Investment Strategy Update

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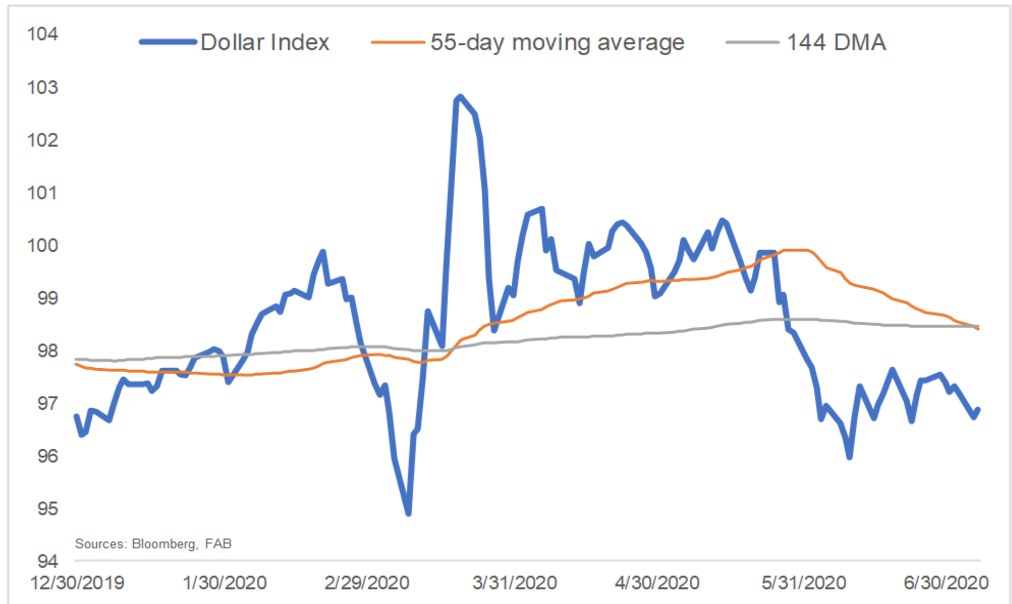
The US dollar is at a make-it-or-break-it point

- **The euro rallied the most in nearly three weeks yesterday and the British pound was advancing strongly today.**
- **The two currencies account for the lion's share of the dollar index.**
- **The greenback was advancing today amid a risk-off tone, reconfirming its status of haven currency.**
- **Cost of carry remains in favour of using dollars to invest in other markets, suggesting further weakness ahead.**
- **The question is whether the weaker-than-expected data in Europe and a virus resurgence in Japan will prompt the ECB and the BoJ to push rates further into negative territory.**
- **FAB AAC remains overweight high-quality investment grade bonds.**



The US dollar is at a turning point, and what it does at this juncture matters for many markets, especially for risk assets of developing nations. After a period of weakness, the 55-day moving average of the dollar index is now about to cross the longer-term 144-day moving average, a bearish sign for the greenback.

To be sure, just as the event is about to unfold, the dollar has caught a bid today, amid some risk aversion. The currency has acted as a haven asset since the beginning of last year and has rallied whenever volatility picks up. Today's move, however, comes right after the euro, one of the key components of the dollar index, rallied 0.54% yesterday, its best session since 22 June. The euro has been responsible for some 58% of the latest movements in the dollar.

The dollar index has dropped nearly 5.5% since 23 March, when the Federal Reserve intervened to reduce volatility in financial markets. The Fed injected so much dollar liquidity and cut rates so fast that it has become profitable, on a hedged basis, to borrow dollars and invest even in negative-yielding government bonds such as those from Japan or Europe. That would suggest further dollar weakness ahead and a victory for the bears.

However, in the past two weeks, the amount of swap lines outstanding with the Fed has dropped in half to about US$225 billion. Some US$17 billion of swap lines maturing this week are expected to not be renewed. That means international banks are demanding fewer dollars, which suggests that, despite being cheap to do so, investors and financial institutions are not borrowing so much in dollars.

Yet, if the economics remain in favour of the carry trade, the euro and the yen could continue to appreciate further.

The dollar index is about to cross a key technical barrier that could signal weakness

That poses a conundrum for the Japanese and European central banks, as the higher currency value dampens inflation and makes the exports of these nations more expensive. As German industrial activity already came below expectations yesterday, it is fair to assume the ECB may be annoyed at the euro strength.

If that is the case, the central bank may soon try to increase euro liquidity, something that could reverse the carry trade economics. That could strengthen the dollar. If it does, emerging markets are the ones most likely to suffer, as their currencies and government bonds are usually the key targets for carry trades. The Fed, naturally, also prefers a weak dollar. So it may come down to which central bank can ease more aggressively.

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