MyStratWeekly
Market views and strategy

N° 189 / **January 20, 2025**


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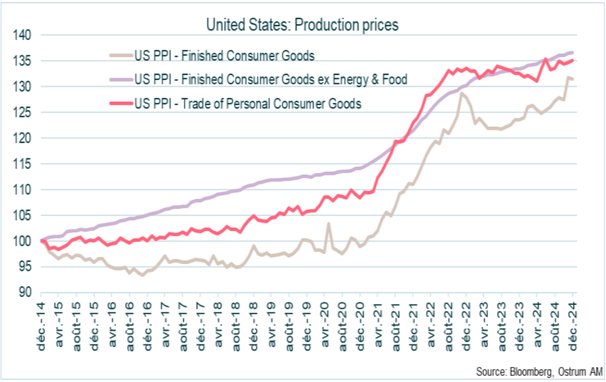
Topic of the week: The dollar in the era of the Trump presidency.
by Zouhoure Bousbih

- A weak dollar is Donald Trump's obsession to restore the glory of the American manufacturing sector. However, since his election in November, the dollar has strengthened and is close to its historical levels.
- The strong dollar of 2025 bears similarities to the first term of R. Reagan (1981-1985), which led to significant global financial instability and the famous Plaza Accord.
- The significant deterioration of the United States' net investment position (80% of GDP) is a point of vulnerability for American financial markets.
- A strong dollar is inconsistent with concerns about the sustainability of American debt, as reflected in the rising term premiums.

Market review: The Elephant in the room
by Axel Botte

- Lower US and UK inflation prints trigger a rally in bond yields;
- US dollar eases as Waller signals that the Fed's easing bias is intact;
- Credit and stock markets perform in the wake of lower long-term rates;
- Euro sovereign spreads tighten as Bund yields fall.

Chart of the week



The producer prices in the U.S. continue to rise at a steady pace.

The prices of US-made consumer goods have already erased the decline resulting from the improvement of supply chains in 2023 and are up 6.4%y in December 2024.

The prices of trade services, indicative of the evolution of retailers' margins, have increased less and are expected to adjust upward, especially as the expected tariffs will raise the cost of imports. This increase in retailers' margins will translate into a rise in consumer prices.

Figure of the week

5

China has achieved its growth target of 5% this year, thanks to the upward revision of GDP growth for Q3 from 0.9% to 1.3% quarter-on-quarter, as well as a growth of 1.6% quarter-on-quarter in Q4. The stimulus is heading in the right direction.
Source: NBS

Topic of the week

The dollar in the era of Trump presidency

Today, D. Trump is seeking a second term in the White House that promises to be more radical than the first. This is reflected in his universal tariff policy, financial deregulation, and his willingness to deport illegal migrant workers. While his tariff policy has sparked considerable debate since his election in November, the American president has also repeatedly expressed his obsession with weakening the dollar during his campaign. However, at the beginning of this year, the opposite has actually occurred.

The strong dollar of 2025 resembles that of R. Reagan (1981-1985)…

The dollar is close to its peaks of March 1985...

Trump and his vice president JD Vance have cast doubt during their campaign on the benefits of a strong dollar for the American economy. Both believe that a devaluation of the dollar would restore the former glory of the American manufacturing sector. A weak dollar would, all else being equal, enhance the competitiveness of the American manufacturing sector and create jobs.

Since his election last November, a contrary trend has emerged: the dollar has strengthened against all currencies, reaching levels close to the peaks of March 1985, as illustrated in the accompanying chart. This appreciation is largely attributed to his tariff and budgetary policies, which favor the greenback. The budgetary policy he intends to implement is expected to worsen the U.S. budget deficit, leading to inflationary pressures.

...which had led to global financial instability and the Plaza Accord.

