IceCap
Asset Management Ltd.

THE POSSIBILITY OF A REVALUED USD:

Will the United States revalue the Dollar to be used as a foreign policy tool?

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DISCLAIMER

An investment in any strategy, including the strategy described herein, involves a high degree of risk. There is no guarantee that the investment objective will be achieved. Past performance of these strategies is not necessarily indicative of future results. There is the possibility of loss and all investment involves risk including the loss of principal.

In the financial world there is considerable debate on the outcome of the United States Dollar. Many investors feel that a combination of excessive debt, geopolitical tensions, and the Federal Reserve's actions will cause the USD to decline. Others feel that the USD will appreciate due to the world's financial system being completely dependent on the USD. In this paper we offer a third possible outcome—one that is hardly ever spoken about—that the USD might be revalued upwards.

A revalued USD would be one of the most significant financial events of our lifetime. It would cause significant volatility across markets and have a deteriorating effect on geopolitics. The USD being revalued upwards used to be viewed as almost unthinkable due to the previously mentioned reasons, however, the current economic and geopolitical environment leads us to believe that the possibility of the USD being revalued is no longer 0%. Because there is a chance of this happening, and because of the implications that this will have for markets, investors need to consider this possibility as a significant tail risk event.

To begin, we believe that the USD could be revalued upwards primarily for the following three reasons:

1. US-China political tensions are deteriorating.
2. The United States may elect to trigger a further deterioration in global trade to harm China.
3. The United States is beginning to better understand that the USD is one of the most powerful weapons in its foreign policy toolkit.

When reading the analysis below, some points may be perfectly logical while others may seem a little counterintuitive. Despite this, we believe that after reading this paper, investors will at least have to consider the possibility that an upwardly revalued USD will be used as a foreign policy tool against China should encroachments in Asia and other geopolitical issues continue. It is crucial to consider the effects that this will have on their portfolios.

THESIS FOR A RAPIDLY APPRECIATING USD

The first point to consider is that the USD is strengthening independently of US-China relations.

My colleagues Brent Johnson and Keith Dicker have covered the rationale for a strong USD in depth. Brent's brilliant Dollar Milkshake Theory is well known by many who run in Global Macro circles, and Keith Dicker has been speaking about USD strength quite extensively in the more recent editions of the IceCap Global Outlook. We encourage everyone to read their research and watch their presentations to understand the reasons why we believe that the USD is poised to break out.

To summarize their thesis, the USD as the global reserve currency enjoys many advantages that other currencies do not. Most the of the world's trade occurs in USD and there has been an explosion in USD borrowing throughout emerging and developed economies. As trade declines and the velocity of money remains at an all time low, this will create a supply and demand imbalance for USD, making it poised to rapidly appreciate. As economic conditions worsen, the world's central banks will look to utilize quantitative easing as a remedy, the liquidity from which will in turn flow into the United States as it is a safe haven for capital and controls the world's reserve currency.

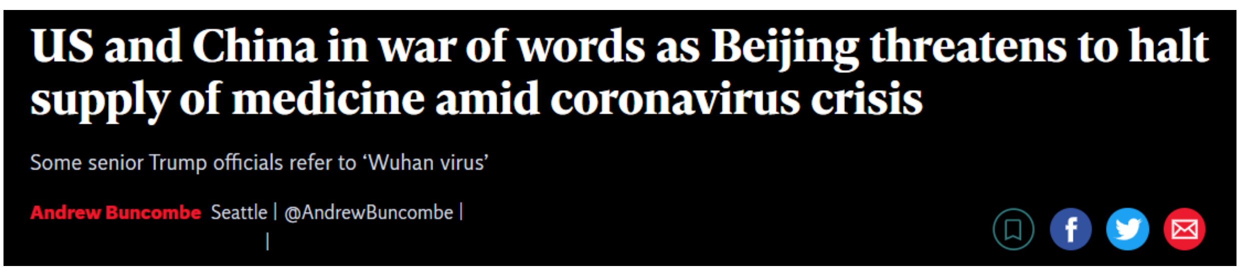
Many investors have noted that the DXY index (measuring a basket of primarily Euro, Yen, and other major currencies against the USD) has been largely flat and they might argue that there is no USD strength. We would counter by pointing out that the USD has already broken out against many emerging market currencies and suggest that the majors will have their time later. Also, remarkably, the flat DXY is happening while the Americans are implementing unprecedented fiscal stimulus and the Fed is printing money at unprecedented levels. Imagine what would happen if America simply stopped implementing policies that lend themselves to USD devaluation.

GEOPOLITICAL TENSIONS

The next point to consider is that US-China relations are the worst that they have been possibly since normalized relations began in the 1970s.

