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# The CIO Monthly Perspective

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## WINNING BY BEING LESS BAD

### The Dollar's reign as the global reserve currency

July turned out to be a month of conflicting signals such that bulls and bears can both find evidence to bolster their narratives. For market bulls, the earnings reporting season was another beat-and-raise lovefest for many companies, the Senate delivered a bipartisan infrastructure bill, and Fed Chairman Powell appeared to have used the rising Delta variant case count as an excuse to push out the tapering announcement. To frustrated bears, the precipitous drop in long bond yields in the face of much higher-than-expected inflation, the Russell 2000 Index's decline, and the rise of Delta variant cases portend tougher sledding ahead. They can also point to Amazon's rare sales miss as an indication of difficult comparisons ahead for many of the work-from-home and e-commerce beneficiaries.

I find myself on the cautious side for now as major stock indices' relentless climbs to new highs have not been matched with broader participation among index components. The puzzling slide in long bond yields, which even Chairman Powell had a hard time explaining at his post-FOMC presser, could be a canary in the coal mine since the bond market is generally viewed as more prescient than equities in spotting trouble. Potential issues on the horizon include China's corporate credit market and the unregulated cryptocurrency space. Chinese regulators' heavy-handed intervention in multiple industries have shaken investor confidence. The rapid slide in the stock and bond prices of China Evergrande Group, China's largest property developer and one of the country's biggest debt issuers, foreshadows a probable need for a government bailout. On the cryptocurrency side, Tether, the world's largest stablecoin issuer, is rumored to own billions of commercial papers issued by Chinese developers. With the size of Tether's investment portfolio having grown to rival some of the largest money market funds, a hiccup at this unregulated and unaudited entity could ripple across the globe. Indeed, Eric Rosengren, President of the Boston Fed, has publicly singled out the controversial Tether cryptocurrency as a risk to financial stability.

Lastly, for what it's worth, Robinhood's IPO may have just jinxed meme stocks. Historically, the listing of the poster child of each era had at times marked the peak of the cycle. To wit, Blackstone's high-profile IPO in mid-2007 coincided with the peak of the financial engineering era that ended with the Great Financial Crisis. Glencore's market debut in May 2011 missed the commodity super-cycle's peak by a month. Coinbase's IPO in April preceded Bitcoin's price peak by just one day. While I do not wish losses on anyone, these corrections may be healthy developments to wring out some excess in the more speculative corners of the market.

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## MY OLD FRIEND

It was forty years ago, mid-February 1981 to be more exact, that the late Carl Perkins unexpectedly received a phone call from Paul McCartney inviting him to Montserrat to jointly record a song. The Tennessee native had no idea where Montserrat was, but he was not about to turn down the invitation from an ex-Beatle.

In 1977, Sir George Martin, the Beatles' legendary producer, fell in love with the eastern Caribbean Island of Montserrat and went on to build a state-of-the-art, get-away-from-it-all recording studio there. In early 1981, Martin was producing McCartney's Tug of War album on the island and suggested that Paul invite his favorite musicians to work on it with him. Paul and his fellow Beatles were big fans of Carl Perkins, who pioneered an early style of rock'n'roll called Rockabilly, which blends the sounds of country and western with rhythm and blues. During the band's formative years in the late 1950s and the early 1960s, John, Paul, and George would crouch around the record player to jot down chords and lyrics from Perkins' songs. Paul had even claimed, "If there were no Carl Perkins, there would be no Beatles."

The eight days that Perkins spent with the McCartney family on Montserrat was so enjoyable that on the night before his departure, he felt an urge to write a song to show his gratitude. Perkins recalled that the tune and the lyrics just came to him so effortlessly that he did not even need to write them down. The following morning, Perkins sat down with Paul and Linda and played the song which he titled *My Old Friend*. The song started with Perkin's deep, soothing voice singing the lines, *"On the Isle of Montserrat/Though I never shall forget/Just a country boy, a guitar and a song."* Paul listened intently, but his eyes welled up upon hearing the lines, *"My old friend, may this goodbye never mean the end/If we never meet again this side of life/In a little while, over yonder, where it's peace and quiet/My old friend, won't you think about me every now and then?"* He then stood up abruptly and walked out to collect himself.

