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“Trump Rally” at Crossroads: Three-way Tolerance Tested for a Sustainable Stronger Dollar

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<Substantial Change of Trump Rally from “Expectation-oriented” to “Reality-focusing”>

The so-called Trump Rally in the financial market has entered into a new stage after the press conference by President-elect Mr. Trump held on January 11 for the first time since his victory in the presidential election. Of course the importance and degree of attention will be far greater on his inaugural speech scheduled on January 20. But on the occasion of his first press conference he has failed to give fresh information on his economic policies and invited disappointment of market participants over its contents, further accelerating the purchasing back of the Japanese yen against the dollar. The fact that the progress of a rising dollar has met a considerable adjustment in this way seems to indicate that the expectation-oriented market psychology that lasted for about two months has been changed and entered the next stage of facing up to reality in which they try to find out in a calm way what on earth will change and how.

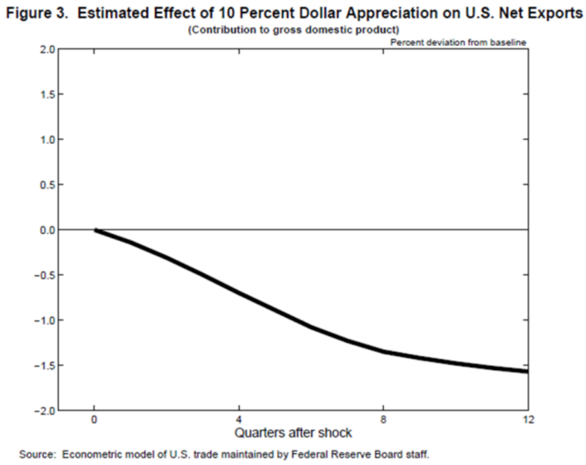
Yet, the details of “Trump Reflation” policies that the markets are desperately seeking for will not become clear all at once in Mr. Trump’s inaugural address and we will have to wait until the end of January or the occasion of State of Union Addresses scheduled in early February for any crystallized measures of them. And in the first place, the implementation of Trump reflation measures will happen during the latter half of the year even if everything goes well, and it will not be before 2018 that the actual spillover effects can be felt. Actually the IMF recognizes the existence of such time lags, and in its World Economic Outlook (WEO) issued last week, it revised upward the 2018 forecast of the US GDP by 0.4% (from 2.5% in the October 2016 forecast) while limited the upward revision to only 0.1% for the 2017 growth rate (from earlier forecast of 2.3%).

In an environment where it will take time before the detailed contents can be confirmed and their effects take place, will the expectations for the Trump reflation risen in the past two months be maintained with Trump rally continuing? It seems dependent on to what extent the three stakeholders, the Fed, Emerging Economies, and supporters of Mr. Trump can tolerate the adverse impacts of the stronger dollar respectively. In other words, the adjustment process will become much deeper if these three entities show any negative responses to the current appreciation of the dollar in the environment where it will take some time for the market to comprehend and digest the contents of economic policies of the new administration.

<Tolerance 1: Fed more vigilant on the adverse effects of the stronger dollar >

Needless to reiterate, in the background of across-the-board higher dollar in the Trump rally there was an expectation for the "policy mix of budget stimulus and monetary tightening" by the new government. Based on the assumption that the growth of the US economy and the price rise will be accelerated with Mr. Trump's reflationary policies centered around the large fiscal expenditures that include "tax reduction, infrastructure investment, and deregulation", the markets rapidly incorporated into their behavior a scenario that the expansion of budget deficits will push inflation higher, causing the US long-term yields to rise (with accelerated rate hikes by the Fed) , and bringing higher interest rates and higher dollar.

< Chart 1：Estimated Effect of 10% Dollar Appreciation on US GDP through Net Exports>



（Source） Stanley Fischer: "The Transmission of Exchange Rate Changes to Output and Inflation"）

However, as I noted earlier, the implementation of the reflationary policies will come in the latter half of this year at the earliest, and there will be a time lag of almost one year before the positive impacts of them will be realized. If so, the adverse impact on the US economy of the stronger dollar which rose almost by 10% on the index base since last November will be materialized first. For instance, Fed Vice Chairman Mr. Stanley Fischer referred in his lecture in November in 2015 to an estimate that "a 10% dollar appreciation has a negative contribution through the net export channels to the U.S. growth rate of about 0.3% in a half year." If the adverse effects of the dollar appreciation should actually be seen in the macroeconomic indicators, the current consensus forecast of "the Fed rate hikes about three times in 2017" will recede or be moderated at least temporarily. Whether or not the judgment of the Fed led by

Chair Janet Yellen who adheres to the data dependent policy will become more cautious with the effects of the dollar appreciation will become of a great concern in this early spring (on such occasions as the FMOC to be held on March 14 and 15, etc.)

