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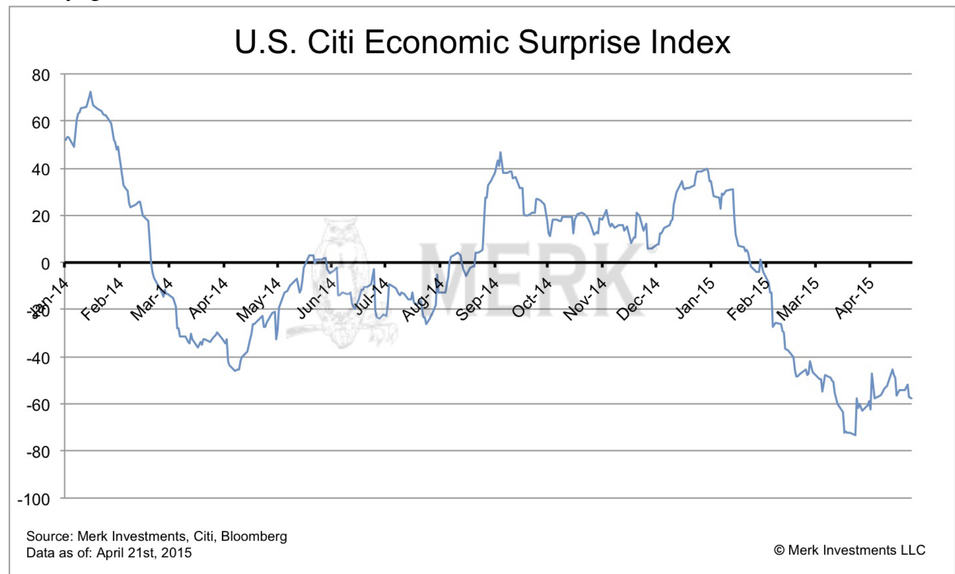
Outlook on Dollar, Currencies & Gold

Has the tide turned, or is the dollar merely taking a breather? Is the euro's recent bounce off its lows just a *dead cat bounce*, or is it a sign of other changes to come? Why has gold not rallied with the recent retreat of the dollar? What dynamics might be unfolding for the rest of the year? Below we share our outlook and analysis on how economic and financial developments might affect the price of the U.S. Dollar, other currencies, as well as the ultimate hard currency, gold.

Bubbles Everywhere?

We have been told over and over again the U.S. is on its way of raising rates. In anticipation of higher U.S. rates and lower rates elsewhere, the greenback enjoyed a dramatic and sustained rally. We believe the market got way ahead of itself. Even with the recent leveling off, we believe the *Dollar may still be expensive*.

Considering the unprecedented number of speculative positions betting on the dollar rising based on CFTC data, the market suggested a meteoric rise of the U.S. economy while the Eurozone and the rest of the world would crash and burn. Clearly this has not happened, and we do not expect it to happen any time soon. Quite the contrary, some indicators, for example the Citi Economic Surprise Index, suggest that things in the *U.S. economy might be developing worse than anticipated, whereas the Eurozone economy may fare less badly than feared*. In our analysis, asset bubbles tend to pop after too many people have piled into the same trade. In this context *we think stocks, bonds and the dollar are all vulnerable*.



Euro: Greek Default Would be a Blessing

We believe the euro's recent uptick can be explained by profit taking, a short squeeze and a re-pricing of expectations. Europe, in our humble opinion, has always been a mess and will likely continue to be a mess. But, Europeans have always muddled through, if only by stiffening the upper lip and tightening the belt.

There may be two key dynamics to consider that are playing out in the Eurozone, each pulling the euro in opposing directions:

- Diminished threat of contagion due to a possible Greek default, reducing negative pressure on the euro.
- Continued dramatic euro short positions by speculators, sustaining negative pressure on the euro.

We consider a *Greek default one of the better outcomes for the euro*. At the other end of the spectrum would be significant debt forgiveness without anything in return. This "easy" path out would encourage other weak countries to follow suit and may cause havoc in the respective bond markets that, in turn, could make the euro the valve for investors to express their dismay. As such, it is *important to continue monitoring how peripheral Eurozone debt trades for any spillover effects*.

Commodity Currencies: Beware the Oil Price Dependency

Just about anyone who has tried to forecast oil has been wrong over the past year. Rather than trying to fix a price target, let's consider how oil price affects commodity currencies, such as the Canadian Dollar, Australian Dollar and Norwegian Krone. They all suffered substantially as the price of oil was plunging, and had a bit of a comeback since oil prices have rebounded.

Of the currencies mentioned, the Australian dollar may be least dependent on the price of oil; Australia's economy is very much dependent on iron ore and other hard commodities, notably exporting those to China. As such, *the Aussie has often been considered a proxy for the health of China's economy*. At the same time, we see when we look at the Aussie is that the Reserve Bank of Australia (RBA) has been desperate to weaken its currency. Yet the currency rallied the other day on the RBA's decision to cut interest rates to 2% (yes, there's a central bank that's not at zero!).

