ALL EYES ON THE US DOLLAR

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In this month's *EVA Chartbook*, we're exploring one of the most important and timely questions in the investing world today. ***Is the US dollar bull market running out of steam or gearing up for another disruptive run?***

As you can see in chart to the right, the dollar bounced around in a relatively tight trading range for more than five years after the global financial crisis and then exploded by roughly 25% in the second half of 2014.

If there was any doubt, it is now clear that stimulus in Europe and Asia is not the same as stimulus in the United States. When foreign central banks ease against the backdrop of a tightening Fed, that "divergence" drives the world's still-dominant reserve currency higher with immediate and profound implications for almost every market and asset class.

Over the last 18 months, we've seen a sharp collapse in commodity prices and emerging market currencies, a significant jump in credit spreads, waves of risk aversion in major equity markets, and an alarming slowdown in global economic growth. Few economists disagree that another dollar surge could destabilize the global system in even more profound ways, but the real question is whether this powerful trend has run its course.

While the divergence between major central banks likely has limited room to run (given the tightening we've already seen in the United States), it's not hard to imagine another 10% to 15% rise in the trade weighted dollar with a little help from the Fed, the European Central Bank, the Bank of Japan, and the People's Bank of China.

That, in our opinion, is where the rubber meets the road. Eventually, divergence will give rise to convergence as a slowdown (or outright recession) in the US leads to an about-face in Fed policy. While history suggests the dollar could spike further in the event of a global panic, eventually the greenback's reversal should lead to a reflation in commodity prices (especially energy), a calming in credit spreads*, a recovery in major equity markets, and a re-acceleration in global growth.

Let's dive right in.

*Credit spreads are the difference between corporate bond yields and the yields 10 year US Treasuries.

Trade Weighted US Dollar

Source: Evergreen GaveKal, Bloomberg

5 CATALYSTS THAT COULD DRIVE THE DOLLAR HIGHER

I. The Federal Reserve hikes interest rates & signals further tightening

II. The European Central Bank extends & expands QE

III. The Bank of Japan expands QE

IV. The People's Bank of China allows its currency to depreciate

V. Emerging Market capital flight fuels global risk aversion

MARKETS EXPECT A FED FUNDS HIKE ON DECEMBER 16

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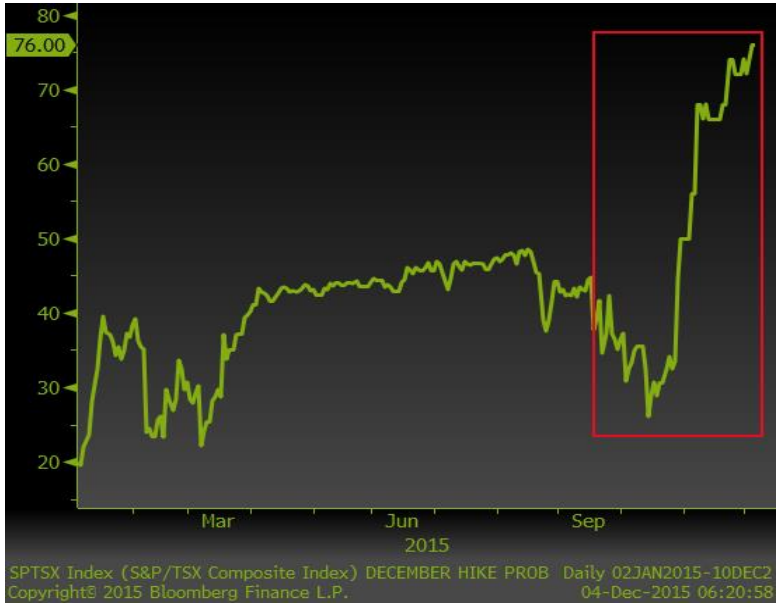
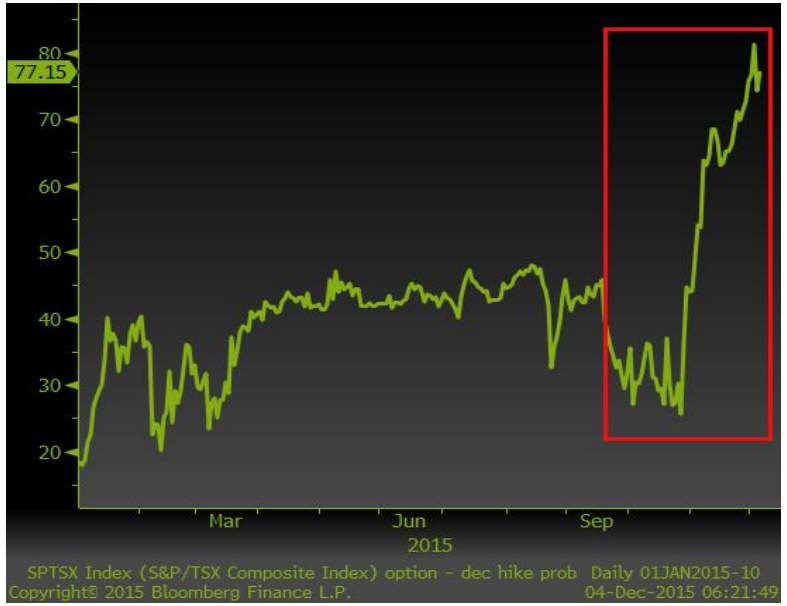
Fed Funds Futures,
76% December Hike Probability



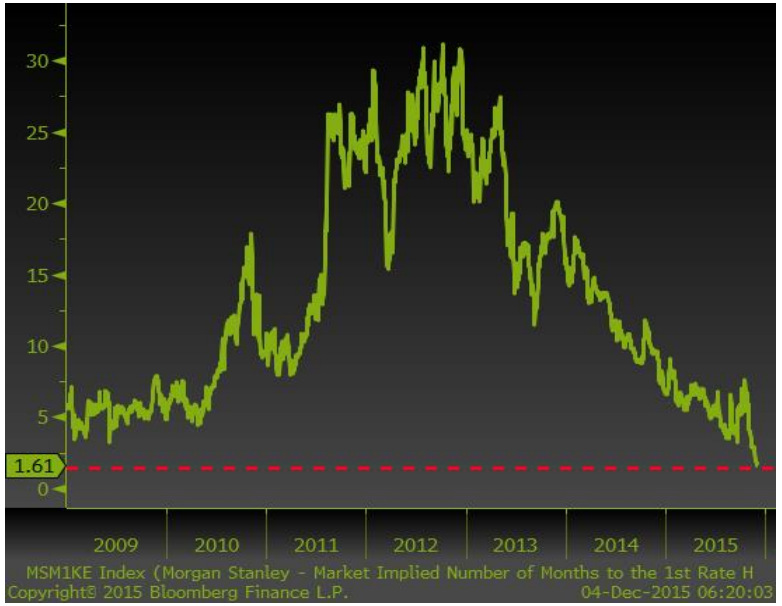
Source: Evergreen GaveKal, Bloomberg

Overnight Index Swaps,
77% December Hike Probability



Source: Evergreen GaveKal, Bloomberg

Morgan Stanley's Number of
Months to 1st Rate Hike Index



Source: Evergreen GaveKal, Bloomberg

- Market expectations for a rate hike at the Fed's December 16 policy meeting have shifted dramatically in recent months as you can clearly see in the federal funds futures market (left chart, 76% implied probability) and the overnight index swaps market (middle chart, 77% implied probability).
- Morgan Stanley's "Number of Months to 1st Rate Hike" Index (right chart) is telling a similar story after falling to its lowest levels at any point in the post-2008 recovery.