Perkins was taken aback and gave Linda a perplexed look. Linda warmly put her arm around Perkins and thanked him for getting Paul to finally release his grief over John Lennon's tragic death 80 days earlier. She went on to recount that during the famous duo's final conversation, John had said to his former bandmate, *"Think about me every now and then, old friend."*

Paul was so touched by the song that he asked Perkins to record it in the studio that day, then took it to England to work on the arrangement. The song's public debut did not take place until twelve years later, on April 27, 1993, when Perkins sang it with Paul humming along in harmony while backstage in Memphis. It was part of a 19-minute vintage jam session between the two rock legends.

| Equity Markets Indices[1] | 6/30/21 Price | 7/31/21 Price | MTD Change | YTD Change |
|---|---|---|---|---|
| MSCI All Country World | 720 | 724 | 0.6% | 12.1% |
| S&P 500 | 4298 | 4395 | 2.3% | 17.0% |
| MSCI EAFE | 2305 | 2321 | 0.7% | 8.1% |
| Russell 2000®[2] | 2311 | 2226 | -3.6% | 12.7% |
| NASDAQ | 14504 | 14673 | 1.2% | 13.8% |
| TOPIX | 1944 | 1901 | -2.2% | 5.3% |
| KOSPI | 3297 | 3202 | -2.9% | 11.4% |
| Emerging Markets | 1375 | 1278 | -7.0% | -1.0% |
| **Fixed Income** | | | | |
| 2-Year US Treasury Note | 0.25% | 0.19% | -6 | 6 |
| 10-Year US Treasury Note | 1.47% | 1.22% | -25 | 31 |
| BBG Barc US Agg Corp Sprd | 0.80% | 0.86% | 6 | -10 |
| BBG Barc US Corp HY Sprd | 2.68% | 2.94% | 26 | -66 |
| **Currencies** | | | | |
| Chinese Renminbi (CNY/$) | 6.46 | 6.46 | 0.1% | -1.0% |
| Brazilian Real (Real) | 4.97 | 5.21 | 4.9% | 0.3% |
| British Pound ($/GBP) | 1.38 | 1.39 | -0.5% | -1.7% |
| Euro ($/Euro) | 1.19 | 1.19 | -0.1% | 2.9% |
| Japanese Yen (Yen/$) | 111.11 | 109.72 | -1.3% | 6.3% |
| Korean Won (KRW/$) | 1126.15 | 1150.25 | 2.1% | 5.9% |
| U.S. Dollar Index (DXY) | 92.44 | 92.17 | -0.3% | 2.5% |
| **Commodities** | | | | |
| Gold | 1770 | 1814 | 2.5% | -4.4% |
| Oil | 73.5 | 74.0 | 0.7% | 52.4% |
| Natural Gas, Henry Hub | 3.65 | 3.91 | 7.2% | 54.2% |
| Copper (cents/lb) | 430 | 448 | 4.3% | 27.4% |
| CRB Index | 213 | 218 | 2.2% | 30.0% |
| Baltic Dry Index | 3383 | 3292 | -2.7% | 141.0% |

**Source: Bloomberg**

Perkins said that *My Old Friend* meant more to him than any other songs he had written, including his huge hit, *Blue Suede Shoes*. He was convinced that his creative urge to write the song on the night before his departure from Montserrat was really John using him as a medium to talk to Paul from the beyond. In 1997, several months after the song was released in his final album "Go Cat Go!", Perkins told this story during an on-camera interview in his recording studio. Upon finishing the story, his wife Valda interrupted via intercom with the message that Paul McCartney had just called. Stunned at the coincidence, Perkins turned to the camera and said, "If you think that this boy has not got a connection to the spirit world…"

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Carl Perkins left for the spirit world in early 1998, followed by Linda a few months later. I wonder if he was able to ask John over yonder whether *My Old Friend* was indeed relayed to him, and if Linda had reminded John of Paul's tribute to him in *Here Today*, the final song of the *Tug of War* album.

## MONEY IS TRANSITORY

*Tug of War*, released in April 1982, was McCartney's eleventh album after the Beatles' breakup. It was critically acclaimed, and some considered it even better than *Band on the Run*. There was a little-known song from the album that stood out to me for its unique lyrics, which diverged from pop songs' usual themes of love, desire, pain, nostalgia, etc. *"The Pound is Sinking"* was about currency trading, as Paul was bemused by the daily recaps of forex movements which he had compared to weather reports. Interestingly, of the nine currencies cited in the song, four – the lira, mark, franc, and drachma – have been consigned to the dustbin of history. They were replaced by the euro, arguably the world's biggest currency experiment in recent memory.

