politics!

US Politics: The madness of King Trump and its implications...

In our base line projections for the US economy and the USD, we implicitly assume that a degree of rationality ultimately prevails, there is some conciliation between the Republicans and Democrats and business goes on perhaps not entirely as usual but without grinding to a halt either.

However, Trump's actions over the past few months should warn us that nothing can be taken for granted. Let's take the White House's war on the Fed. The fact remains that the president did not stop at criticizing the Fed but somewhat publicly explored options of removing Fed Chairman Powell. This assault on the autonomy of the Fed especially in the domain of interest rate determination, as sacrosanct a territory for a central bank as it can be, is unprecedented. The bigger risk is of course that things don't end just here. As is in the case of Secretary of Defense James Mattis (who resigned on the 21st of this month), the Fed Chairman is "tweet-hounded" to a point where he see no option but to resign. If he is replaced promptly by a Trump puppet who pares interest rates promptly, the market's shock or wrath at the emasculation of inarguably the world's most powerful and independent central bank is likely to overshadow the relief that comes from a rate cut. We see significant risk of a market collapse were that to happen.

While we place our bets on the back-channels of Washington D.C to deliver an end to the budget impasse, Trump's latest communiqué in which he has drawn the proverbial line in



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the sand on his USD 5 bn funding demand for a border wall does bring a whiff of the risk of the shutdown continuing. If it extends well into the new year, markets will panic. As risk goes "off", it remains to be seen whether the USD benefits from safe haven buying into US treasuries or a sell-off in the dollar. Gold and the Yen have risen against the USD in the last couple of days – they might well take over the mantle. This remains uncertain. What we are sanguine about is that 2019 will see the rockiest of legislative sessions with a divide in congress and the antagonism across the political aisle at fever pitch. Thus volatility seems here to stay if not amplify in the coming months.

Finally, one could argue that the implications of the Mattis resignation are not yet fully priced in by the market. His resignation was in response to Trump's decision to pull all US troops out of Syria and halve their presence in Afghanistan. This leaves a huge strategic vacuum in the Middle-East that could rock global politics going forward. It is perhaps needless to say that asset markets will feel the impact.

We keep our fingers tightly crossed!