

Oh The Places We Could Go

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MR. MICHAEL CEMBALEST: Good morning and welcome to the late April Eye on the Market podcast. Before getting into this week's discussion on the dollar, two quick things. US economic data is really strong right now in Q1/Q2, but all the long data leading indicators we look at that look out six, nine, 12 months suggest that there is a material slowdown coming ahead. I don't think it's anything catastrophic. We still think the stock market lows of last year hold. I don't think if there's a recession, it's anything more than a mild one, but a lot of indicators we're looking at are all pointing in the same direction. So we have a table on those; you can take a look.

#	Category	Leading indicator...	Advanced by...	Predicts a deterioration in...
1	Economy	New orders less inventories in ISM survey	3 months	ISM manufacturing index
2	Employment	Unemployment, labor force participation rate, PCE inflation and avg. hourly earnings	12 months	Non-farm payrolls
3	Employment	Single family home sales	16 months	Initial jobless claims
4	Inflation	Small business pricing plans	12 months	Median CPI
5	Inflation-goods	Retail inventory to sales ratio	12 months	Core goods CPI
6	Inflation-services	Services prices in ISM survey	9 months	Consumer price inflation in services
7	Inflation-services	Producer prices inflation in services	9 months	Consumer price inflation in services
8	Inflation-services	Job openings	9 months	CPI in services ex-shelter
9	Lending	Banks tightening C&I loans	9 months	Corporate defaults
10	Lending	Respondents reporting tighter credit standards	9 months	Bank lending
11	Construction	Leading economic indicators	18 months	Construction activity
12	Profits	Fed Funds Rate, effective corporate tax rate, unemployment and productivity growth	8 months	Economy-wide profits
13	Profits	Economic activity, business confidence, supplier deliveries, wages, inflation, cyclical GDP	12 months	S&P profits
14	Rents	Zillow observed rent index	12 months	Rent inflation
15	Revenue	Active truck utilization	6 months	S&P revenue growth
16	Wages	Avg. growth in wages advertised in job postings	4 months	Median wages
17	Wages	Rehiring rate proxy	12 months	Wages

Source: Alpine Macro, Bloomberg, Morgan Stanley, Piper Sandler, Steno Research, Trahan Macro Research, JPMAM. April 2023.

And then there's a quick comment on the fact that after 16 years of misleading levelized cost of energy statistics that Lazard has been publishing, they now have finally realized what me and other people have been writing about for years, which is that levelized cost of energy is flawed since it

doesn't include the cost of backup thermal power or energy storage. They are now incorporating some of those costs. And of course their revised wind and solar cost estimates are much higher than natural gas for that reason. Anyway, brief comment on that.

So the main topic for this week is an article that caught my eye out of the South China Morning Post called, let's see, "End of Dollar Dominance Will Also Spell the Demise of US Hegemony." Wow, the places we could go on that one, right. I mean, I could write a piece that looks at the press freedom that the South China Morning Post enjoys or does not enjoy and compare press freedom measures by country. I could look at the issues related to the ownership of that particular publication. We could look at Chinese currency intervention after joining the WTO and its impact on US manufacturing wages. We could look at mercantilism, we could look at issues around rule of law, judicial independence, property rights, capital controls. Now is probably a bad time to do all that. And since I've written on some of those topics before, this Eye on the Market only addresses the issue of the dollar as the world's reserve currency since a lot of clients ask about it.

I think it's important to look at the big picture and to look at the numbers so that we're not overly influenced by individual anecdotes about countries adopting the renminbi or something other currency for trading and settlement purposes. So de-dollarization, here's the bottom line. De-dollarization is a very hot topic, but there's a lot more smoke than fire so far.

As a reminder, being the world's reserve currency is a really big deal. And the easiest way to think about that is that the US shares of trade in the world is just around 10 or 12%. The US is only around 20 or 25% of global GDP, yet the dollar has a much higher share of foreign exchange, trade, debt issuance, and foreign exchange reserve investment by foreign central banks. So that's why it's important to be the world's reserve currency.

