

Prescription then Description

“Everything is complicated; if that were not so, life and poetry and everything else would be a bore” – *Percy Bysshe Shelley*

The prescription first.

If you are in...

...Singapore, buy US dollars.

...the UK, buy US dollars.

...Australia, buy US dollars.

...Canada, buy US dollars.

...an emerging market, sell everything and buy US dollars.

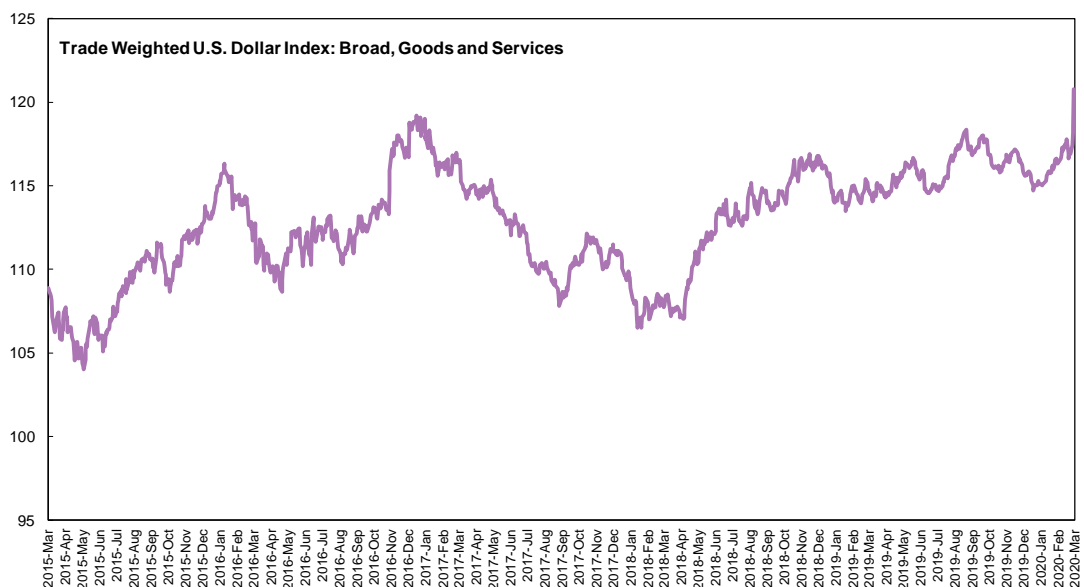
And if you own gold, you probably do not own enough US dollars.

The prescription should be clear: Long USD.

At the start of the year, we wrote:

“Using \$DXY as the guidepost, long US dollar below 95 versus the Australian dollar and New Zealand dollar, given the low cost of carry.”

The “below 95” call has been one of our better calls but not including more currencies was, in hindsight, short-sighted.



The above is the broad trade weight US dollar index, not \$DXY, and it is breaking out.

Before we get to the description, we want share to two messages we received this week. One from the treasurer of a major British bank and the other from a member of the balance sheet management team at a major European bank.

“Despite the USD swap lines, top tier US bank paying 90bps above LIBOR for short date cash! LIBOR just set higher. Despite OIS going lower...And long-term USD FX swaps at 2% despite Fed cutting to zero.”

“[Name of bank] is in serious issues it has got margin calls left right.”

Lastly for the anecdotes, JP Morgan and Citi issued 10-, 20- and 30-year bonds this week priced with yields to maturity around 4 per cent. In contrast, just 10 days earlier, JP Morgan issued similar instruments with yields to maturity around 1.5 per cent.

The actions the Fed has taken thus far are not proving sufficient to overcome dislocations taking place in funding markets.

Eurodollars

To put things in the proper context, we first want to briefly touch upon the structure of global banking operations, specifically the Eurodollar market.

“The Euro-dollar market is the latest example of the mystifying quality of money creation to even the most sophisticated bankers, let alone other businessmen. Recently, I heard a high official of an international financial organization discuss the Euro-dollar market before a collection of high-powered international bankers. He estimated that Euro-dollar deposits totalled some \$30 billion. He was then asked: “What is the source of these deposits” His answer was: partly, U.S. balance-of-payments deficits; partly, dollar reserves of non-U.S. central banks; partly the proceeds from the sale of Euro-dollar bonds.

