RBC WEALTH MANAGEMENT

Global Insight

Focus Article

The U.S. dollar in an era of protectionism

While protectionism raises uncertainties for the dollar's nascent recovery, we think the dollar will be able to navigate the cracks in its newly formed floor.

Laura Cooper

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All values in U.S. dollars and priced as of April 30, 2018, market close, unless otherwise noted.

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Focus article

The U.S. dollar in an era of protectionism

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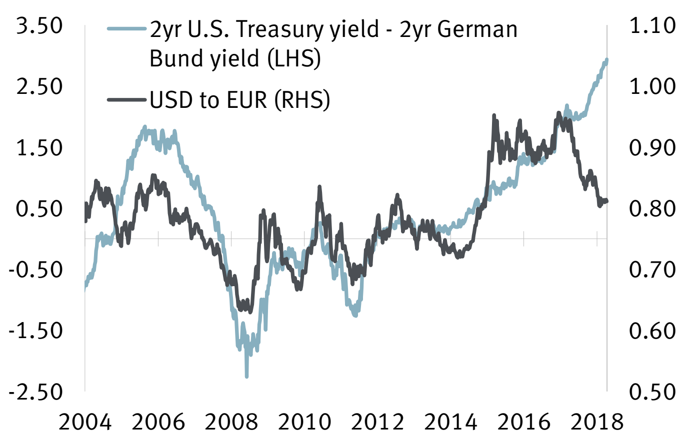
The rise of protectionism has added a new risk to the equation, forming cracks in the dollar's nascent recovery. While we think the trade tensions will prove to be more bark than bite, and that the dollar will sidestep the cracks and keep its recovery intact, investors should still consider what protectionism could mean for the dollar.

Despite heightened trade uncertainty, currency markets seem to be taking recent developments in stride. Currency market volatility is sitting at multi-month lows. The dollar has waded through the tensions of the past few months, trending broadly sideways against a basket of currencies. What negative U.S. dollar sentiment remains appears to stem from external factors, namely improved economic growth conditions outside of the U.S., and financial market caution around the extent to which the Federal Reserve will raise rates.

Sentiment has seen the dollar break away from traditional drivers



Negative sentiment has contributed to a breakdown between the dollar and its relationship with interest rates.

Source - RBC Wealth Management, Bloomberg; data through 4/13/18

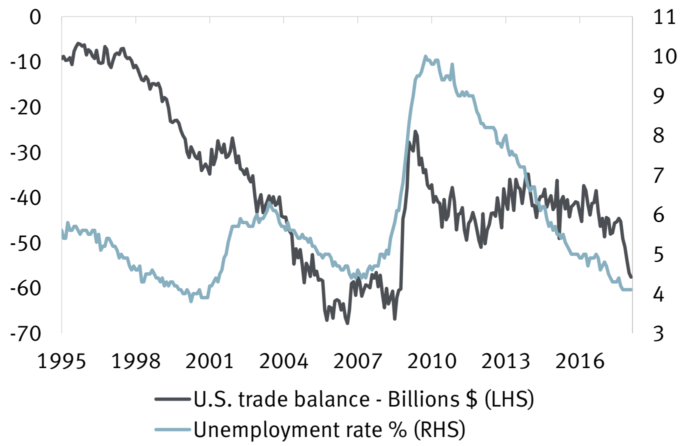
Recent trade tensions, in our view, largely reflect posturing with an easing of the aggressive tone likely to prevail and a global trade war unlikely to occur. This would allow for a renewed focus on a backdrop of strengthening economic growth, moderately rising inflation, and a gradual tightening of monetary policy, all of which would support the dollar finding a floor in 2018.

However, the confluence of factors at play in the current environment—notably, the injection of fiscal stimulus at a time of economic strength and a widening in the trade and budget deficits, all amidst Fed tightening—warrants a closer look at what protectionism could mean for the dollar.

Trade snapshot

The U.S. runs a large trade deficit with the rest of the world, with the bulk of the imbalance coming from trade with China, followed by Germany and Mexico. Importantly, a trade deficit does not naturally confer a position of economic weakness upon a country. A stronger economy with falling unemployment and rising incomes positions consumers to afford a greater amount of goods, both domestic and imported.

Strong labour market enables consumers to afford a greater amount of goods



A stronger economy with rising household incomes positions consumers for higher spending, both domestic and imported.

Source - RBC Wealth Management, Bloomberg; data through 3/31/18

Tariffs are not a panacea

Trade deficits are typically little changed following the imposition of tariffs.

If a country buys more goods and services from the rest of the world than it sells, it must effectively "borrow" from abroad to pay for the purchases. It does this by selling financial assets such as stocks, corporate bonds, and government securities (Treasuries) to foreigners, and then uses the proceeds to fund the extra goods and services it wishes to purchase. The currency exchange rate ensures that demand for investment funds balances with the flow of goods and services.

Tariffs distort this process. Goods entering a country become more expensive as the extra cost from the tariff (tax) can be passed on to consumers. While the rationale behind tariffs is to shift demand towards relatively cheaper domestically produced products and thereby stimulate domestic sectors, in practice, this is often not the outcome. Trade deficits are typically little changed following the imposition of tariffs.[1]

The recent U.S. tariffs on steel and aluminum are likely to have only a negligible effect because of the small size of these industries relative to the U.S. economy. However, a tit-for-tat escalation could leave the Fed weighing the inflationary

[1] Consensus points to tariffs being inflationary; they can push up the prices of imports with the resulting rise in demand for domestic goods spurring higher prices as well. The higher import prices effectively lower demand for imports. This implies less demand for foreign funds used to pay for the goods. The domestic currency strengthens as a result, and a country's goods become relatively more expensive for the rest of the world, leading to an export pullback. On net, theory suggests that the trade balance would thus be little affected by tariffs, yet volumes would be lower and consumers would face higher prices.

impact of tariffs against the need to not stifle economic growth. The net effect could be increased interest rate policy uncertainty, which would likely constrain the dollar.