Around 35% of all Treasury bonds are owned by foreign official and private sector investors, and if that figure ever dropped to 20%, which is the average foreign ownership share of European countries, there would be an extra \$3.5 trillion in Treasury supply that somebody would have to buy,

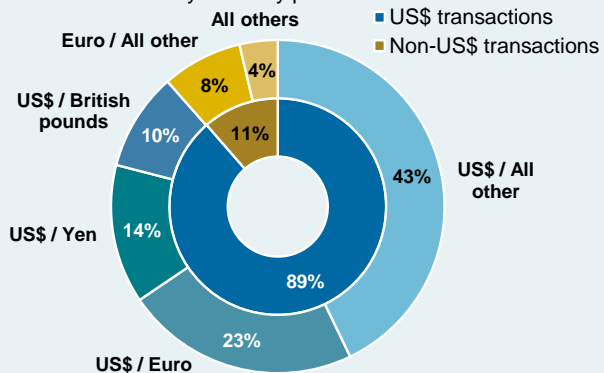
and obviously that could be very painful for US Treasury yields. So when and if the dollar loses, or were to lose its reserve currency status is a big deal.

So we have a piece this week that walks through the issues. I'm just going to summarize them here because there's a lot of information here, mostly with charts and things that make it pretty clear. There's no evidence that the dollar's role in foreign exchange is changing over the last 20 years, and the dollar accounted last year for 89% of all foreign exchange transactions. In other words, the dollar was on one side or the other in 89% of all foreign exchange transactions. It also dominates the currency forward in swap markets. The renminbi has grown a little bit, but is still very, very, very small, and then we get into the issue of foreign exchange reserves.

So the dollar is still the primary choice for investment to foreign exchange reserves, at about 60%. That share has declined by a few percent over the last few years, but as Barry Eichengreen, who is one of my favorite experts on these topics at Berkeley describes, most of that 6% shift is explained by increased allocations into smaller economies like Australia, Canada, Sweden, and the Korean won.

Dollar still dominates FX transactions

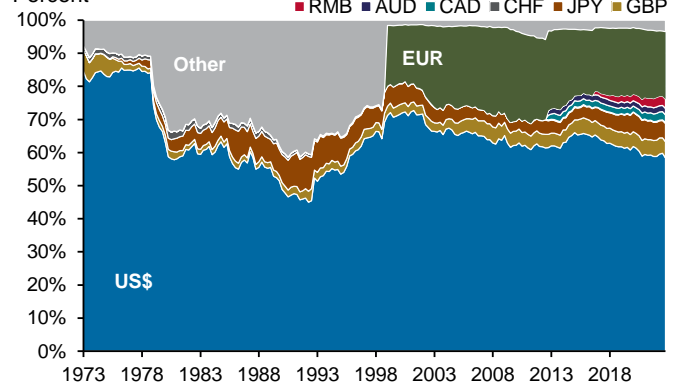
% of world transactions by currency pair



Source: BIS. April 2022.

Share of global foreign exchange reserves by currency

Percent



Source: International Monetary Fund, JPMAM. Q4 2022.

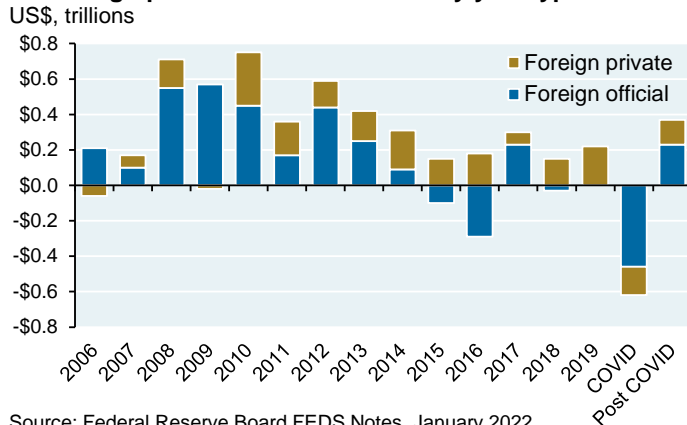
And so only a small bit of the recent shift is explained by increased allocations to the renminbi, most of which is driven by Russia. And if anything, given the massive size of China's bond market, it's the third-largest in the world and bigger than Germany, France, and Spain combined, and the fact that the IMF added China to its special drawing rights basket a few years ago, the real question to ask is why is their renminbi so small still rather than the fact that it's being

held in foreign exchange reserves at all, right? The right question is why is it still so small?

There was an article in the FT recently that talked about the 8% decline in dollar reserves in absolute terms over the last couple of years. And the author cited this as evidence of the dollar's weakening status. This was pretty flawed and sloppy economics, because the absolute decline in dollar reserves is almost entirely a reflection of rising bond yields and falling bond prices. So you can pretty much ignore that, and we explain that.

