

## **The Dollar, Emerging Markets, China and Gold**

By Markus Bachmann & Douglas Orsmond | 22 August 2018

Financial markets are facing deep disruptions that have emerged since mid-April 2018. These developments have the potential to unsettle many asset classes. Therefore, we would like to take the opportunity to connect a few dots that we hope will help our readers to orientate themselves in this very fast changing environment. Although the issues discussed are complex topics, we have not drilled down into each aspect too much, in order to keep to the short format of this market comment. However, we encourage the reader to contact us if they wish to discuss the contents further ([info@cratoncapital.com](mailto:info@cratoncapital.com))

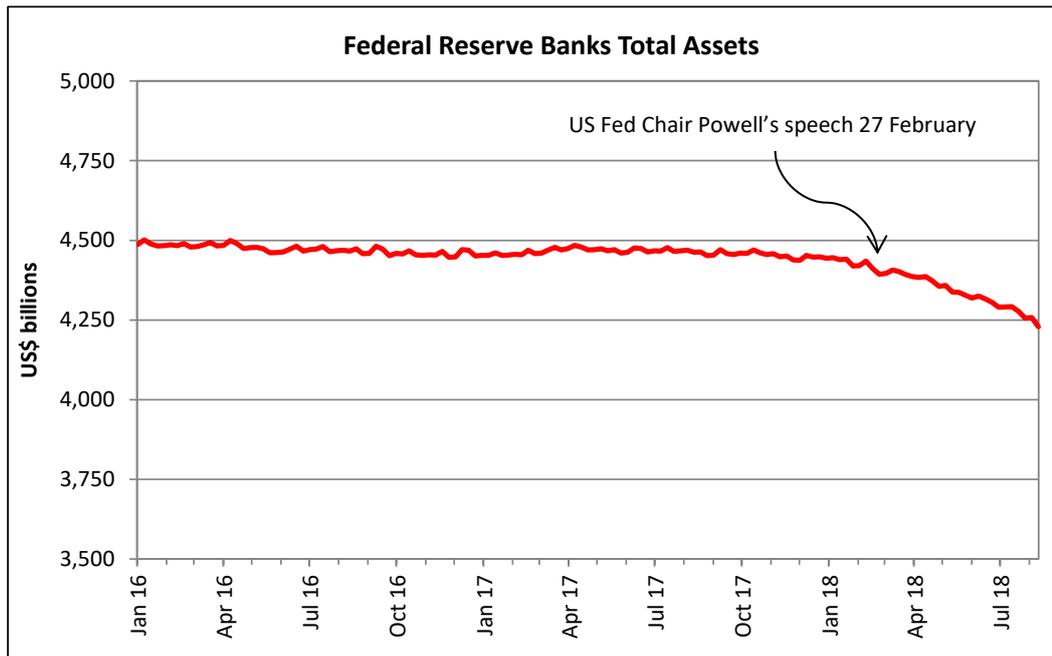
Gold was not really a part of the conversation in the recent market turmoil, other than it has been caught in the cross fire between dollar strength, trade war tensions and emerging markets disruptions. Hence, the following comments will focus mostly on macro-economic and broader financial market aspects, rather than on gold.

We will give the metals and miners centre stage in further market comments that will be available shortly.

