America's Surging Twin Deficits Point to a Weaker U.S. Dollar

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Highlights

- Historically, when America's budget and trade deficits have expanded significantly the result has been a weaker U.S. dollar.
- As evidence mounts that America's trade deficit is surging along with exceptionally aggressive fiscal stimulus, a multi-year decline in the U.S. dollar looks likely.
- There are important caveats, especially since growing external imbalances are centered on the U.S. and China. That said, a weaker U.S. dollar tends to favor non-U.S. versus U.S. equities.

America's Twin Deficits Are Surging in Response to the Pandemic

There are many factors that can affect the value of the U.S. dollar, but the concept of "twin deficits" has been a workhorse concept used for exchange rate analysis. The twin deficits concept refers to two key financial balances: (1) the external deficit, largely the gap between exports and imports, and (2) the federal budget deficit, the gap between the government's revenue and its spending.

The basic idea is that substantially wider deficits of either type can flood the global system with so much dollar debt that the value of the dollar has to adjust downward to bring supply and demand back into balance. Conversely, substantial narrowing of those deficits can create a shortage of dollar liquidity leading to a rise in the dollar's value.

A conventional measure of America's twin deficits is the sum of its current account and federal budget deficits expressed as a percentage of GDP. Historically, this measure has been a good long-term leading indicator of trends in the value of the U.S. dollar. For example, using quarterly data from 2000 to 2019, the twin deficits measure advanced by six quarters has had a 92% correlation with the Fed's real broad trade-weighted U.S. dollar index (Chart 1). As expected, expanding twin deficits have led to a weaker U.S. dollar, while contracting twin deficits have tended to lead to a stronger dollar.

Now, due to the fiscal impact of the coronavirus pandemic, the twin deficit index is pointing down for the dollar – and to an unprecedented degree. But some important caveats will soon follow.

First, the numbers. In the final quarter of 2019, America's twin deficit was 6.9% of GDP. That could be considered a "Goldilocks" reading, very close to its twenty-year average of 7.0%. Then came the Great Lockdown shock, which hit the economy hard beginning this March and with cyclone force in the second quarter, when U.S. real GDP fell at an unprecedented 31.7% annual rate. Based on Bloomberg's survey of economists, the twin deficit ballooned to 15.9% of GDP in the second quarter, the largest ever recorded. Most of the deterioration in this measure came from the widening federal budget deficit.

Fiscal Policy Divergences Are Causing Widening Trade Imbalances

The budget deficit expanded not only because of the sharp drop in tax revenues due to the economic contraction. It also expanded because of America's very aggressive

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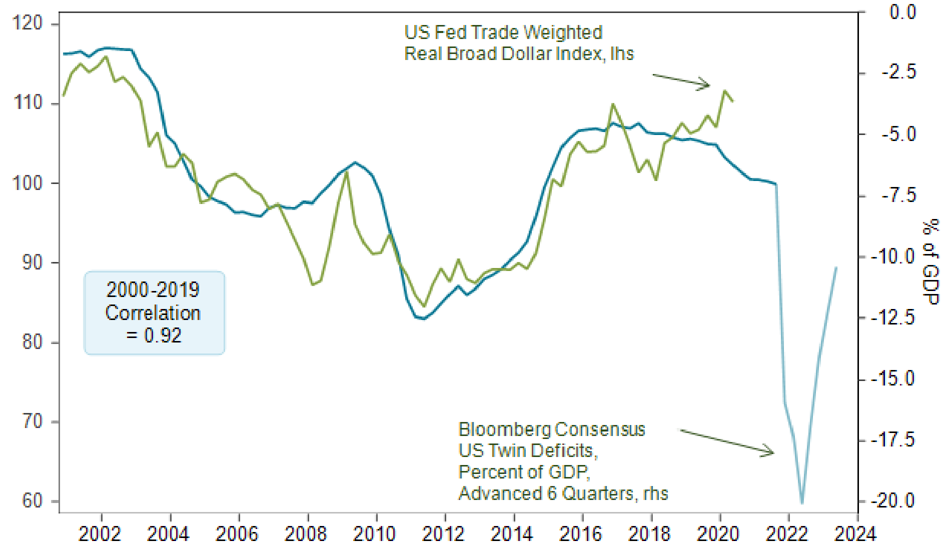
CHART 1: U.S. Twin Deficits Lead the U.S. Dollar by About Six Quarters