In the past couple of years alone there have been flare ups affecting US-China relations stemming from artificial islands in the South China Sea, Taiwan, and the Korean Peninsula. These issues focus primarily on military matters, and both sides clearly want to avoid a military conflict. The Chinese People's Liberation Army (PLA) is the largest military in the world in terms of enlisted personnel, and the United States military leads the rest of the world in military spending by far.[1] Both are nuclear-armed, and the militaries of both countries are simply too powerful to engage in an open conflict. The tensions between the two tend to be expressed in other ways, most notably economic and informational, leading both countries to behave as cold war adversaries.

The information war is well-known and has come to the forefront during the coronavirus pandemic. China has tightly controlled information in mainland China largely through the "great firewall".[2] The United States has placed the blame for the coronavirus largely on China, causing China to retaliate. Cyber warfare has also become more prominent in recent years. Both sides keep accusing each other of human rights violations and tend to stoke unrest in each other's geopolitical spheres of influence.



US and China in war of words as Beijing threatens to halt supply of medicine amid coronavirus crisis

Some senior Trump officials refer to 'Wuhan virus'

Andrew Buncombe Seattle | @AndrewBuncombe |

Figure 1. US-China tension is escalating. Source: Independent U.K.

Economics has become one of the main battlegrounds between China and the United States. Major issues surrounding the economic cold war between the two countries are as follows:

1. Trade. A continuing trade war between the countries has been a major theme in international news headlines, with tit-for-tat tariffs and sanctions. Although the trade war eased since its peak in 2019, many tariffs remain in place today. The coronavirus has also awakened the U.S. to their dependence on China for essential goods such as medicine and personal protective equipment

[1] Source: Armedforces.eu
[2] Source: The Financial Times

(PPE). This will be a powerful motivator for the U.S. to bring many of these industries back to the United States.

2. Intellectual property. China has been stealing intellectual property for many years now. This is well documented and has cost United States' companies billions of dollars.
3. The value of the Renminbi (RMB). China's currency otherwise known as the Yuan, a pegged currency, has allowed them to have massive trade surpluses with the United States.

The global pandemic has put further strain on US-China relations, with each side blaming the other for the crisis.

Figure 2. Donald Trump's frustration with China. Source: Twitter

When evaluating the state of US-China relations, we also need to consider the effect of the November 2020 presidential election. We can clearly evaluate the current administration's stance towards China in real time, especially in their reaction to the developing crisis in Hong Kong. Should Donald Trump win re-election, this will likely continue. If the Democrats win the election in November, we have no reason to believe that their stance against China will be any less soft. After all, a major sticking point between the United States and China under the Obama presidency, in which Democratic presidential nominee Joe Biden served as Vice President, was the sale of arms to Taiwan.

FURTHER DETERIORATION OF TRADE AND HOW CHINA IS AFFECTED

The coronavirus has already done quite a number on global trade with the WTO estimating that global trade may fall between 13% and 32% in 2020.[3] Deteriorating US-China relations will also cause trade to decline, especially if both countries which are the world's two largest economies, further engage in tit-for-tat tariffs. This has been used extensively by both the United States and China, the trade war of 2019 being fresh in the minds of many investors.

[3]Source: WTO

A significantly stronger USD would result in overall slower global economic growth. This is because an estimated over 60% of global trade is conducted in USD and its revaluation would make goods more expensive for most in the global economy.[4] It will also drive liquidity to the United States and away from other economies, especially emerging markets including China. A strong USD also results in less USD to be in the system as companies and governments scramble to source USD wherever possible to service USD denominated debt or invest in USD denominated assets in the United States.