The fact that these currencies are no longer in circulation should not be a surprise. Historically, currencies tend to have limited longevity due to a variety of factors: economic crises as with the Weimar Republic's hyperinflation; loss of sovereignty like the collapse of the Austria-Hungarian Empire; revolution, for instance, the Chinese Communist Party gaining power in 1949; or adoption of currency unions such as the euro. The Fab Four's home currency, the British pound sterling, is a rarity in having survived for more than 1,200 years. The U.S. dollar is the world's next oldest continuously used currency, which traces its origin to June 1776, when the Continental Congress authorized the issuance of the first $2 bills. Considering that the U.S. is a younger nation than many European states, the word "transitory" comes to mind as far as currencies are concerned.

Money is also hardly a store of wealth, as paper currencies inevitably lose purchasing power due to the scourge of inflation. History is replete with heartbreaking stories of impoverishment caused by currency collapses. The steady loss of purchasing power is unavoidable, even with the world's reserve currency. Using July 1944 as a starting point – that is, when the Bretton Woods Agreement was signed to create the post-WWII global monetary and financial system – the greenback has lost its purchasing power at an annual pace of 3.61% over the last seventy-seven years. This means that $100 in July 1944 is worth around $1,530 today, and one dollar today buys only 6.5% of what a dollar used to buy in 1944. Come to think of it, how is it a good idea that our esteemed central bankers want to generate a 2% inflation every year, which would steadily reduce our money's purchasing power? Over a decade, it would result in an 18% loss of purchasing power. Adding insult to injury, central banks also artificially suppress interest rates (setting negative interest rates in some countries) so that one cannot generate sufficient income to offset inflation without moving up the risk spectrum. It's no wonder that some view cash as trash, though it will still come in handy if there is ever a market crash.

## FROM BRETTON WOODS TO NIXON SHOCK

The Bretton Woods Agreement created a global fixed exchange rate currency regime in which member countries peg their currencies to the U.S. dollar and maintain exchange rates within a 1% band in either direction via market intervention. The U.S. dollar, as the global reserve currency, would be pegged to gold at a fixed rate of $35 per ounce. Foreign governments could exchange U.S. dollars for gold at this rate but would be encouraged to hold the currency instead as most international transactions were denominated in the U.S. dollar. This "pegged-rate" currency regime was designed to avoid competitive devaluation and to provide stability for international trades.

The challenge in implementing the Bretton Woods system at the onset was that much of the world was impoverished by the war and lacked sufficient U.S. dollars to buy products from the U.S., the world's lone superpower with an unscathed industrial base. The U.S. responded with the Marshall Plan, which provided large-scale financial aid to various European and Asian countries to aid their reconstruction efforts. From 1947 to 1958, this direct injection of U.S. dollars to the rest of the world resulted in a balance of payments deficit in the U.S. but achieved the desired goal of rebuilding many countries and fending off the spread of Communism.

Years of running a balance of payment deficit by the U.S. led to a significant buildup of offshore U.S. dollars. These Eurodollars – U.S. dollar deposits at banks outside of the U.S. – facilitated international commerce and the lending of this money by banks fueled global growth and further increased quantity. However, it also led to an outflow of gold from the U.S. as some countries, especially France, chose to convert some of their U.S. dollars to gold.

In the late 1960s, with President Johnson's "Guns and Butter" programs driving up trade deficits and domestic inflation, it became clear that the U.S. dollar was overvalued, and the precious yellow metal at $35 per ounce was undervalued. U.S. policymakers were alarmed that more foreign demand for gold in exchange for their overvalued greenbacks would severely drain America's gold reserves. The inflation-induced increase in the monetary base had already reduced the U.S. government's gold coverage ratio, which measures the value of the Federal Reserve's gold holdings to the monetary base, from about 75% in 1944 to 18% by 1971. Interestingly, U.S. investors were not allowed to trade gold due a relic from the Great Depression era -- FDR's Executive Order 6102 issued in 1933, which outlawed American ownership of gold in coins and bullions.

