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*"It's our currency but it's your problem."*

-JOHN CONNALLY, Former US Treasury Secretary, gruffly informing his global counterparts in late 1971 that a strong dollar was not a priority for the Nixon administration.\*



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## INTRODUCTION

**Upsetting the dollar cart?** The year 1971 has been on my mind a lot this week. On a personal note, my wife and I have been staying at one of Arizona's oldest and most charming resorts, the Wigwam, right outside Phoenix. It was established in 1927 by the Goodyear (as in tires) family on a "mere" 17,000 acres. Upon arrival in those days, guests were given a key—and a horse! Even on horseback, it must have taken weeks to see the entire spread.

My first experience at the Wigwam was 44 years later, in 1971, and horses were no longer supplied (though I would have enjoyed the riding). Now another 46 years have elapsed and my recollections are a bit fuzzy but I remember being awed by the authentic adobe bungalows and the beautiful grounds. The resort looks much the same today so it's been a wonderful trip down memory lane to return. Yet, I have to admit, 1971 was just a bit more momentous for what happened to the US dollar.

In case you may have forgotten, it was at that time President Nixon severed the link between the greenback and gold. In other words, the only thing backing the buck became the full faith and credit of the US government. Or, as it's known in economics, the dollar became a "fiat currency". Remarkably, all these decades later, it remains the planet's reserve currency—despite many instances of its demise being greatly exaggerated, typically during periodic bouts of weakness (of which there have been many).

In this month's EVA, Gavekal's Charles Gave examines the implications of Trumponomics on the dollar's reserve currency status. After a mere two weeks in office, it's becoming clear that Mr. Trump's policies are the most protectionistic since Herbert Hoover (and we know how those turned out!). Like Evergreen, Charles appreciates some of Mr. Trump's more rational proposals such as regulatory roll-back and tax reform. But he also worries about the potential for a "violent economic and financial dislocation" due to Mr. Trump's goal of greatly reducing, or even eliminating, the US trade deficit. This sounds good in theory, but because of the dollar's reserve currency status, anything that materially curtails its availability runs the risk of contracting global liquidity and, by extension, economic activity.

Another factor that could make dollars harder to come by for other countries is the Republican party's proposed Border Adjustment Tax (BAT). It is a critical aspect of the GOP's plans for corporate tax reform and it definitely syncs with the President's desire to improve America's balance of payments. (The BAT is roughly equivalent to the value-added tax, or VAT, used to raise revenue—and favor exports—in many other countries.)

It's my belief from talking with numerous clients that most aren't aware of its key provisions such as eliminating tax deductions for imported goods sold in the US. Thus, a retailer who is heavily reliant on selling US consumer's products brought in from overseas would have to pay taxes on their profits without being able to deduct the cost of goods sold on the imported items. Conversely, companies who source products in the US and sell them overseas may actually have a negative tax rate—even if they are exceedingly profitable. Obviously, these radical changes, if actually implemented, have the potential to be extremely destabilizing.

Charles also points out that when the US came off the gold standard back in 1971 it allowed for an explosion in global debt creation. This was due to a phenomenon known as a "double pyramid" in credit creation. In plain terms, it meant that the US no longer had to settle its trade deficits with actual gold, as it theoretically had to do prior to 1971. Further, because the "fiat" dollars sent overseas were typically recycled back into the US (such as by Middle Eastern or Japanese investors buying US treasuries), they were still available for domestic lending. As a result, credit expansion effectively doubled versus what had occurred in the past (when the gold outflow would have restricted debt increases in the deficit country).

\*In addition to this famous quote, Mr. Connally also went down in history for having been seriously wounded while riding next to JFK in Dallas eight years earlier.

Charles logically concludes that this effect has played a big part in the massive credit growth of the past nearly half-century. Initially, consumer inflation was a result. Since the early 1980s, however, rampant price increases have tended to occur in asset values, fed by the credit proliferation (and, in recent years, zero- and, even negative-interest rates), rather than in the CPI. Central banks, including the Fed, have turned a blind eye to the resulting asset bubbles—until they imploded, of course. As noted in various past EVAs, bubbles were a rare occurrence prior to the late 1980s; since then, though, they have become increasingly commonplace.

Consequently, if this era of abundant dollar liquidity and “double pyramid” credit creation is coming to an end, it is enormously significant—with profound implications for the financial markets. As usual, US stock investors seem utterly oblivious to any downside from these radical shifts.