Note: Bloomberg's U.S. Twin Deficits Index is based on the sum of the current account deficit and federal budget deficit as a percentage of GDP.
Source: GW&K Investment Management, Bloomberg, and Macrobond

The pandemic is expected to create an unprecedented deterioration in America's twin deficits. If history is any guide, that points to a weaker U.S. dollar in years ahead.

fiscal stimulus, which boosted real disposable household incomes by nearly 12% from a year earlier in the second quarter (Chart 2). This occurred even as unemployment soared and actual labor income plummeted. In contrast, China responded to the pandemic with policies that support firms and production, while being very restrained in directly supporting consumers and households.

The U.S.-China fiscal policy divergence is a recipe for widening international trade imbalances, with the U.S. on the deficit side of the ledger and China on the positive side. That is reflected in data that shows America's goods trade deficit surging from an annual rate of $787 billion in January to $960 billion in July, or from 3.6% to 4.9% as a percent of GDP. China has also reported monthly trade surpluses in July and August which surged to nearly 5% of GDP, up from 2.9% in 2019.

The Eurozone's fiscal policy has also been more restrained than America's. According to the European Central Bank's forecast, the Eurozone's budget deficit will rise from 0.6% of GDP in 2019 to 8.8% in 2020. That's a notable rise of 8.2% of GDP, but small compared to a projected rise of 12.3% of GDP in America's federal budget deficit over the same period. That's a huge difference in "fiscal impulses" --i.e., a measure of fiscal stimulus based on year-on-year deficit changes. The data source is Bloomberg's consensus survey of economists which projects the U.S. deficit rising from 4.7% of GDP in 2019 to 17.0% in 2020. The U.S.-Eurozone fiscal policy divergence is also a recipe for widening international trade imbalance. Once again, U.S. support for household incomes and consumption looks exceptional.

In short, America's twin deficits are likely to rise from both sides, including external imbalances and budget deficits.

Caveats: (1) The Chinese Yuan is a Managed Currency and (2) Budget Deficits Are Rising Everywhere

Now for two important caveats. First, China manages its currency and has a number of options to offset upward pressure on the Chinese yuan. Second, the fact that the budget deficits of all major nations are worsening at the same time means that Chart 1 – the twin deficits vs. the U.S. dollar chart – may be giving an excessively negative signal on prospects for the U.S. dollar.

Regarding China's currency management, its main option for offsetting upward pressure on its currency is to simply have its authorities buy the dollars that are generated by its trade surpluses and let its foreign exchange reserves accumulate. That could open it up to charges of "currency manipulation" aimed at holding down the value of its currency. It used that technique for many years in the past as it built up its current reserve position of $3.2 trillion, although we doubt that the U.S. will turn a blind eye to that practice regardless of who is in the White House next year.

China could also choose not to repatriate a significant portion of the dollars it earns overseas.[1] However, that raises the issue of where to park the money when China's 10-year government bond yields are 3.1% compared to just 0.7% for 10-year U.S. Treasuries, and 0% and -0.5% respectively for comparable Japanese and Eurozone government bonds. If it invests its dollar earnings into euro- or yen-denominated securities, it will put overall downward pressure on the dollar against those Developed Market (DM) currencies. That in turn will put upward pressure on the Chinese yuan against the basket of currencies it is managed against, which currently has only 21.6% weight to the U.S. dollar.

Regarding the second caveat, we do think that Chart 1 gives an excessively negative picture of U.S. dollar prospects. As we argued in our June and July Global Perspectives pieces, the pandemic has created a surge in government deficits in all major countries so the U.S. twin deficit measure has to be taken with a grain of salt.

