# USD Bull Market Rally Regains Momentum into 2017

PERSPECTIVES

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**Executive Summary**

- The US dollar (USD) bull market entered its fourth consecutive year in 2016, but a key driving factor—monetary policy divergence that underpinned the rally—was losing its potency.
- The Federal Reserve maintained its protracted tightening cycle while central banks of the US, EU and Japan (G-3) moved away from negative interest rate policy. However, the surprising US election result signified a defining moment for the USD that allowed it to regain its momentum.
- We believe factors are aligning for the USD rally to enter its fifth consecutive year, a potentially significant one.

**Key USD Drivers in 2017**

There are three factors that will fuel the USD rally in 2017: fiscal stimulus proposal, US rate normalization and idiosyncratic factors. The degree to which these factors materialize will determine the intensity of the USD strength.

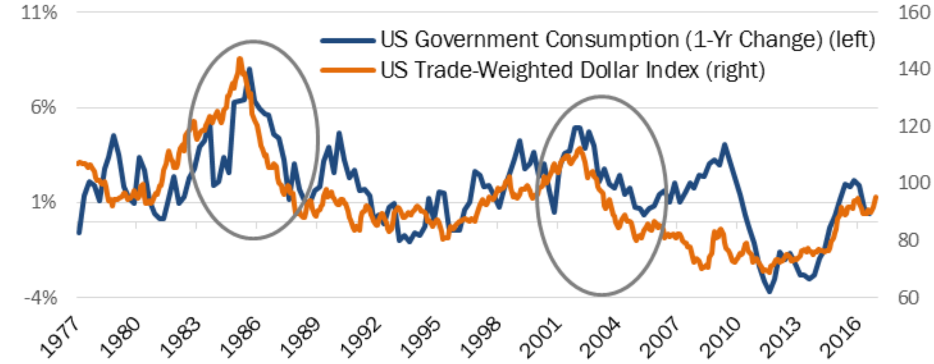
1. **Fiscal stimulus proposal**

We expect much easier fiscal policy to be one of the two biggest drivers rejuvenating the USD rally in 2017. However, it is also the factor with the greatest upside risk. There is a strong relationship between a looser fiscal policy and the USD. Some prior USD bull rallies have been associated with easier fiscal policies, such as 1981 to 1986 and 1997 to 2002 (see chart on page 2). The recent rally has drawn parallels to the 1980 to 1984 record USD bull market in which the US implemented a very tight monetary policy and easy fiscal policy.

The incoming Donald Trump administration is proposing an ambitious economic plan consisting of $1 trillion of infrastructure spending over the next 10 years, a cut in personal income taxes and a reduction in corporate taxes from 35% to 15%. The Center for Budget Responsibility estimates Trump's tax plan will cost $6 trillion in revenue over 10 years. We will not know the final details of the tax plan in the first quarter of 2017, but preliminary projections from the Tax Policy Center estimate a 1.5% boost to gross domestic product (GDP) in the first year while ABN AMRO Group projects a 2.5% boost to gross domestic product over two years.

**Historical Strength of the Dollar**

**Some USD bull rallies have been attributable to easier fiscal policy**




*Source: Datastream and Pioneer Investments. Last data point 12/15/16.*

*Most currency strategists estimate that 80% of offshore earnings are in USD.*

We anticipate the USD to benefit from easier fiscal policy in a number of ways. First, we expect the US to grow solidly above trend. This should lead to a widening in growth differentials against G10[1] economies. The estimations of Pioneer Investments' Macroeconomic team suggest that, in case of full implementation of announced policies, US growth could notably accelerate over the course of the next several quarters. Should this occur, it will likely force the Federal Reserve to accelerate its pace of monetary tightening.

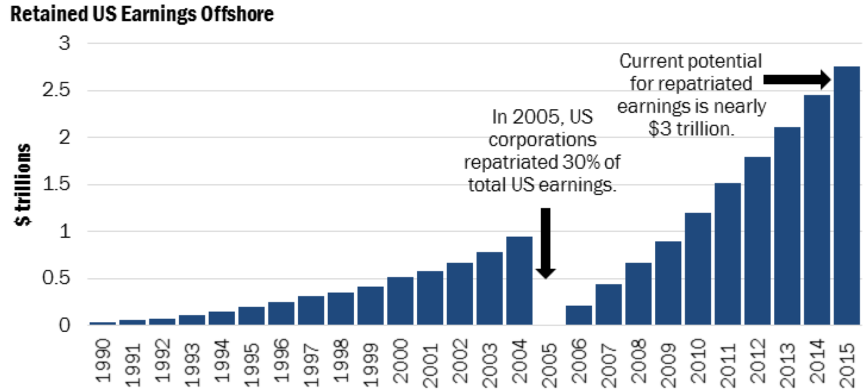
Additionally, as part of the overall corporate tax reform and possibly to fund the fiscal stimulus program, there is a proposal for a repatriation tax holiday. The one-off tax holiday would give multinational corporations a low tax rate to repatriate off-shore earnings. A similar proposal, named the Homeland Investment Act (HIA) in 2005, brought in around $300 billion (USD and non-USD). There are between $2.5 trillion to $3 trillion in earnings kept overseas (see chart on page 3).