US ECONOMIC DATA (AS THE FED INTERPRETS IT) SUPPORTS A RATE HIKE

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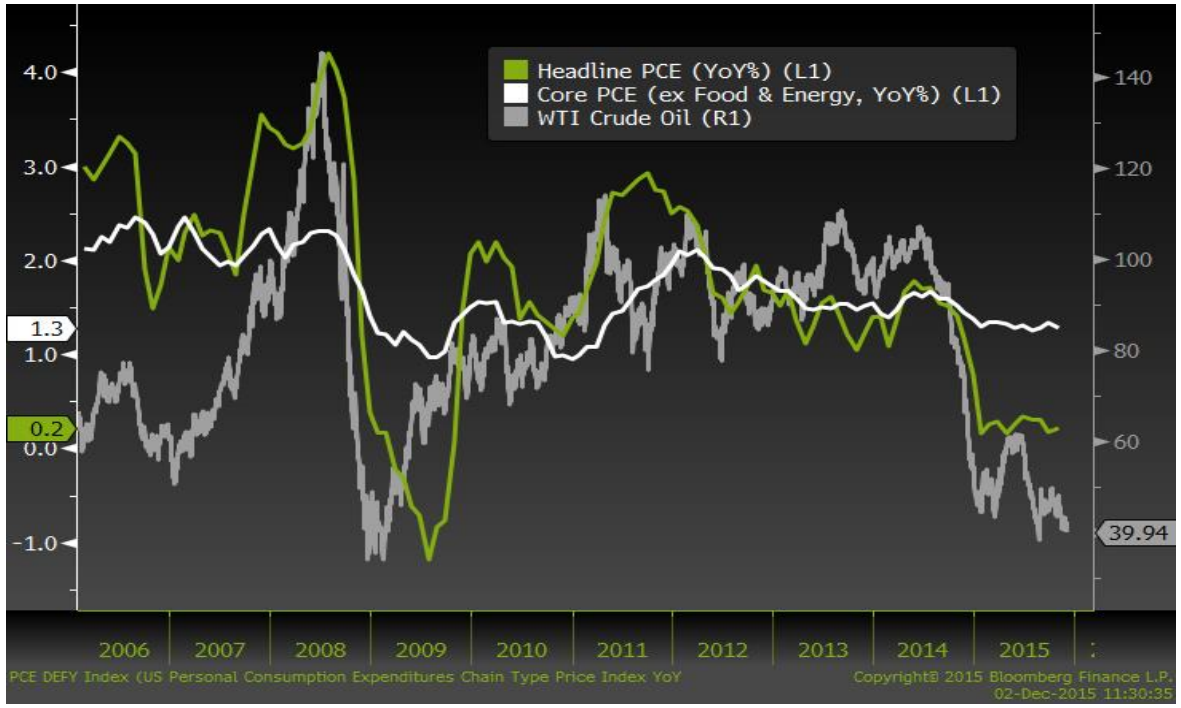
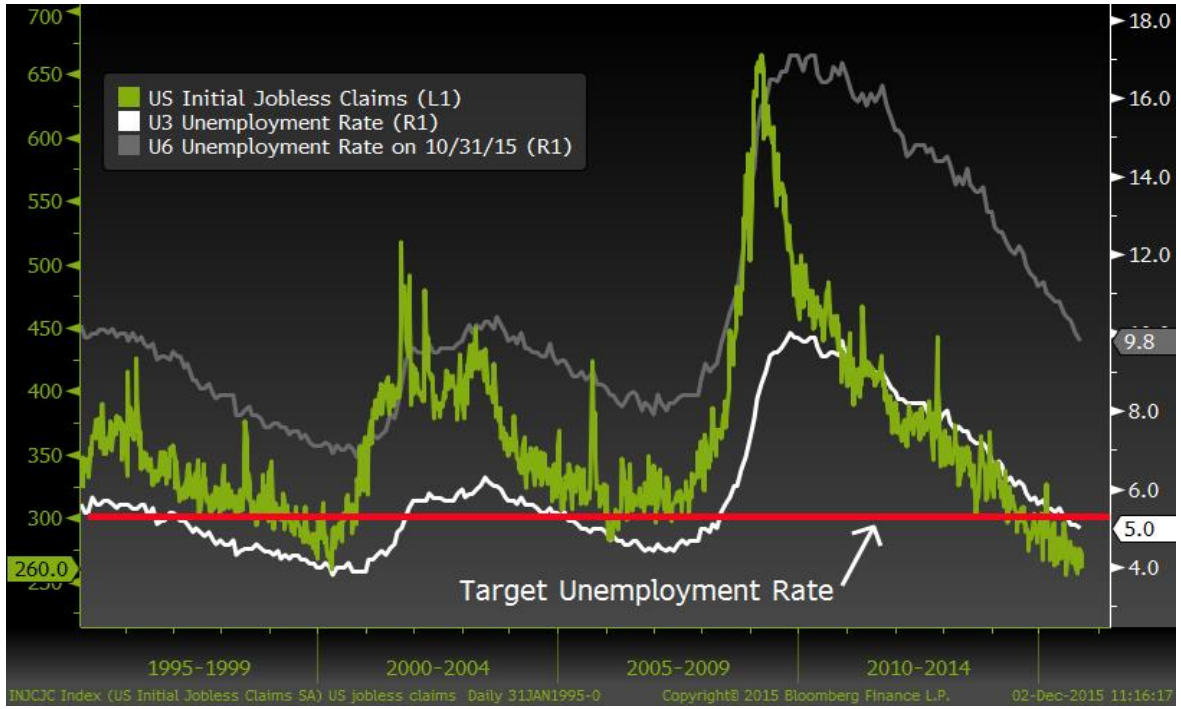
US Inflation



Source: Evergreen GaveKal, Bloomberg

US Employment



Source: Evergreen GaveKal, Bloomberg

- While headline and core personal consumption expenditures (left chart) continue to show inflation running well below the Fed's 2% long-term target, the rate-setting committee believes soft inflation readings are the product of short-term drags from a strong US dollar and weak commodity prices. In other words, the Fed expects inflation will rise back to its target whenever the US dollar falls and commodity prices recover.
- More importantly (according to recent FOMC statements), the US labor market is now at or near the Fed's target "full employment" level with the headline unemployment rate (right chart, white line) at just 5.0% and jobless claims at their lowest levels since 2000.

WHILE CREDIT SPREADS ARE RISING, VOLATILITY IS CALM & EQUITY MARKETS REMAIN BUBBLY

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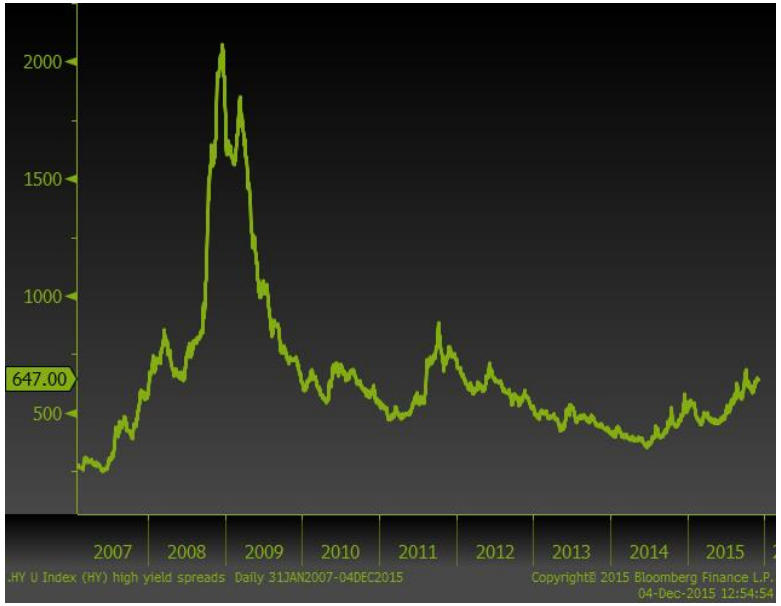
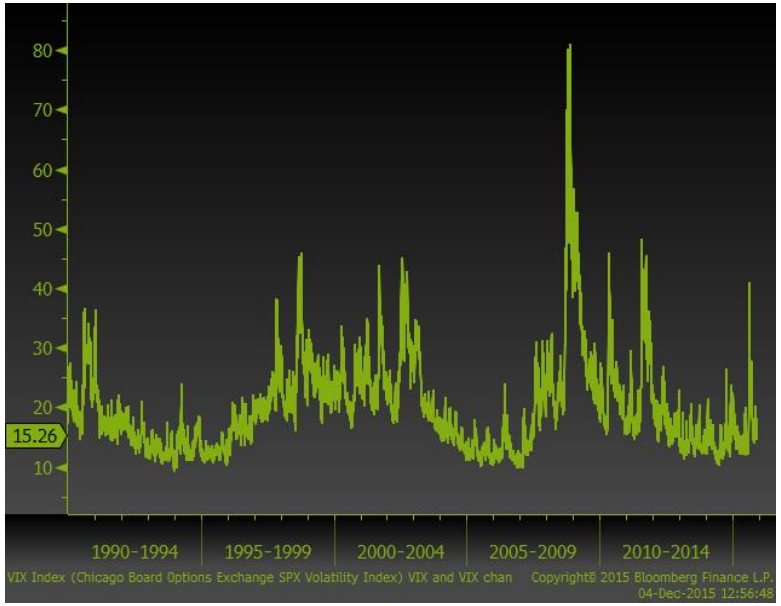
Credit Spreads*



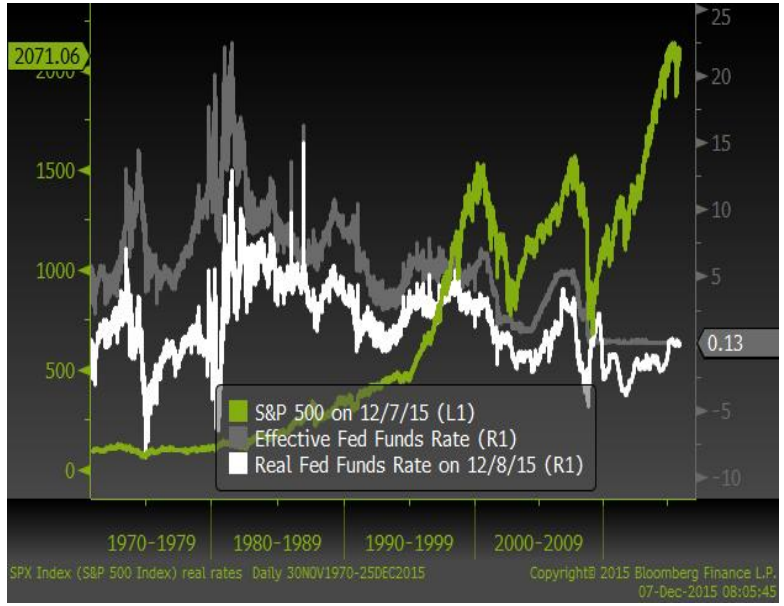
Source: Evergreen GaveKal, Bloomberg

US Equity Volatility



Source: Evergreen GaveKal, Bloomberg

Seven Years of ZIRP



Source: Evergreen GaveKal, Bloomberg

- Given this morning's stronger-than expected November employment report, the only thing that can delay a December hike is a sharp deterioration in financial conditions like we saw in August's "Flash Crash."
- While credit spreads are now at their highest levels since 2011 (left chart), US equity volatility (middle chart) continues to grind lower. As we noted in last month's *EVA Chartbook*, this amounts to a window of opportunity for the Fed to exit its long-standing zero interest rate policy (also known as "ZIRP").
- A lot can happen in two weeks, but the Fed needs to balance short-term volatility associated with tighter monetary policy with the longer term risks to financial stability after holding interest rates at zero for nearly seven years (right chart).