The current strengthening of the dollar recalls the period from 1981 to 1985 when Ronald Reagan was in power.
His term was marked by tax cuts and increased military spending (notably through the Star Wars initiative), resulting in a budget deficit. To contain inflationary pressures, the U.S. Federal Reserve maintained high interest rates, thereby attracting foreign capital and strengthening the dollar. Between January 20, 1981, and its peak in March 1985, the dollar gained over 40% of its value. However, this strength of the dollar harmed the competitiveness of the American manufacturing sector, worsening the trade deficit.

Moreover, the robustness of the dollar created tensions for emerging countries indebted in dollars, contributing to sovereign debt crises, particularly in Latin America, with repercussions on the global economy. Speculation surrounding fluctuations in the dollar has also increased volatility in financial markets, fueling overall financial instability.

To counter the appreciation of the dollar, which threatened the American economy, Ronald

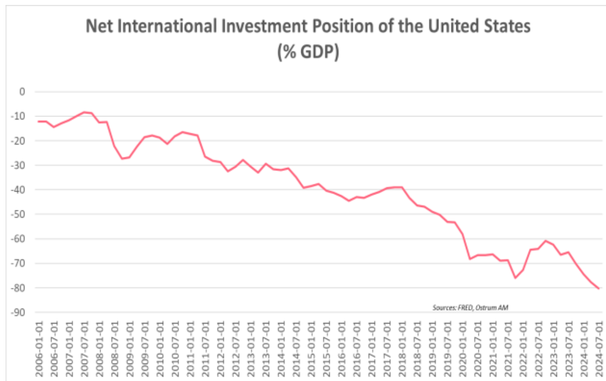
Reagan negotiated with France, the United Kingdom, Japan, and Germany an agreement to intervene in the foreign exchange market and weaken the dollar, known as the Plaza Accord of 1985. This agreement allowed for a decrease in the value of the dollar, except for the Japanese yen. For this reason, it was largely viewed as an ultimatum issued by Washington against Japan. The appreciation of the yen harmed the competitiveness of Japanese exports, plunging the Japanese economy into an economic slump from which it struggled to recover.

A similar agreement to the Plaza Accord is impossible today. China will never agree to weaken its yuan for D. Trump’s objectives, considering that the Plaza Accord is responsible for Japan's economic stagnation.

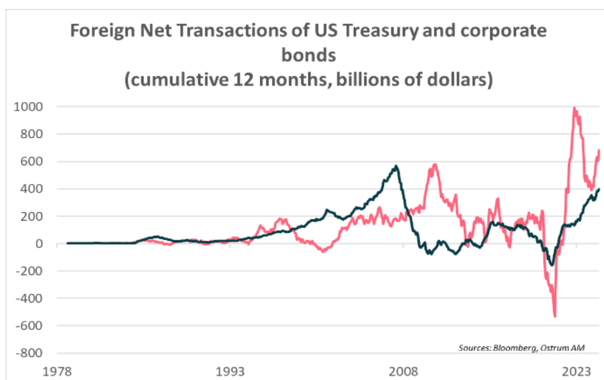
…But with a stronger destabilizing power

The negative net international investment position of the United States (80% of GDP) constitutes a point of vulnerability for American financial markets.

The accompanying chart shows the net international investment position of the United States as a percentage of GDP. This represents the difference between the assets held by American residents abroad and the liabilities held by non-residents in the country. A negative balance indicates an increased dependence on foreign financing.



Most assets held by non-residents are in the form of portfolio flows, meaning transactions in American equity or bond markets. Since the Fed began raising its rates in March 2022, speculative flows have intensified, as illustrated by the accompanying chart showing net purchases of Treasuries and corporate bonds by non-resident private sector investors.



Since 2018, the net international investment position of the United States has become significantly negative, representing 80% of American GDP in Q4 2024. This poses a point of vulnerability for American financial markets. If confidence erodes regarding fiscal and monetary conditions (threatening the independence of the Fed), it could lead to capital outflows from the United States, potentially creating a dislocation in global financial markets.