## What is causing the dollar strength?

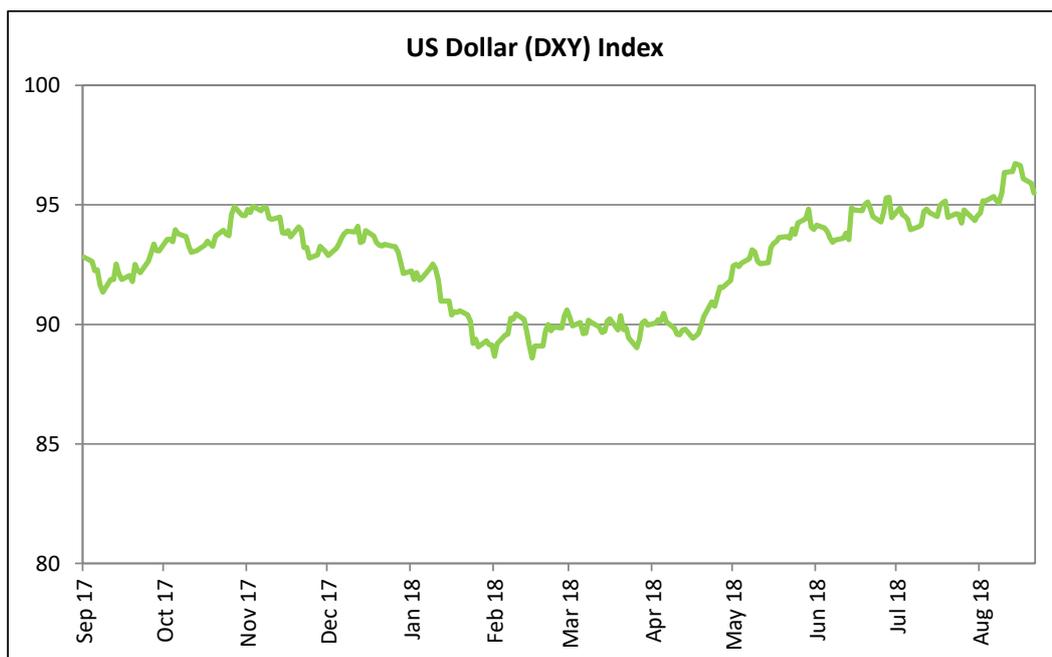
One of the factors that triggered the current dollar strength is the quantitative tightening stance by the US Fed under its new chair. The US Federal Reserve is well into its interest rate rising cycle but since February 2018 it also started to reduce the size of its balance sheet in earnest. A reason why the Fed contemplated that route is that it had to counteract the actions by the US administration in stimulating the US economy by way of tax cuts and an aggressive fiscal stimulus program. There is a case to be made that Trump is actually over-stimulating an already robust economic growth outlook. A knock on effect of this downsizing of the balance sheet was that it created a structural shortage of dollars in the global financial system. That is the root of some of the current emerging market problems.

**Figure 1: Fed Balance Sheet Shrinking – Quantitative Tightening accelerated under Powell**



Source: Board of Governors of the Federal Reserve System (US), Federal Reserve Bank of St. Louis

**Figure 2: US Dollar has strengthened with the acceleration of QT**

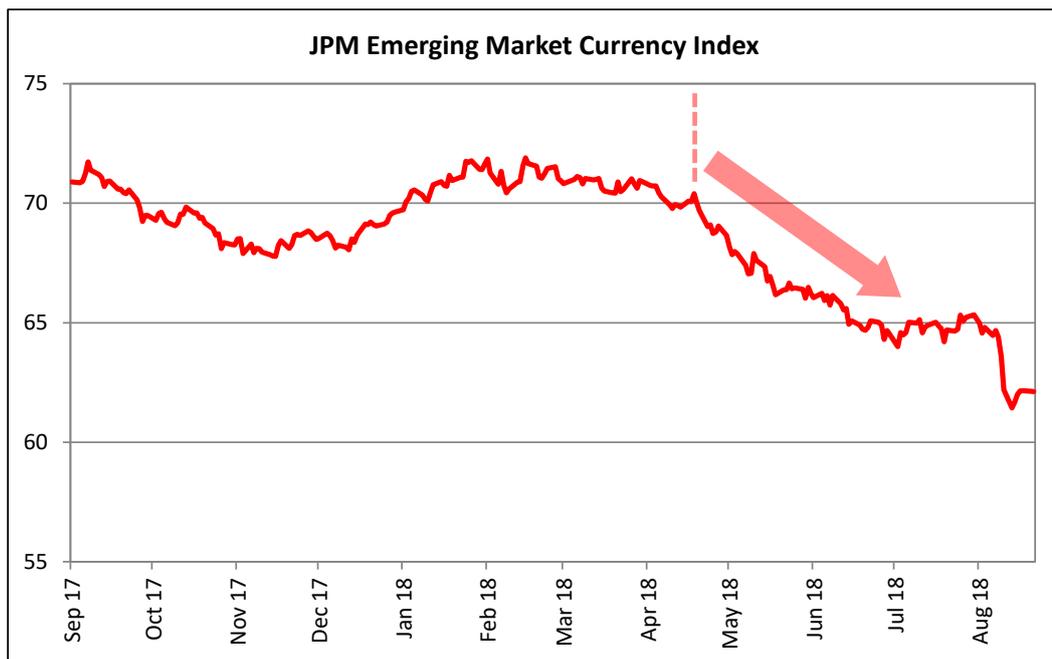


Source: Bloomberg.

## Why does Fed tightening affect emerging markets?

The financial system is still coming to terms with some of the unintended consequences of QE in the aftermath of the Financial Crisis of 2008. One consequence of QE was that the availability of credit to emerging markets ballooned post 2010. A recent report by the Bank of International Settlement (BIS) states that USD denominated loans to emerging market based companies stood at 3.7 trillion dollars at the end of Q1 2018. That is twice the levels of 2010. The dollar denominated liabilities of developed market companies were at 7.8 trillion dollars at the end of Q1 2018. The sharply increased emerging market corporate debt is not a significant issue by itself, but the problems increase rapidly if the respective local currencies start to depreciate against the greenback.