*Credit spreads are the difference between corporate bond yields and the yields 10 year US Treasuries.

SOME ANALYSTS ARGUE THE FIRST FED HIKE SHOULD *WEAKEN* THE DOLLAR

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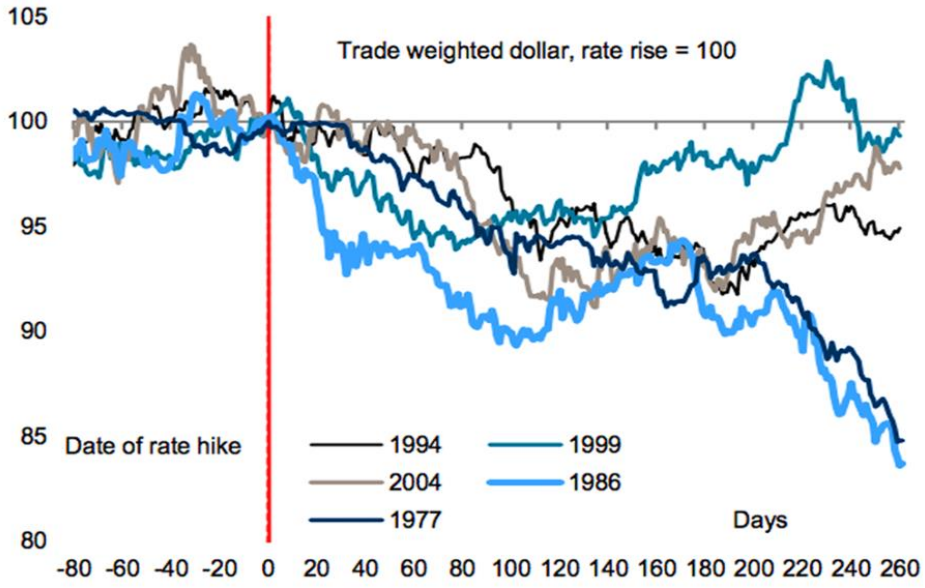
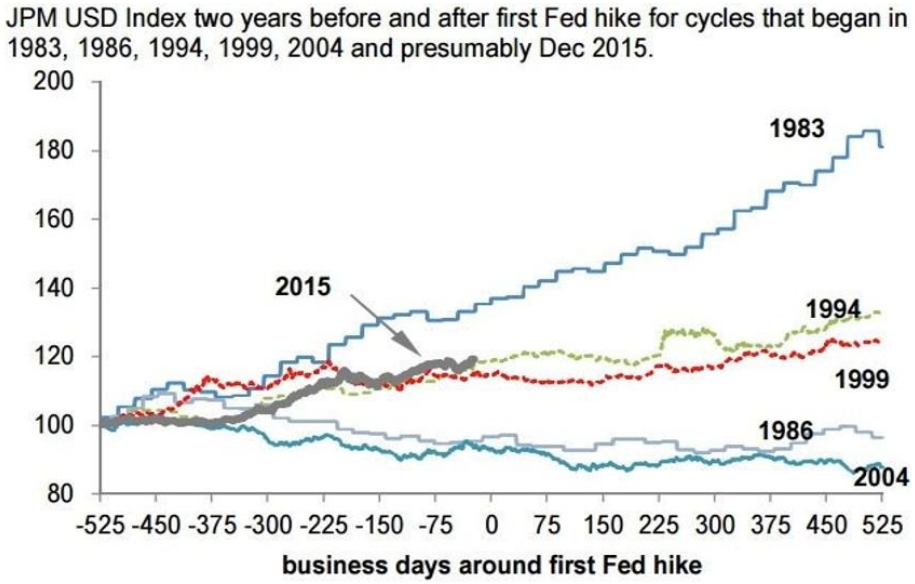
Initial Fed Hikes & the US Dollar



Source: Credit Suisse

The US Dollar 2 Years Before & 2 Years After Fed Hikes



Source: JP Morgan

- The trade-weighted US dollar has historically fallen after the Fed's first rate hike (left chart), prompting some analysts to predict the dollar will decline after the Fed's December meeting.
- While the initial rate hike used to mark the beginning of the Fed's tightening cycle, we have to consider how monetary policy has changed with the use of new policy tools like forward guidance and quantitative easing. If tightening now begins long before the Fed's first interest rate hike, the dollar could react in a very different way to what amounts to *subsequent* tightening later this month.
- As you can see in the chart to the right from JP Morgan, the US dollar's rise over the last two years already ranks as the second strongest pre-hike move in recent history. If you compare the dollar's performance over that timeframe (right chart) to past tightening periods (left chart), you'll see that this dollar rally has already powered through the weakening phase normally associated with the beginning of a tightening cycle.

BUT WE BELIEVE TAPERING IS TIGHTENING

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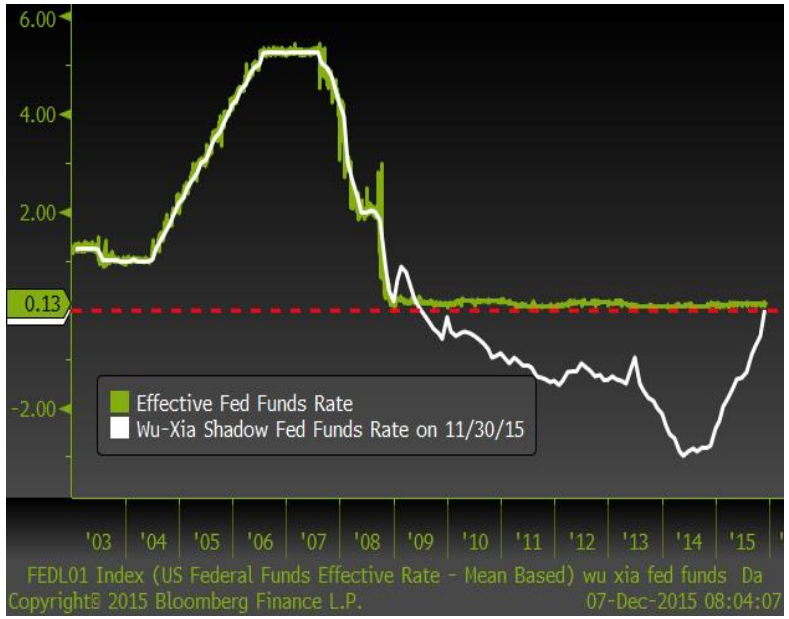
Fed Balance Sheet & Fed Funds Rate

Source: Evergreen GaveKal, Bloomberg

Atlanta Fed's Shadow Fed Funds Rate



Source: Evergreen GaveKal, Bloomberg

Financial Conditions & the US Dollar

Source: Evergreen GaveKal, Bloomberg

- As we would expect at the beginning of a tightening cycle, the US dollar (right chart, white line) traded down in 2013 after outgoing Fed Chairman Ben Bernanke signaled the Fed's intentions of winding down its previously open-ended QE3 asset purchases. An argument can be made that this was the beginning of the tightening cycle (the taper of QE-forever expectations), but there is no question that financial conditions started to deteriorate as QE3 drew to a close in 2014.

- From that perspective, the data suggests that tapering is tightening. Although rates remained at zero (left chart, white line), the Fed's balance sheet stopped growing in October 2014 (left chart, green line). Since that time, we've seen a dramatic tightening in US financial conditions in line with the rising dollar (right chart) and what has amounted to a roughly 300 basis point tightening in the Atlanta Fed's shadow fed funds rate (middle chart, white line).