This answer is almost complete nonsense. Balance-of-payments deficits do provide foreigners with claims on U.S. dollars. But there is nothing to assure that such claims

will be held in the form of Euro-dollars. In any event, U.S. deficits, worldwide, have totalled less than \$9 billion for the past five years, on a liquidity basis. Dollar holdings of non-U.S. central banks have fallen during the period of rapid rise in Euro-dollar deposits but by less than \$5 billion. The dollars paid for Euro-bonds had themselves to come from somewhere and do not constitute an independent source. No matter how you try, you cannot get \$30 billion from these sources. The answer give is precisely parallel to saying that the source of the \$400 billion of deposits in U.S. banks (or for that matter the much larger total of all outstanding short-term claims) is the \$60 billion of Federal Reserve credit outstanding. The correct answer for both Euro-dollars and liabilities of U.S. banks is that their major source is a bookkeeper's pen.

[...]

Just what are Euro-dollars?

They are deposit liabilities, denominated in dollars, of banks outside the United States. Engaged in Euro-dollar business, for example, are foreign commercial banks such as the Bank of London and South America, Ltd., merchant banks such as Morgan Grenfell and Co., Ltd., and many of the foreign branches of U.S. commercial banks. Funds placed with these institutions may be owned by anyone-U.S. or foreign residents or citizens, individuals or corporations or governments. Euro-dollars have two basic characteristics: first they are short-term obligations to pay dollars; second, they are obligations of banking offices located outside the U.S. in principle, there is no hard and fast line between Euro-dollars and other dollar-denominated claims on non-U.S. institutions – just as there is none between claims in the U.S. that we call “money” and other short-term-claims. The precise line drawn in practice depends on the exact interpretation given to “short-term” and to “banks”.

— Excerpts from *The Euro-Dollar Market: Some First Principles* (1971) by Milton Freidman

Eurodollars, in layman terms, are unsecured bank deposits held at banks outside the US and therefore do not fall under the regulatory regime of the Federal Reserve or the US Government. They come into existence when (1) a domestic US bank transfers US dollar deposits to a foreign bank or branch or (2) a foreign bank creates a US dollar loan or buys a dollar-denominated security.

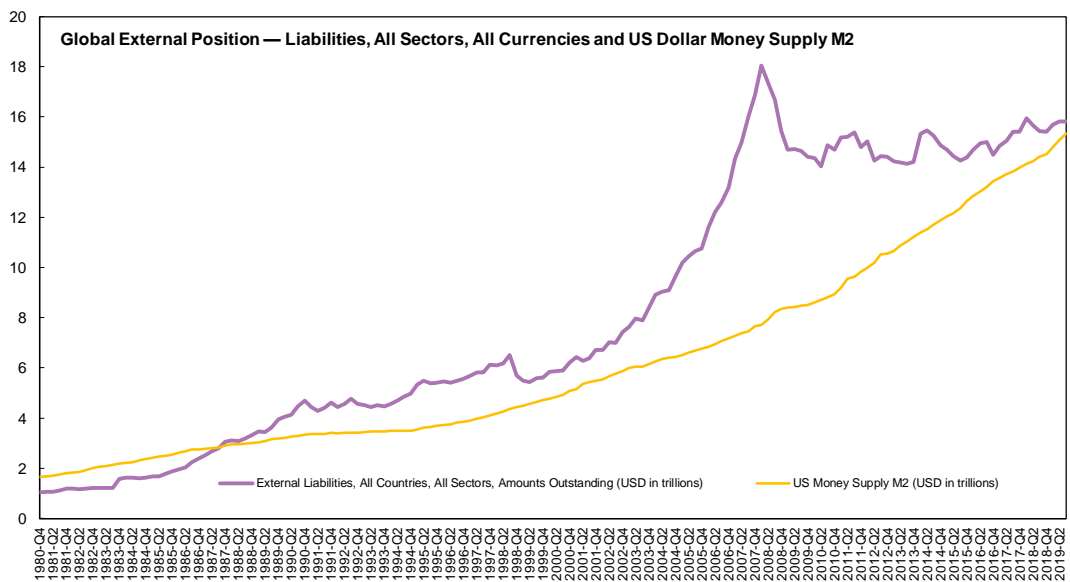
The Eurodollar system came into existence primarily to facilitate global trade and that remained its function up until the late 1990's. Since the late 1990's, however, Eurodollars have increasingly facilitated funding structures of domestic US bank

and non-bank financial institutions (otherwise referred to as the shadow banking system).

If you are wondering what happened in late 1990's to enable the transformation, it was the repeal of the Glass-Steagall Act, which in turn removed the regulatory barriers stopping Eurodollars to make their way back into the US.

Given the scale of the Eurodollar system, its transformation from a facilitator of global trade to a source of domestic funding in the US had a profound impact in asset markets — essentially, it enabled the tech and housing bubbles.