**Figure 3: Emerging Market currencies selloff accelerated in April**



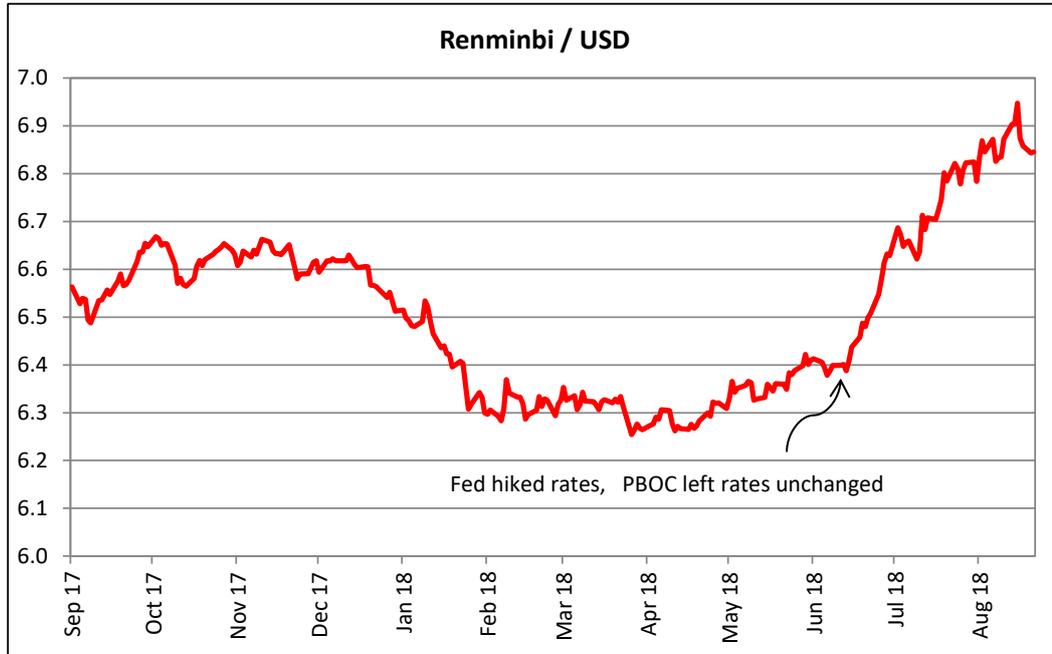
Source: Bloomberg

The problem is further exacerbated if there is a mismatch between domestic based assets, or income, and dollar denominated debt. This creates a situation where dollars are in high demand to service interest, pay back debt or hedge the exposure against the backdrop of a weakening domestic currency. Observers will note the breakdown of the JP Morgan Emerging Market Currency Index since mid-April. We can conclude that the rapid depreciation of a many emerging market currencies increased the pressure for USD denominated EM corporate debt to be hedged or paid back. A knock-on effect is that the demand for USD has significantly increased as a contributing factor in an environment where the Greenback is becoming increasingly in short supply.

## China

The question then arises: What pulled the EM currencies down? The growing trade tension between the Trump administration and the rest of the world, China in particular, was certainly a contributing factor. The 12 months USDCNH chart below shows how the Renminbi has weakened since the second half of April.

**Figure 4: China's currency has weakened since April**



Source: Bloomberg

The accelerated move (i.e. stronger depreciation against the dollar) since June 14<sup>th</sup> is interesting. Recall that the Fed hiked its benchmark rate by 25bps on that day. The same day, the PBOC left its interest rates for its open market operations unchanged, thus breaking with a 22 year history of moving its policy in sync with the Fed. Since then, the Renminbi has fallen rapidly against the greenback in one of its fastest depreciations in recent history. A consequence, whether intended or not, of the move was that it cushioned the impacts of the US tariffs imposed on Chinese goods. But this not a sustainable policy. According to the BIS, Chinese companies owe US\$548 billion (out of the \$3.7 trillion) of the USD denominated emerging markets debt and a further depreciation of the Chinese currency will add to the stress levels of servicing these liabilities. Yes, a weaker RMB is a temporary relief for Chinese exporters but it could be detrimental to many Chinese corporate balance sheets. In addition, the POBC does not seem to have intervened in the currency market, but has rather kept its power dry. Dollar demand out of China has reportedly accelerated in recent weeks, further contributing to dollar strength.

