Opinion **The Long View**

Higher bond yields fail to arrest an ever-weakening dollar

Strong run for gold hints at worries over inflation that also hamper the US currency

JOHN AUTHERS

A strong US currency has in the past triggered emerging markets crises by making dollar-denominated debts harder to repay © Bloomberg

John Authers 4 HOURS AGO

Investors have persuaded themselves that they can calm down. Two weeks after a surprisingly high figure for average hourly earnings growth in the US triggered a correction for stock markets around the world, the relief is palpable. Leading share markets are back in positive territory for the year, and volatility has largely failed to spread to other asset classes — and this is despite further evidence of rising inflation in the US this week, and further rises in US bond yields. The US 10-year note yield this week topped 2.9 per cent.

But one vital market does not conform with this picture. The US dollar gained briefly during the volatility, which is to be expected as frightened investors flee for the perceived safety of US assets. But it has given that all up and is now back at its lowest level since 2014.

This is strange because the dollar generally follows differentials in yields. If a country has higher yields, then international investors will prefer to put their money there, thus pushing up the

currency. As worries about inflation have intensified, so US bond yields have risen, and more than in Europe or Japan. The gap between US and German 10-year yields has widened to 2.15 percentage points, from only 1.7 percentage points last summer, and yet the dollar has weakened in that time.

The US is booming, according to all available narratives. That should attract money, rather than turning it away.

A weak dollar helps many. It flatters US companies' earnings as it boosts their overseas earnings in dollar terms. It satisfies the Trump administration's desire for a currency that is competitive in international trade. And it alleviates pressure on emerging markets. A strong US currency has in the past triggered emerging markets crises by making dollar-denominated debts harder to repay. Emerging markets have enjoyed a great rebound since they sold off in initial horror at Mr Trump's election in late 2016.

* Yield on 10-year Treasury less yield on 10-year Bund
Source: Thomson Reuters Datastream
© FT

The only people who are seriously inconvenienced, in the short run, are the people running monetary policy in Europe and Japan. Germany and Japan both need exports rather more than the US does, and are not helped by a strong currency. Japan in particular enjoys great advantages from a weak currency, but it has stayed silent as the yen has enjoyed a strong rebound this year.

So, why is this happening? There are two interesting explanations.

First, China. Chinese authorities do not want to be seen to be manipulating their currency weaker. So they have helped push the renminbi up significantly, to reach its level of early August 2015. This date is important because it was a sudden and poorly explained devaluation that month that led to the last global sell-off. That episode is now closed.

China still has big trade surpluses that build up reserves — so it can manoeuvre the dollar up by buying fewer US treasuries (pushing their yield up) and buying other countries instead. The latest data from the US Treasury show reduced Chinese buying, even as its reserves increase. This naturally leads to higher US yields, a weaker dollar, and stronger US exports and higher US inflationary pressure by making all those imported Chinese goods more expensive.

Second, bond vigilantes. On this version, foreign investors do not want to touch the dollar — even if US bond yields are higher. They think the US is bound for higher inflation, think yields *should* be higher, and thus want to steer clear.

Gold's behaviour amplifies this. Gold and treasury bond prices tend to rise together in times of stress, as they are seen as havens. Gold should also benefit from inflationary worries, as its great virtue is its ability to hold its value. And indeed it is up some 28 per cent in dollars from the low at the beginning of 2016. That implies concern about inflation, but also a lack of fear of the Fed. A Fed that oversteps the mark, and raises rates too much, would be bad for gold, as it would maintain a deflationary environment. Rising gold suggests people do not believe this.

Where does that leave us? When it comes to bond yields, Alan Ruskin, Deutsche Bank's foreign exchange strategist, has it right that a 2.9 per cent yield is not yet enough to trigger a major shift in asset allocations (even if did trigger a spasm of volatility two weeks ago). The level of 3 per cent — going through a round number and surpassing the high set four years ago after the "taper tantrum" — might be the point to wait for.

China continues to be critical. This is less because of the size of its economy, and more because the scale of its foreign exchange reserves give it power to move exchange rates. For now, a weaker dollar keeps everyone far more comfortable and China seems to be aiding that.

Finally, the Federal Reserve remains the linchpin of the financial system. The bet in equity and precious metals markets at present is that the Fed will blink and not move aggressively against inflation. That would allow US stocks to continue with their "melt-up" and also justify buying gold. But it would explain the discomfort with buying US bonds, and also the weakness of the dollar.

john.authers@ft.com

Copyright The Financial Times Limited 2018. All rights reserved.