Charles, being the cheery chap that he is, ends his note with a policy prescription to avoid the potential chaos of an abrupt end to the dollar paradigm we’ve seen since 1971. But, echoing John Connally, the current administration seems to feel that what happens to the world’s sole reserve currency is someone else’s problem. Considering that 40% of the S&P 500 revenues now come from overseas, investors may soon find out we’re all in this together, for better or for worse.

## THE END OF THE DOLLAR STANDARD

By Charles Gave

I find myself in the strange situation of cheering Donald Trump’s nascent program of economic renewal for the US, while worrying deeply about the domino effect that may topple a dollar-based global financial system whose health has relied greatly on benign neglect by the United States.

The good news is that since the fall of the Berlin Wall I have never seen a president or prime minister of the right come into power with an agenda that so squarely opposes the doxa of left-leaning elitist circles. Whether in education, regulation, taxes, ecology, energy production, culture, justice, military strategy or national security, most of the president-elect’s cabinet nominees have for decades fought a flabby intellectual orthodoxy.

Yet, while I welcome Trump’s attack on a credo which has done much to enfeeble the Western world, I am not blind to the violent economic and financial dislocation which may mark the transition from one reserve currency order to another. At the end of this paper, I offer a modest suggestion for avoiding a scenario which has the potential to morph into a 1930s-style beggar-thy-neighbor episode on steroids.

The starting point is that the US dollar has been the world’s reserve currency since the end of World War II, with 1971 marking the transition to a pure fiat regime. Markets, institutions and investor habits have developed according to this basic building block. Yet there is nothing immutable or inevitable about the US sponsoring such a currency arrangement. Indeed, Trump’s core economic platform of trade protection points to the US pursuing an objective which is guaranteed to kill the existence of the US dollar as the sole reserve currency—namely the US’s apparent pursuit of a current account surplus.

## THE DOUBLE PYRAMID OF CREDIT

To explain my point, I will use Jacques Rueff’s powerful framework for thinking about the US dollar’s international relationships, namely the “double pyramid of credit”. Rueff was an economist and senior civil servant who between 1923 and 1969 was France’s chief negotiator at international monetary conferences, and a sophisticated observer of the international payments system. Rather like his arch rival John Maynard Keynes, Rueff was both a theoretician and a practical man of action who was involved in actually building the global financial system.

One of his key ideas was that in the post-gold standard era, a side effect of one country controlling the reserve currency would be an end to the zero sum game of credit expansion associated with an independent speciebased system. Instead, Rueff’s double pyramid of credit idea described a new order that would likely be characterized by inflation, over indebtedness, capital misallocation, and episodic financial crises.

By way of a simplified example, consider a Rueffian take on the relationship between the US and Japan under the post-1971 US dollar reserve system. Say the US went through a big credit expansion, causing it to run a large current account deficit with its East Asian trade partner. The corresponding current account surplus in Japan would spur creation of new Japanese bank deposits, and with them a credit expansion.

Under the gold exchange standard, such credits in Japan would have been offset by reduced money supply in the US due to the physical transfer of gold from the US to Japan by way of deficit settlement. As a result, the global system of payments was a zero sum affair and credit expansion did not, on balance, change over time.

This was upended in 1971 when the US stopped settling its current account deficit in gold (Charles de Gaulle, on Rueff's advice, catalyzed this shift by demanding that the US settle with a physical transfer of gold ingots). Subsequently, US dollars earned by Japanese firms have not been exchanged against gold, but rather "redeposited" at the Federal Reserve via a process of foreign exchange reserve accumulation. As a result, the US has not faced higher interest rates from its deficit with Japan and by extension from its habitual global current account deficit.

It was this ability for credit to keep growing in both the US and its creditor nations that led Rueff to coin his double pyramid moniker. In the above example, both Japan and the US were able to sustain credit growth, although the ultimate source for both was "excess" US money supply.

This money creation machine has only properly broken down during periods of high US inflation which have necessitated sustained tightening by the Federal Reserve. Experience has shown that the US central bank has kept obsessively focused on consumer price inflation and disregarded events in asset markets, even if stocks were surging, the dollar exchange rate was plunging and property prices were going stratospheric. The Fed has proven willfully blind to effects from the double pyramid of credit by responding only to US price and growth data. In short, it may be the world's central banker, but the Fed has resolutely only followed US rules.

### THE PROBLEM OF DIVERGENCE

The problem with this double expansion of credit is that it tends to compound economic divergence, rather than convergence, which for all its faults was the logic of the old gold exchange standard. Consider the experience of Japan and the US over the last 30 years. The former proved unable to manage twin objectives of limiting yen appreciation and keeping control of its money supply. The upshot was a huge asset bubble in the late 1980s, which turned into a bust from which Japan has never fully recovered.