REAL QUESTION IS HOW MUCH LONGER THE TIGHTENING CYCLE WILL RUN

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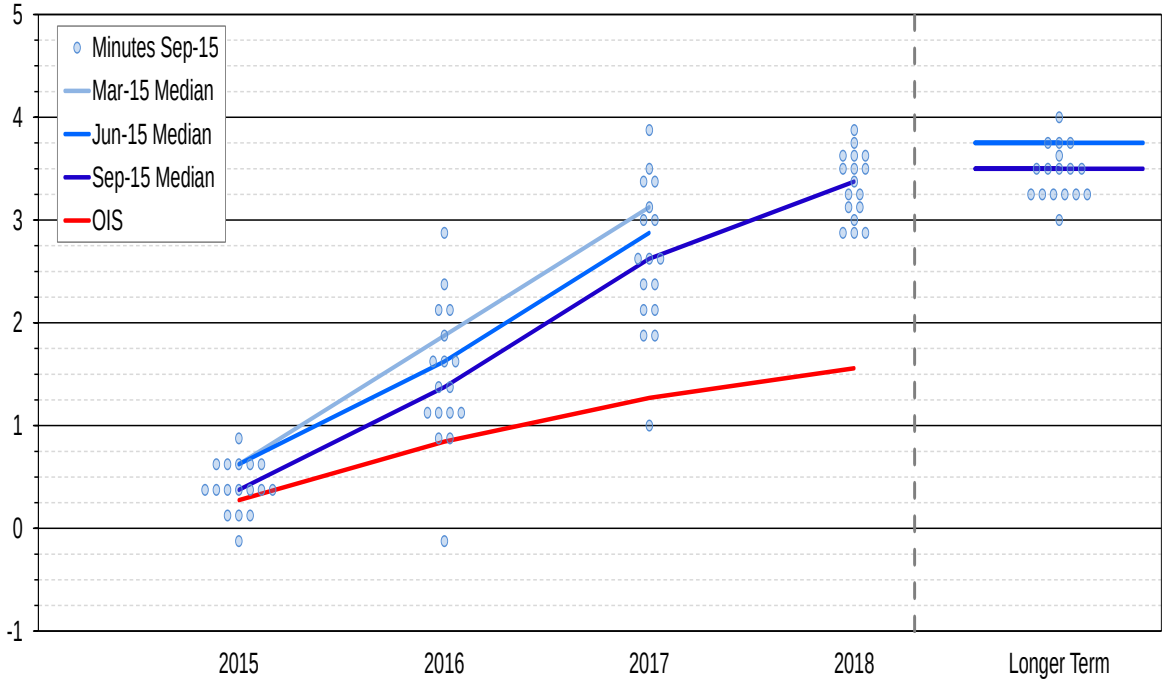
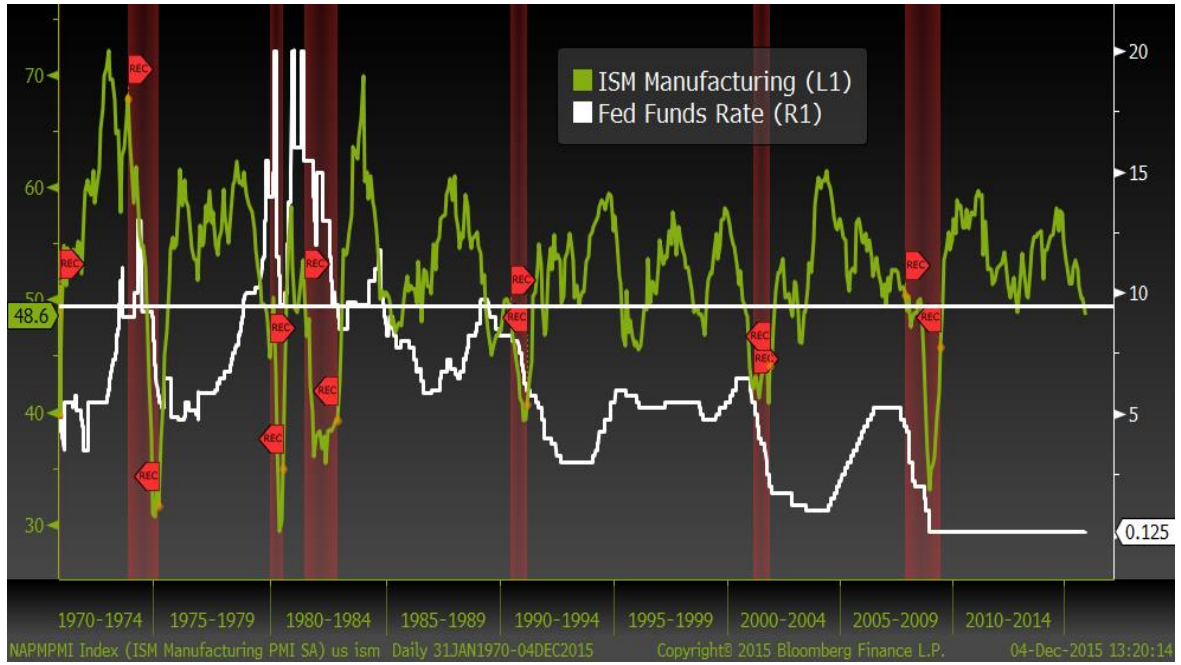
FOMC "Dot Plot"



Source: Federal Reserve, Bloomberg

ISM Manufacturing Index, Fed Funds Rate, & US Recessions



Source: Evergreen GaveKal, Bloomberg

- As the FOMC's "dot plot" (a quarterly release showing where anonymous Fed voters see rates going over time) from the September 2015 policy meeting shows, the Fed still anticipates (left chart, purple line) that it will hike interest rates further and faster over the next three years than the overnight index swap market (left chart, red line) expects.
- While the Fed has steadily relaxed its projected rate hike path each quarter over the last year, the majority of Fed voters still believe that rates will be greater than 1% by the end of 2016 and greater than 2% by the end of 2017. If true, then the dollar has a ways to go.
- Considering the weakness we're already seeing in US industrial activity (right chart), we have to wonder if the tightening cycle can run as far as the Fed or the market currently expects. According to Jones Trading's Mike O'Rourke, "The last times the Fed funds rate moved higher after sub-50 ISM manufacturing prints were single episodes in 1985 and 1986, which were not followed by additional tightening and were followed by additional easing within 6 months."

WHILE A FED HIKE WILL PROBABLY BOOST THE DOLLAR, MORE QE IN EUROPE &/OR JAPAN COULD SEND IT SOARING

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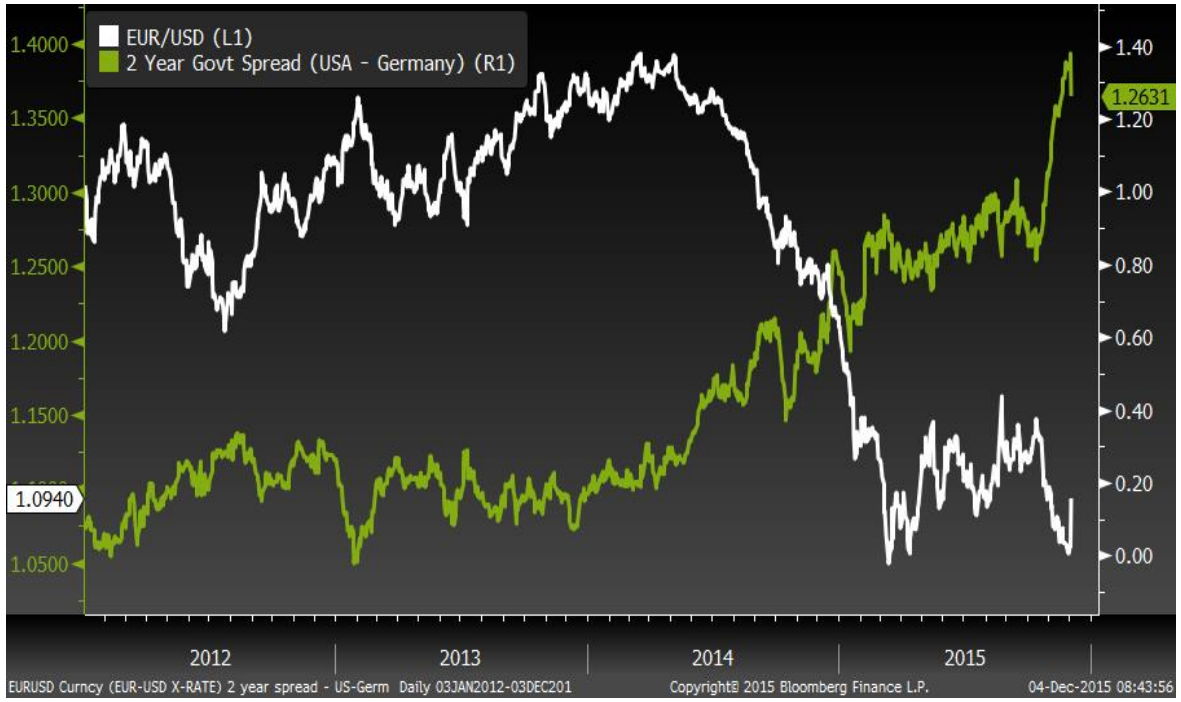
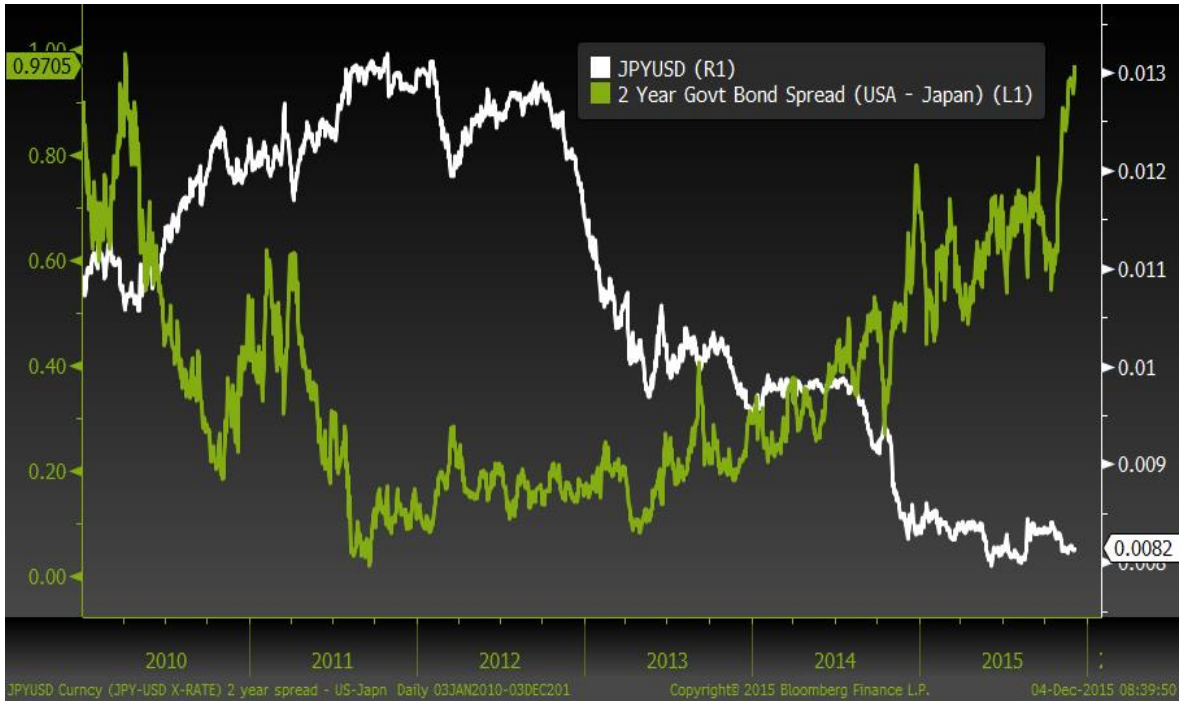
EUR/USD & Trans-Atlantic Rate Divergence



