

## FX Insight

# USD - Pause or More Room for Weakness?

### USD Weakness Due to Broader Macro Factors

Dollar index traded below 89-handle, for the first time in more than 3 years yesterday (25 Jan). The move lower in the USD was already underway but comments at Davos from Treasury Secretary Steven Mnuchin added fuel to fire. He said “a weaker USD is good” for US economy via trade and opportunities. However Trump’s subsequent comments overnight (25 Jan) - “Dollar is going to get stronger and stronger” saw a rebound in the USD. That said we believe broader term shifts were already underway to support the case for broad USD downtrend, including (1) US tax reforms and its wider implication on deficit, debt and the USD; (2) reserve diversification away from the USD; (3) USD countercyclical play; (4) USD downtrend cycle. We also shared our revised DXY forecasts in this report (page 9).

### Rising Deficit and Debt to Weigh on USD

On the impact of US tax reforms on the USD, we examine historical relationship between past US tax reforms and the Dollar. In periods of expansionary fiscal policies (during Reagan Administration and Bush Administration) when tax cuts were implemented, spending was increased, budget deficit to GDP and debt as % of GDP rose, USD typically tends to fall. While the period of contractionary fiscal policies under Clinton Administration saw USD rose. In the current episode that is unfolding, tax reforms is expected to widen US budget deficit to -5.4% of GDP (vs. -3.4% currently) while debt to GDP will rise to 97.5% of GDP (vs. 75% of GDP currently), according to Congressional Budget Office (CBO) estimates. And if history is of any guide, the current period of tax reforms (widening budget deficit and rising debt to GDP) is akin to expansionary fiscal policies and like previous periods, the USD should weaken. In addition, the US twin deficits (referring to current account and federal budget) appears to be widening again and this could reinforce the USD downtrend.

### Trend is Your Friend but Caution for Rebound Risks

The 78-month USD rally cycle (as seen in 1978 and 1995 episodes) appear to suggest that the rally which begun in 2011 has ran out of steam since 2017 and the broad downtrend over the next 30 - 40 months is already underway (currently in the 12<sup>th</sup> month into the down cycle). Nonetheless FX is not a one way move, we do not rule out sporadic USD rebounds especially on potential repatriation inflows into US amid stretched positioning, German/Italy political risks (EUR long unwinding), etc. DXY’s bearish momentum on monthly, weekly and daily charts remain intact. But stochastics is cautioning for oversold conditions and that DXY could face some rebound risks. Resistance at 91.20 (38.2% fibo). Next key support levels seen at 87.30 (50% fibo retracement of 2008 low to 2017 high) and 83.35 (61.8% fibo).

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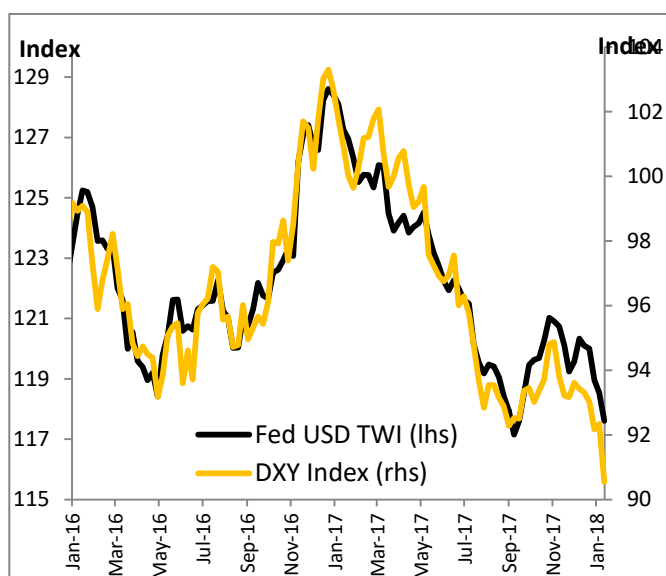
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## Taking Stock of Dollar Demise

