SayeNvest Caps

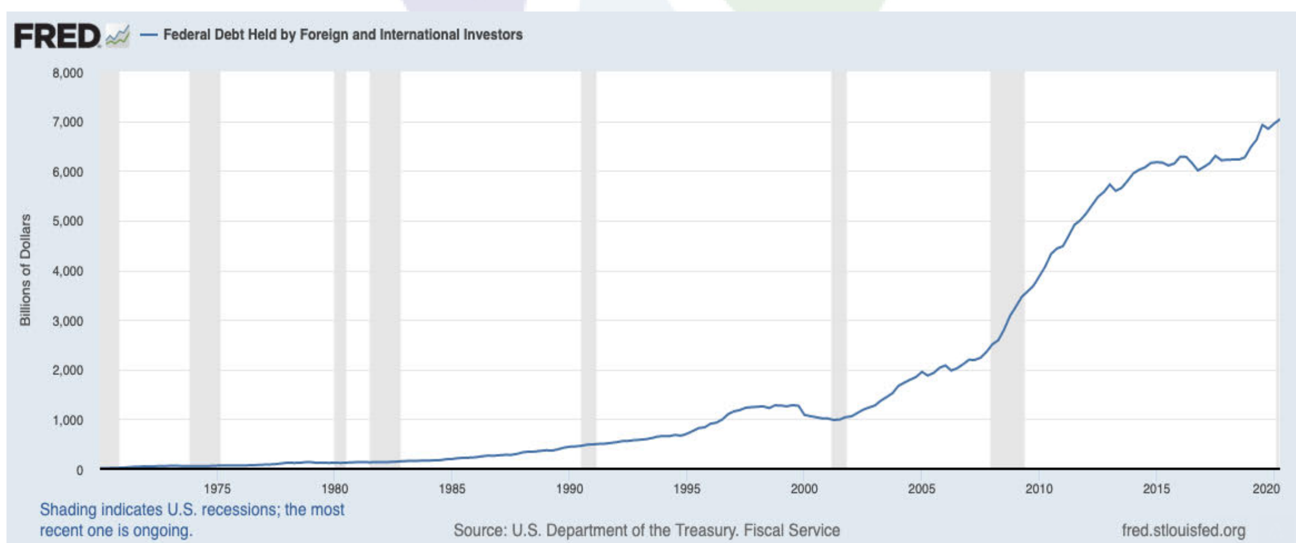
+44 7541 637237
info@sayenvestcaps.com
www.sayenvestcaps.com

Economic Bulletin: September – October 2020

The fall-out of COVID is here to stay, and COVID was just the match that lit fire to the latest debt cycle the world is experiencing. In this month's economic outlook, we shine some light on the role of the U.S. dollar within this debt crisis and its effect on developing countries.

Before jumping into it, let me clearly state that the global economy is a complex, intricate web. Predictions are quite hard to do, and there are many counteracting factors which cannot be covered in a short article. Nevertheless, investors need to think hard about the future of the U.S. dollar and its status as the world reserve currency since it affects everything from commodities to emerging markets. This article is purely educational and not investment advice. With this caveat out of the way, let me outline one possible example for the dollar.

As of July 2020, the world owes $12.6 trillion in U.S. denominated debt. More than a quarter of all U.S. federal debt is owned by non-U.S. persons and institutions. This is quite significant. Locally denominated debt can be easily inflated away by the power of the central bank and that is happening. For this very reason, creditors in developing countries prefer issuing debt in dollars. Now, nobody besides the U.S. can print the U.S. dollar. (ignoring cases like the Euro/Dollar market). Most central banks in the world are currently lowering interest rates and trying to prop up their economy with cheap money. While the global monetary expansion strongly influences equity and debt markets, it is also crucial to think through the effects this has on the dollar as the world's reserve currency. The dollar, while it is losing its purchasing power, does so relatively less compared to all other currencies due to the size of the dollar market and the demand for dollars.



SayeNvest Capital Advisory Limited
71-75, Shelton Street, Covent Garden
London WC2H 9JQ.

Struggling businesses and countries have a higher dollar demand since many of them cannot service their debts anymore, a large part of which are US$-denominated. This increased demand creates a dollar shortage and pushes the value of the dollar up. The increase in the dollar value makes the same debts harder to service, and more businesses and eventually countries will default. This could lead to a spiral of indebtedness and a domino effect in highly-indebted emerging markets (most of which have loaded up on debt consistently in the last two decades).

We can see this already happening in Turkey, Argentina, and other countries. Demand for dollar, gold, bitcoin, and other hard(er) assets are going up. Now, the debt levels were already harmful before COVID, but they have been skyrocketing around the world ever since. Private and government debt has grown much more in a single year compared to many years, combined after the Great Recession. Investors must think through their strategy to protect their assets in the context of such a scenario of an appreciating dollar and a global debt spiral.

There are important counter-arguments regarding this scenario: Some people look at the dollar performance recently and shrug their shoulders, saying, “the dollar lost 10% from its recent peak in March.” While that is true, it ignores the comparative performance of the dollar. The dollar has dominated almost all other currencies. From the beginning of the year to August 2020, the dollar has strengthened relative to 96 out of 146 currencies. Many people call out for the demise of the dollar in the near future due to the aggressive monetary policy of the Fed and the rising debt levels in the U.S. However, the fact remains that the dollar won’t go away anytime soon. The global world economy and its payment channels are designed to work with the dollar. The world cannot quickly move to another currency even if there was a viable contender (which there isn’t) and even if other countries agreed upon a new standard. It is an entrenched system.

While the Federal Reserve could easily print more money and start creating even more central bank liquidity swap lines. It is unlikely that they will be able to “outprint” the USD demand that is generated from defaulting businesses and eventually defaulting emerging countries who mostly hold their debt in USD denominated liabilities. If the Fed did so this would have huge implications on the Fed’s balance sheets and the U.S. economy.

In the medium-run, the U.S. stock market, the dollar, and the U.S. import-industry will benefit from this dynamic at the costs of emerging markets and the world economy. But what about the long-run? What happens if more and more countries won’t be able to service their US-denominated debt? This debt-default spiral could put the whole world-currency status of the dollar into question. While this might sound radical, please keep in mind that monies come and go. To quote Ray Dalio in his book “Principles”: “of the roughly 750 currencies that have existed since 1700, only about 20% remain,

And of those that remain all have been devalued." Similarly, world-currencies change approximately every 100 years, and the dollar is officially the world currency for 76 years. We are getting close. Changes in the worldwide economic infrastructure tend to go hand in hand with debt cycles. How much more debt needs to be created before we see emerging markets tumbling, the dollar rising, and the world economy fundamentally changing? It's hard to tell, but we at SayeNvest know that a good strategy is necessary to anticipate some of these changes that will unfold over the upcoming years. Call us if you want our advice.

Wolf von Laer, PhD

An economist by training, Wolf writes about monetary theory, regulation, cryptocurrencies, and financial markets. He heads Economics and Financial market research for SayeNvest Capital Advisory Limited.

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