Source: Evergreen GaveKal, Bloomberg

JPY/USD & Trans-Pacific Rate Divergence



Source: Evergreen GaveKal, Bloomberg

- If the Fed's ultimate rate trajectory is shallower than expected (as our investment committee at Evergreen GaveKal believe), any further rise in the US dollar will ultimately depend on foreign central banks.
- As you can see in the charts above, there is a strong relationship between the euro/dollar (left chart, white line) and yen/dollar exchange (right chart, white line) rates and the rate differentials (green lines in both charts above) with short-term US government debt. Should the European Central Bank and/or the Bank of Japan expand their ongoing QE programs, the US dollar could strengthen given that US interest rates are already considerably higher.

THE ECB DISAPPOINTED THIS WEEK…

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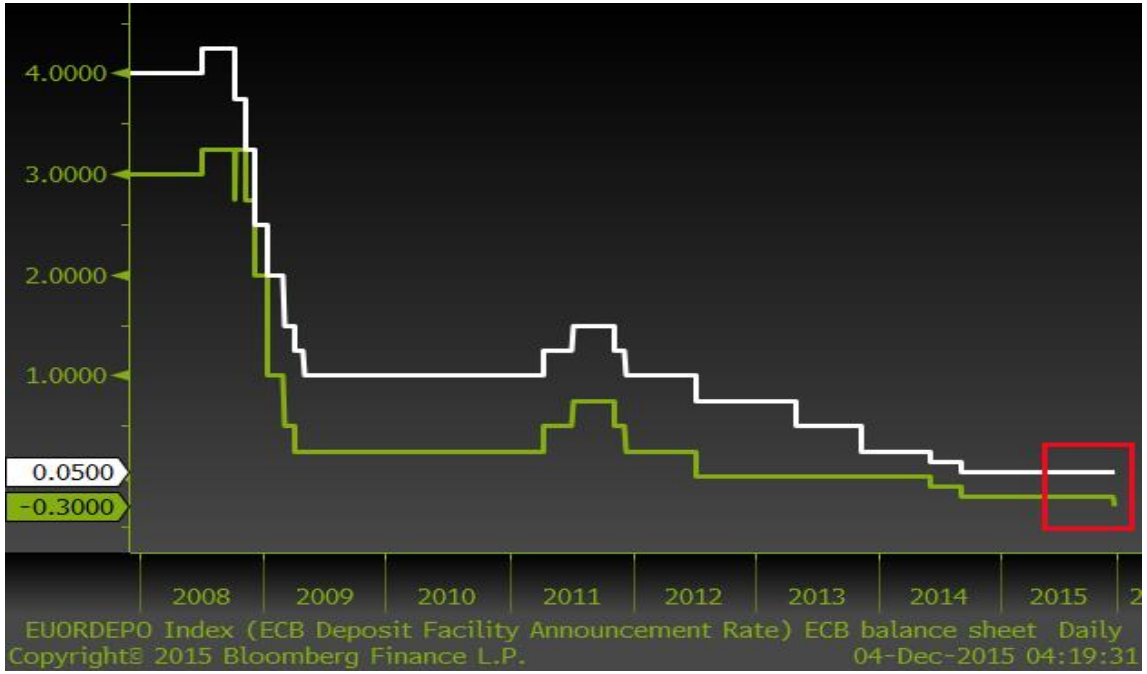
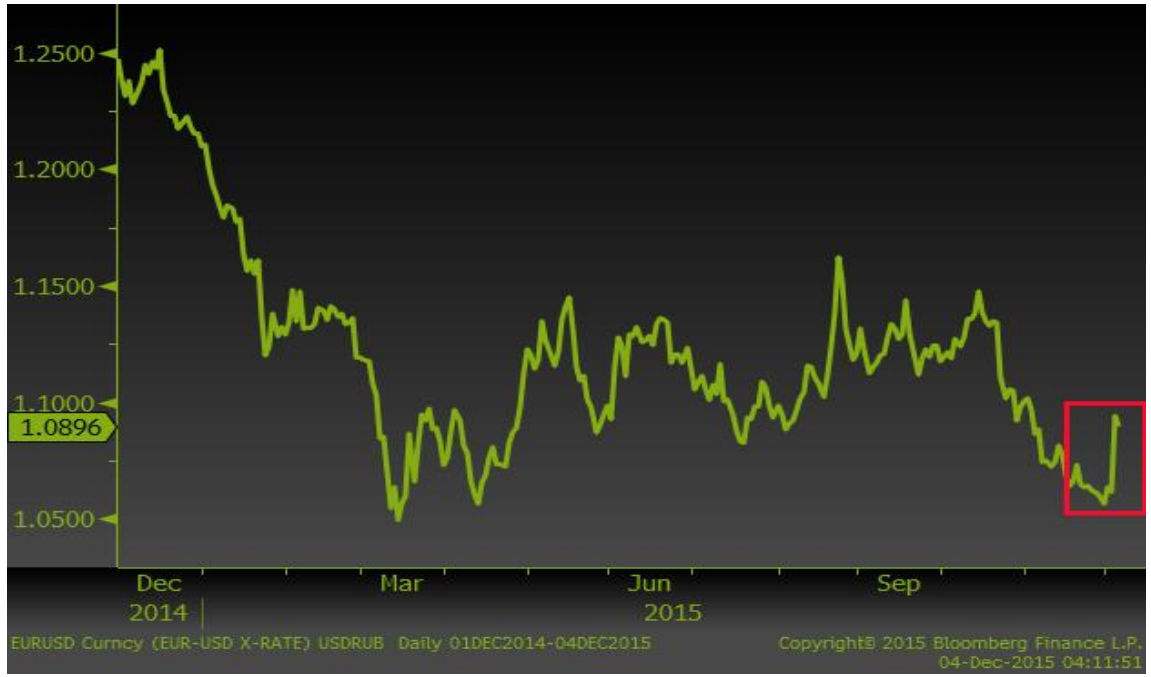
ECB Deposit Rate Cut



Source: Evergreen GaveKal, Bloomberg

EUR/USD



Source: Evergreen GaveKal, Bloomberg

- While the European Central Bank cut its discount rate yesterday by 0.10% to -0.30% (left chart) and extended what had already been a rather open-ended QE program to "at least March 2017," it sorely disappointed the markets which had been expecting an aggressive expansion in the pace of monthly QE purchases.
- After falling from $1.15 to $1.05 over the last six weeks in anticipation of more QE, the euro (right chart) surged all the way back to $1.08 on Thursday.
- Markets are behaving as if the ECB is done making adjustments to its QE program, but we believe the ECB is just stepping out of the way to allow the Fed to hike (which will likely weigh on the euro just like more ECB QE) before deploying additional funds.

… BUT MORE QE IS STILL LIKELY

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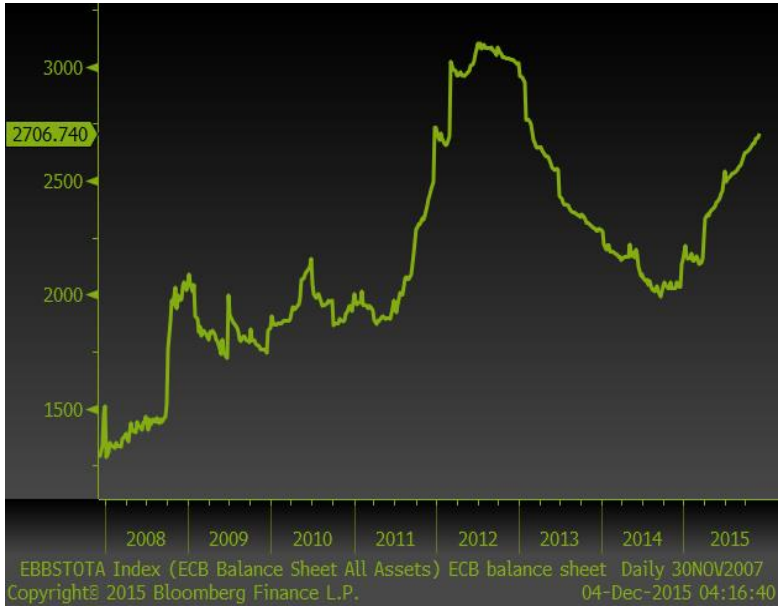
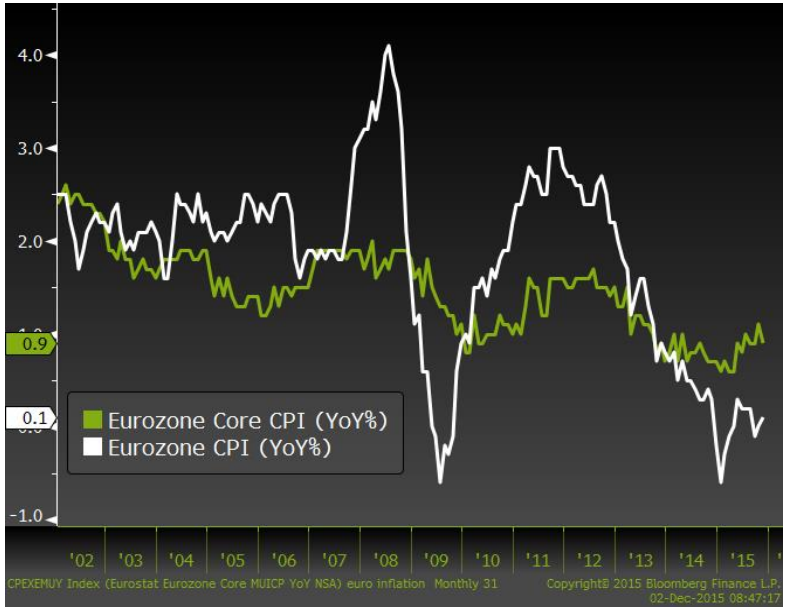
ECB Balance Sheet