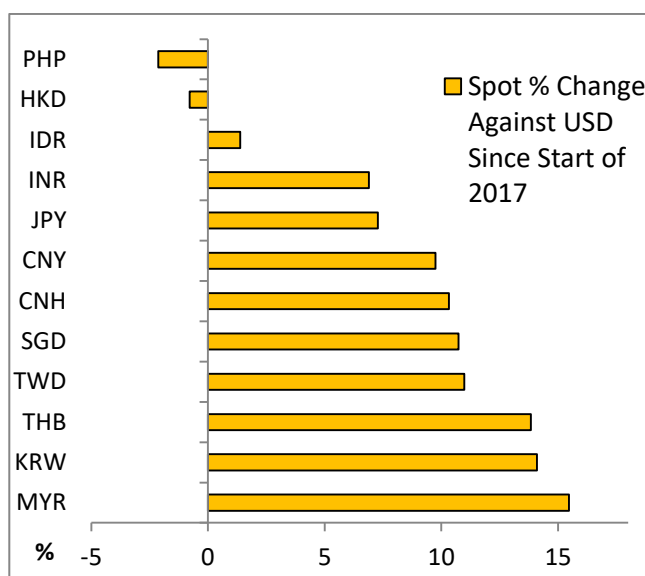
The USD started the New Year on a softer footing, with DXY falling more than 3% and US TWI down by about 2%. While the USD decline can be attributed to recent development including Steven Mnuchin's comments (24 Jan) - ***“that a weaker dollar is good for us as it relates to trade and opportunities”***, EUR strength on progress with German coalition and hopes of faster than expected pace of policy normalisation, GBP strength amid positive development with Brexit, gains in commodity-linked currencies such as AUD, CAD and MYR owing to stable and higher oil prices and renewed fears of US protectionist policies (tariffs imposed on imported solar panels, washing machines), we believe broader macro trends are underpinning the USD downtrend since 2017 (DXY fell more than 12% since start of 2017). Against most Asian FX, USD has also fallen, in particular against trade-dependent and commodity-linked FX including MYR, THB and KRW between 13 - 15%.

### Dollar Index and US TWI Decline Underway



Source: Bloomberg, Maybank FX Research & Strategy

### USD Also Fell Sharply vs. Most AXJs since 2017



Notwithstanding rebounds which may be sporadic and short-lived amid stretched positioning, we believe there are a handful of broader term shifts to support the case for broad USD downtrend, including (1) US tax reforms and its wider implication on deficit, debt and the USD; (2) reserve diversification away from the USD; (3) USD countercyclical play; (4) USD downtrend cycle.

### US Tax Reforms - Potential Implications on the Economy

The “Tax Cuts and Jobs Act” (TCJA) was signed into law on Dec 22, 2017. Although the tax policy left out many controversial overhauls that have been put forth, the final reconciled bill between the House and the Senate still saw major reforms including corporate tax cuts to 21% from 35% and one-time tax repatriate of earnings and profits at 15.5% and 8% for reinvestments (further details are outlined in Appendix 1 at the end of this report). These tax reforms will have implications on broader economy, politics and the US Dollar.

Briefly on the economic front, the TCJA is expected to increase US GDP by 0.8% in 2018, reduce marginal tax rates and increase personal consumption. Output and aggregate demand will be lifted, hence boosting government

revenue, according to Tax Policy Center's (TPC) analysis on macroeconomic effects of tax reforms.

### Repatriation and Potential Implications on the USD

On the tax reforms' implications on FX, it is not as clear cut. The one-time repatriation could lead to demand for USD. Take the case of recent Apple's announcement (17 Jan) to repatriate a portion of its global cash pile (believed to be about \$350bn) back to the US economy, including a record \$38bn tax bill to the US Treasury. Apple also announced plans to use its repatriation to ramp up spending in US on creating jobs and investments in manufacturing and data centres. This news subsequently saw a brief USD rebound in response. Potentially, the USD could find some support if other US corporates such as Intel, Amazon follow, leading to demand for USD however the net impact is far from clear as repatriation inflows may only provide one-off support. The use of funds following repatriation will matter - if it results in capex increases, job creation or if funds are channelled into share buyback or dividend pay-out (as in the case back in 2004 when 90% of the repatriated profits went to).

### US Tax Reforms - Potential Implications on the USD

On the impact of US tax reforms on the USD, we examine historical relationship between past US tax reforms - in particular if the reforms translate into expansionary or contractionary fiscal policies and its impact on the USD since 1980s.

In periods of expansionary fiscal policies (during Reagan Administration and Bush Administration) when tax cuts were implemented, spending was increased, budget deficit to GDP and debt as % of GDP rose, USD typically tends to fall.

In periods of contractionary fiscal policies during Clinton Administration when tax rates were increased, spending was cut, both budget deficit and government debt (as % of GDP) were reduced with budget deficit even turning into surplus, the USD rose.