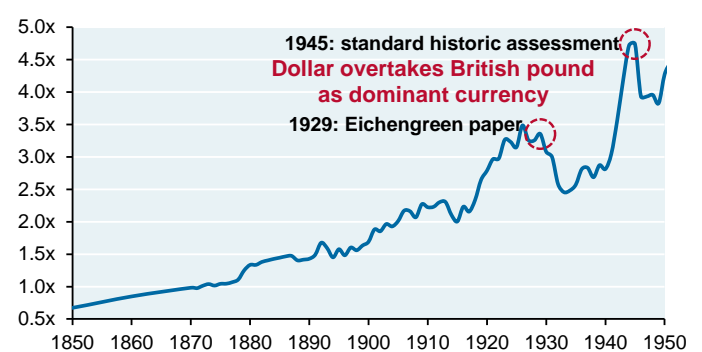
We have a section in here on what happened during COVID. There was a brief period of central bank selling of Treasuries, but they have since rebounded. We have a section in here on when the dollar overtook the British pound. Yes, the Chinese economy is now larger than the size of the US economy, but when the US overtook the British pound, the size of the US was somewhere between three-and-a-half and five times the size of the UK. So the mere fact that China's economy is the same size as the US doesn't really tell you that much. Reserve currency status depends upon a lot of things more than size.

Net foreign purchases of Treasuries by year/type



Source: Federal Reserve Board FEDS Notes. January 2022.

The US economy was 3.5x-5x larger than the UK when the US\$ replaced the pound as the world's reserve currency
US GDP as a % of UK GDP



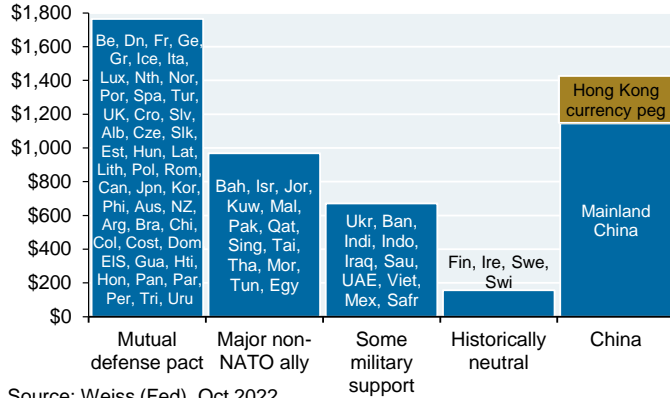
Source: Conference Board, Angus Maddison Project, JPMAM. 2022.

One of the major arguments that gets made sometimes is the impact of Western sanctions on Russia is going to really change the desire to hold dollar reserves. I think this is a bit premature, and the risk to the dollar from these sanctions may be exaggerated. When you look at the, historically there's a link between a country's geopolitical ties and how they invest their FX reserves, for all the obvious reasons. And today about 50 to 60% of US government Treasuries and agencies are held by foreign governments that

have strong ties with the US. And then that figure rises to 75% when you include countries that have military cooperation with the US.

Est. safe dollar asset holdings by foreign official investors

US\$ billions, December 2021



Source: Weiss (Fed). Oct 2022.

So a lot of the dollar holders, other than China and Hong Kong, have either explicit or implicit military cooperation agreements with the US, and I think despite all the whining sometimes that you hear, I think the dollar departures are going to be a lot slower than sometimes advertised. And even as it relates to Hong Kong's peg, as it relates to Hong Kong, the currency peg requires that they have at least 80% of their liquid assets in dollars, and currently that figure is around 90%. And then similarly, Saudi Arabia and the UAE also pegged their currencies to the dollar.

So it's really when we're talking about the risks to dollar holdings, it's primarily an issue on China. Chinese bankers told Chinese officials in April of last year that diversifying into yen and euros was not very practical given the massive size of China's reserves. And while China dollar holdings have been declining, the share of dollars in China's reserves has been roughly unchanged at 60% for at least the last ten to 15 years. So I think sometimes the sanctions issue may be over-exaggerated as a risk to the dollar.

Gold holdings in Official Reserve Assets vs gold prices



Source: IMF, Bloomberg, JPMAM. April 2023.

Russia and Turkey, the gold shares tend to be somewhere between 5 and 10%, sometimes a little bit lower. And I get the sense that 10%, maybe 12% is about as high as a lot of central banks want to go in terms of their gold holdings. And sometimes there's a lot of discussions about sanctions driving people to own gold, but some of the more interesting studies we've read recently show that the drivers of gold allocations are primarily your monetary and fiscal policy rather than sanctions-related issues.

