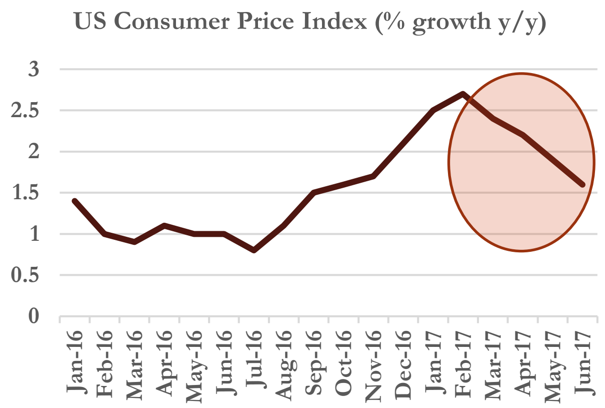
## USD: UNITED STATES (DILEMMA) DOLLAR

***"We don't have a trillion-dollar debt because we haven't taxed enough; we have trillion-dollar debt because we spend too much" – By Ronald Regan U.S. President***

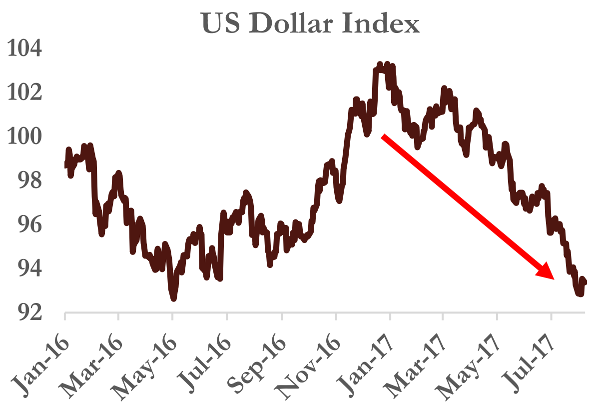
When the bets are against you, no matter how hard you try no luck is going to fetch you win. This is exactly what is happening to US dollar - nothing seems to be working in its favour. Since the start of this year dollar index has lost more than 10% against all the major currencies. The US dollar (USD) has weakened by both political uncertainty and sluggish US macroeconomic outlook. We in this note try to highlight the reasons behind US dollar depreciation; its likely impact on US monetary policy and impact on Commodity & Currency market.

### STICKY INFLATION:




After years of pumping money into the system, US Federal Reserve is contemplating on when and how to unwind the already bloated US balance sheet and raise the benchmark interest rates. US has already increased the interest rate and is planning another rate hike by this year end. Fed's willingness to **increase the interest rates** and thereby tighten the policy **despite of meagre inflation** is somewhat hard to digest. Fed's estimation of economic recovery and probably high inflationary situation has always gone overboard. After all, inflation is result of demand outpacing supply. But the current weak inflation is evidence that supply has kept pace with demand. The presumption under which Fed increased the interest rate, that falling unemployment rate should lift inflation soon has gone drastically wrong. This is mainly because Fed seem to have conveniently overlooked the fact that **US labour force participation rate** has consistently declined over the past decade. The participation rate has dropped from 66% in 2008 to 62.9% in Jul.17. Which means US inflation is unlikely to rise in future, post the assumption that Oil prices shall continue to stay around $50/bbl. Which also means that less room available for further monetary policy tightening.

### DOLLAR IN DOLDRUMS?

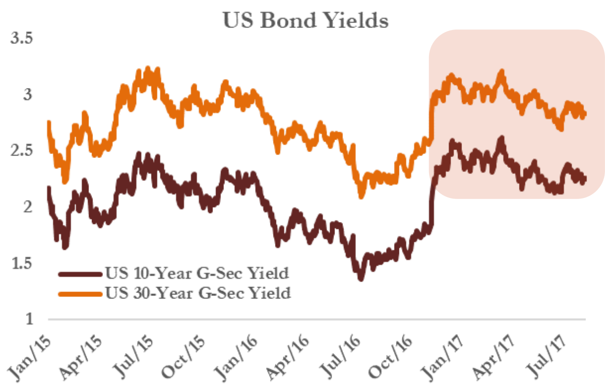



Post the US election results and before the newly elected US President Mr. Donald Trump took the office in Jan.17, USD appreciated to new high since 2003. Though the election results were of big surprise, it certainly cleared the ambiguity and USD appreciated on the expectations of new policies that would get the US economy back on track. But since Jan 2017, USD has been plunging one side against all the major currencies. Much of the damage seems to be self-inflicted and is one off reason for high commodity prices.

Reasons for USD weakening both economic and political are as under:

- Failure to convince congress and push through reforms by repealing and replacing Obamacare

- No clarity on US tax reforms – Corporate tax cuts
- Unrealistic economic growth assumptions
- Unachievable spending cuts
- Trade Protectionism – increase in trade tariffs
- High fiscal and trade deficit
- Uncertainty over passing the budget proposals by Congress and possibility of US govt. shutdown by Sept.17
- FBI investigation into Russia meddling in 2016 presidential election damaging the reputation and leading to the charge of obstruction of justice on US President and
- Rising alarm over risky US bank lending to corporates




All these factors have contributed to negative market sentiments towards US dollar. Currencies are most vulnerable to shifting sentiments. US Federal Reserve pushing ahead with plans to start shrinking its balance sheet in Sept.17 is only going to add more trouble to already sluggish US economy. The pre-emptive tightening would lead to contraction in market liquidity which will drive up the short-term and long-term interest rates. This would further impact the employment generation and decline in US corporate profitability given the high cost of funds. A rate hike is typically an indication that economy is doing well and attract funds towards higher bond yields. But the recent interest rate hike has failed to increase the bond yields reflecting the stubborn attitude of Fed towards raw data.

## CONCLUSION:

A lot needs to be done on policy front by US Federal Reserve to bring back the positive confidence in Dollar. If congress fail to agree on the proposed fiscal budget and does not reach any conclusion before 30th Sept.2017 - the possibility of US govt. shutdown should weaken the USD. Needless to say, any agreement on fiscal budget before deadline should reverse the negative sentiments. A weak dollar should keep the commodity prices volatile and more often elevated in short-term. The falling corporate profitability; weak inflation and probable liquidity squeeze may force US Federal Reserve to go slow on its monetary tightening programme. The dilemma over USD weakening shall continue if the pessimism among investors continue to rise.

| Currency | Trading Range | Current Rate* | Remark |
|---|---|---|---|
| EUR-USD | 1.1300 to 1.2150 | 1.1750 | Till Sept.17 |
| AUD-USD | 0.7675 to 0.8070 | 0.7885 | Till Sept.17 |
| USD-INR | 62.65 to 64.75 | 63.73 | Till Dec.17 |

*As on 9th Aug.17