Fifty years ago this month, on the evening of Sunday, August 15, 1971, President Nixon announced during a prime-time address to the nation that he would "temporarily" suspend

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convertibility of the dollar into gold. This brazenly unilateral decision - dubbed Nixon Shock - was made without consulting any allies or even the State Department. Treasury Secretary John Connally later quipped in front of a group of hapless European finance ministers that, "The dollar is our currency, but it's your problem." Various foreign central banks had to buy the greenback to slow the pace of their currency's appreciation. Connally led a series of negotiations that produced the Smithsonian Agreement in December 1971, which pegged the dollar at $38 per ounce of gold and created a new set of fixed exchange rates for other countries. This new framework turned out to be unsustainable and the dollar, in February 1973, was devalued again to $42 per ounce of gold. A month later, Japan and various European countries had had enough and decided to let their currencies float. It marked the demise of the Bretton Woods system and the beginning of the fiat currency era with floating exchange rates.

## LONG LIVE THE PETRODOLLAR

The transition away from Bretton Woods was not easy. During the first couple of years, the trade-weighted U.S. Dollar Index (DXY) had declined as much as 23% from the level right before the Nixon Shock. Some were worried that various central banks would reduce their U.S. dollar holdings over time, even though many were buying the greenback to slow their own currencies' appreciation. Fortunately, Nixon was able to pull off a secret strategic deal that would go a long way in preserving the U.S. dollar's reserve currency status.

After the OPEC's crippling oil embargo was lifted in 1974, Nixon convinced King Faisal of Saudi Arabia to invest the country's rising oil profits in U.S. Treasuries to finance America's deficit spending. The U.S. would offer Saudi Arabia military assistance and protection in return. The Saudis insisted that the purchase of U.S. Treasuries be kept anonymous to avoid domestic and regional backlash. Nixon, known for his penchant for secrecy, was glad to oblige by having the Treasury Department fudge the auction data for years.

The deal to recycle Saudi's petrodollar to fund our deficit was a trifecta for the U.S.: a steady supply of oil from the world's largest producer, a reliable source of funds to soak up our debt, and most importantly, "dollarizing" Saudi Arabia's wealth ensured that OPEC would continue to price crude oil in the dollar. The last point, in essence, pegged the U.S. dollar to the world's most important commodity. Since most countries need to purchase crude oil, they all had to keep a substantial portion of their reserves in U.S. dollars.

## THE 1978 DOLLAR CRISIS

The U.S. was beset with persistently high inflation throughout the 1970s. The seeds of higher inflation were sown by President Johnson's "Guns and Butter" programs in the second half of the 1960s and the Fed's willingness to prioritize full employment over price stability. Johnson had reportedly shoved his Fed Chairman William McChesney Martin Jr. against the wall in order to coerce him to help finance the administration's big spending initiatives. Nixon had asked his Fed Chairman Arthur Burns to pursue an expansionary policy in the run up to the 1972 election. In fact, it was Chairman Burns who started the practice of excluding supposedly transitory noises such as price fluctuations in energy, food, and commodities, which became what is known today as the "core" inflation rate. The problem was that, by 1975, Chairman Burns had stripped out so much "noise" that he was looking at only 35% of the CPI and it was still rising at a double-digit rate.

A nasty stagflation recession from November 1973 to March 1975, which included the oil crisis and a stock market crash, helped to bring inflation back to the mid-single digit by 1976, but it was too late to save Gerald Ford's presidency. The Carter Administration inherited a nascent economic recovery, but somehow gave markets the impression that it favored a weak dollar policy to help revitalize growth. It triggered a new round of decline in the U.S. dollar in early 1977, which was viewed positively by the administration for its potential to reduce the trade deficit. By early 1978, however, with the depreciation having gone too far (having lost 18% and 12% vs. the Japanese yen and the Deutsche Mark in 1977), the U.S. was forced to take more aggressive measures to stabilize the dollar. Starting in April 1978, the Fed had to raised interest rates repeatedly, sometimes more than once per month, while it sold gold and purchased the dollar in the open market. President Carter even made a nationally televised speech announcing his plan to slash budget deficits, reduce the federal workforce, and rein in wage increases. These bitter pills were still insufficient to stop the slide of the dollar, which had dropped as much as 26% versus the yen by late October 1978. The precipitous decline was finally halted when the administration rolled out several coordinated measures on November 1st: Fed hiked the discount rate by 100 bps to 9.5%; the bank reserve requirement was raised by 200 bps; a $28.8 billion money pool was created to support the currency (equivalent to 6% of 1978's federal spending); and the pace of gold sales quadrupled to 1.5 million ounces per month.

