**Chapter 5**

**Global capital markets amid the pandemic:**

**With emphasis on the dynamics of US dollar[[1]](#footnote-1)**

It is fair to say that, although both the global financial crisis of 2007-08 and the current COVID-19 pandemic crisis got governments and monetary authorities around the world by surprise, the speed of response by the authorities in the two episodes differs significantly. In the pandemic one, due to the nature and the size of the crisis (health, economic, financial) and the very fact that it threatens the lives and livelihoods of citizens around the world at lightning speed and on a scale unseen in living memory, policymakers have generally responded with speed and tenacity.

1. **Global risks ahead**

While major monetary and fiscal policy actions have helped calm markets, downside risks remain while new short and medium-term uncertainties could amplify stress in financial markets and unexpected shocks. More precisely:

*In the short run:*

**The second wave of coronavirus infections,** unfolding already, would weight on the global economic growth. A new disruption to the economic activity could exacerbate financial stress. Lower for longer commodity prices could trigger financial distress among commodity producers. On the positive side, most countries are now better placed to manage a second wave in terms of healthcare capacity and treatment. Also, the news on vaccine development is promising although 2021 is the most optimistic timeline.

*In the medium term*:

**Deterioration of corporate bond credit quality and potential spillovers to other markets**

Given elevated corporate high-yield bond and leveraged loan outstanding globally, the combination of rising leverage and slower earnings growth would erode the debt sustainability and could contribute to a considerable increase in ratings downgrades and defaults. For example, according to OECD, BBB rated corporate bonds amounting to USD 261 billion could be expected to be downgraded to non-investment grade within one year, in case of a significant economic downturn. If corporate bonds issued by financial companies are also considered, the amount of so-called “fallen angels” would increase to approximately USD 500 billion, which could trigger an adverse financial shock.

**Also, a no deal Brexit outcome** – December 31, 2020 is around the corner - would result in greater disruption to EU-UK trade and not only (bilateral post-Brexit UK trade agreements with the rest of the world are often conditional on a UK-EU trade deal, at least in principle) and correspondingly sharper economic slowdown, on the back of weak demand and supply-chain disruptions due to the pandemic. All the more so given the possibility of a UK breakup within the next 5 years from the exit of Scotland and/or Northern Ireland. The City of London will be more or less OK, it may lose some business to other capitals of EU member states but, by pursuing bold deregulation, would attract business from all over the world. But the consequences of hard Brexit would extend far beyond economics. I am afraid the damage will be for both UK and Europe first and foremost political. It’s bad news for both. Europe will miss a big reformer country and global influence (geopolitical, military, etc.) without the UK. And the UK will lose its voice and influence in European and world debates on big issues like the future of globalization, the 4th industrial revolution, climate change, etc.

**To government bonds.** In summer, both the US and the euro area government bond yields remained at historical low levels mainly due to the supportive ultra-expansionary monetary policy stance by the Fed and the ECB and the zero and negative key interest rates. However, part of this summer’s gains reversed driven by the risk-on sentiment and increased issuance. In particular for the US fixed income, the US treasury yield curve bear steepened with the 10-year Treasury hitting an all-time low of 0.51% in the beginning of August as an initial reaction to the Fed’s policy announcement for a flexible average inflation targeting but reversing thereafter. Long-term yields rose while short-term yields remained pinned near zero but then bond yields gave back much of the gain, perhaps on the realization that it could be a long time before inflation actually shows up in a meaningful way.

Turning to the euro area fixed income, on the back of the huge fiscal response needed to counteract the Covid-related global crisis, yearly borrowing requirements have suddenly jumped to record levels for all major sovereign debt issuers of the euro area. Just to take a few examples, Italy’s and Spain’s net bond issuance on the year has increased by, respectively, 3.5 and 4 times vs initial yearly targets, while among core countries Germany’s funding needs rose even higher, consistent with its huge fiscal stimulus. In a nutshell, 70% and 80% of overall gross and net EZ sovereign supply, respectively, estimated for all of 2020 was placed in the first seven months of the year, with the ECB to be supportive on the demand side due to its purchase programmes. Looking forward, the outlook for the euro area sovereign bond markets remains a positive one despite continued headwinds to growth and inflation as the demand/supply backdrop is likely to support the present environment of low and negative yields in core countries at the same time to support the periphery debt, despite the strong tightening in spreads delivered in the last months.

It may be fair to say that a vaccine would quickly undermine the case for QE which would imply a spillover onto nominal yields. A vaccine could be a game change: it could point to the direction towards the end of a perception that central bank balance sheets are on a perpetual expansion and so on. This perhaps is the beginning of the new narrative that a combination of a Biden fiscal stimulus and a vaccine as early as Q1 2021 would prompt the end of an era of low rates for ever. And this is my fourth verdict.