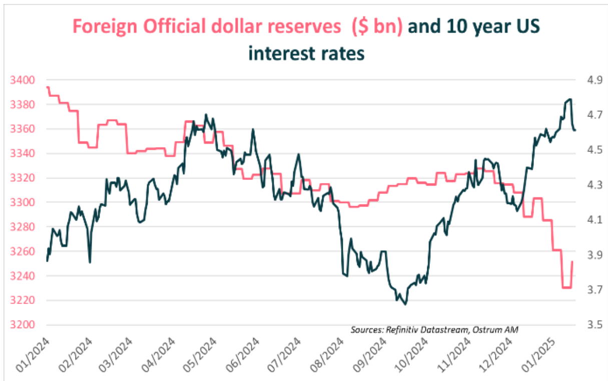
This episode of a strong dollar is inconsistent with concerns about the sustainability of American debt.

The surge in U.S. long-term rates is related to the increase in real rates and term premiums...

The rise in long-term U.S. sovereign bond yields observed at the beginning of this year is led by real interest rates and term premiums, rather than an increase in inflation expectations. The rise in term premiums reflects concerns about the sustainability of American debt, which is incompatible with the recent appreciation of the dollar.

...But also to the decline in dollar reserves held by official institutions, such as central banks.

The decline in dollar reserves held by foreign official institutions also seems to exert upward pressure on long-term interest rates (Ahmed and Rebucci 2024, *A 'reverse conundrum' and foreign official demand for US Treasuries*), as shown in the accompanying chart. Since September, these institutions have reduced their dollar reserves, coinciding with the rise in 10-year sovereign bond yields. They may have turned to gold, whose prices have increased by nearly 30% over the year, despite the rise in real U.S. rates and the appreciation of the dollar.



Thus, a slight decrease in the share of U.S. Treasuries in the reserves of foreign official institutions, such as central banks, could have a significant impact on the U.S. Treasury markets in the short term and ultimately on the dollar.

Conclusion

A weak dollar is Donald Trump's obsession to restore the glory of the American manufacturing sector. However, since his election in November, the dollar has strengthened, showing similarities to the period (1981-1985) when Ronald Reagan was in power. Its destabilizing power is heightened due to the significant deterioration of the United States' net international investment position (and the large speculative flows). If confidence erodes regarding fiscal and monetary conditions, capital outflows could create dislocations in the financial markets. One can find reassurance in the fact that such a scenario has never occurred so far, but who knows... The decline in dollar reserves held by official institutions in favor of gold could also have a significant impact on the U.S. Treasury markets and ultimately on the dollar.

Zouhoure Bousbih

Market review

The elephant in the room

Donald Trump's inauguration day comes as tensions ease in the bond markets, thanks to somewhat better inflation data. Risk assets, particularly in the credit sector, are benefiting from the decline in interest rates.

The recent surge in bond yields has come to a halt following the release of economic indicators suggesting a moderation in inflation. The yield on the 10-year T-note, now at 4.60%, fell by 15 bps as the December CPI revealed an improvement in core inflation, which slowed to 3.2%. The adjustment predominantly reflects a downshift in real yields. Several members of the FOMC have highlighted the price data, reaffirming their intention to cut rates later this year. Consequently, the U.S. dollar has depreciated by 0.5% last week, benefiting European equities, which rose by 3%, as well as credit markets. Nonetheless, the rebound in crude oil, industrial metals, and gold underscores the persistent inflationary risks, particularly in light of announced tariff increases.

From an economic perspective, U.S. growth remained above potential towards the end of the year. Industrial production rebounded by 0.9% in December following autumn strikes, while retail sales excluding volatile items rose by 0.7%, indicating robust consumer activity last month. However, the imminent increase in tariffs likely prompted consumers to bring forward their spending. A pullback seems likely in the first quarter, especially with rising gasoline prices. In China, the growth target of 5% appears to have been met, supported by an increase in the trade surplus at year-end. The real estate and retail sectors are also showing signs of recovery from very depressed levels.