### Expansionary/ Contractionary Fiscal Policies' Impact on USD

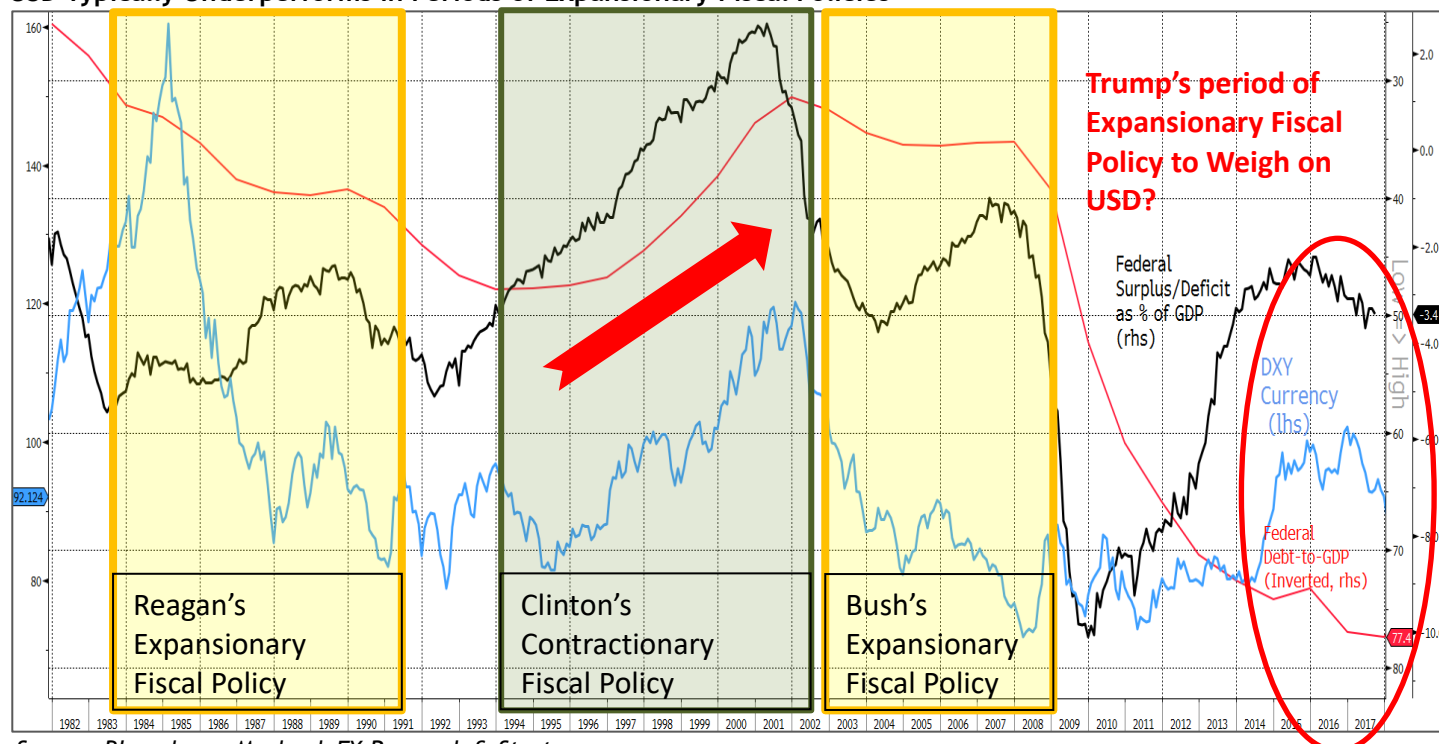
Fiscal Expansion	1986 - 1989	Reagan's tax reform saw budget deficit narrowing as his supply-side (Reaganomics) reform boosted tax revenues	Dollar ↓
	2001 - 2007	After the dot.com bubble, defence spending substantially increased following the 9/11 attack, while Bush's tax cut saw tax revenue decreasing, where budget deficit increased	
	2007 - 2009	Budget deficit increase was largely due to the great banking bail-out from the Financial Crisis	
Fiscal Contraction	1992 - 2001	Clinton's tax hike narrowed the budget deficit (even into surplus in 1998)	Dollar ↑
	2012 - 2016	American Taxpayer Relief act narrowed the fiscal deficit	

Source: Maybank FX Research & Strategy

In the current episode that is unfolding, tax reforms is expected to widen US budget deficit to -5.4% of GDP (vs. -3.4% currently) while debt to GDP will rise to 97.5% of GDP (vs. 75% of GDP currently), according to Congressional Budget Office (CBO) estimates.

And if history is of any guide, the current period of tax reforms (widening budget deficit and rising debt to GDP) is akin to expansionary fiscal policies and like previous periods, the USD should weaken.

### USD Typically Underperforms in Periods of Expansionary Fiscal Policies



Source: Bloomberg, Maybank FX Research & Strategy

### USD Impact on Different Episodes of US Fiscal Expansion/Contraction

	Federal Debt as % of GDP	Fiscal Deficit as a % of GDP (negative denotes surplus)	USD % Change
1986 - 1990 (Fiscal Expansion)	↑ (35.3% to 39.3%)	↓ (4.8% to 2.7%)	↓ (24% decrease)
1993 - 2000 (Fiscal Contraction)	↓ (46.6% to 33.6%)	↓ (4.9% to -2.4%)	↑ (26% increase)
2001 - 2007 (Fiscal Expansion)	↑ (31.4% to 35.2%)	↑ (-0.9% to 1.3%)	↓ (34% decrease)
2012 - 2016 (Fiscal Contraction)	↑ (70.4% to 77.0%)	↓ (6.5% to 2.6%)	↑ (23% increase)
2017 Onwards (Fiscal Expansion)	↑ (77.4% to 97.5%)	↑ (3.5% to 5.4%)	↓? (?)