Fast forward to the early 2000s when two new beneficiaries of this double pyramid of credit started to take off. One was China and the other, what we have called "platform" companies, or firms which outsource much of their production and working capital needs to dispersed supply chains in places such as East Asia, Eastern Europe and Mexico.

The rational actions of these two "actors" following Rueff's doublepyramid-of-credit logic has resulted in violent asset price cycles—Chinese financial repression led to surging property prices, oil experienced an epic boom-bust cycle and US equities have been pumped up on the promise of permanently cheap money. The flip side has been acute deindustrialization in the US as firms have shifted production to China and other low cost production centers. Put simply, the double pyramid of credit phenomenon hugely exacerbated the hollowing out of the US industrial sector, and so is the proximate cause of Trump's rise to power.

Indeed, it is ironic that US automobile firms are making cars in Mexico for sale to US buyers who can't—by any normal measure—afford to buy them, as they don't have a proper job. Luckily US auto firms have organized credit lines for their buyers, even though it is obvious that much of this debt will never be repaid.

As with the US-Japan relationship, the US automobile ecosystem has been on a trajectory of divergence rather than convergence. The double increase in leverage (both in Mexico and through vendor financing offered by US auto finance firms) has replaced demand that comes from an organic rise in US living standards. The logical end result would be for car production in the US to be eliminated, and displaced "workers" given government handouts so they can buy Mexican-made vehicles from firms that can declare splendid earnings guaranteed by Uncle Sam.

I exaggerate for effect, but this example shows that the US's "exorbitant privilege" has little to do with free market principles as it means the US (i) lacks a foreign trade constraint, and (ii) can force other countries to accept payment in dollars. Should either of these conditions end then the credit pyramid would implode. And indeed for decades commentators have fretted that the rest of

the world may one day lose confidence in the US dollar as a store of value, resulting in soaring US interest rates and an economic crash—the Japanese, Chinese and a Brazilian supermodel have, at different times, all been touted as potential liquidators.

I never believed such scare stories so long as the US remained a superpower capable of corralling international respect. What worried me was a situation where the US, for domestic political reasons, pulled up the drawbridge and chose to pursue a current account surplus. Such an outcome was always going to be driven by Americans at large concluding that the global production system was being run against their interests.

### THE EMERGENCE OF TRUMPONOMICS

This was the backdrop for the emergence of “Trumponomics” and the fact that the US apparently wants to challenge China and Germany to become a surplus economy. To this end, US policymakers hope to tax imports at 20% and subsidize exports by a similar amount (i.e. what many export focused economies do through VAT systems). Returning to Rueff’s monetary construct, Trump may just as well have said that he wanted to destroy the double pyramid of credit, which has grown relentlessly outside of the US since the mid-1960s.

Whatever the rights and wrongs of the global economic status quo, dismantling such a huge pyramid of credit threatens havoc for the financial system. Should the US return to a current account surplus, the rest of the world will move to an aggregated current account deficit. Since all other countries have a trade constraint, the system will inevitably start to contract, led by those nations already running a current account deficit. Such economies will have to tighten policy almost immediately, resulting in a big decline in domestic demand and so reduced imports.

The consequence will be that even “surplus” economies will move into a current account deficit and be forced into a tightening cycle. Those with an eye for history will have recognized a pattern as this chain of events was roughly what happened in the 1930s when another big pyramid of external credit collapsed—in this period, Britain was unable to regain its primacy at the center of the old gold standard system and the US was not willing to assume an economic leadership role. When the US sought a reflationary devaluation of the dollar in 1934 by constraining the sale of gold, it did so despite running a current account surplus. That decision aided the US’s economic recovery, but helped tip the German and French economies into a depression, ensuring the onset of World War II.

Fast forward to today and in some ways the ambition of US policymakers exceeds that of the 1930s. In addition to trade protection measures, Trump wants to ensure that dollars held outside of the US, especially those controlled by US multinationals, are sent back home. On the basis that history rhymes rather than being repeated, it is worth recalling that in the 1930s US banks aggressively recalled German loans, leading to the collapse of the German banking system.

