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Stars begin to converge for a bit of a US dollar rally

◆ **Key pairs, such as euros, British pounds, Australian dollars and Chinese yuan versus US dollars are all nearing key technical thresholds.**

◆ **Central banks outside the US have been increasingly vocal about their currency strength concerns.**

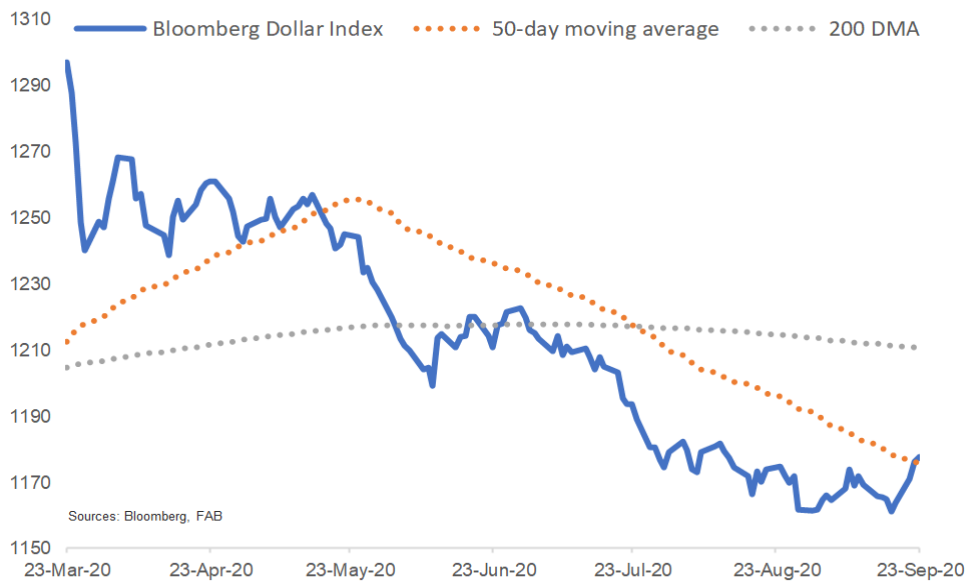
◆ **The Federal Reserve is unlikely to take any action ahead of the election, unless the market gets really unsettled.**

◆ **Diverging central bank narratives in the US and in other developed countries start to favour flows into greenback-denominated assets.**

◆ **The FAB AAC remains underweight equities and overweight gold, though less so than in the second quarter.**

The US dollar is perhaps the most important asset to watch when it comes to investments, particularly for those who have money in emerging markets. If the dollar strengthens, most commodity prices and currencies of developing nations tend to drop. Similarly, it impacts the translation of foreign earnings for large companies listed in the United States, so it affects the stock market there. Finally, it reduces inflation and growth in the US, as imports become cheaper, and exports, pricier.

In that sense, the US dollar was helping the world's biggest economy recover from its worst recession in nearly a century. In the past six months, the Bloomberg dollar index, which uses a trade-weighted basket of currencies, has dropped 9%. In the meantime, the other main currencies of the world were in ascension. The euro rallied by 9%, the Chinese yuan, 4.3%, and the British pound, 10.3%.



The gains were such that they have started to raise the alarm bells in some of the central banks of these countries. In the past two weeks, a couple of European Central Bank governors have indicated that they are watching the value of the euro. The People's Bank of China twice this week fixed the yuan at a weaker level than the market expected. And, when it meets next, the Reserve Bank of Australia is widely expected to either cut rates, or signal that it will, to curb the strength of the Australian dollar.

These attacks from multiple fronts are coming also as the US dollar has shown signs that it has moved too far, too fast. Over the past few days, it has started to appreciate and it is now testing some key technical levels which, if breached, could indicate a trend shift.

Perhaps more important, some of the fundamental drivers of the dollar depreciation could also be about to face a few short-term tests.

The US dollar index is close to breaching key levels which could signal a trend shift

The record amount of liquidity that the Fed created starting in March made dollars so plentiful that it became cheaper to borrow them to invest in Japanese yen or euros, even if the nominal rates in these currencies are negative. That relationship has changed in the past month, and the value of borrowing in dollars and investing in other currencies is no longer so clear. The direction of carry trade flows now will depend on incremental liquidity.

The Fed will have a trouble adding liquidity until the election. To bat, two Fed governors said recently that the central bank has done enough. So, if other central banks keep churning the money machine, it will become cheaper to borrow in, say yens, and invest in dollars. It may not last long, but the dollar may be on the rise.

Investment Strategy Update

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