As an aside, when valuations metrics such as the cyclically adjusted price to earnings ratio, or CAPE, are used to compare markets today with long-term averages, they are much less meaningful for data prior to the late 1990's given the non-stationarity of the data. That is, the transformation of the Eurodollar market essentially created different market regimes with very different dynamics — the pre-transformation regime was that of a scarcity of capital and the post-transformation regime became one with an abundance of capital. More capitals ergo higher valuations and tighter credit spreads.



The above chart compares the external liabilities in foreign currencies of all sectors across all reporting countries (as reported by the Bank for International Settlements) versus the money supply M2 in the US. The former is a suitable proxy for the size of the Eurodollar system — one caveat is that the series comprises of all

foreign currencies, given the reserve currency status of the greenback approximately 80-90% of series can be approximated to be Eurodollars, which is good enough for our analysis.

From the above, we can see the parabolic move higher in the size of the Eurodollar system starting in the late 1990's. Second, following the Global Financial Crisis, we can see the stagnation of the growth in Eurodollars — the repeal of Glass Steagall Act unleashed the system, the introduction of Basel III and Dodd-Frank regulations has restrained it.

The stagnation of the growth in Eurodollars combined with the continued growth of money supply in the US points to why calls for a rotation out of US assets into non-US, particularly emerging market, assets have been incorrect. Since the Global Financial Crisis, global markets have undergone a regime change once again — this time dollar-denominated capital bifurcated: abundance in the US and scarcity everywhere else. This is why comparing the current relative valuations between non-US markets and US markets versus those from prior market regimes no longer provided a meaningful signal.

The US Dollar Squeeze

Global Trade

In mid-February we shared our notes from meetings with the number of the leading multinational consumer packaged companies to understand the supply chain challenges caused by the breakout of the COVID-19 virus in China.

“[T]he suspension of Chinese manufacturing has revealed the deep-rooted interdependencies within global supply chains — much like the interdependencies between global financial institutions revealed by the Lehman bankruptcy. Given these interdependencies, it is no surprise that there is panic and investors are rushing into safe haven assets.”

One of the factors we overlooked at the time was how a collapse in trade would impact FX markets. What transpired was first a sharp decline in corporations' need to drawdown trade finance facilities. This improved the liquidity situation at financial institutions engaged in trade finance. Since most trade is conducted in US dollars, this created a temporary abundance was dollar negative.

Following, the global spread of the COVID-19 virus, global markets start to crater. This in turn unleashed a vicious unwind of carry trades financed in euros, yen and the Swiss franc and contributed to a further weakening of the greenback.

These were the first order effects, to say.

Secondary Effects

Next what followed were defaults, missed payments and reduced trade, which all of a sudden meant US dollar stopped flowing from debtors to creditors and Eurodollar creation has come to a screeching halt. Producing a shortage of US dollars at non-US financial institutions.

This shortage of US dollars is now starting to prompt central banks, without swap lines with the Fed, to (a) monetise dollar-denominated securities or (2) to drawdown their foreign reserves from accounts in London, Hong Kong and other financial centres, to make hard currency available to their domestic banks.

This has increased the supply of Treasury securities and corporate bonds in the market and government bonds have sold-off concomitantly with stocks — when government bonds stop serving as a hedge, the pain felt by real money investors increases exponentially.

Then, the Fed by cutting interest rates to zero caused capital out of money market funds and in bonds, where there was still yield to be had. US banks and US branches of foreign banks utilise money market funds as a source of dollar funding. Money market funds are also where commercial paper is financed. The flow out of money market funds has exacerbated the dollar shortage and reduced the availability of funding for corporations at the very moment they need it most.

The Fed announcing late Wednesday it is establishing a special backstop for money market mutual funds comes as no surprise.

Large corporations (Boeing, AerCap Holdings, etc.) are drawing down their unutilised credit facilities just in case they need the funds and / or the facilities are cancelled. This too is placing stress on bank balance sheets.

Deposits and Regulatory Implications

Deposits from non-financial corporations are, in regulatory terms (i.e. risk-weighted cost and liquid coverage requirements), the most efficient form of funding for financial institutions.

While commercial activity has markedly slowed down, corporations still have to bear fixed costs (rent, salaries, etc.). Consequently, companies are now drawing down deposits without replenishing them with increased revenue. This is further reducing the amount of funding available to banks. Moreover, banks are having to replace low cost funding with more expensive sources funding.

Banks are being squeezed from all angles and the more painful it gets for them, the higher the US dollar will go. There is only one portfolio hedge today and that is the greenback. Embrace it.

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