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Weekly Note: The End of a Strong USD Policy

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For more than two decades, the United States government has maintained the position that a strong dollar is good for America. While adherence to this "strong dollar policy" has occasionally been little more than lip service, the rhetoric nevertheless has remained intact. If the election of Donald Trump put the strong dollar policy on life support, it now looks as if the administration has killed it altogether. Get ready to adjust to the new reality.

TABLE 1 THIS WEEK IN MARKETS

Name	YTD %	MTD %	WTD %
DOW JONES	6.58%	6.58%	0.88%
S&P 500	6.19%	6.38%	1.49%
RUSSELL 2000	5.02%	5.02%	1.63%
NASDAQ COMPOSITE	8.06%	8.06%	2.21%
Euro Stoxx 50	4.60%	4.53%	1.38%
FTSE 100	-0.06%	-0.06%	-0.54%
DAX 30	4.79%	4.79%	2.68%
NIKKEI 225	5.17%	5.17%	0.30%
HANG SENG	10.16%	10.16%	3.05%
S&P/ASX 200	-0.17%	-0.17%	0.65%
EUR-USD X-RATE	3.17%	3.17%	1.64%
EUR-GBP X-RATE	1.81%	1.81%	1.01%
Gold Spot $/Oz	4.02%	4.02%	2.13%
Crude Oil	6.92%	6.92%	0.98%

You need to go back a quarter-century to find the last time that a U.S. Treasury Secretary actively advocated for a weaker dollar. Lloyd Bentsen eventually got his wish, and the outcome was a sharp Fed tightening cycle and a brutal bear market in bonds.

In 1995, Robert Rubin announced the strong dollar policy to counter the inflationary consequences of a seemingly relentless weakening of the greenback. Ever since, successive administrations have maintained that a strong dollar is in the interest of the US, regardless of whether they actually believed it.

To be sure, a strong dollar has not come without cost. The US current account deficit widened soon after the announcement of the strong dollar policy and has never been back to early 1990s levels. For a president with Trump's protectionist instincts, that's a "disaster".

A year ago, Steven Mnuchin fired a warning shot across the bows of the strong dollar policy by observing that "an excessively strong dollar" could have negative consequences for the economy. On Wednesday, he actively praised the impact of a weaker dollar.

Coming on the heels of a high-profile imposition of tariffs, it's hard not to see this as a conscious policy shift. In a sense, Mnuchin announced the death of the strong dollar policy. Perhaps Trump will read its eulogy in Davos on Friday.

Why does this matter? Well, the dollar is something of an anti-Goldilocks for the rest of the world. If it appreciates too strongly, foreign entities with dollar liabilities struggle to fund them. If it weakens too quickly, mercantilists start moaning about a "currency war".

Meanwhile, domestically, a weak dollar will push up inflation on the margin and should introduce a greater risk premium into Treasury yields, particularly given an increase in net supply this year. If foreign buyers expect to lose on their dollar exposure, they're going to need a higher interest rate to compensate them for that.

Given the significance of the dollar to the global financial system, it shouldn't come as much of a surprise that volatility in the price of the greenback is associated with volatility elsewhere. While cross-asset volatility remains low, it is notable that it has picked up recently.

On the margin, a weak dollar is probably less bad for the global economy than a strong dollar, at least for the time being. Dollar weakness encourages more dollar borrowing and leverage, whereas a strong dollar is associated with deleveraging. In small doses, more risk taking (albeit at the cost of lower inflation and higher volatility) can be a good thing.

But too much leverage can sow the seeds of its own destruction. With monetary authorities still putting the pedal to the metal, the opportunities for the misallocation of capital are rife.

It looks like the strong dollar policy is dead, and the market is attending the funeral in Davos this week. Be prepared for more volatility ahead.