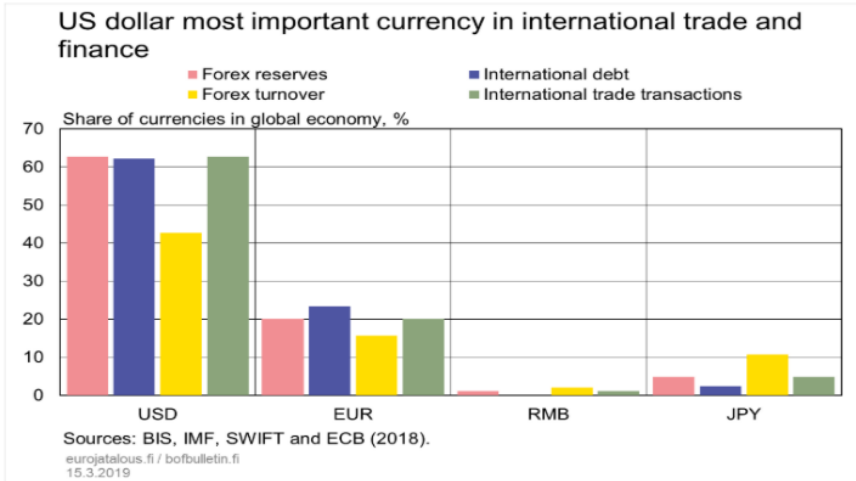


Figure 3. USD's dominance in global trade. Source: The Bank of Finland Bulletin

It is important to remember that China's economy is largely based on trade. This requires the ability to move USD freely throughout the global economy to settle transactions, pay interest, and access markets. A strong USD would not be good for this system. If the value of the USD becomes too high, access to USD will become increasingly limited as foreign governments scramble to acquire available USD wherever they can find them. If access to USD tightens, then trade deals settled in USD will become less feasible. China's customers will find goods to be unaffordable in USD while still being reluctant to trade in RMB, and trade will grind to halt, largely eroding Chinese economic competitive advantage. Also, China imports many raw materials such as oil, base metals, steel, etc., used in manufacturing. These are bought and paid for in international commodity markets, all of which are settled in USD.

The Communist Party of China's (CPC) ability to control the country is a much easier task to do while economic times are good. 2020 is also a big year for China, considering it is the culmination of the country's 13th five-year plan. A slump in global trade and demand not only makes the five-year plan goals unattainable, but it could lead to layoffs and unemployment. If layoffs happen due to a reduction in trade, then social unrest will likely follow. Civil unrest in Xinjiang province and Tibet are well documented, and pro-democracy protests have increased over the past few decades. This is something that the CPC is concerned about and trying to avoid at all costs. Washington understands this. They also understand that China is experiencing significant economic strain due to large scale borrowing in the past 10 years, and from fallout due to the coronavirus pandemic.

THE WEAPONIZATION OF THE USD

The United States has a history of using economics as a tool for foreign policy. This is typically done by denying access to the global payments system, as has most notably been done with Iran and North Korea. Other tools being used are, of course, tariffs and trade barriers which have been discussed in the section

[4] The Bank of Finland Bulletin

above. Washington is also looking into denying Chinese companies access to the U.S. capital markets and sanctioning key individuals within the Communist Party of China (CPC).

A less thought of method of economic warfare is to allow the USD to rapidly appreciate. This might seem counterintuitive considering that China holds large USD reserves, sells goods in USD, pays workers in RMB, and the fact that fixed rate RMB has been a major sticking point in US-China relations. Despite this, a rapidly appreciating USD could in fact be awfully bad for China.

Washington is beginning to wake up to using a strong USD as a viable tactic. While President Trump has previously stated his preference for a weaker USD, he has recently been coming around to the idea that a strong USD would be "an overall good thing", while conceding that some industries may suffer.[5] Senior economic advisor Larry Kudlow has also expressed his preference for a strong USD[6] and former Trump advisor Steve Bannon, who is rumoured to be gaining influence inside the Whitehouse again, recently stated his preference for a strong weaponized USD targeted at China, in an interview with The Wire China.[7]

China is keenly aware of their exposure to a strong USD. They have been trying to reduce their reliance on the USD as the world's global reserve currency for years but there are simply no viable alternatives. The viability of the Euro to continue as a currency is seriously in question. Japan has been experiencing more than twenty years of economic malaise which has made the Yen an unattractive option. International markets do not trust the fixed rate, tightly controlled RMB. One of the primary features of the USD as the world's reserve currency is its deep, liquid, broadly traded U.S. Treasury market. China's debt market has none of these features. And as long as China has an open current account and a closed capital account, foreign capital will never see RMB as an alternative to the USD. Even if the rest of the world agreed that that the USD system should change, it would take a remarkable amount of political will, consensus, economic pain, and many years to develop a new system. There is simply no other option in place.

China is also aware of the risk of a stronger USD. They are trying to squeeze as much USD out of developing countries as possible through the Belt and Road Initiative. They are also trying to gain access to as much USD as possible through access to foreign markets via Hong Kong while it still enjoys its preferred trading status. At the same time, China is trying to reduce USD expenses by setting up RMB traded commodities futures.[8] They are also exploring ways to engage in currency warfare of their own, as China holds over one Trillion USD in U.S. Treasuries, only in this case it would be to devalue the Dollar. This was considered to be a major risk during the summer of 2019.

HOW THE USD WOULD BE REVALUED

Washington has a couple of options to accomplish this.

The first option is to sell USD assets, taking USD out of the market and contributing to the supply and demand imbalance. This is also a well-known economic principle.