A unique position

The savings and investment behaviours of countries tend to play a greater role in trade balances than trade policy alone. Countries with a surplus of domestic savings, like China, which save more than they invest within their own borders, essentially "lend" the excess funds to countries abroad by purchasing foreign assets, such as U.S. Treasuries. This, in turn, provides a surplus of funds for the U.S. to purchase foreign goods, resulting in a current account deficit (includes goods and services and net income/transfers from abroad). Appetite for U.S. Treasuries remains strong amongst China, Europe, and Japan, and the inflow of foreign capital enables the U.S. to fund its current account deficit.

A sizeable sale of foreign holdings of U.S. Treasuries—China is the largest holder—would likely spur higher U.S. interest rates and tighter financial conditions, slowing U.S. economic activity and dragging down the dollar. This is not our base-case scenario, but it presents a meaningful risk, which highlights the threats posed by retaliatory tariff actions and the potential knock-on effect to U.S. assets. These could further weigh on already negative dollar sentiment.

Add a larger budget deficit to the mix

The current fiscal injection is coming at a time when economic momentum is strong and surplus capacity is rapidly diminishing, potentially overheating the U.S. economy.

The added challenge in the current environment is that the U.S. federal budget (fiscal) deficit is almost certain to widen given the implementation of tax cuts, and would increase further if an infrastructure spending program is passed. With a reliance on capital from China and other countries to cover part of this budget shortfall, all else equal, this implies a larger U.S. current account deficit.[2]

Another concern of markets is that the current fiscal injection is coming at a time when economic momentum is strong and surplus capacity is rapidly diminishing, potentially overheating the U.S. economy.

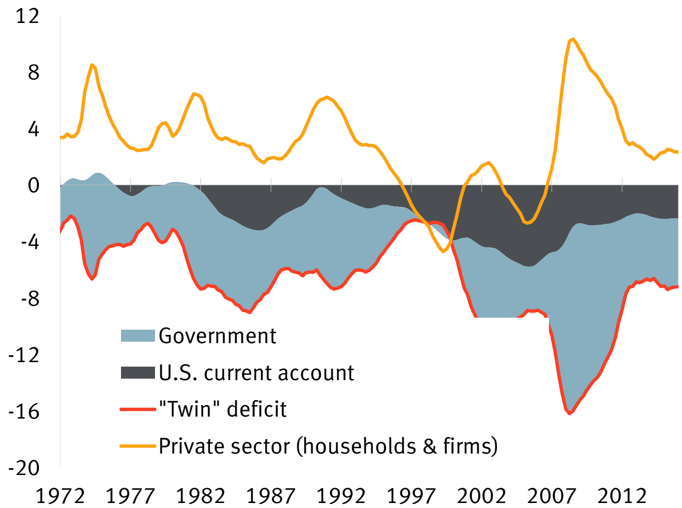
At the same time, heightened uncertainty around protectionist objectives could cause investors in U.S. securities to demand to be compensated for taking that extra risk, potentially making U.S. financial assets less attractive to some foreign investors.

Historically, the dollar's performance has been mixed under conditions of rising trade and fiscal deficits, and largely dependent on the actions of the Fed. In the current environment, the fiscal deficit may be less problematic for the dollar. Private savings from households could provide some offset to rising fiscal deficits given the relatively better financial position of households compared to previous periods. This alongside a Fed that has signaled it could raise rates beyond current market expectations could limit the dollar downside against a protectionist backdrop.

[2] U.S. Net Saving = minus Rest of World Net Saving; so a decline in the government budget balance (decline in U.S. net saving) must correspond with a decline in the U.S. current account or equivalently a rise in net borrowing from the rest of the world.

Widening deficits may be less problematic for the dollar this time around

% of GDP



Private savings from households could get a lift from tax cuts, providing some offset to rising fiscal deficits.

Source - RBC Wealth Management, Bloomberg

Dollar recovery intact

While protectionism raises uncertainties, our view remains that the dollar will navigate the cracks in its newly formed floor.

Confidence in the economic outlook saw the Fed raise its key interest rate in March, for the sixth time this recovery cycle. The Fed's optimism about the economic expansion led it to adopt a modestly higher rate hike forecast path beyond 2018. The robust economy, augmented by fiscal stimulus, argues for an uptick in inflationary pressures, which could provide scope for the Fed to raise rates somewhat faster than currently planned. Were that to occur, it would provide an additional tailwind to the nascent dollar recovery.

More aggressive protectionist and tariff strategies by the U.S. administration and its trading partners could, however, add a layer of uncertainty to this outlook. First, a potential exodus of capital flows from the U.S. at a time when the country will need to rely on these funds to finance ballooning deficits would inevitably be dollar-negative. Second, a more cautious Fed on account of a clouded economic outlook related to trade uncertainty could also weigh on dollar performance.

While protectionism raises these and other uncertainties, our view remains that the dollar will navigate these cracks in its newly formed floor. The trade disputes are ultimately likely to be handled reasonably and rationally, rather than degenerate into aggressive back-and-forth implementations of tariffs across a wide range of goods.

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