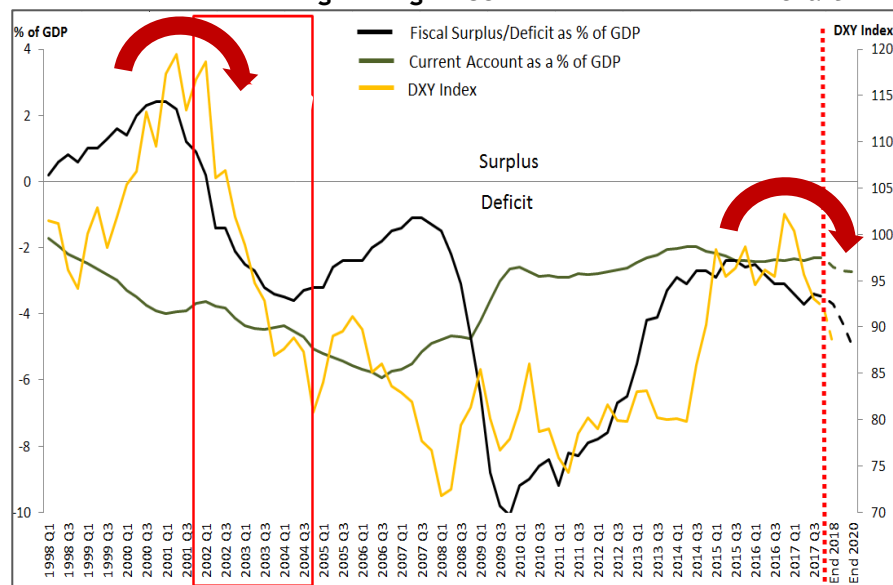
Source: Bloomberg, Maybank FX Research & Strategy

## USD Suffers from a Deterioration of Twin Deficits

To add, the US twin deficits (referring to current account and federal budget) appears to be widening again and this could reinforce the USD downtrend.

The last time this happened was back in 2002, where tax cuts were not matched by spending cuts, and the budget went from surplus of +1% of GDP to deficit of -3.5% of GDP in 2004. Current account deficit also widened to -5.7% of GDP in 2004 (vs. -3.8% of GDP). The same period saw a period of USD weakness.

### Twin Deficit Deteriorating Adding to USD Downside Pressure <chart>



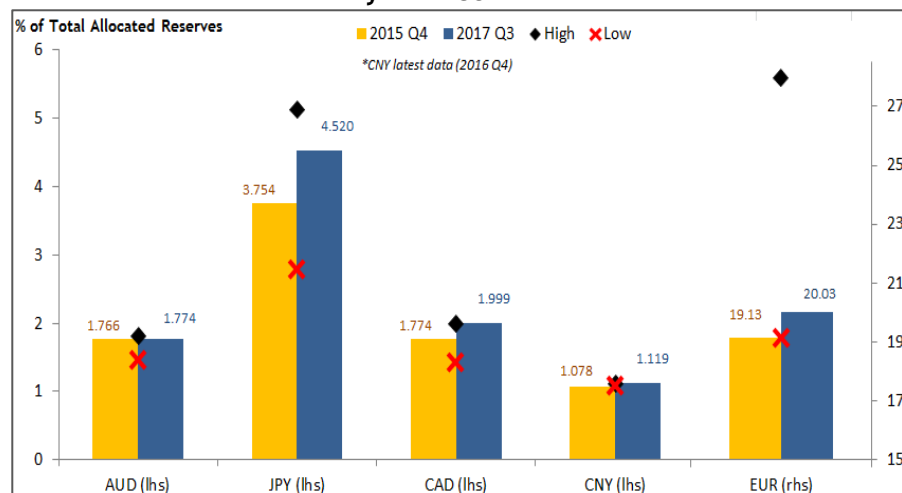
Source: Bloomberg, Maybank FX Research & Strategy

## Ongoing FX Reserves Diversification Weighs on Dollar

Recent release of IMF's quarterly COFER confirms the ongoing trend of reserve diversification away from the USD since 2Q 2015.

Dollars as a share of global central banks' reserves fell to 63.5% in 3Q 2017 (from 66% in 1Q 2015). Post-2000 low was seen at 60.78% in 2Q 2011. According to the data, central banks' holdings of EUR, JPY, CAD, AUD and CNY picked up.