The release of the CPI has prompted a reassessment of Treasury bond positioning, as yields closed the week at 4.60%, 20 bps off January's high. The unwinding of short positions in Treasuries was significant. Comments from Governor Christopher Waller hint at a scenario of three to four Fed rate cuts in 2025. Uncertainty regarding the Fed's actions this year remains significant. The decline in British inflation has magnified the rally in long-term yields, allowing Gilts to recover from their underperformance since the beginning of the year. Meanwhile, the 10-year Bund approaches 2.50%. The easing of risk-free yields is benefitting all sovereign spreads. François Bayrou's general policy speech has been positively received by the markets, with the 10-year OAT spread falling below 80 bps, while Italian BTPs stand at 110 bps. The tightening of swap spreads continues for the 10-year sector, which helped covered bonds and supranational debts to rally. In emerging markets, dollar bond spreads remain close to their lows.

Credit demand remains robust, keeping spreads around 90 bps over swaps. The primary market is oversubscribed, as new issue premiums shrink. credit fund inflows remain strong in IG space but are weakening in the high-yield sector. Nonetheless, spreads on speculative-grade bonds have narrowed by one bp over the week. Intrum's exit from the XOVER index caused the bulk of the tightening of the CDS index spread. Equities are firmly regaining upward momentum, fueled by falling rates that are rekindling the outperformance of growth stocks. US banks' earnings releases are also driving stock prices higher, with Europe participating in the upward trend.

Axel Botte

Main market indicators

G4 Government Bonds	20-Jan-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Bunds 2y	2.23%	-7	+20	+15
EUR Bunds 10y	2.52%	-9	+24	+16
EUR Bunds 2s10s	29.5 bp	-2	+4	+1
USD Treasuries 2y	4.28%	-10	-3	+4
USD Treasuries 10y	4.63%	-15	+10	+6
USD Treasuries 2s10s	34 bp	-6	+13	+1
GBP Gilt 10y	4.66%	-23	+15	+9
JPY JGB 10y	1.2%	0	-4	+0
€ Sovereign Spreads (10y)	**20-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
France	78 bp	-7	-5	-5
Italy	110 bp	-11	-6	-6
Spain	64 bp	-6	-5	-5
Inflation Break-evens (10y)	**20-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR 10y Inflation Swap	2.04%	-4	+11	+11
USD 10y Inflation Swap	2.57%	-3	+13	+10
GBP 10y Inflation Swap	3.6%	-8	+10	+7
EUR Credit Indices	**20-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR Corporate Credit OAS	98 bp	-3	-2	-4
EUR Agencies OAS	57 bp	-4	-5	-5
EUR Securitized - Covered OAS	52 bp	-4	-6	-5
EUR Pan-European High Yield OAS	315 bp	-5	+6	-3
EUR/USD CDS Indices 5y	**20-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
iTraxx IG	55 bp	-5	-2	-3
iTraxx Crossover	294 bp	-26	-17	-20
CDX IG	49 bp	-4	-1	-1
CDX High Yield	303 bp	-21	-6	-9
Emerging Markets	**20-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
JPM EMBI Global Div. Spread	322 bp	+2	-6	-4
Currencies	**20-Jan-25**	**1wk (%)**	**1m (%)**	**2025 (%)**
EUR/USD	$1.039	1.723	-0.345	0.4
GBP/USD	$1.228	0.887	-2.291	-1.9
USD/JPY	JPY 156	0.963	0.308	1.0
Commodity Futures	**20-Jan-25**	**-1wk ($)**	**-1m ($)**	**2025 (%)**
Crude Brent	$79.9	-$1.1	$7.3	7.0
Gold	$2 708.5	$47.6	$85.6	3.2
Equity Market Indices	**20-Jan-25**	**-1wk (%)**	**-1m (%)**	**2025 (%)**
S&P 500	5 997	2.91	1.11	2.0
EuroStoxx 50	5 173	4.42	6.40	5.7
CAC 40	7 748	4.58	6.51	5.0
Nikkei 225	38 903	-0.73	0.52	-2.5
Shanghai Composite	3 244	2.65	-3.67	-3.2
VIX - Implied Volatility Index	15.97	-16.78	-13.02	-8.0

Source: Bloomberg, Ostrum AM

Additional notes

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