Conservatively, I believe we may see a repeat of the inflows seen in 2005. In 2005, US corporations repatriated 30% of total US earnings. If that percent holds true again, it could equate to $780 billion. Most currency strategists estimate that 80% of offshore earnings are in USD. Therefore, the potential of offshore earnings denominated in non-USD that are repatriated could amount to $156 billion, compared to an estimated $60 billion in 2005. According to a Westpac analysis, European states account for the bulk of US offshore earnings, exceeding $1 trillion, followed by Canada, the United Kingdom, Switzerland, Singapore, Mexico and Japan.[2] Therefore, we believe the euro, Canadian dollar, British pound, Swiss franc, Mexican peso and Japanese yen are most vulnerable to repatriation.

[1] G10 are nations that meet on an annual basis. The member countries are: France, Germany, Belgium, Italy, Japan, the Netherlands, Sweden, the United Kingdom, the United States and Canada, with Switzerland playing a minor role.

[2] Westpac "Another repatriation wave into the USD" 12/12/16.

**Cumulative Repatriated Earnings Since 1990**




*Source: Bureau of Economic Analysis, Westpac, Pioneer Investments. Last data point 12/31/15.*

*Our analysis shows the Federal Reserve is behind the curve in tightening monetary policy.*

**1. US rate normalization gathers steam**

The monetary policy divergence theme is the other big and reliable driver behind the USD rally. We expect two key themes could lead the Federal Reserve to tighten at a quicker pace, compared with the last 12 months. Our analysis shows the Federal Reserve is behind the curve in tightening monetary policy. In the post-Volker Rule era, the Federal Reserve has increased interest rates an average of 270 basis points during its tightening cycle while Personal Consumption Expenditures Core Index has risen 0.2% and the unemployment rate has fallen 2.4%. In this tightening cycle so far, the Federal Reserve has increased interest rates 50 basis points but the inflation rate is up 0.8% and the unemployment rate has plunged 5.3%.

What is unusual about this tightening cycle is that the Federal Reserve has waited one year before increasing interest rates again. In addition, inflation and wage indicators are on a firm upward trend and within striking range of the Federal Reserve's target, while spare capacity in the labor markets has completely disappeared. Likely to aggravate the situation, there is no sign that the US economy is losing momentum heading into 2017. In fact, we expect the US economy to grow steadily above trend, with upside risks. A loosening of regulations could incentivize investors and perhaps finally revive fixed investment. Easier fiscal policy will certainly add to growth. There is a disconnect between the Federal Reserve's dot plot (showing the rate predictions of the FOMC members) and market expectations for interest rate increases in 2017. As a result, we expect the Federal Reserve to pick up its tightening cycle and increase rates more than is currently priced into the markets.

**2. Idiosyncratic factors**

Finally, there will be idiosyncratic factors driving the USD stronger against the euro, British pound and Chinese yuan.

**The Euro**

The rise in far right populist parties will add to political uncertainty and weigh on the currency. Politics are having a stronger impact on the currency. The examples of Brexit and the Italian Referendum show how the currency came under pressure ahead of the event as investors were selling British and Italian fixed income securities. The French presidential elections in April and May and German general elections in September are potential risk events that could add to euro volatility. Following the shocking results from Brexit and the US presidential elections, investors are sure to be anxious as we approach these two critical European political elections in 2017.

Widening interest rate differentials and rising political volatility should lead to a serious test of EUR/USD parity in 2017.

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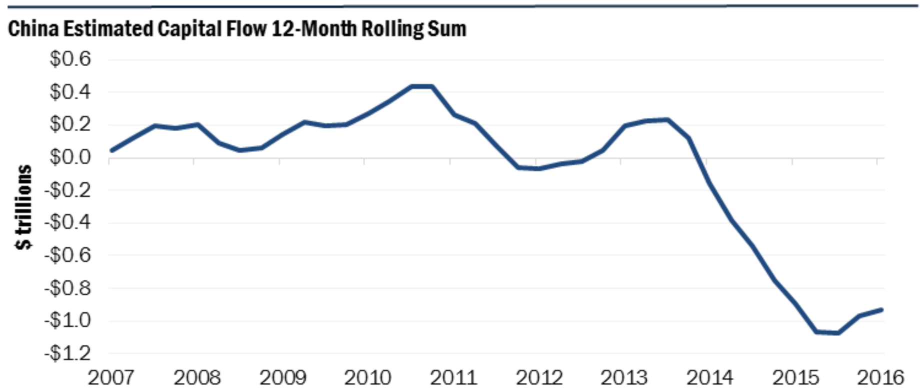
**The British Pound**

The pound remains highly vulnerable to Brexit-related news. This will remain the case next year as Prime Minister Theresa May is expected to trigger Article 50 of the Lisbon Treaty sometime in late first quarter or early second quarter of 2017. As long as Brexit remains the course, the British pound will come under downside pressure. In addition, the likely continued lack of foreign direct investment will highlight the difficulty of financing the massive current account deficit that will act as a structural headwind on British pound. As a result, we expect the value of the pound to fall below $1.20 in 2017.