But here is that grain: if the correct concept has to do with the relative deterioration of America's budget deficit there is still a big issue. As our earlier Global Perspective pieces demonstrated, America's budget deficit is growing at a much more rapid pace than budget deficits in most other major nations. Thus, Chart 1 is probably directionally correct regarding prospects for the U.S. dollar even though the magnitude or the speed of the future decline may be overstated by the twin deficits index.

Will the Current Cycle of Dollar Weakness Be Long Lived?

History shows that cycles in the value of the U.S. dollar have tended to be long-lived, ranging from six to ten years (Chart 3). If the peak of the dollar in this cycle was in April, as we believe, the duration of this dollar downtrend also seems likely to last many years. Here are some factors pointing in that direction:

- The U.S. is likely to emerge from the pandemic with one of the largest government debt-to-GDP ratios of any major nation, trailing only Japan and Italy.
- Even though there are currently few fiscal hawks in Washington, the large debt will create pressures for fiscal consolidation, could dampen growth, and keep real interest rates low for years.
- The Fed has recently adopted a softer approach to inflation targeting than the European Central Bank or Bank of Japan, which both have institutional tendencies not to follow the Fed.
- A sweep by the Democratic Party in November is likely to result in higher taxes on capital, including a hike in corporate income taxes from 21% to 28% that could discourage capital inflows.
- A continuation of divided government could well bring back disruptive partisan disputes over the debt ceiling, which is currently suspended until July 2021.
- Foreign interest in U.S. Treasury Securities has been waning as issuance has soared, with foreign holdings of Treasuries having fallen from 34% of the total in 2015 to 27% this June.

A key lesson for investors from previous dollar cycles is that U.S. equities tend to outperform non-U.S. equities in rising dollar periods, while the reverse is true in falling dollar periods (Chart 4). This has been particularly true for a comparison of performance for the S&P 500 versus the MSCI Emerging Markets (EM) Index. In rising dollar periods, the S&P 500 outperformed MSCI EM with a double-digit annualized margin in U.S. dollar terms. But MSCI EM had a similar double-digit edge over the S&P 500 during falling dollar periods.

Finally, while interest-rate differentials facing international fixed income investors are generally narrow now, differentials in long-term earnings yields facing equity investors are notably in favor of non-U.S. equities. For example, using the inverse of Shiller PE ratios, the S&P 500 had a long-term earnings yield of 3.5% at the end of August compared to 6.2% for MSCI EAFE and 7.5% for MSCI EM.

In short, both relative equity valuations and the potential for a multi-year decline in the U.S. dollar represent good reasons for American investors to hold international positions to complement their domestic holdings.

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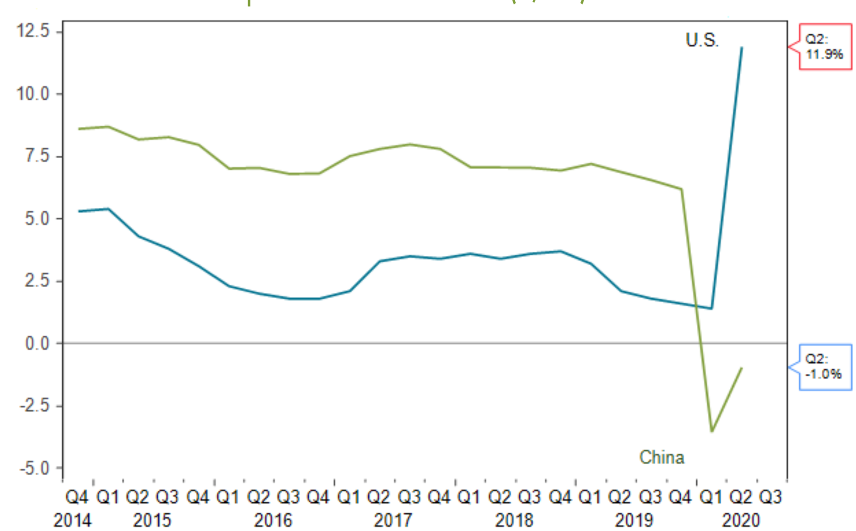
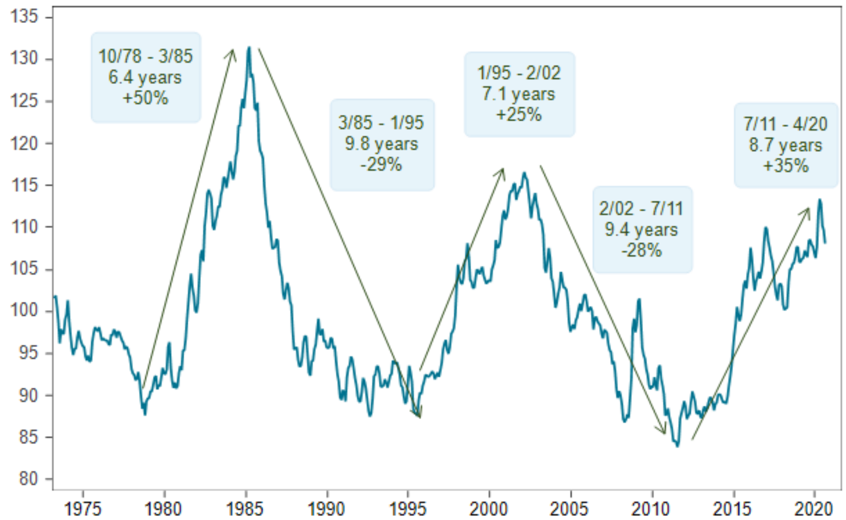
Chart 2: Different Strokes: China vs. U.S. Real Disposable Income Growth (Y/Y%)

