TD Securities

FX Daily Dispatch

Global Rates, FX & Commodities Strategy

14 October 2021

▶ GLOBAL ▶ FX ▶ GLOBAL MARKETS

Hedging Stagflation With the USD

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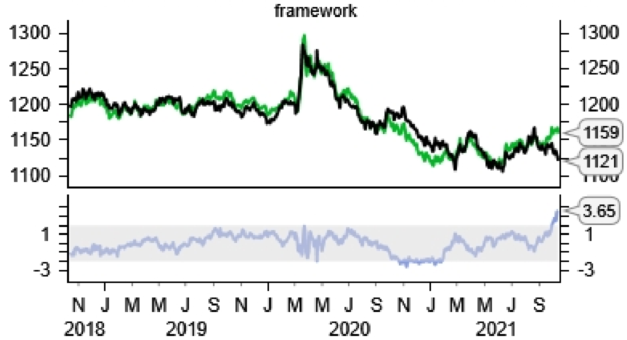
- The BDXY is down for the second day, reflecting the improvement in risk sentiment, pullback in real yields, and signs that global data surprises have carved out a bottom. As the market tries to understand the balance between stagflation and reflation, some near-term evidence points to the latter.
- Keep in mind that proper stagflation consists of high inflation that crushes both growth and demand. Alternatively, reflation implies high inflation but generally supportive growth, supported by loose financial conditions and risk sentiment. We think the latter distinction is critical - points discussed in our latest Global FX Monthly (Stagflation, Reflation, or Something in Between?).
- In today's FXDD, we again run through some of this analysis, noting the hefty USD premium seen across a range of our tools. We think it is linked to stagflation-related hedging and would reverse if signs of reflation return. The US to EM equities ratio also reveals a high risk of a short-term USD correction, pointing to a 1% slide ahead. EURUSD real rate spreads offer some confirmation of a new 1.15-1.18 range.

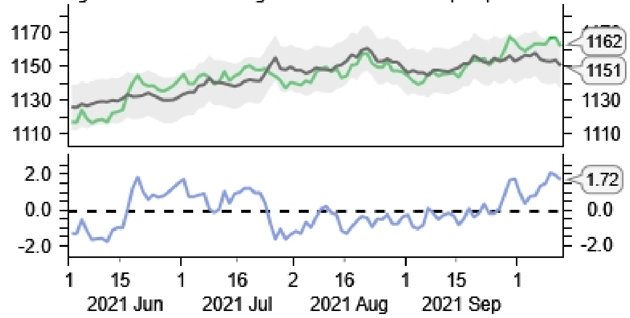
Charts of the Day

How much global macro risks are priced into the USD?
3y regression of BDXY to the first four factors of our Global Macro PCA framework



Source: Macrobond, TD Securities

Tracking the USD on relative equity performance
Regression of BDXY to log ratio of SPX/MSCI EM | r-squared=67%



Source: Macrobond, TD Securities

Pick your flation. The broad USD seems to have peaked once again. The outlook partially rests on the Fed and, more importantly, on how things flush out regarding stagflation, reflation, or, dare we say, deflation. Arguably, the policy impact that central banks and investors place on these varying states of the world will largely dictate the price action moving forward. That's the primary point of discussion in our latest Global FX Monthly, VUCU. Much of this debate surrounds semantics and how you measure these states of the world. Yet stagflation is an environment where high inflation pummels growth and demand suffers in turn. Alternatively, reflation rests in a state with higher inflation, but demand remains relatively robust. Deflation sees China exporting a balance sheet crisis to the rest of the world, though the least likely. One of these states, reflation, offers a world with supportive financial conditions and risk sentiment even with higher prices. As discussed in the October VUCU, early evidence still favors reflation. It's not a slam dunk, and markets remain in price discovery mode. Still, we note the following:

1. Global PMIs remain above 50, moving higher in September
2. Global growth expectations for the year ahead, while having recently decelerated, point to expansion next year
3. Global financial conditions and risk sentiment sit at the most accommodative levels seen in years

The USD Hedge? This setup and the path of these "flations" matters immensely for the USD and global risk markets. One of the most appealing theories about the recent USD bump links portfolio allocations to the shift in these narratives. It also dovetails with much of our tactical tools, which point to a hefty USD risk premium. In simple terms, that means the USD level doesn't quite jibe with its underlying macro drivers. One possible answer is that the rally in the USD has little to do with macro fundamentals and more to do with portfolio hedging. For international investors that trade equities and credit, the USD has been a tool to hedge the risks of stagflation even if they have a portfolio geared for reflation. That's one possible reason why the USD's correlation to the SPX has flipped recently. Equally important, we note that it runs a quite hefty risk premium across a range of tools. This month's VUCU looks at the USD versus financial conditions, risk sentiment, global growth expectations, and the like. Against all these drivers, the USD runs a 2-3% premium, suggesting parts of the recent rally aren't fundamentally inspired. The first chart looks at the USD in the context of Global Macro PCA factors. Recall, we extract four individual factors from a sample of 130 assets. The aim is to identify fair value and associations of correlations to these indicators.

Risk premiums abound. In the first chart, we look at a 3y regression of the USD to these four factors, capturing the implied versus the current level. The bottom panel displays the z-score of the residuals. Currently, the USD trades with a 3.7-sigma premium - the largest one seen over the past few years. The most significant risk premium we got during the trade wars was 2-sigmas. Of course, that doesn't stop the USD from rallying at these levels. Yet, we also think it dovetails closely with the stagflation worries that have recently gripped markets. The rub here is that US assets and growth are also starting to underperform, while front-end rate differentials have moved against the USD. Finally, we note the shift in regional and global growth expectations. Despite all the worries about China and other global growth drivers, the US accounts for the biggest slide in growth expectations for the year ahead. Moreover, it has seen the biggest correction in delta terms through 2021, reflecting the back-and-forth on forthcoming fiscal support and the drag as the prior stimulus wears off. For its part, the market slashed Chinese growth expectations for the next year earlier this year and now sits 5.59%. Non-G10 US has been upgraded in the past few months while EM Ex-China has been stable. The second chart also plots how the S&P has peaked and recently started to underperform MSCI EM. A simple gauge of USD attractiveness also points to a near-term top, especially if stagflation worries are overdone.