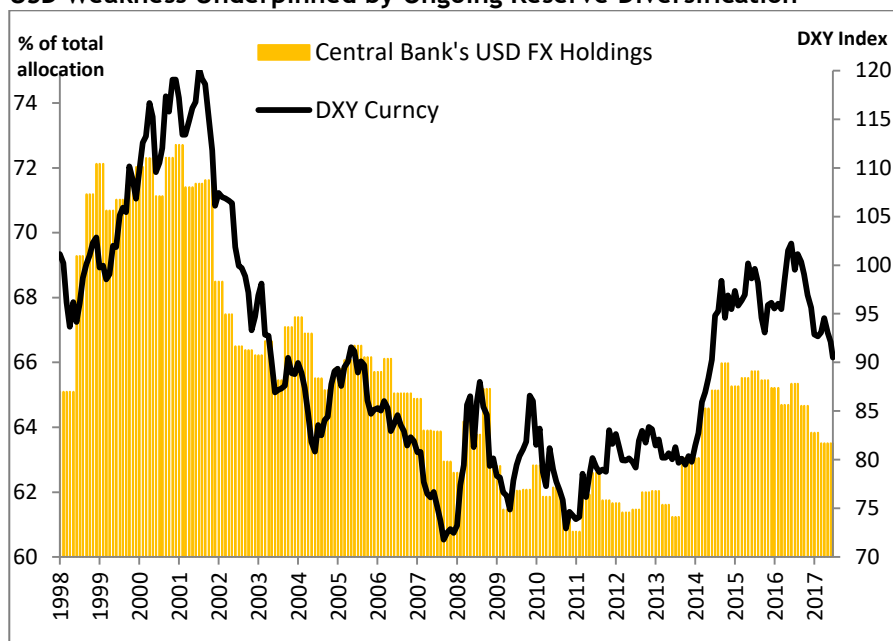
### Reserves Diversification away from USD since 2015



Source: IMF COFER, Bloomberg, Maybank FX Research & Strategy

The shift in FX reserves away from the USD was further reinforced after the RMB was added to IMF's special drawing rights (SDR) basket in 2016. The recent Asian Financial Forum (14 -16 Jan) held in Hong Kong saw central bank speakers suggesting further increases of Yuan or Yuan denominated assets in their currency reserves. Germany's Bundesbank is also said to be in preparation to add the RMB to their reserves, suggesting the growing importance of the Yuan globally. And we believe ongoing diversification away from the USD should continue to underpin USD weakness.

### USD Weakness Underpinned by Ongoing Reserve Diversification

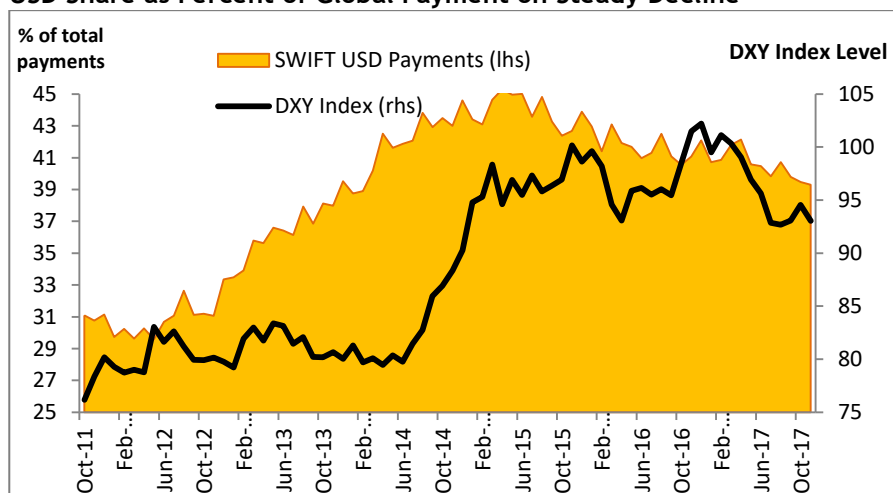


Source: Bloomberg, Maybank FX Research & Strategy

### Gradual Shift Away from USD as Global Payment Currency?

While USD remains the most commonly used currency in global payments (based on SWIFT payments), its share as a % of total payments have started to see a steady decline from 45.3% since 2015 to about 39% in Nov 2017. Growing preference in the use of EUR (second most commonly used payment currency) or even CNY could continue to see a shift away from the USD as global payment currency and that may weigh further on the USD.