America's aggressive fiscal stimulus boosted household incomes by 12% in the second quarter. China supported production rather than consumption. This is a recipe for wider trade imbalances.



Source: GW&K Investment Management, China NBS, U.S. BEA, and Macrobond

Chart 3: The Fed's Real Trade-Weighted Dollar Index

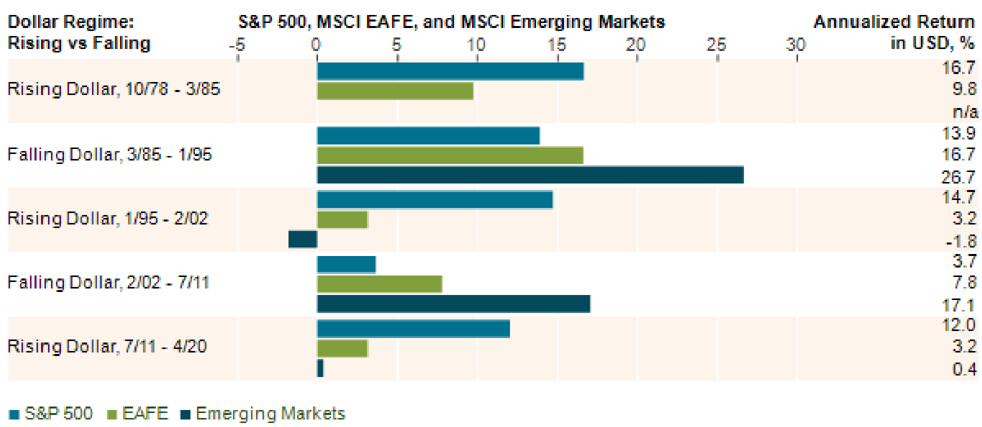


Source: GW&K Investment Management, Bloomberg, and Macrobond

Historically, cycles in the value of the U.S. dollar have been long lived, ranging from six to ten years. If a new downtrend began in April, as we believe, history suggests it could last for many years.

Chart 4: U.S. Equities Have Outperformed Non-U.S. Equities in Rising Dollar Periods - and Vice Versa

Rising dollar periods have favored U.S. equities while falling dollar periods have favored non-U.S. equities. This relationship has been especially pronounced with respect to U.S. versus EM equities.



Source: GW&K Investment Management, Macrobond

Endnotes:

1 Goldman Sachs analysts recently estimated that only 32% of the net proceeds of China's July trade surplus was repatriated. See Mike Bird, "China's Exports Are Booming and Trade Surplus is Widening: Why Is the Yuan So Weak?", Wall Street Journal, September 7, 2020