1. **US dollar post US elections**

Risk-on sentiment drove the US dollar lower against major currencies while the euro appreciated to a two-year high against the US dollar above $1.19, (see Figure). Expectations that Europe will recover faster from lockdowns than the US and the EU’s plan for a joint financial response to the virus supported the single currency. Looking ahead, the evolution of the pandemic and the US election uncertainty, may be weighing on the currency, so a move to 1.2 during the current period of USD weakness seems achievable before the euro comes under increased scrutiny from ECB policymakers.

**Figure: EUR-USD performance since July 2020**



*Source: Bloomberg.*

Let me focus a bit more on the big known unknown these days, namely dollar’s decline and future dynamics.

A fall in dollar usually is good news for trade and the global economy, but this time in the pandemic crisis, this might not be the case. This is so because of the obvious obstacles from the corona virus to global trade and other impediments hindering the ability of economies to adjust. Since last March the dollar in the FX market is losing popularity among investors and has fallen 10% against the euro.

The dollar is sensitive to global risk sentiment and in times of generalized uncertainty it assumes the role of a safe heaven. A long dollar position is a hedge against a risky portfolio.

It is true that an interest rate differential has supported the dollar over the past 10 years. Investors buy US Treasuries for their higher yields compared say to Europe denominated bonds. While the yield differential is still in the dollar’s favour, the difference has declined since March: just to give you one figure the spread between 10-year US Treasuries and German bunds of similar maturity has declined from 2.3 % at the start of the year to just 1% today. On top of that, Fed’s recent dovish monetary policy framework revision resulting in a higher inflation tolerance and the idea that base rates would remain close to zero until unemployment falls back to pre-pandemic levels, will contribute to a further dollar weakening.

Ι am coming now to two questions on the future dynamics of the dollar and make an attempt to provide sensible answers and hopefully during the Q&A we will hear your own views on this.

*Q1: What is the dollar’s outlook post-U.S. Presidential elections?*

*Q2: And in the medium term? Say in 5 years from now, is its status at risk as the only serious global reserve currency?*

Let me start with the second one, easier to answer.

On the future dollar dominance as a reserve currency, I would point out that, apart from the economics (share in global trade, FX reserves etc.), one should not underestimate the role of power politics in currency choice. In other words, the status of a reserve currency issuer as a financial, industrial and military powerhouse is central. Geopolitics do matter.

In other words, the global role of the dollar does not depend only on US exports, ratings, FDI etc. but is also affected by the geopolitical order it has built. Economic nationalism (“America first”) is the real threat to the future role of the dollar, not the euro.

If in post US elections an American-led reconstruction of global trade and order starts to develop, this would secure the dollar’s dominance for years to come. At the end, it’s politics over economics.

On the first question, and the dollar’s outlook post-US elections, I would start by saying that high fiscal deficits usually do have an impact on currencies. Since the start of the pandemic, budget deficits in most countries have increased. In the past, higher bond yields accompanied higher deficits but this time Central Bank asset purchases, negative base rates and forward guidance all deter any increase in yields.

The empirical relationship between the US yield curve and the dollar is as follows: the flatter the yield curve, the more negative this is for the dollar. Long-end yields do not matter much for the dollar, only front-end and base rates do.

In a nutshell, fiscal policy does matter for the dollar but the Fed is more important. Back in 2017 the Fed turned hawkish, crowding out the Trump fiscal stimulus, and pushed the dollar up. This time the Fed’s new average inflation targeting will keep the yield curve very flat and push front-end real yields as low as possible. This will be negative for the dollar. That is why a post COVID fiscal stimulus (a Biden one?) is going to be much more dollar negative than the Trump one.

A short digression may be in order here on Trump’s economic record. As his presidency nears the end of term, no matter what he did with tax cuts and deregulation, he will be remembered for his confrontational trade policies and a surge in protectionism. His growth record was an annual average of 2.5%, much lower than his early promises of 4%, while his claims that tax cuts would pay for themselves proved quite wrong (budget deficit rose from 4.4% to 6.3% of GDP). To his credit is a buoyant stock market and the fact that, before COVID-19, US unemployment was at its lowest level in 50 years. History, however, will likely give a poor grade to Trumpnomics, mainly because of his tariffs, a self-defeating policy to promote manufacturing, economic growth and prosperity.

From a global risk perspective, Biden is a much more risk-friendly candidate. This is so because:

a. of his credentials for multilateralism and a predictable foreign policy

b. of the faith in and support to international economic and military organizations

c. of a less disruptive trade policy

d. under Biden’s administration, especially a blue-wave one (Democratic control of both the House and Senate), one expects higher budget deficits and larger US fiscal and current account deficits which contribute to a weaker dollar.

There is a counter argument to that: for many analysts, an early vaccine, say by Q1 2021, is more important for global markets than the US elections since it affects every country in the world and is the ticket to normalization and to a solid recovery after the rebound. Growth matters to the markets, too.

1. Opening remarks at Market News International (MNI) Roundtable, held in London on the 13th October 2020. [↑](#footnote-ref-1)