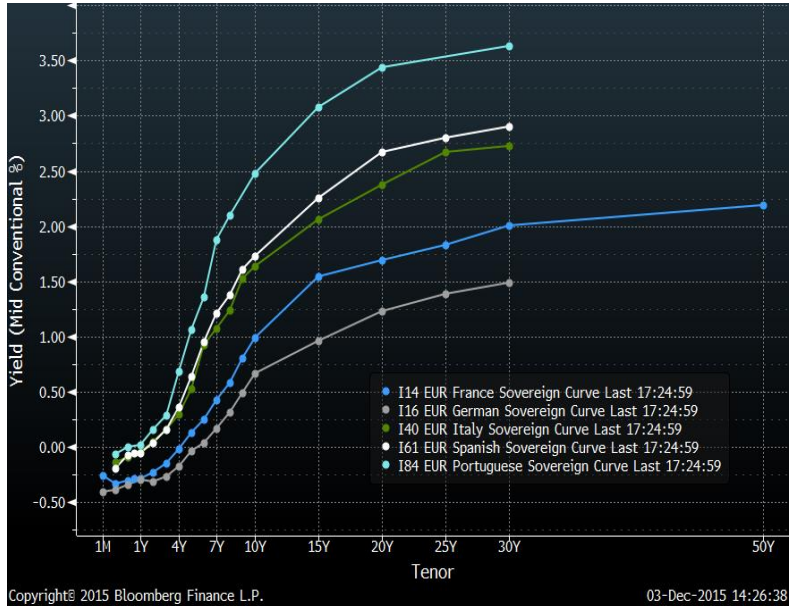
Source: Evergreen GaveKal, Bloomberg

Euro Area Inflation



Source: Evergreen GaveKal, Bloomberg

Key Euro Area Yield Curves



Source: Evergreen GaveKal, Bloomberg

- Technically, the ECB only has one mandate: to ensure price stability across the highly-indebted Eurozone. As you can see in the middle chart, it is failing miserably as core CPI remains tepid and headline CPI is hanging on the edge of deflation.
- While Mr. Draghi recently reaffirmed his 2012 “whatever it takes” commitment by saying the ECB would “do what we must to raise inflation,” the ECB’s growing balance sheet (left chart) is still well below its 2012 levels.
- What makes the ECB’s position so difficult at this juncture (and more QE so much more likely) is that it is tasked with holding a politically fragile monetary union of 19 countries together (by anchoring short term rates, right chart) in the face of structural competitive imbalances, emerging threats from anti-establishment political parties, and the slow disintegration of European unity in light of the escalating refugee crisis.
- We do not believe the ECB is done… not by a long shot.

ABENOMICS IS STRUGGLING

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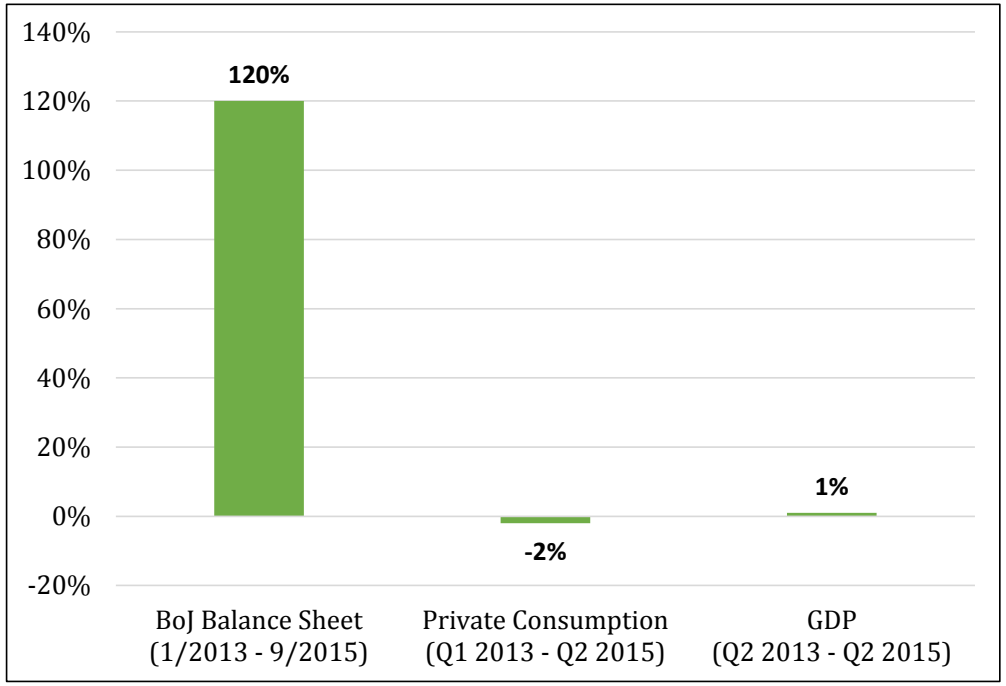
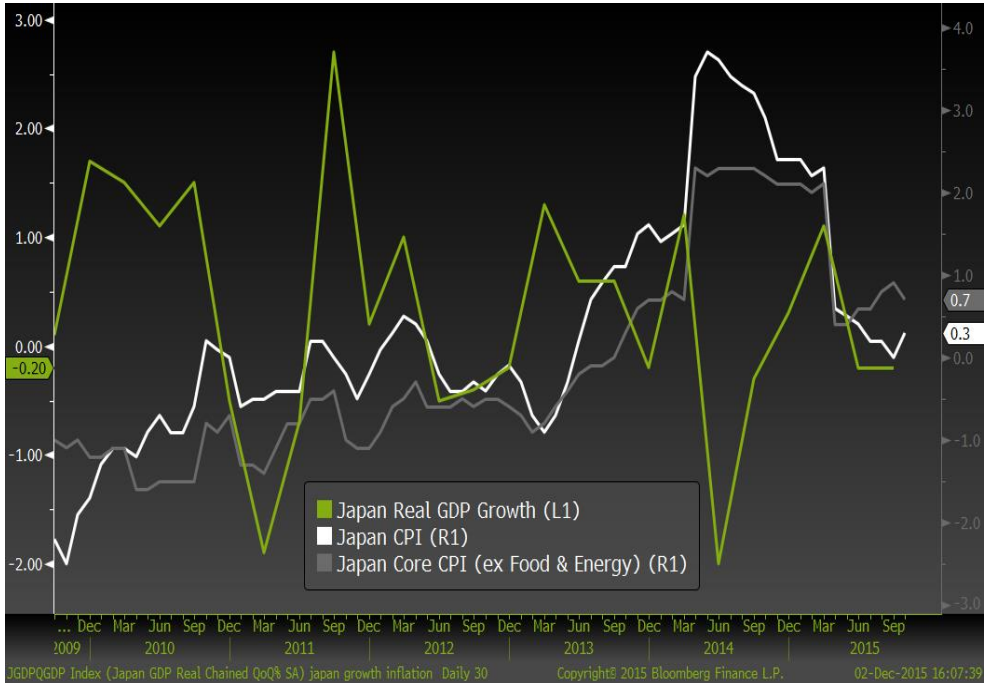
BoJ Balance Sheet, Consumption, & GDP Growth Since 2013



Source: Evergreen GaveKal, Financial Times

Japanese Real GDP Growth & Inflation



Source: Evergreen GaveKal, Bloomberg

- On the other side of the world, Japan has officially fallen into technical recession (right chart, green line). While the Bank of Japan's balance sheet has more than doubled since 2013, it's produced next to nothing in terms of consumption or GDP gains (left chart). Moreover, massive QE has failed to kick-start a self-sustaining inflation cycle as hoped. Suffice it to say that Abenomics is struggling to support current economic activity despite meaningful progress toward longer-term structural reforms.
- The Bank of Japan has to make a choice. Will it expand its QE program to support growth, stoke inflation, and defend its hard-won trade competitiveness? Or will it sit tight while Abe's upcoming consumption tax hike (in April) combines with a rising yen to throw the country deeper into recession and back into deflation?