### USD Share as Percent of Global Payment on Steady Decline



Source: Bloomberg, Maybank FX Research & Strategy

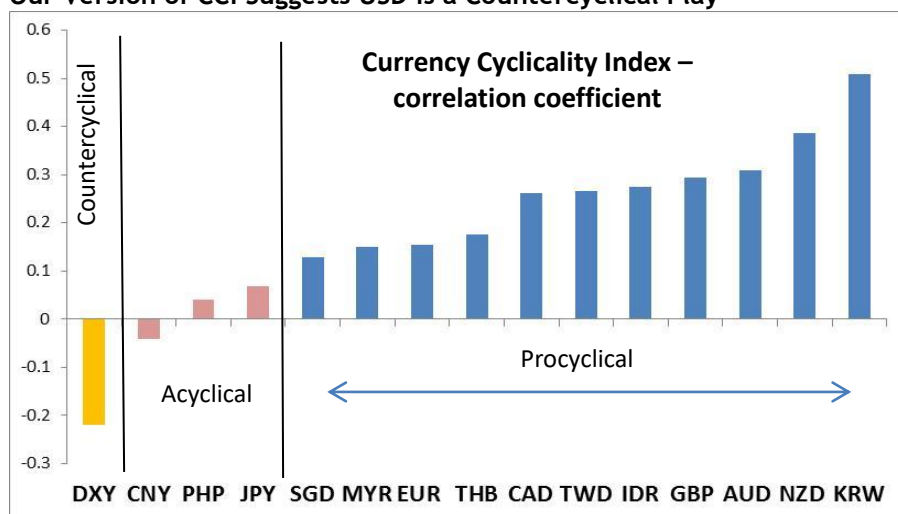


## USD Countercyclical Play - Underperforms when Global Growth is well

We look at the correlation between economic activity proxied by world Industrial production and various exchange rates and classify these currencies as procyclical (if currency appreciates when growth is well), countercyclical (if currency depreciates in good times) or acyclical (correlation coefficient below 0.1; insignificant).

We calculate our version of currency cyclical index (CCI) using monthly data for currencies including the majors and most AXJs over a period of 16 years from 2001. Our analysis shows that US dollar is a countercyclical currency - underperforms when global growth picks up and outperforms when global growth slips.

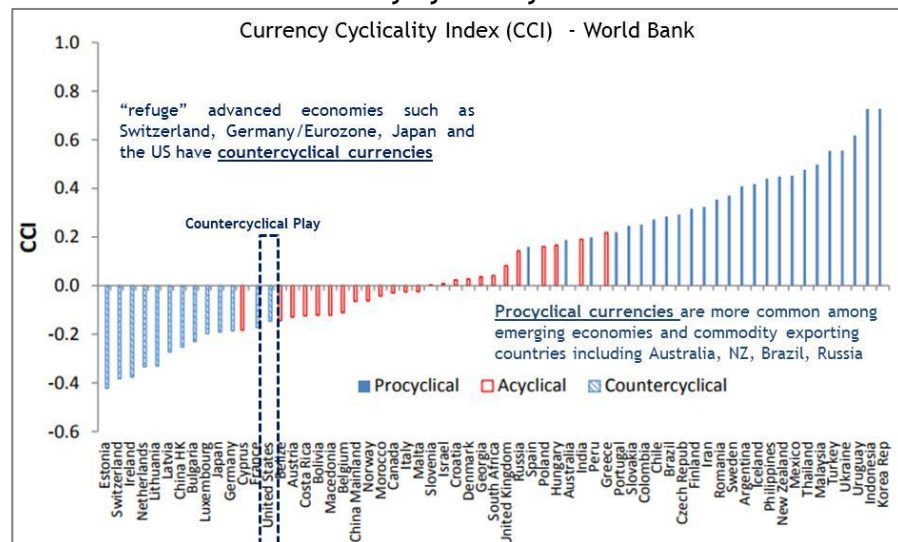
### Our Version of CCI Suggests USD is a Countercyclical Play



Source: Bloomberg, Maybank FX Research & Strategy

We also wish to draw findings from a World Bank Group Paper on What Makes a Currency Procyclical? An Empirical Investigation, published in 2014. The paper looked at the correlation between cyclical components of the GDP and the respective NEERs and classifies the countries' currencies as procyclical, countercyclical or Acyclical otherwise. Their sample period is longer (period of 30 years using quarterly data) and involved more currencies (63 countries). Nonetheless the findings are similar to ours - USD is a countercyclical currency.

### World Bank version of Currency Cyclicity Index for NEER



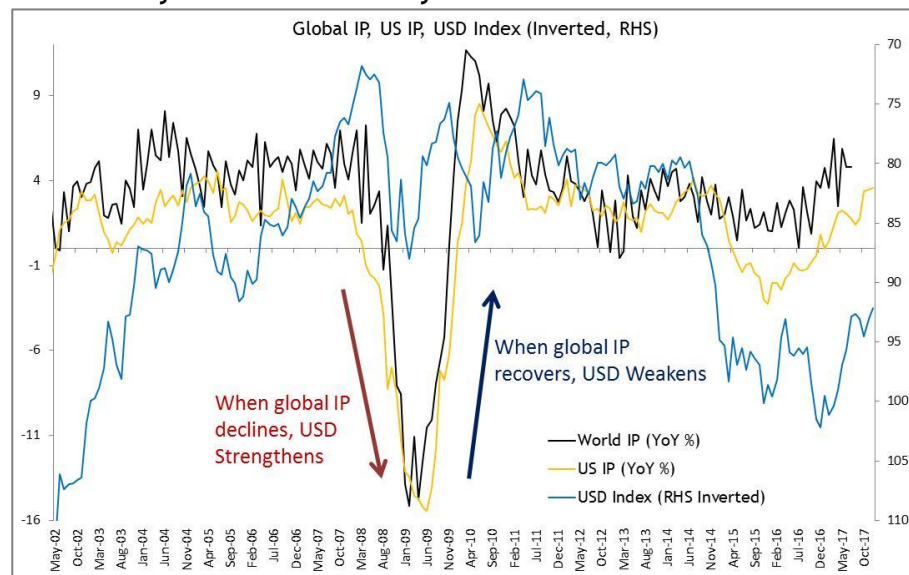
Note: Correlations between exchange rates and GDP are calculated using quarterly data and HP trend filtered series. Two-tail tests with significance at 10 percent level are used to divide the countries into procyclical (positive and significant correlation), countercyclical (negative and significant correlation) and acyclical (non-significant). Sample period for CCI is between 1975 and 2013.

