The Advisor

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Market Update - Fourth Quarter, 2022

GROUNDHOG DAY. In the 1993 comedy film Bill Murray's character gets trapped in a time loop that forces him to relive February 2nd over and over again. The markets are similarly trapped in a loop of selling due to the negative macroeconomic factors that are dominating the entire global financial system. By macro, we mean overarching factors such as central bank policy, inflation, bond yields and geopolitical risks that become so influential it forces the micro story (company fundamentals) to the background.

But there is another part to the macro story that is often overlooked and that is how liquidity flows through the monetary system. For our purposes in this newsletter, we'll focus in on the U.S. dollar (USD). We want to shine some light into the shadows of this topic because the dollar is responsible for a significant portion of the volatility we are seeing in the marketplace.

King Dollar

The dollar is the dominant reserve currency of the world meaning it is the preferred intermediary acting as the conduit for global financing and commerce. It is also an anchor currency by which other currencies are pegged as well as being widely held by private institutions, central banks and governments around the world.

To illustrate just how dominate the dollar is we'll highlight the words of the Federal Reserve Bank of New York which state approximately half of all cross-border loans, international debt securities, and trade invoices are denominated in U.S. dollars and 60 percent of global foreign exchange reserves are in dollars. Currency transactions are also heavily dollar-based, with close to 90 percent of all currency trades having the dollar as one leg of the transaction.

But I thought the USD was going to crash?

Despite the non-stop warnings for the dollar's demise, we find in reality, the USD is as strong as it's been in 20 years. Inflation levels over the last year and a half alone should have gutted the dollar not to mention the size and scope of the government payment programs handed out by both political parties in conjunction with the Fed's zero interest rate policy. Nonetheless, the dollar has soared by all measures this year while stocks and bonds can't get out of the bear cave.

Ok, the dollar hasn't crashed but why is it so strong?

The simple answer – demand for USD's is outstripping supply. The price of a currency represents supply and demand just like it does for other commodities. Regardless of how the imbalance develops, when there are more buyers (demand) versus sellers (supply) the price goes up.

The question then becomes why such demand? The first explanation is the Fed raising their benchmark rate. Higher interest rates will absolutely make holding dollars more attractive but this cannot entirely explain the dollar's strength because central banks around the world are also raising their benchmark rates; it's not as though the Fed is the only game in town.

The next explanation is the strength of the U.S. economy. Strong GDP will create demand for dollars. But again, the explanation falls a bit short under current circumstances considering the U.S. just completed two quarters of negative GDP growth and forecasts remain subdued for Q4 and 2023.

In addition to the above reasons, the USD is considered a safe haven and given the worldwide turmoil it is viewed as an attractive place to park while the storms pass.

But there is more to it – the supply side.

Here is where things get interesting and help fill in the gaps of explaining why the USD has skyrocketed and consequently wrecked financial markets in its wake. Remember, there are trillions of dollar denominated loans, debt, invoices and currency transactions in the world. What this means, essentially, is the USD (and equivalents such as U.S. Treasuries) are part and parcel of the global monetary system; they are a must-have to transact business, renew funding terms and settle liabilities.

We know credit conditions are tightening around the world which is just a financial way of saying it's getting more expensive to source and transact in USD. This environment creates a scramble for dollars and even forced selling (e.g. margin call) which can lead to selling off all sorts of assets (like stocks and bonds) to generate dollars in order to renew funding, secure loans and protect business and/or government interests. Here is an example from the Fed describing one such instance:

FOMC Minutes, December 1963: *It was reflected, however, in transactions in the New York money market; the Japanese government, for instance, was selling U. S. Treasury bills to provide funds for Japanese commercial banks to repay Euro-dollar loans they were unable to renew.*

Simply stated, the Japanese government needed to source dollars so they sold U.S. Treasury bills they had in reserve to provide liquidity to their commercial banks so they could renew funding.

Fast forward to the present and we find another example in the headlines about U.K. pension funds being forced to liquidate stocks and bonds in order to generate funding to meet margin calls despite having built up reserves over the years to protect against rising rates.

Market Impact

We bring attention to the USD and liquidity flows in the monetary system because it underpins overall market functioning and performance. When the USD is at nosebleed levels, it signals the monetary plumbing is clogged and by extension volatility will be the order of the markets.

The silver lining here, price fluctuations aside – the dollar is not facing imminent demise. If anything, its current strength has silenced the dollar debasement fire and brimstone crowd. Also, we are not facing an existential threat to U.S. banks.

What we are facing is a bear market that has been compounded by a lack of liquidity in the system which begets periods of extreme selling. Recency bias will trap us mentally and make it difficult to see a new dawn on the horizon. That statement isn't to dismiss the difficulty or severity of the current state of markets nor are we calling a bottom. Instead, we offer a perspective beyond the pervasive negativity and "world is ending" narrative; one that builds a framework to consider, just maybe, the world will not end. And it's in that space, the space when recovery turns into a new bull market, that opportunity proves worthwhile for the committed investor.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters. To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on your specific situation.