[5] Source: Bloomberg News
[6] Source: CNBC
[7] Source: The Wire China
[8] Source: South China Morning Post

The second option is for the U.S. Federal Reserve to reduce or stop completely the swap lines currently available to foreign central banks. This action will reduce the supply and availability of USD in international markets thereby causing USD to appreciate relative to other currencies.

The next, and perhaps more interesting option, would be to simply jawbone the USD higher. While this seems a little crude, let us set the stage a little bit to give you a sense of how this might be done.

A press conference with Steven Mnuchin, Larry Kudlow, and Donald Trump would be called. They all come out, sit down in front of their microphones, and state that they believe that the USD is undervalued by X%. This statement will, of course, include all the economic jargon and pageantry you would expect from that kind of an announcement.

The method that Washington chooses to jawbone the USD higher is largely irrelevant. There are numerous ways that the President and his administration would be able to get this message out. If Washington states that they believe the USD should be revalued higher and that they are willing to take actions to increase the value of the USD, markets are certain to react.

It is also worth noting that Washington can do this completely independently. While the move will be certain to ruffle feathers with other U.S. institutions, and with America's allies and enemies alike, it is undebatable that America has the geopolitical clout to force this action through. After all, they control who gets swap lines and who does not.

Sounds impossible? What if we told you a similar process has been done before—and not that long ago? In 1985 the leaders of the G-5 (U.S., U.K., France, West Germany, and Japan) met at the Plaza Hotel in New York to devalue the Dollar. All the leaders agreed wherever possible to push down the value of the Dollar, and it worked. The Dollar fell by 50% against the Yen and the Deutschmark.

While it is true that the Plaza Accord was put in place to devalue the Dollar, it is easy to imagine a similar process to revalue the Dollar upwards. This was also done—on a lesser a scale and much less famously—in 1987 with the Louvre Accord which was designed to stop the falling value of the Dollar.

BUT ISN'T A STRONG USD BAD FOR AMERICA?

The short answer to this question is… it is complicated, it is relative, and it is all about trade-offs. A slowdown in global trade is generally bad for most countries. It reduces economic activity and acts as a disincentive to buy goods in USD, which is how most global trade is settled. This makes the United States' manufacturing sector less competitive. While it is true that exporters, U.S. companies operating abroad, and tourism will be hurt, other key economic sectors will benefit.

Anyone who has spent any time at all watching market news knows one thing: The consumer is the key to, and the saviour of, the U.S. economy. A strong USD will increase the purchasing power of consumers thus helping to ease the burden of the fallout from the coronavirus. Imports will become cheaper and thereby bolster U.S. consumer spending while harming the most important Chinese sector (manufacturing and trade).

We also need to remember that this action would take place in an environment of heightened geopolitical tensions. We have already demonstrated that America and China are behaving as cold war adversaries. If this cold war heats up and America adopts a more aggressive stance towards China, it will be more willing to suffer the effects of a strong USD. After all, it controls the global reserve currency, and when times get tough it will be able to take comfort in the knowledge that it will be the last one standing.

If you subscribe to the idea that a strong USD is good for America, that's great. We are done. Feel free to skip to the next section of the paper for ideas on how to position your portfolio. If you think a strong USD is bad for the U.S., then consider this question: How much economic pain is the U.S. willing to go through to achieve its geopolitical aims regarding China? Remember, it is a relative game and a strong USD likely hurts the Chinese much more than it will hurt the Americans.

WHO LOSES?

A strong USD is bad for most in the global economy. This section will just deal with the most obvious. This paper argues not that China and the U.S. are heading into an economic cold war, but rather that they have been there for a while now and the war really is not that cold. This economic war will only escalate along with geopolitical tensions. Just as with an open military conflict, there will inevitably be collateral damage. In today's highly globalized economy no one will be unaffected by a strong USD and tensions between the U.S. and China, however there are some who will feel the pain more than others. The most obvious casualties are discussed below.

CHINA

The most obvious loser would be the target of the USD upward revaluation—China. As an emerging market economy, China and Chinese companies have used considerable USD denominated debt to fuel growth throughout the last decade. They are certain to feel the strain of increased borrowing costs. China will also be harmed due a strong USD's effect on global trade, harming the crucial economic sectors of manufacturing and exports. IceCap continues to have zero exposure to China.