Source: World Bank, Maybank FX Research & Strategy

The paper<sup>1</sup> shows that many of the advanced economies such as **US, Switzerland, Eurozone, Japan** have **countercyclical currencies** while countries that are emerging market commodity exporters such as Brazil and advanced commodity exporting countries such as NZ and AUD have **Procyclical currencies**.

Given that the relationship has been established - USD underperforms when global growth continues. This explains the USD weakness since 2017 amid synchronised economic recovery, also since the start of 2017. And we expect this recovery momentum to be sustained into 1H 2018, to further reinforce USD downside pressure.

### Continued Synchronised Recovery Should Reinforce USD Weakness



Source: Bloomberg, Maybank FX Research & Strategy

### Dollar Down Trend Underway according to USD Cycle

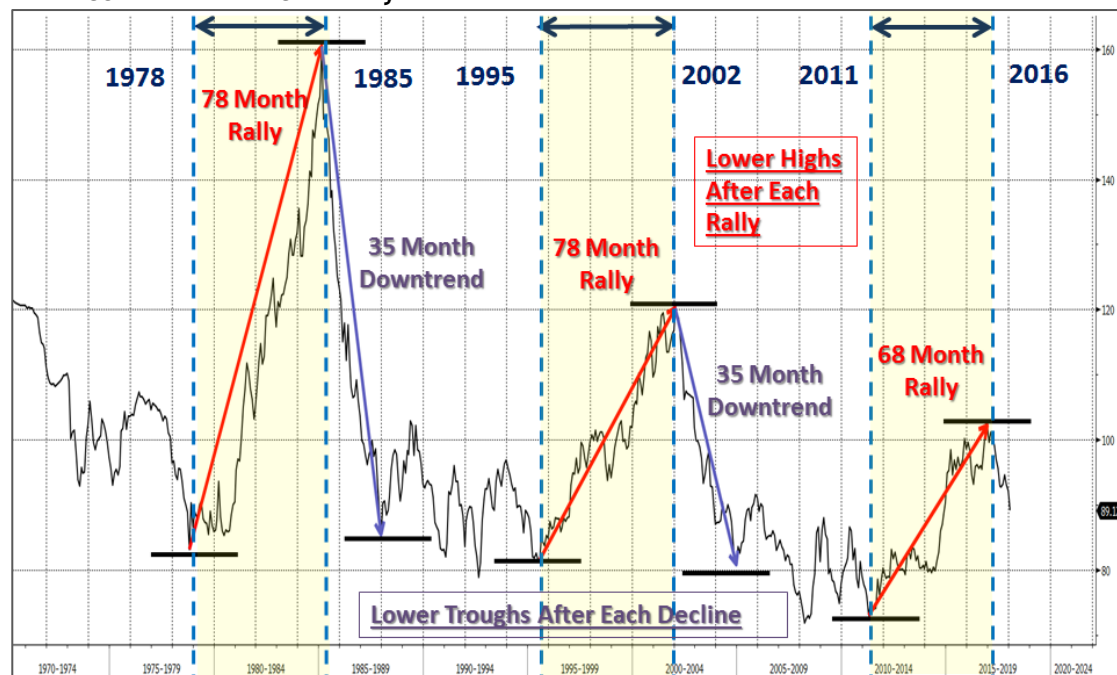
We believe the broad USD down trend is likely to be in place this year, as mentioned in our [previous report](#).

The 78-month USD rally cycle (as seen in 1978 and 1995 episodes) appear to suggest that the rally which begun in 2011 have ran out of steam since 2017 and the broad downtrend over the next 30 - 40 months is already underway (about 13<sup>th</sup> month into the down cycle).