While President Carter managed to finally halt the dollar's slide, he was soon confronted with another crisis that pretty much sealed the fate of his re-election – the Iranian Revolution. Ayatollah Khomeini's overthrow of the Shah of Iran precipitated the second oil shock of the decade, a demoralizing hostage crisis, and a recession right before the 1980 presidential election. It also marked the rise of Islamic fundamentalism over secularism.

## MORNING IN AMERICA

After meandering sideways at the 1978 crisis levels for nearly two years, the U.S. dollar started to appreciate steadily in the autumn of 1980 when it became clear that Ronald Reagan would win the general election. It turned out to be the start of a spectacular bull market for the dollar thanks to Paul Volcker's

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tight money policy and Reagan's pro-growth initiatives. Ironically, one positive side-effect of 1970s' elevated inflation was the debasement of debt, which brought our gross debt-to-GDP to 31% by the time Reagan entered the White House in 1981. The reduced debt burden gave the Reagan Administration more budget flexibility to pursue an expansionary fiscal policy despite Volcker's aggressive interest rate hikes.

The combination of falling inflation, expansionary fiscal policies, and Reagan's philosophical preference for a strong dollar sent the U.S. Dollar Index (DXY) to an all-time high of 165 in February 1985, up 81% from Reagan's inauguration in January 1981. The strong dollar made U.S. exports less competitive and pushed up our trade deficit. Various interest groups – exporters, unions, and farmers – started to lobby for currency intervention or protectionist measures. By early 1985, James Baker, the newly appointed Treasury Secretary, realized that something had to be done to arrest the greenback's relentless rise.

On September 22, 1985, finance ministers and central bankers from the Group of Five countries – the U.S., the U.K., West Germany, Japan, and France – reached a historic agreement at New York's Plaza Hotel. The joint agreement, dubbed The Plaza Accord, effectuated coordinated currency interventions to depreciate the overvalued dollar by driving up the Deutsche mark and the yen. The interventions worked so well that, exactly 15 months later, these parties had to regroup again to create the Louvre Agreement to jointly halt the dollar's precipitous slide. The Louvre Agreement marked the last time that major countries would officially coordinate currency interventions.

## ENTER THE DRAGON

The collapse of the Soviet Union in the early 1990s left the U.S. as the world's sole superpower. However, with the threats of communist invasion and nuclear annihilation removed, our allies had less of a need for Pax Americana or American hegemony. Some Europeans were looking forward to a multi-polar world with the ascendancy of the European Union, which would start with an integrated market and a common currency. The euro, first conceived in the 1960s and officially rolled out in 1999, was expected to become a major global reserve currency. In 1995, some had predicted that the euro could de-throne the U.S. dollar by 2022 if two conditions were met: the U.K. adopting the euro, and continued greenback depreciation due to Uncle Sam's growing debt. At the onset of the Great Financial Crisis in 2008, they doubled down on their predictions and pulled in the target date from 2022 to 2018. Of course, we know the rest of the story: the flaws of the currency union were exposed during the Eurozone's sovereign debt crisis, and, instead of adopting the euro, U.K. electorates opted for Brexit.

There was another major development in the 1990s – the emergence of China. In the early 1990s, China decided to transform itself into an economic powerhouse by pursuing a mercantilist strategy. In 1994, China started to fix the yuan at 8.28 per U.S. dollar. Pegging the renminbi to the U.S. dollar offered the currency stability that was craved by domestic and foreign importers and exporters. China even won praise from the U.S. for sticking to this exchange rate during the Asian Financial Crisis in 1997 and 1998, when it could have opted for competitive devaluation as many other Asian currencies were sharply devalued.

In the spring of 2000, President Clinton asked Congress to permanently grant China normal trading privileges with the U.S., which would pave the way for China to join the World Trade Organization (WTO). Clinton argued that by joining the WTO, China will import more of not only American products but also values – freedom and democracy. He emphasized that the growth of the Internet would undermine Beijing's control over its populace and make China a more open society (how naïve of us, with the benefit of hindsight). Despite fierce opposition from labor unions and human rights activists, Congress voted by surprisingly wide margins to normalize trade relations with China.