## Turkey

Issues around Turkey's dollar debt and its knock on effects are well documented. Therefore, we don't want to elaborate on it further, but merely add one observation: According to the BIS, Turkish companies have in excess of US\$300 billion of USD denominated debt on their balance sheets. Its share of Turkish GDP is 6x higher than corporate China's corresponding share. A complicating factor is that some \$200 billion of this dollar debt will need to be rolled over in 2019. Turkey is a very small part of the global economy but additional dollar demand in the current environment could trigger knock-on effects elsewhere. However, the country's strategic position between Europe and the East, in particular at the centre of all-important trading routes, makes it too risky to fail. Therefore, the recent financial pledges from the Middle East, China and Europe are signals that have to be monitored carefully and could be regarded as stabilizing factors.

There are numerous other factors, apart from those discussed above, which have contributed to the recent macro volatility. These include the bond market - where European investors continue aggressively purchasing US Treasuries, thus contributing to the cross-border money flow, strengthening the USD and keeping the yield curve down (and therefore ironically contribute to loose monetary conditions). General equity markets too have played a role in the volatility.

However, one key takeaway is that we caution against aggressive short/long positions in any asset class in this current environment. The investor faces geopolitical dynamics that are subject to change on a daily basis. Changes to market conditions can happen at the release of a single tweet. Interventions by Central Banks, or other role players, or concluding of international agreements can turn an investment case upside down within hours. We hope to drill deeper into related topics in future market comments in the coming weeks and months.

## Metals and Miners

We mentioned in the introduction that gold played a very small role “in the conversation” lately. Gold, other metals and miners were caught in the crossfire of the emerging macroeconomic factors and geopolitical dynamics. Let’s recap the events: up until April 2018, gold was following a very constructive set –up to break out of its consolidation channel. Readers of our newsletter will recall that we regard the top of \$ 1’377, reached in 2016, as a key resistance that has to be broken. A move through the \$1’380 - \$ 1’400 “zone” has the strong potential to trigger the first leg of a new lasting up-cycle in gold. The sell-off in metals since mid-April has not invalidated this scenario from a technical perspective, i.e. the long-term support levels (\$ 1’140, \$ 1’050 respectively) have not been breached. However, its recent weakness has pushed gold into the lower end of its consolidation channel and temporarily invalidated the immediate breakout set up that it approached multiple times this year. Gold and metals have to re-group. Gold in the recent market turmoil behaved as it always does in times of heightened financial tensions: its safe haven status is that of a source of much needed liquidity.

Geopolitical tensions aside, it is noteworthy that since early May global gold ETF’s have witnessed net outflows for 13 consecutive weeks.

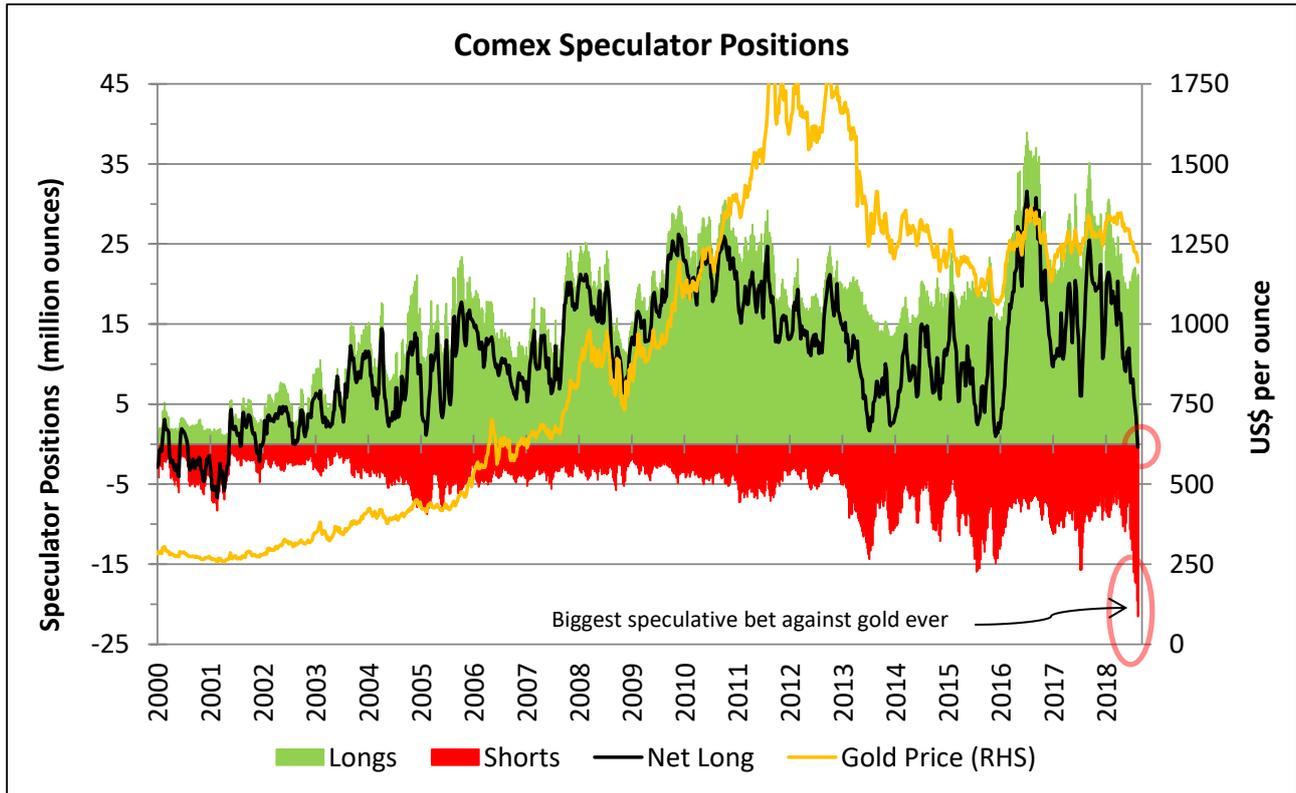
Further, the strong dollar and a fast emerging consensus trade (long dollar / short any other currency) left a bloodline in the water, attracting speculators in unprecedented size. They express their views in the futures market<sup>#</sup>, where we note some interesting observations:

- Speculators increased their bets against gold to all-time highs. In plain English - it is the biggest bet against precious metals ever in the futures market.
- Speculators are currently net short for the first time since December 2001 (3’700 contracts, equivalent to 370’000 ounces).
- The level of gross contracts held by shorts has moved to a record 215’000, or over 21 million ounces. This is three times higher that it was in the second week of June.

*# For speculators in the gold futures market, we refer here to Non-Commercial futures positions on gold in the Comex market.*

All things considered, these numbers are extreme and “off the charts” and mirror a very strong view by many market participants (mainly hedge funds). However, at the same time investors will recall that a similar positioning created the inflection points for both the beginning of a 10 year up-cycle in gold (starting in December 2001) as well as the bottom of the decline from the 2011 highs (in December 2015). We are not claiming that history has to repeat itself, or that one should be contrarian for the sake of it. But investors should understand the current positioning and be alert for turnarounds.

**Figure 5: First net short on gold since 2001 – setup for a short squeeze ?**



Source: Bloomberg. Speculator Long and Short positions refer to Non-Commercial Futures contracts on Comex.

Many other metals fell victim to the negative sentiment too. Well-respected commodities analyst Colin Hamilton from the Bank of Montreal noted on August 15<sup>th</sup> the stark disconnect between metals prices such as copper against underlying fundamentals. Colin concludes in his note to clients that *“the price movement in copper and other base metals seems to be driven by financial markets (i.e. speculators, short sellers) and lacks a fundamental basis. We simply have to look to commodities set by physical market (chrome, vanadium, tungsten, steel rebar) to find price robustness reflecting underlying demand that seems to be okay.”*

With regard to copper the recent price decline is nonsensical in the face of a looming supply deficit of 415’000 tons for 2018 (c 2% of mine supply) and the recent decline in global inventories. Investors have to consider this when assessing the recent “crime scene” engulfing global miners, on the back of trade war fears and emerging markets contagion. They also have to take note of the record high speculator short positions on COMEX copper, a situation that does not match the fundamentals supporting the demand outlook.

Exposure to precious metals and to the mining sector in general, is based on a risk / reward strategy (on a stand-alone basis as well as in comparison with other asset classes). Investors will note how the ratios of the S&P 500 vs the Bloomberg Commodity Index and the S&P 500 vs Gold have reached extreme levels. To what extent was the recent metals sell-off justified? Was it based on fundamentals deteriorating factors or was it driven by “fear based” selling and an overpowering consensus view on the USD? What is the probability that the market will make up the drawdown of the recent weeks? What is the probability going forward that metals and miners will not just make up the losses, but deliver returns in excess of other asset classes? How did the asset class react to similar situations in the past? We are convinced that the market will have to provide answers soon. In our view, the Risks have changed very little while the Rewards are now indicating more potential upside.

The current market environment does not allow for complacency. Therefore we will intensify our comments and hope to provide our readers with guidance until calmer waters and clear visibility will be reached. A detailed comment on the gold miners is will be sent out shortly.

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