YEAR OF THE YEN? THINK AGAIN.

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Key Japanese Yen Exchange Rates

Source: Evergreen GaveKal, Bloomberg

- While Bank of Japan Governor Haruhiko Kuroda insists that more QE is unnecessary, another surprise QE expansion like we saw in October 2014 is certainly possible in the event of a Fed hike and additional ECB QE.
- Otherwise, Japan risks giving back the FX gains it has picked up versus Germany and China (two of its biggest trade competitors) since 2012.

WILL THE DOLLAR FALL WHEN DIVERGENCE RUNS OUT?

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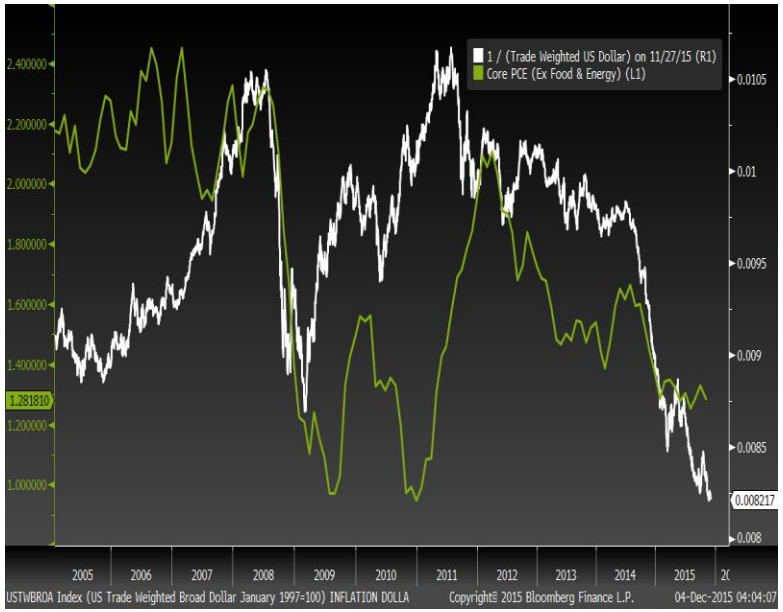
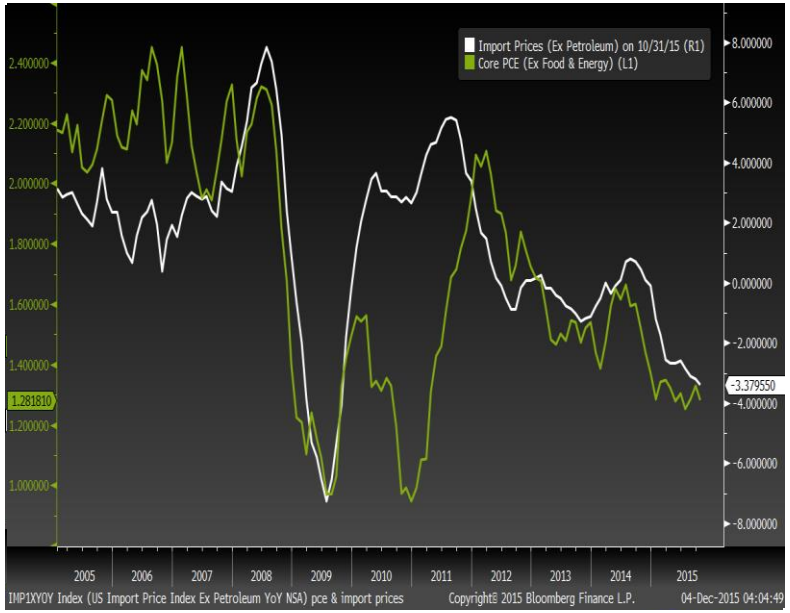
Core Inflation & the US Dollar (Inverted)



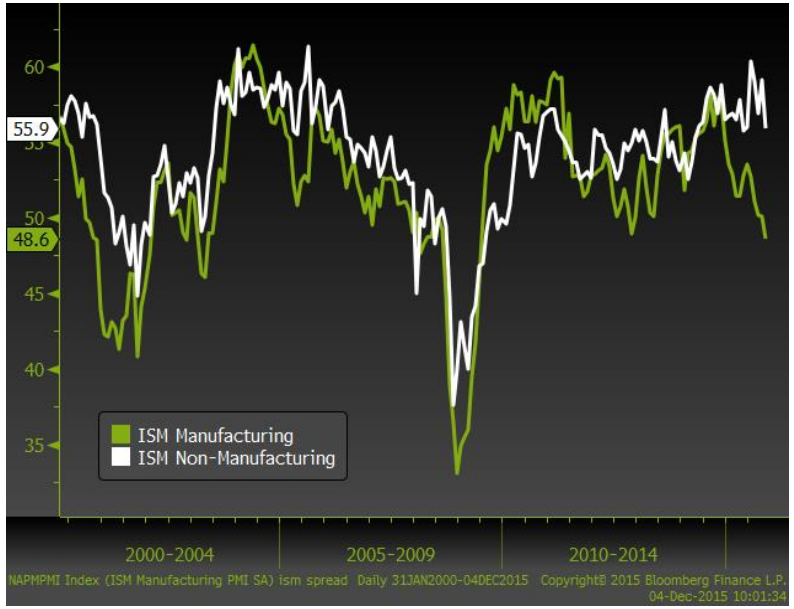
Source: Evergreen GaveKal, Bloomberg

Core Inflation & Import Prices



Source: Evergreen GaveKal, Bloomberg

ISM Manufacturing vs. Non-Manufacturing



Source: Evergreen GaveKal, Bloomberg

- It goes without saying that further dollar appreciation will further weigh on US inflation – largely as a function of import price disinflation (right chart, white line) – and industrial activity (right chart, green line).
- While the ISM Non-Manufacturing Index (right chart, white line) continues to suggest rather strong economic activity in other sectors of the US economy, the wide spread with the Manufacturing Index (right chart, green line) and declining trend in both indices suggests that recession may be closer than the Fed would like to admit.
- In the event that a stronger dollar and tighter financial conditions start to produce a more pronounced slowdown in the United States, we believe divergence between major central banks will likely give way to convergence as the Fed is forced to do an about face (and possibly QE4). In the event of a global panic, the dollar could run a bit further on risk aversion – as it did in 2008 – before reversing.

WILDCARD: THE CHINESE YUAN

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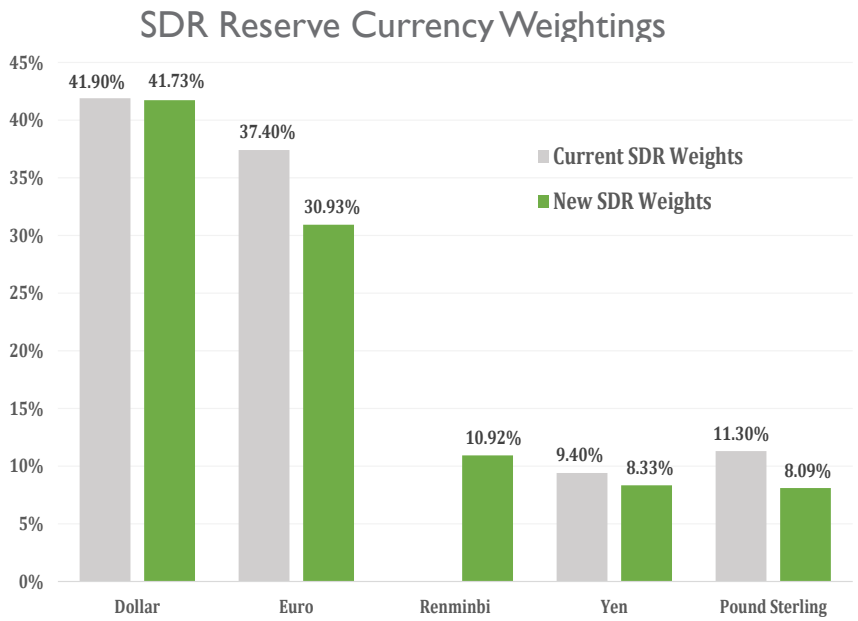
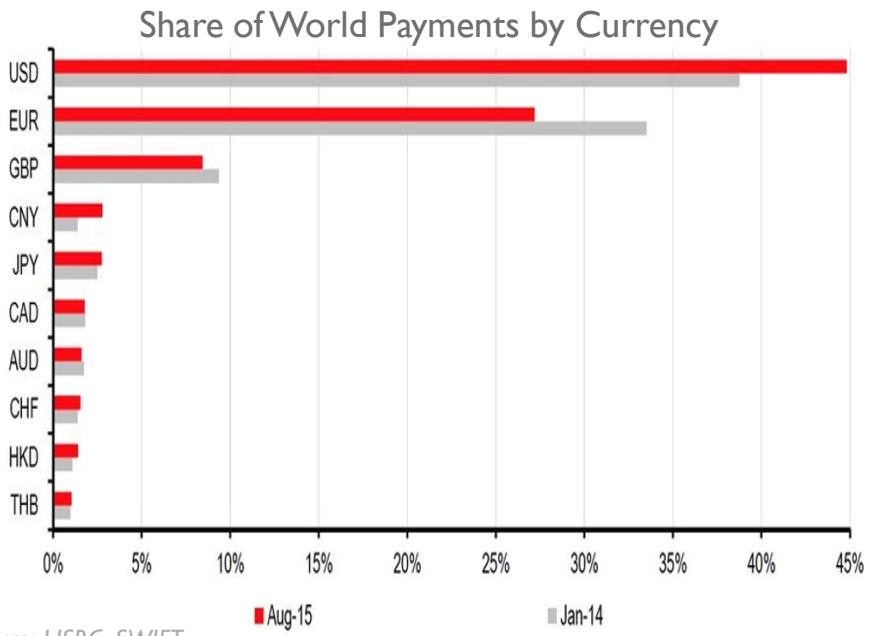