By the end of 2004, the U.S. trade deficit with China has ballooned from $30 billion in 1994 to $162 billion, yet the renminbi's peg to the dollar had remained unchanged at 8.28. The yuan was clearly and unfairly undervalued. The Bush Administration sent veteran Treasury official Olin Wethington as a Special Envoy to engage with China on exchange rate and financial market reform. China finally relented in the summer of 2005 by allowing the yuan to appreciate; it eventually peaked at 6.04 yuan per dollar in early 2014. In August 2015, in the wake of softening economic growth and a stock market crash, China surprised the world by depreciating the renminbi by 3% and ended the market's one-way bet (i.e., continued appreciation) on the yuan. Since then, the renminbi has fluctuated between 6.2 and 7.2 yuan per U.S. dollar.

In October 2016, China's decades-long march to become a global powerhouse reached an important milestone when the IMF added the renminbi to a basket of currencies – the U.S. dollar, euro, yen, and British pound – that make up the Special Drawing Right (SDR). The SDR was created in 1969 as an international reserve asset held by central banks. It was meant to be an alternative reserve asset to the U.S. dollar due to concerns over the greenback's over-valuation in the waning days of Bretton Woods. The collapse of the Bretton Woods system subsequently reduced the importance of the SDR, but the inclusion of the renminbi still signaled the yuan's rising importance as a reserve currency.

## THE EXORBITANT PRIVILEDGE

Former French President Valéry Giscard d'Estaing, while serving as the country's Minister of Economy and Finance in the 1960s, had coined the phrase "exorbitant privilege." It is used

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to characterize the benefits that the greenback's global reserve currency status has conferred on the U.S. Indeed, the rest of the world must produce real goods and services for Americans in exchange for the dollars that cost us practically nothing to "print." Foreign institutions, from central banks to private entities, have been financing America's borrowing as their U.S. dollar-denominated reserves are mostly held in U.S. Treasuries and agency debt securities. This foreign purchase of U.S. debt also lowers America's interest rates. On the geopolitical front, the largely U.S. dollar-based global financial system gives the U.S. an extraordinarily potent weapon in the form of financial and trade sanctions.

While the reserve currency status has indeed been an exorbitant privilege for the U.S., it has also created a burden, as first observed by Belgian-American economist Robert Triffin in the 1960s. With the rest of the world's economic growth being dependent on an ever-increasing amount of greenbacks in circulation outside of the U.S., America has to run an on-going trade deficit. If the U.S. were to have a trade surplus, it would in effect drain U.S. dollars from the rest of the world and cause a global recession. Many countries also artificially depress their currencies relative to the dollar in order to accumulate U.S. dollars through trade surplus. It winds up hurting U.S. competitiveness and widening America's inequality. In short, in order to prop up the global economy, the U.S. has to run chronic current account and budget deficits.

Despite this "burden", the benefits of reserve currency status are so enormous, especially from a geopolitical vantage point, that many Americans are worried we might lose this exorbitant privilege someday. Indeed, our foes and competitors alike have been trying to undermine the U.S. dollar hegemony for years. Russia, a frequent target of our financial sanctions, has been most aggressive in pursuing a de-dollarization strategy. It has been proactively reducing its exposure to the dollar by pricing its exports in euro and by holding the euro and gold in place of the dollar in its foreign exchange reserves. China has been playing the long game by increasing its influence via trade, project financing, and its belt-and-road initiatives. Today, more than 70% of countries worldwide trade more with China than with the U.S. Over time, China will likely try to entice these countries to increase the share of their bilateral trade in renminbi, which will drive them to hold more yuan in their foreign currency reserves. It remains to be seen if China can pull that off without more concrete measures to liberalize the renminbi. It is also unclear if China's recent introduction of the digital yuan will help accelerate this process. Indeed, the so-called central bank digital currencies (CBDC) have created much buzz among policymakers and investors, yet this trend is still quite amorphous at the present. It's a subject that I intend to address in more detail in the near future.