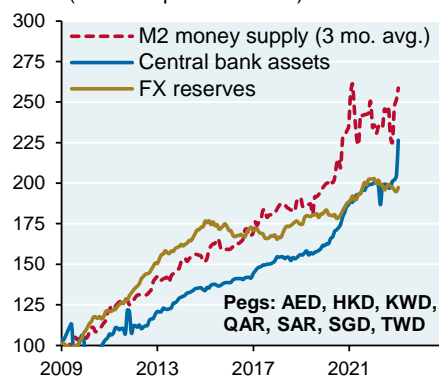
To me, one of the really interesting questions here on China is what would it take to see greater diversification by central banks and private sector entities into the renminbi. And we have a page here that looks at this. China has a massively high money supply, the highest in the world, when compared to their own GDP. If they fully opened their capital account and let residents take their money out freely in terms of a fully convertible currency, that could create incentives for other entities around the world and central banks to buy and sell debt denominated in renminbi, and that would create the depth in liquidity like you have with the dollar and the euro markets. The problem is China appears to not really want to have a fully convertible capital account, because we have no idea how much renminbi could leave and cause a collapse in Chinese equity and real estate markets.

Instead of investing in other fiat currencies, certainly other central banks could sell dollars to buy gold, and that has been happening over the last few years. Gold holdings fell a lot from the early 90s to, let's say 2007, 'cause gold prices weren't doing anything. And then once gold prices started going up, central banks started adding gold again. But outside of

So a colleague of mine in Singapore, Alex Wolf, did some really interesting analysis. We have some charts in here that show just how different China looks relative to freely floating currencies and also to pegged currencies in terms of how their money supply is massively out of whack relative to the amount of central bank assets and FX reserves. You have to see the charts; I don't think I could do justice to it explaining it. But when you see the charts, you realize that China is a really different entity in terms of the massive disconnect between money supply, reserves, and central bank assets. And the only way you can sustain that is having a continuously closed capital account. And if that's the case, I'm not so sure how much diversification into renminbi that you're going to see.

Pegged currencies

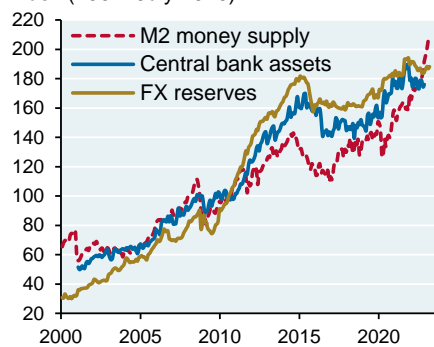
Index (100 = September 2009)



Source: Bloomberg, JPMAM. February 2023.

Mexico: monetary policy and currency aligned in free-floating economies too

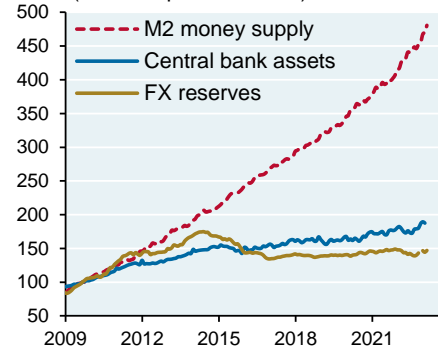
Index (100 = July 2010)



Source: Bloomberg, JPMAM. March 2023.

China: disconnect between money supply & central bank assets/reserves

Index (100 = September 2009)



Source: Bloomberg, JPMAM. March 2023.

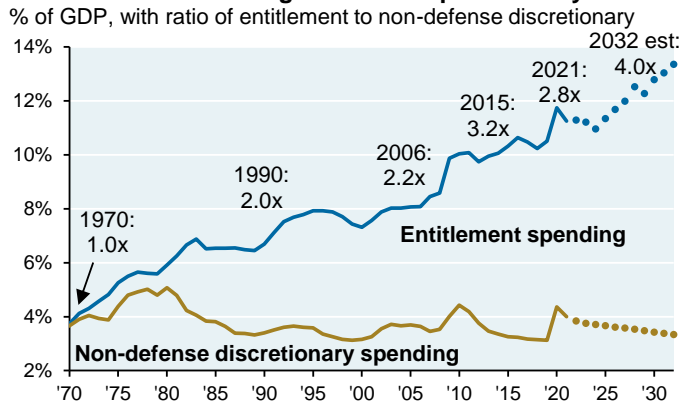
So yeah, we're going to watch all of these little de-dollarization themes, right. The Saudis and the Chinese oil flows that may, some of which may be denominated in renminbi, Indian purchases of Russian oil, some of which are denominated in UAE dirhams, gas flows from Russia to China, which are being negotiated maybe in euros or renminbi, Chinese purchases of iron ore from Brazil, right. But the amounts matter, and it's not clear yet that all of these negotiations are going to be really material in the bigger picture.