Source: Evergreen GaveKal, International Monetary Fund



Source: HSBC, SWIFT

- While we're on the topic of policy divergence possibly giving way to risk aversion, it's worth noting that the IMF just threw out a serious wildcard this week by including China's yuan in its "Special Drawing Rights" basket of reserve currencies.
- Although many investors have looked forward to the yuan's inclusion in the SDR basket as trigger for an outright collapse in the US dollar, it's important to note that the yuan's rise as a payments currency (right chart) has NOT come at the expense of the dollar, but of the euro, the pound sterling, and the yen. The new SDR weights (left chart) will reflect that reality when they go into effect next October, but we should note that this does not necessarily mean that central banks, pension funds, or sovereign wealth funds are going to suddenly pile in to Chinese assets. That story will take years to play out.
- In the meantime, the IMF expects the yuan to become more "freely useable" as the October 2016 SDR implementation approaches, which means Beijing will have to allow money to flow more freely into and out of Chinese assets through a more market-oriented exchange rate system. That likely means a weaker yuan.

A MARKET-DRIVEN YUAN COULD TRIGGER A GLOBAL FLIGHT TO SAFETY

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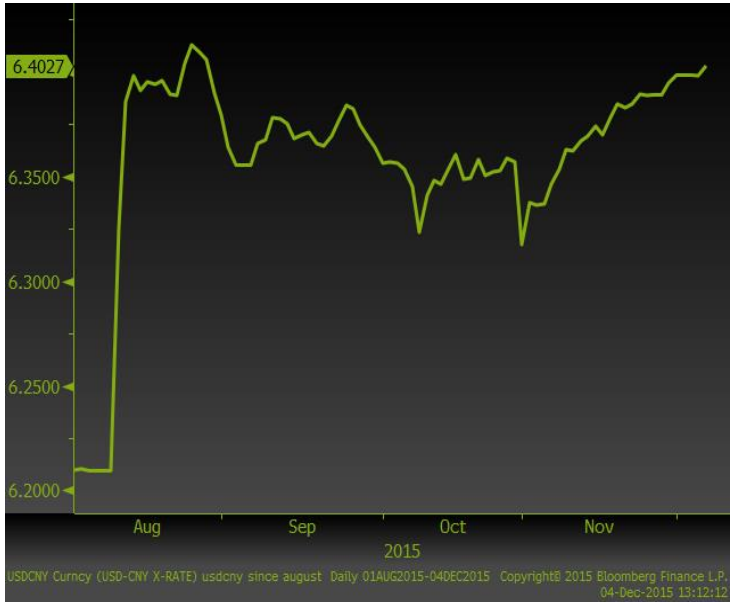
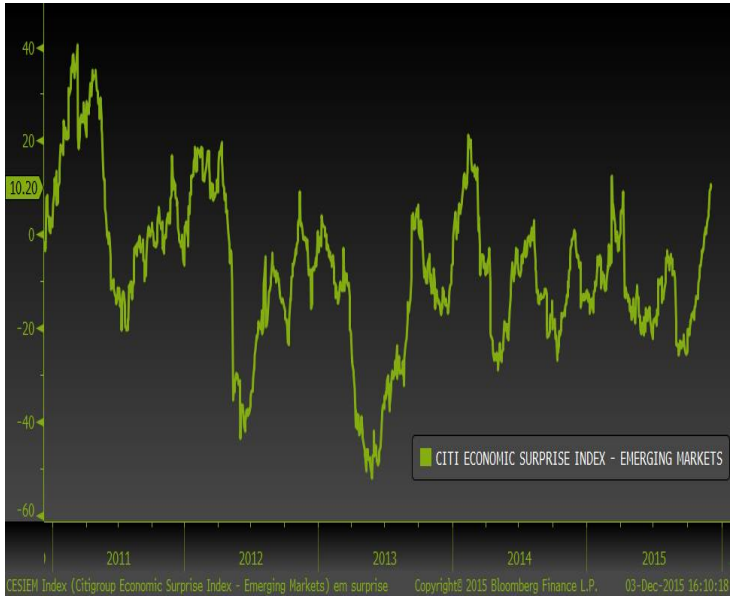
USD/CNY Exchange Rate



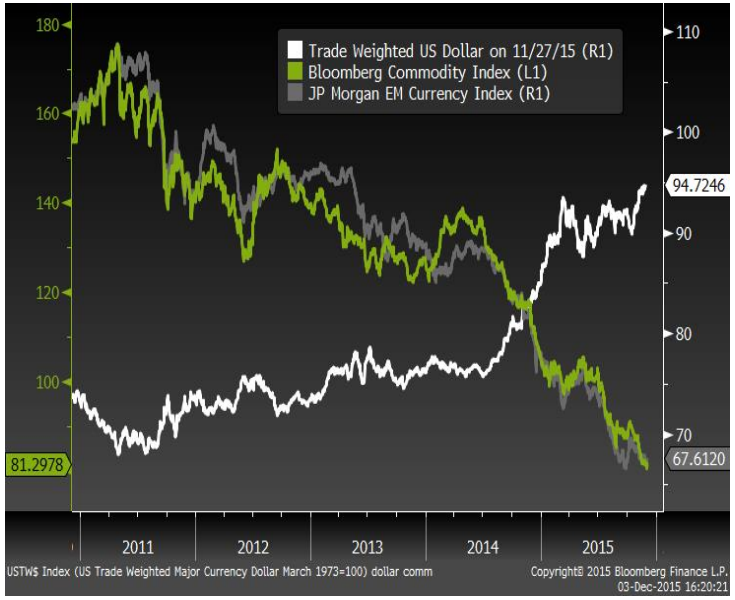
Source: Evergreen GaveKal, Bloomberg

Emerging Markets Economic Surprise Index



Source: Evergreen GaveKal, Bloomberg

US Dollar, Commodities, & EM Currencies



Source: Evergreen GaveKal, Bloomberg

- If you recall, the People's Bank of China's move toward a more market-oriented exchange rate in early August sent a shockwave through the global financial system and prompted investors to worry that (1) China's economy was collapsing and/or (2) China was joining the global currency wars.
- Since then, Beijing has chosen to intervene in the open market by drawing on its foreign exchange reserves rather than allowing the currency to weaken against the US dollar. The trouble is, as China opens up in an effort to internationalize its currency, outflows are likely to accelerate. It will be politically difficult within China to drain the country's massive reserves when a weaker currency would boost exports.
- In the event that the People's Bank of China steps back and allows the yuan to gradually depreciate in the wake of a Fed hike, we could see a hard reversal in recently-improving emerging market sentiment (middle chart), a nasty drop in emerging market currencies (right chart, gray line), and a rush for the safe haven of US dollar assets. With that in mind, a weaker yuan could significantly amplify the impact of a Fed hike and whatever divergence we see from Europe or Japan.

CONCLUSION

In sum, a Fed hike looks increasingly likely in December, but the dollar's continued rise will largely depend on foreign central banks. While a number of factors – from more QE in Europe or Japan to another Yuan shock – could drive the greenback higher, we believe this road eventually leads to QE4 as financial conditions tighten and economic growth softens in the United States.

The current risks seem to be coming to a crescendo. The impending Fed hike signals the end of easy money policies in the world's largest economy (which have been getting tighter for the past 18 months). The Chinese economy is still heavily dependent on government support with debt continuing to grow and resource misallocation continuing to compound. Europe is slowly disintegrating in light of the recent refugee crisis and seems to be increasingly disillusioned with Draghi's endless promises of economic aid. The middle east is awash in turmoil that doesn't appear to have an end in sight. Therefore, our goal at this stage in the global cycle, is to error on the side of caution as markets digest the impact of a strong dollar. We believe firmly that in the short run the US stock market could move higher but the risks to the downside remain overwhelming.

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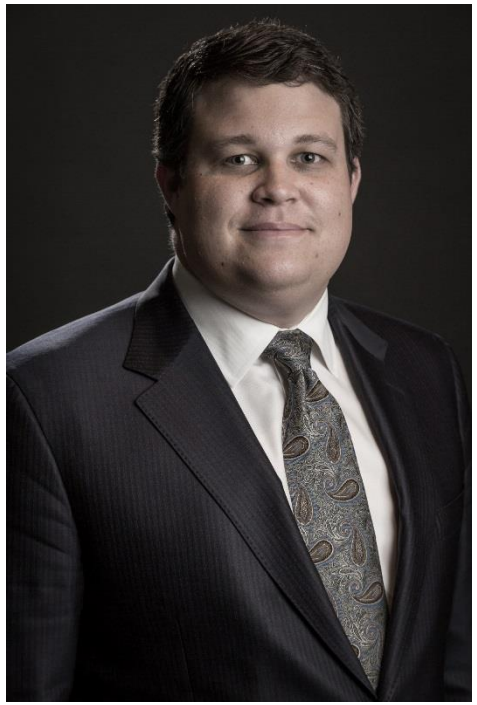

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