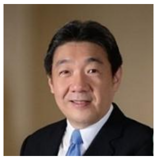


Philequity Corner (July 27, 2020)

By Wilson Sy

US dollar: On the cusp of a multi-year decline

Last week, the US dollar continued its descent. The trade-weighted US dollar index (DXY) declined to a 22-month low, closing at 94.35. This has largely been attributed to the rise of the euro which makes up 58% of the DXY.

The euro surged after the European Union (EU) struck a breakthrough fiscal package to bolster the region's economy. EU leaders agreed last week on a €750 billion recovery fund to support member countries severely hit by the coronavirus pandemic. The rescue fund is seen as a significant step towards achieving fiscal union. It introduces fiscal risk-sharing, central debt issuance and opens the door to central tax collection at the EU level. Hence, this deal has eliminated much of the tail risk associated with the euro.

A pivotal moment for Europe

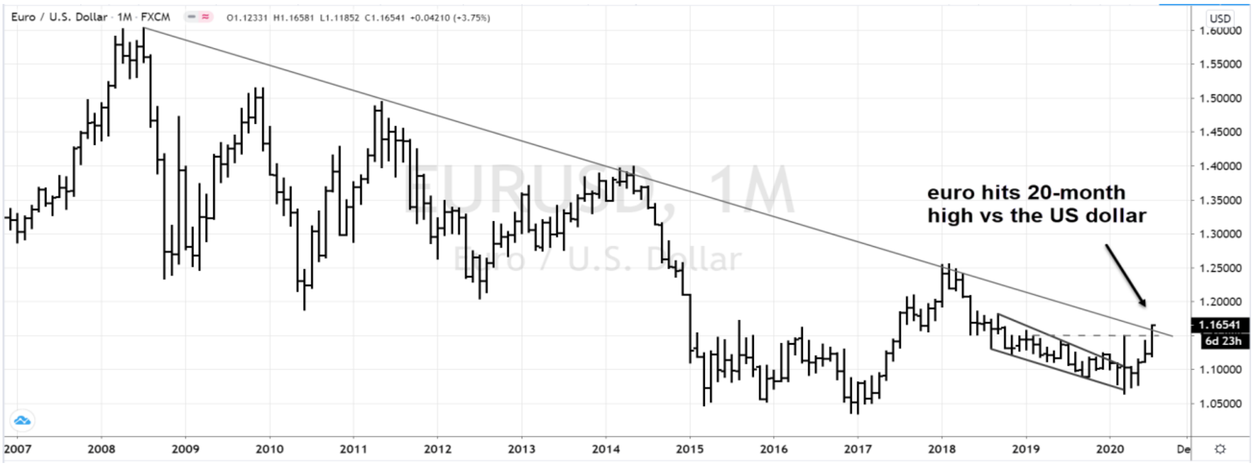
European Council President Charles Michel calls this deal a "pivotal moment" for Europe. It authorizes the European Commission to borrow in the capital markets at the EU level, the first time that the EU has issued joint debt at this scale. EU leaders also agreed on its 7-year budget (multi-annual financial framework, MFF) worth €1.074 trillion, which will fund its initiatives until 2027. In addition, the ECB had earlier expanded its Pandemic Emergency Purchase Program (PEPP), bringing the size of the monetary stimulus to €1.35 trillion.

Reaffirms the euro as a credible safe-haven currency

There has indeed been a shift from the US dollar towards the euro these past few months. Narrowing bond yield differentials has ended the dollar-euro carry trade and caused many hedge funds to cover their euro shorts. Furthermore, institutional funds are now starting to increase their exposure to the euro. This historic EU recovery deal reaffirms the euro as a credible safe-haven currency that can be an alternative to the dollar.

Euro rallies to a new 22-month high

The euro rallied to a new 22-month high of 1.1654 against the US dollar last Friday. It also registered a massive 3.75% gain for the week, the biggest weekly increase in 4 ½ years. The euro now appears to be breaking out of its long-term downtrend that started in 2008, as shown in the chart below. Given euro's large 58% weighting on the US dollar index (DXY), its resurgence should have a pronounced impact on the general direction of the dollar.



Aussie dollar, Kiwi dollar and the British pound rise sharply from their lows

Mirroring the euro, a reversal of the long-term declines in the Australian dollar, the New Zealand dollar, and the British pound are in the offing. These currencies have just completed V-shaped recoveries against the US dollar. From its March low, the Aussie dollar has rallied 19.2%, the Kiwi dollar has increased by 17.3%, while the British pound has risen 10.2%.

Global rush away from the dollar

Much of the capital flows the past decade had been going to the US. As a result, the US dollar index strengthened. But today, the reverse seems to be happening. A global rush away from the US dollar is on the horizon, as shown by the rising euro, Aussie dollar, Kiwi dollar, British pound, as well as emerging market currencies like the Chinese yuan and the Philippine peso.

Looking at the monthly chart below, the DXY is now sitting on critical trendline support at 94. And since major moves in the currency market tend to last for years, a confirmed break below this key support level is significant. The US dollar is on the cusp of a multi-year decline.

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