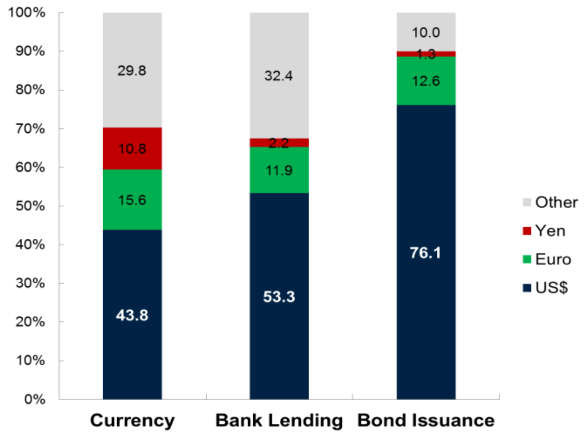
＜Tolerance 2: Negative Spiral of stronger dollar that Emerging Economies Would Face>

On the other hand, it was emerging markets that were hit instantly and most severely by the dollar appreciation. In the emerging markets the non-banking private sector financing denominated in US dollars expanded rapidly after the global financial crisis of 2007-2008, which has caused a big turmoil in these markets with the appreciation of the dollar. According to the BIS and others, the debts outstanding denominated in dollars of private sectors in emerging economies drastically expanded from about $6 trillion in 2007 to more than $20 trillion in the second quarter of 2015. The dollar-denominated funding increasingly has taken the form of direct financing like bond issues rather than the traditional indirect financing like bank loans. As Chart 2 shows, about 80% of global bond issues have been denominated in dollars. Before the so-called Bernanke shock in 2013, there was a widespread forecast for a prolonged super-low interest rates in major advanced economies including the US accompanied by a forecast for dollar depreciation, which accelerated the emerging economies' raising of funds by issuing bonds in dollars. However, currently the assumption has been largely collapsed, and many corporations in emerging economies have been faced with a big upset in their fund-raising by a rapid upward reverse of interest rates and exchange rates of the dollar.

Specifically, the jump of the dollar ballooned the amortization costs of these debts, rapidly bringing tightened domestic financing environment and liquidity. It triggered credit insecurity and increased the demand for cash money, causing domestic asset prices to plunge. The appreciation of the dollar with depreciating home currencies has been aggravating this negative spiral. In fact, at the early stage of Trump rally that started last November, countries like Chile, Brazil, South Africa, and Turkey that have high ratio of dollar-denominated bonds experienced a big turmoil in their financial markets.

In the past, emerging economies could expect some positive effects from economic and financial crisis in their market, with depreciation of their currency serving as a shock absorber to give an export drive that stimulates economic recovery and promotes balance of payments adjustments. However, in an environment of long-time stagnation where a low level of demands has become a global problem, there is a natural limit in expanding exports through price factor of lower currency. In the present emerging markets, the credit channel to raise funds from advanced countries, rather than the export channel, is the key to their growth, and therefore the appreciation of the dollar at higher speed and in larger magnitude beyond their expectation will give them a big damage. For the foreseeable future, the emerging markets will face a testing time of to what extent they can tolerate the dollar appreciation before the present turmoil in the emerging markets will develop into a genuine crisis.

＜Chart 2：Dollar denominated transactions in the Global Financial Market (2016,%)＞



（Source）World Bank; Global Economic Prospects, January 2017：The U.S. Economy and the World

＜Tolerance 3：Trump Supporters in the Rust Belt Hit by the Dollar Appreciation＞

Needless to say, Mr. Trump's policy platform and tweets on trade issues suggest his strong stance that he will not allow domestic demands to be exported to other countries. That means he will remedy the export-oriented growth of such countries as Mexico and China that has been maintained through the widening deficits of the US which have resulted from the US domestic demands exported overseas. In contradiction to his conviction, however, large appreciation of the dollar will accelerate the outflow of domestic demands, prompting an expansion of trade deficits which result from exported demands. In other words, there is a theoretical contradiction between Mr. Trump's protectionist policy orientation and the strong dollar policy.

Further, his biggest contradiction may be that it is the US manufacturers in the Rust Belt (US Mid-West area which has traditionally high dependency on manufacturing industry) who served as a driver for Mr. Trump victory that will be most seriously hit by a strong dollar. If the discontent of Trump supporters should grow against the adverse effect of a strong dollar, Mr. Trump may simply make a verbal intervention to talk down the dollar. Not only that, he will be highly likely to easily lean toward protectionist policies like identifying a country as a currency manipulator. To what extent the adverse effects of a strong dollar will be recognized by Trump supporters, the tolerance of whom will be a key to the continuation of a high value of the dollar.

＜Welcoming Mood for the Stronger Dollar May Be Short-lived＞

Mr. Mnuchin, who is expected to assume the position of Treasury Secretary under the Trump administration, stated that "the potential growth rate of the US will be 3-4% and tax cut is most important to make it materialize", or that "he will put more value on the economic growth rather than on the problem of a strong dollar." There is a possibility that the concerns over a strong dollar will not rise so much as long as the US economy continues to grow at a certain acceptable pace.

However, as we have seen above, it does not warrant that the three entities of “the Fed”, “Emerging economies”, and Trump supporters in the Rust Belt are all welcoming a strong dollar with open hands and their “tolerance” on the current appreciation of the dollar may not last for very long. The dollar against the yen fell to the level of 112 yen reflecting an intensified investors’ risk adverse behavior caused the speech of UK Prime Minister on hard Brexit. It is likely that the accelerated adjustment may reflect not only the sense of caution over the Brexit but rather reflect the fact that many market participants are welcoming the current adjustment of the dollar appreciation.