### NOTHING IMMUTABLE ABOUT A DOLLAR STANDARD

It is worth remembering that seemingly fixed elements of the global credit system developed in a haphazard fashion and can easily be reversed. For example, the Eurodollar market evolved after 1963 when John F Kennedy acted to reduce a growing US balance of payments deficit by taxing US investors who took dollars abroad to buy foreign securities. Subsequently, US dollars held outside of the US were mostly taxed at a lower rate than onshore dollars, and it was this “arbitrage” that allowed the City of London to develop and the external pyramid of credit to grow. If the tax system which encouraged US dollars to stay outside of the US disappears, then the US\$1.2trn or so owned by US multinationals—the backbone of international credit markets—may be about to move back onshore. For the City of London, where most external dollars are managed day to day, the blowback could end up being far more serious than the loss of European Union passporting rights due to Brexit.

As a result, the future of international capital flows looks pretty gloomy. Indeed, on a flow basis the US dollar may increasingly become a collector’s item. This matters because many countries rely on US dollars being readily available to plug balance of payment deficits—according to a Bank of International Settlements report from 2015 the preceding decade saw non-US entities borrow some US\$10trn.

Since the US can seemingly no longer be relied on to play the global shock absorber by expanding its current account deficit, the key headache for emerging economies may become servicing their stock of US dollar debt. So long as US short rates stayed low and the dollar exchange rate did not appreciate unduly (i.e. the situation since 2008), this was a manageable task. Yet in the event of the US current account starting to improve markedly (or even going into surplus), borrowers will find it impossible to repay principal as the US currency will have effectively been cornered, and there will not be enough dollars available to satisfy demand.

This situation will be exacerbated if the borrowed dollars were used to build factories whose output is sold in the US. The threatened imposition of a 20% surcharge on foreign-made imports to the US will render such factories unprofitable, but the debt will still have to be repaid. In short, the external part of the double pyramid of credit could involve subprime-type write-offs, only much larger.

#### **POST SCRIPT: A MODEST PROPOSAL TO SAVE THE WORLD**

If somebody were to ask my advice on how President-elect Trump should pursue his perfectly legitimate objectives without wrecking the global economy (and thereby ensure failure), I would suggest the following:

- The US should adopt market-friendly policies that boost the economy's structural growth rate as is clearly the case with the program being put forward by Trump and the House Republicans.
- More difficult, but far more important than the first goal, Trump needs to pursue policies for which he was not elected; namely to prevent a collapse in the growth rate outside of the US.

The transmission mechanism for a bad cycle to unfold will be a far stronger US dollar; the inevitable result of ROIC in the US rising sharply. Such a situation will quickly hurt those fellows detailed above with heavy dollar debts as they never expected the US to actively reduce ROIC in the rest of the world. Should an acute dollar squeeze develop of a type last seen in the early 1980s then the exchange rate will soar, and ultimately the US will suffer due to US firms experiencing a sharply lower return on invested capital. For their part, US lenders will face huge defaults by stressed foreign borrowers.

To avoid such a scenario, the US should stand ready to buy, outright, the currencies of those countries facing payment difficulties. This will leave the US with huge foreign exchange reserves and the rest of the world with enough dollars to service their debts and meet payment obligations. As such, an implosion of the foreign pyramid of credit need not mean a collapse in the non-US money supply. Put another way, the US authorities should stand ready to build reserves in foreign currencies equivalent to the sum that vanishes through the credit contraction it has engendered.

The new US administration should thus launch a strategic fund ready to buy any foreign currency each time it becomes two standard deviations undervalued as measured by the OECD. Funding should come from the Federal Reserve at a market rate of interest and a stipulation should be made that the program is wound up as soon as the "new" foreign exchange reserves reach a level equal to about six months of US imports. The profits that will almost certainly accrue from such a program should be used directly to offset budget deficits that Trump's fiscal expansion is likely to deliver.

## OUR CURRENT LIKES & DISLIKES

### Changes

#### WE LIKE

- Large-cap growth (during a correction)
- International developed markets (during a correction)
- Canadian REITs
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12%
- Intermediate-term investment grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Intermediate municipal bonds with strong credit ratings
- Select blue chip oil stocks (on a pull back)
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Investment-grade floating rate corporate bonds
- Mexican stocks
- **Yield Cos on a pull-back (and profit-taking for tax-deferred accounts, in some cases)**

#### WE'RE NEUTRAL ON

- Most cyclical resource-based stocks
- Large-cap value
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Short yen ETF (closing out positions and removing)
- Emerging market bonds (local currency)
- Short euro ETF (sell a portion for solid gain)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Canadian dollar-denominated bonds
- Long-term municipal bonds
- Mid-cap growth
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- The Indian stock market
- Intermediate Treasury notes

#### WE DON'T LIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small and mid-cap issues appear attractive)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Floating-rate bank debt (junk)
- Lower-rated junk bonds

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