Central Banks: "Fixing" Their Own Mistakes

We believe *market prices, in almost all asset classes, are distorted thanks to the meddling of the central banks*. Case in point is the above example of the RBA trying to weaken its currency.

The most egregious example may well be the Swedish Riksbank, which decided on more QE as recently as at the end of April, despite (quoting their own press release) good GDP growth, improving labor market, inflation rising from low levels and increasing inflation expectations. We believe the Swedish Riksbank, more so than many others whom might still have the excuse of a weak underlying economy, will have to do a U-turn on policy.

Later this summer, various other central banks may also have to start back-peddling on their ultra-loose policy as *inflation is inching up*. At this stage, the ECB is shrugging off calls for a premature ending of QE; the fear may be that inflation expectations plunge

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right back down. *In much of Europe, expect mostly dovish talk, then a change of heart that might come rather suddenly*.

In the U.S., we might see our first rate hike later this year. But the question will be how much is priced in already and what will be the rate path?

Gold: Purchasing Power Protection and Diversification

While currencies will move up, down, or sideways against each other, all paper currencies are at risk of losing purchasing power due to inflation and the incentive for governments to print money to match their debt obligations.

Gold, on the other hand, is a hard currency that cannot easily be "printed" (production can be increased over time). *Its relative independence from government makes gold a valuable diversification candidate regardless of the short-term gold price expectations.* Over long periods of time (think one hundred years, not quarterly reports) gold has maintained its purchasing power. It existed as a store of value and medium of exchange long before the central banks.

In the current environment:

- Stocks may be expensive
- Bonds may be expensive
- Cash may be losing purchasing power

Gold vs. Inflation and Deflation

Gold has been cited as both inflation and deflation hedge. In an inflationary environment, the value of cash versus gold may decline. In a deflationary environment, asset prices in general may decline versus gold, notably if there are defaults. *We believe Gold's low correlation to equities makes it a valuable diversification tool in any environment.*

Gold vs. Equities

Since 1970, through end of March this year, gold had an annualized return on 8.2% per annum while has exhibiting a ***zero correlation to equities***.[1]

The zero correlation to equities is nothing short of stunning. We all have experienced the price of gold move together or in opposite direction with the stock market on certain days. But that, in the long term, they amount to a net zero correlation is quite amazing.

There are two reasons investors might want to add any asset to a portfolio:

- The asset has exhibited low correlation to other components of the portfolio and may hence provide diversification benefits.
- The asset has an expectation of a positive return.

Gold Price Expectations

We do not know where the price of gold is going to be tomorrow, but we do know that promises have been made in the U.S., just as in much of the developed world, that may be difficult to keep. We are particularly concerned about rising entitlement spending over time that might make deficits unsustainable over time. *The temptation to debase the purchasing power to "kick the can down the road" may be great.*

Given this, we believe we may not see positive real interest rates (interest rates adjusted for inflation) for an extended period over the next decade. This spells more erosion of the purchasing power of the paper currency and relative strengthening of the ultimate hard currency, gold. Following this logic, *we believe gold is an asset with a positive return expectation over the long-term.*

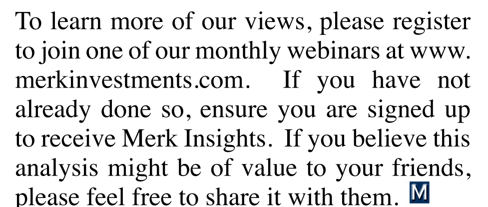
Opportunities: Proceed with Caution

Policy revisions by central banks will create opportunities, some to the upside, such as Sweden, some to the downside, such as the UK, as well as threats. Two points to watch out for:

- While we believe there is a risk the 35-year bull market in bonds will come to an ugly end and that the stock markets will come tumbling down, one can call the exact moment of the tide turning only after it has happened.
- When the tide turns, don't count on a government bailout; this time they may not be able to afford it.

What to Do

Investors may want to consider true diversification to be ready when the tide turns. That is not so easy when many asset classes have been rising in tandem. Even within the currency space, where we so often praise its merits of low correlation, be careful: some of the more successful currency strategies in recent months have been based on momentum. *Should risk sentiment change violently in the markets, many momentum-based strategies that appear to provide diversification on paper may all falter at once.*



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[1] Source: Bloomberg, Merk Investments. In the period 1/1/1970 through 3/31/2015 gold's correlation to equities was 0.00. Correlation is a measure of how tow securities or asset classes move in relation to each other.

ABOUT MERK

Merk Investments, LLC is a leader in the currency asset class and a pioneer in providing uncorrelated returns and portfolio diversification through actively managed currency funds and gold ETFs.

AXEL MERK

Axel Merk is the Manager of Merk Funds and CIO of Merk Investments.

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