<sup>1</sup> Cordella, Tito; Gupta, Poonam. 2014. *What makes a currency procyclical ? an empirical investigation (English)*. Policy Research working paper; no. WPS 7113. Washington, DC: World Bank Group.  
<http://documents.worldbank.org/curated/en/263031468148523567/What-makes-a-currency-procyclical-an-empirical-investigation>



## Broad USD Downtrend Underway



Source: Bloomberg, Maybank FX Research & Strategy

## But Not Without Risks

Nonetheless FX is not a one way move, we do not rule out sporadic USD rebounds especially on potential repatriation inflows into US amid stretched positioning. There are also a number of risk events that could pose risks to our view including German coalition government formation (still need vote from 450,000 Social Democrat party members on detailed coalition plan) and Italy General Elections (4 Mar) which could subject EUR longs to unwinding; unexpected twist on Brexit progression (resulting to profit-taking on GBP longs) or even inconsistent comments from US with regards to USD policy. Take for example Treasury Secretary Mnuchin's comments (24 Jan) that "a weaker USD is good for US" and subsequently Trump's comments (26 Jan) "the dollar is going to get stronger and stronger" and that that Mnuchin's earlier comments were misunderstood. Trump's comments saw a subsequent rebound in the dollar overnight.

We also wish to caution on medium term risk that if US fiscal impulse manifest into a faster than expected pace of Fed rate hikes (owing to faster than expected pick-up in inflation and growth), which may stem off global growth momentum, bring upon risk aversion and pose risk to USD downtrend.

## Reiterating Our House View

That said, our house view remains for gradual pace of Fed rate hikes (about 50 to 75 bps increase in interest rates) for 2018. We reiterate our view that the environment of monetary policy continuity in US (gradual, orderly pace of rate increases), still subdued inflationary pressures amid synchronised global economic recovery should continue to see USD softer.

Forecast	1Q 2018	2Q 2018	3Q 2018	4Q2018
USD Index	90.16 (95.18)	89.49 (94.10)	87.76 (93.02)	86.76 (92.31)

Previous Forecast in Parenthesis

DXY was last seen at 89.30 levels. Bearish trend channel formed since start of 2017 remains intact. Bearish momentum on monthly, weekly and daily charts are also intact. Trend remains your friend though stochastics is cautioning for oversold conditions and that DXY could face some rebound risks. Resistance at 91.20 (38.2% fibo). Next key support levels seen at 87.30 (50% fibo retracement of 2008 low to 2017 high) and 83.35 (61.8% fibo).

#### DXY Technical Chart Suggests Next Key Support at 87.30, 83.35 Levels



Source: Bloomberg, Maybank FX Research & Strategy

## Appendix 1: Highlights of Recent Tax Reforms

	<u>Individuals</u>	<u>Businesses and International</u>
Budget Costs	Keeps 7 tax brackets but <b>lowers marginal individual income tax*</b>	Lowens <b>corporate tax rate to 21%</b> (from 35%)
	Doubles standard deduction (\$12k for singles and \$24k for married)*	Allows <b>100% expensing of qualified property</b> through 2022, then phased out annually by 20% each year through 2026
	Expand child tax credit (doubles to \$2k), fully refundable up to \$1.4k, but phases out for families earning more than \$400k*	20% deduction for <b>pass-through business</b> profits (hence, effective marginal tax rate no more than 29.6%); deduction limited above income of \$157k for single and \$315k for joint filers)*
	Expand <b>medical expense deductions</b> 7.5% for 2017 and 2018, and 10% for 2019 thereafter	Reduced <b>dividends received deductions (DRD)</b>
	Retains education deductions and credits	Eliminates <b>corporate AMT</b>
	Higher trigger limit for <b>estate taxes</b> (40% taxable above \$11.2mn for singles and \$22mn for married)*	<b>Small business reforms</b> ; simplified accounting, increases max current expense threshold to \$1mn, phased out at \$2.5mn
	<b>Increase alternative minimum tax (AMT)</b> exemptions to \$70.3k (single) and \$109.4k (joint); phases out above \$500k (single) and \$1m (joint)*	
Budget Savings	Use <b>Chained-CPI or (C-CPI)</b> measure for tax individual's tax bracket	<b>Net operating loss (NOL) deduction</b> limited to 80% of taxable income
	Caps <b>SALT deductions</b> at \$10K*	<b>Base-erosion prevention measures</b> ; inclusion of GILTI, taxable income in excess
	Caps New mortgage interest deductions of up to \$750k*	Caps <b>business interest deductibility</b> to 30% of income
	Eliminates Obamacare's " <b>Individual Mandate</b> " penalty tax	<b>One-time tax repatriation</b> of Earnings & Profits at 15.5% for cash and 8% for reinvestments
	Modified <b>casualty loss, charitable contributions, and miscellaneous</b> deductions	Gradual write-off of <b>Research &amp; Expenditure (R&amp;E)</b>
* denotes sunset provision - expires after 2025		

Source: CBO, TPC, Maybank FX Research &amp; Strategy

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