At the end of the first quarter of 2021, the U.S. dollar's share of global currency reserves stood at 59.5% - nearly a 25-year low and a material decline from 71% in 1999, when the euro was first introduced. The euro and renminbi accounted for 20.6% and 2.4% respectively. The substantial market share lead that the greenback still enjoys means that the U.S. dollar will remain the most widely held reserve currency for years to come. However, within a decade or two, assuming Europe manages to keep the euro intact, global currency reserves will likely evolve to a more multi-polar arrangement with diminishing U.S. influence. Indeed, in October 2020, the euro has surpassed the dollar for the first time in the share of international and domestic payments, according to SWIFT, or the Society for Worldwide Interbank Financial Telecommunication. As of May 2021, the euro has maintained a slight lead over the dollar at 39% to 38.4%. The pace of market share shift in global currency reserves will likely accelerate as various fintech innovations – CBDC, cryptocurrencies, stable coins, etc. – transform global finance and payment schemes. Significant changes in the relative values of various currencies would also affect the composition of reserve currencies. In summary, the more we abuse our exorbitant privilege with fiscal profligacy and monetary mismanagement *relative* to other major economies, the faster the decline in the greenback's status as a dominant global reserve currency.

## EURODOLLAR TO THE RESCUE

As previously mentioned, the Eurodollar came into existence with the Marshall Plan showering greenbacks around the globe after World War II. The Eurodollar is really a misnomer since the money is not just limited to Europe. Over the years, the continued growth of this pool of off-shore U.S. dollars has made it a large, unregulated source of capital to fund activities from investments to trade financing around the globe. A Senate Finance Committee report from March 1973 had already characterized Eurodollars as "the real lubricants of international speculation." No one really knows how big this pool of money is, as the fractional reserve banking system can create new Eurodollars through lending. The 1973 report had estimated that it was already four times greater than the gold and currency reserves held by the U.S. government. That was in an era of paper processing for transactions. Imagine how quickly the Eurodollar has multiple with the arrival of computerized systems over telecom networks.

This massive pool of overseas U.S. dollars is a significant source of liquidity that drives economic and asset prices around the world. During times of financial crisis, forced and pre-emptive de-leveraging would reduce the quantity of these offshore U.S. dollars. This shortage of dollars then drives up the greenback's value. The Fed has no jurisdiction or control over this vast offshore market but would still react with domestic monetary easing to indirectly rekindle risk appetite in the Eurodollar market. It is the Wild West of global finance, and most policymakers rarely bring it up since no one has a complete grasp of the Eurodollar's size, scope and pressure points.

Ironically, although neither the Fed nor the U.S. Treasury has control over the Eurodollar, they can probably count on this pool of unregulated offshore money, much of it created

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through the magic of offshore fractional reserve banking, to help fortify the U.S. dollar as the leading reserve currency for a long time to come.

## AN UNCOMFORTABLE EQUILIBRIUM

On April 22, 2008, the trade-weighted U.S. Dollar Index (DXY) hit its all-time-low at 71.3 as investors became increasingly concerned about the fragility of the U.S. banking system and the economy after the collapse of Bear Stearns. However, when the Great Financial Crisis crescendoed in the second half of that year, the DXY started to surge as deleveraging around the world created a shortage of greenbacks. By the time the S&P 500 Index bottomed out on March 9, 2009, the DXY had already soared 25% from its all-time-low to 89.

The Great Financial Crisis ushered in an era of radical monetary policies characterized by helicopter money and extremely low interest rates. However, inflation was kept low throughout the last decade since many countries were pursuing fiscal austerity while banks curtailed loan growth due to tighter regulations. The U.S. dollar started to appreciate in the middle of last decade as the Fed was able to pull off several years of monetary tightening until investors balked in late 2018. Indeed, the Fed had looked like a paragon of monetary probity relative to the ECB and the Bank of Japan's negative interest rate policies.

COVID-19 caused a brief but deep recession and brought back fiscal activism reminiscent of the Lyndon Johnson era. Similar to the late 1960's, the Fed is staying highly accommodative in the face of rising inflation to help Uncle Sam (or Aunt Janet) fund big spending programs. Fed officials are also dismissing higher inflation readings as transitory, just like Arthur Burns did in the 1970s. Another similarity is that Chairman Powell appears to be prioritizing full employment, now including racial equity, over price stability. If history is any guide, the combination of aggressive fiscal spending and easy money policies are likely to lead to a period of elevated inflation. In time, as fiscal impulse wanes while the economy returns to the sub-2% trend, we may once again be confronted with stagflation. For now, however, investors appear to have embraced the Fed's inflation-is-transitory narrative, as indicated by falling long bond yields in the face multi-decade high inflation readings.