So yes, there are seeds of de-dollarization happening, but this is a really good example of something where you want to see the numbers and measure their magnitude before you make any judgments about reserve currency status. All of that said, the dollar's reserve currency status may not be under siege, but that doesn't mean the dollar can't fall from here,

because it just recently it was at its highest level in 30 years. And so there's a lot of economic outcomes that could drive the dollar lower, but just don't confuse the macroeconomic cycle issues with reserve currency issues.

So last comment, and again reading the piece is a little bit easier, this is a macroeconomic topic that lends itself to kind of charts rather than words, I'm not ignoring the long-term fiscal issues that the US faces. I've written about them a lot. And you remember that chart that I call the chart that everybody hates, we repeat it in this chart, it's the one that shows how non-defense discretionary spending is being crowded out by entitlements. There used to be a one-to-one in terms of the split between the two. And by the end of the decade we'll be spending, the US will be spending \$4 on entitlements for \$1 spent on everything else, and that's got some negative productivity issues and will also drive up debt-to-GDP ratios.

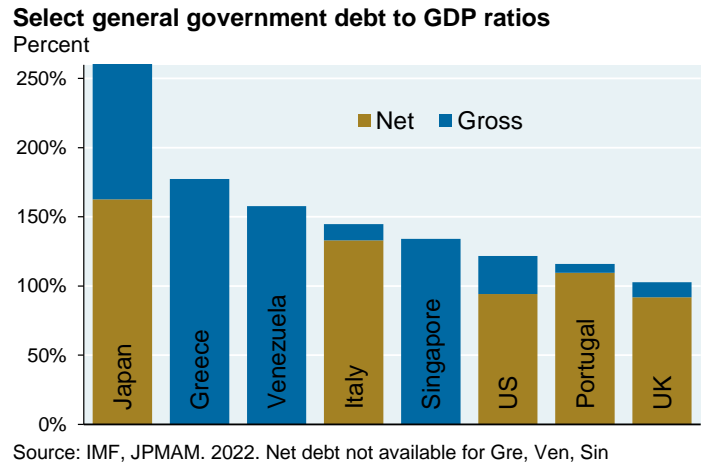
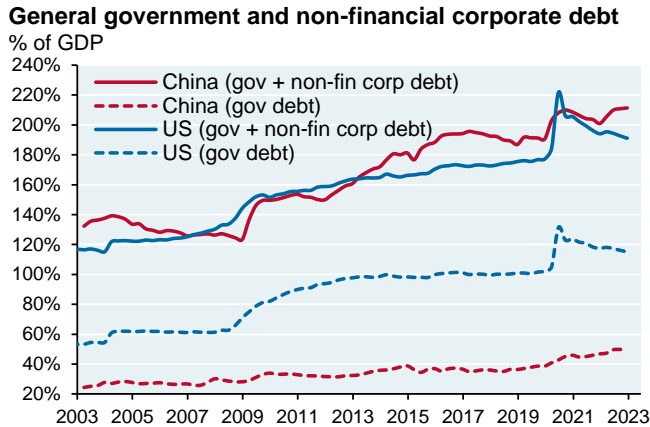
What does the Federal government spend money on?



Source: CBO, JPMAM. May 2022. Dots are CBO projections.

But I figure that the US has about 20 years to figure things out before there's a more sustained reserve currency threat from the renminbi, because China has a lot debt issues of its own. If you actually look at the sum of corporate and government debt in China, it's around the same level as it is in the United States. And in China, some of the corporate sector is increasingly indistinguishable from the government itself. If over the next 20 years, the United States veers off into Greece, Japan territory with respect to the federal debt and doesn't do anything about entitlements, then at that point I think the long predicted decline of the dollar as the reserve currency might finally happen. But a lot of the comments that we're reading right now seem premature, and this week's piece is one way of looking at that. So thanks

for listening, and see you next time.



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