**The Chinese Yuan**

The renminbi depreciated 6.5% in 2016 – the fourth worst-performing foreign exchange among major G10 and emerging market countries. Capital outflows, as well as sluggish domestic and global growth were the key forces weakening the currency. Last year, outflows peaked at just over $1 trillion on a rolling 12-month period (see chart below). We expect capital outflows to remain the biggest depreciating factor behind the renminbi. The economy could weaken as credit growth slows once again and could revive market anxiety over the size of China's massive private sector debt. There remains some uncertainty if there is a rise in trade tensions between the US and China. This could potentially become another factor behind renminbi weakness. We project the Chinese yuan to depreciate around 6% to ¥7.30 vs the USD in 2017.

**China's Capital Outflows Contributed to Its Weakened Currency**




*Source: Bloomberg and Pioneer Investments. Last data point 12/30/16.*

**Key risks**

While the prospects of a stronger rather than weaker USD are asymmetrically greater, two keys risks could lead to a divergence in USD performance between G-3 currencies and emerging markets.

**Changes in US trade policy**

The US President can unilaterally impose trade sanctions and tariffs. During his campaign, incoming President Trump has emphasized free, but fair trade and has explicitly singled out China, threatening 45% tariffs. In addition, there has been discussion on the need to make changes to the North American Free Trade Agreement (NAFTA). We believe the market may be underestimating the prospects of some form of protectionist policies that will have consequences in currency markets.

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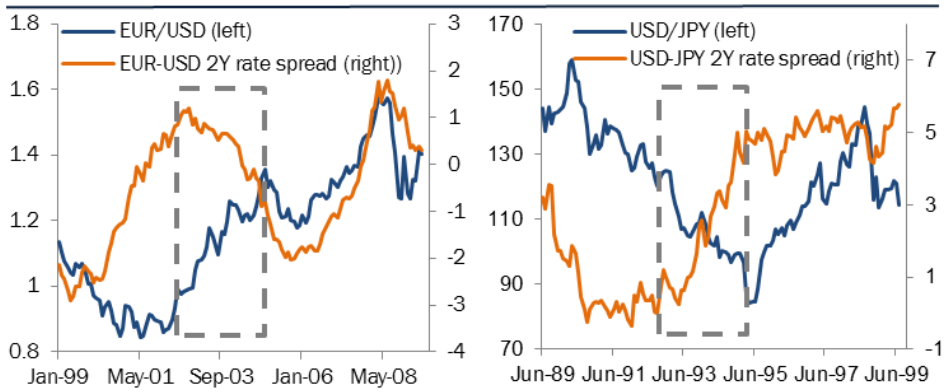
If we see any form of protectionist trade policies, I anticipate a divergence in USD performance between G-3 and emerging markets. Prior unilateral US presidential actions have led the USD to depreciate versus the euro and Japanese yen (see chart below). In 1993, President Clinton unilaterally imposed tariffs on Japanese auto manufacturers as its trade surplus with the US exceeded 1% of gross domestic product. As a result, USD/JPY plunged 30% from 1993 to 1995. Another notable example was in 2002 when President Bush imposed tariffs on European steel producers for six months and sent the euro sharply higher by 10%. In both cases, the USD depreciated, despite seeing a widening in interest rate differentials in its favor.

**Past Effects on the US Dollar of US Presidential Unilateral Actions**




*Source: Credit Agricole. Last data point 12/31/16.*

On the other hand, US trade sanctions or tariffs risk a trade war. Emerging market countries dependent on trade will be most vulnerable to weaker growth prospects that will lead to a selloff in their currencies (see chart below). Overall, emerging market Asian currencies such as South Korean won, New Taiwan dollar, Singapore dollar and Chinese yuan are most vulnerable while potential tweaks to the North American Free Trade Agreement (NAFTA) leave the Mexican peso and Canadian dollar most exposed to a sell off against the USD.

**A Trade War Would Leave EM Asian Currencies Vulnerable**

**Trade with the US as a percent of country GDP**


*Source: Bloomberg and Pioneer Investments. Last data point 12/31/16*

*We expect strong fundamental underpinnings behind the rejuvenated USD bull market rally.*

**G-3 Tapering**

Market based measures of inflation expectations have risen sharply. Since the post-Brexit low, US and European inflation expectations have risen 66 basis points and 46 basis points to 1.96% and 1.73%, respectively as of December 9, 2016. With growing signs of global reflationary pressures, the European Central Bank and even the Bank of Japan could begin to taper and start the process to remove excessive accommodative policy. We do not expect this until the second half of 2017 with the European Central Bank likely to move before the Bank of Japan. In anticipation of tapering, interest rate differentials should reverse and move in favor of Europe and Japan, which could mark a turning point in the USD rally against the euro and Japanese yen.

**Conclusion**

We expect strong fundamental underpinnings behind the rejuvenated USD bull market rally. Easy fiscal policy to boost growth and a corporate tax holiday leading to robust inflows could support the USD. It should also contribute to tighter monetary policy, helping to cement the monetary policy divergence theme. However, the prospects of protectionist policies and G-3 tapering could be turning points for the USD against G-3 currencies.