Over the coming months, the inflation-is-transitory narrative may gain more credence as the pace of month-on-month inflation is expected to decelerate materially from June's 0.9% (11% annualized). However, on a year-over-year basis, I believe the headline CPI will likely stay above 4% into early 2022. Over time, investor's focus will shift to where inflation settles at relative to the Fed's arbitrarily 2% target. What will the Fed do if inflation winds up being closer to 3% than the 2% target while the economy reverts to sub-2% growth?

I suspect the Fed will continue to prioritize employment over price stability when confronted with stagflation. The transition to stagflation will likely rattle financial markets, and the Fed will have to decide which of the three major markets – stock, bond, and currency – to prop up. Its first choice is likely to "save" the bond market by suppressing interest rates to help Uncle Sam finance its deficit spending and manage its bloated debt. The Fed may also be reluctant to meaningfully tighten liquidity for fear of hurting stock prices. That would leave the U.S. dollar to fend for itself, as a decline in its value would be viewed as least damaging, or even as a positive to those favoring a weak-dollar policy to drive export growth.

In short, assuming no major crises in other major economices, the U.S. dollar is likely to weaken over time as result of the Fed's "benign neglect" and Uncle Sam's more aggressive deficit spending relative to other major economies. However, during times of financial market distress, the U.S. dollar may still spike up, similar to what had happened during the Great Financial Crisis. Ultimately, the Fed could really be put to the test if something similar to the 1978 dollar crisis were to happen. That is not my base case as a dollar crisis would probably be the result of much higher domestic inflation coupled with relatively tighter policies overseas. With every major economy currently pursuing some degree of unconventional policies, today's range-bound equilibrium in the currency market could still be maintained. Those countries deemed relatively less fiscally irresponsible are likely to see their currencies appreciate, though no one seems to want a strong currency. It's a new era in which winning means being less bad.

## PERMANENT & MAINTENANCE FREE

I hope my concern about stagflation turns out to be misplaced, and that the Fed will stick a perfect landing in nudging inflation back to 2% while keeping the expansion going for years. However, hope has not proven to be a good investment strategy.

Stagflation will be a sticky issue for most investors and policymakers since we have not had to confront it since the 1970s. During those dark days, bonds were called "certificates of confiscation" and stocks had negative real returns because of valuation contraction. Fortunately, there are more investment options today to deal with stagflation than forty-plus years ago. For example, well-managed long-short, macro, and volatility arbitrage hedge funds could conceivably go on the offense while traditional long-only strategies are under pressure.

Then there is the barbarous relic, gold, which has proven itself as a good investment during times of stagflation in the 1970s. Interestingly, it was President Gerald Ford who finally rescinded the 40-year ban on ownership of gold coins and bullions by signing a no-name bill, Public Law 93-373, in August 1974.

Gold is the antithesis of fiat currencies. It is permanent rather than transitory. As a unique metallic element with outstanding resistance to corrosion and high temperatures, gold is practically indestructible such that every ounce ever mined is still in existence. It is relatively scarce and universally accepted

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as a store of value for thousands of years. It is also one of the few maintenance-free financial assets. That is, most financial assets need continuous work to sustain their values – stocks and bonds need cash flow generation, real estate requires upkeep, cryptocurrencies are nothing without electricity and computing power. Gold, on the other hand, will likely maintain its value by just being there, and has no counter-party risk if held in its physical form. Of course, this maintenance-free characteristic is also a source of controversy as some would argue that a non-productive asset should not retain much value. However, the same can be said of jewelry and works of art, yet their values have only grown over time as fiat currencies lose their purchasing power to inflation.

Most investors tend to trade gold based on its inverse relationship with the real U.S. 10-year Treasury yield – when the real yield moves down, gold goes up, and vice versa. Yet lately, gold price has meandered sideways even as the real 10-year yield hit new lows. It seems like the market has lost interest in this barbarous relic, which is a good contrarian signal to me.

For long term investors, holding a position in gold is not to speculate on the direction of the real yield, but to potentially hedge against scenarios where the market loses confidence in our policymakers' ability to keep on propping up asset prices with unconventional monetary policy tools. That could happen if and when the consensus view on inflation shifts from "transitory" to "persistent," as it would cast doubt on the sustainability of quantitative easing and low-interest rate policies.

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