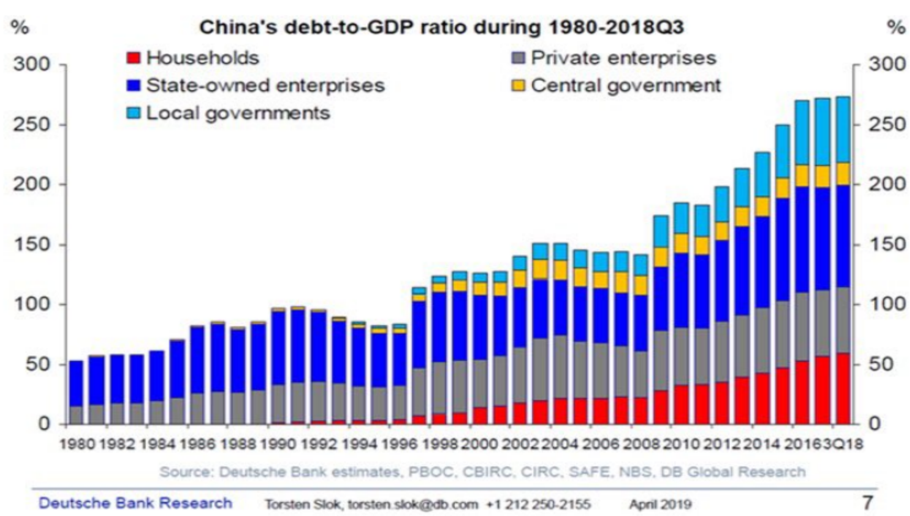


Figure 4. Rapidly escalating Chinese debt levels. Source: Deutsche Bank

EMERGING MARKETS

Emerging markets will also experience significant stress. Many of these countries have borrowed extensively in USD and will struggle to source higher value USD to service their debt. Also, many EM economies rely on cheap labour costs giving them an edge in manufacturing and export sectors. This creates a compounded effect whereby debt servicing costs will increase dramatically while USD flowing into emerging markets will be reduced due to a drop in global trade and due to a flight to safety away from emerging markets and into the U.S. markets. IceCap is avoiding emerging market debt and equity for our long-only portfolios. This move has worked out quite well during the recent market turmoil and has helped us protect investor capital.

HONG KONG AND THE DOLLAR PEG

The Hong Kong Dollar peg was established in 1983 at the rate of $7.8 HKD for every $1 USD and is allowed to trade between $7.75 and $7.85. Its purpose was to restore order to markets and the economy which were in turmoil caused by talks between the U.K. and China regarding the handover of Hong Kong. It has been in place ever since, notably surviving an attack on it by George Soros during the Asian Currency Crisis.

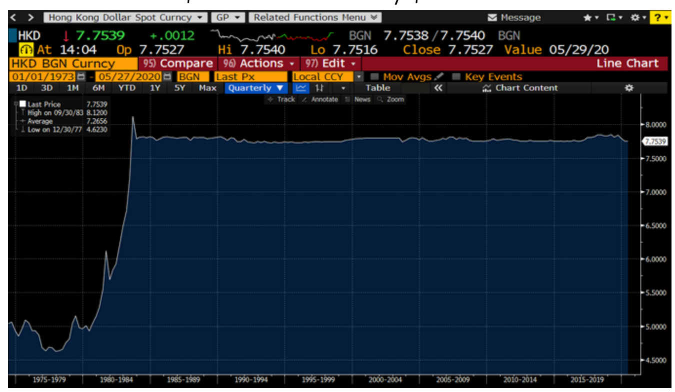


Figure 5: The Hong Kong Dollar peg. Source: Bloomberg

The peg is maintained by Hong Kong's de facto central bank, The Hong Kong Monetary Authority (HKMA). To maintain the peg, the HKMA buys and sells HKD and USD when the exchange rate approaches either end of the target range. As of April 2020, the HKMA has $441.2 Billion in foreign reserves to defend its currency.[9]

It can be argued that the stresses of today will prove much more difficult for the HKMA to manage than the 1998 peg attack from George Soros. Factors that might cause the peg to break are as follows:

1. A strong USD—due to independent factors as well as the possibility of Washington upwardly revaluing the USD as a foreign policy tool.
2. Hong Kong's position on a geopolitical fault line between the U.S. and China. On May 22, 2020, the United States removed Hong Kong's preferential treatment as a separate customs and travel territory from China. At the time of writing of this paper, the U.S. is considering revoking Hong Kong's special trade status.

[9] Source: The Standard

3. Vulnerability of key economic sectors comprising the majority of Hong Kong's economy:
    a. Financial services. This sector is threatened by competition from Shenzhen, Shanghai, and Singapore, and the loss of preferred status by the United States. Chinese encroachment could erode legal and economic structures that give Hong Kong a competitive advantage.
    b. Trading and logistics. This sector is vulnerable to a trade war between China and the United States, and a decline in global trade in general.
    c. Real estate. The world's most expensive housing market is exposed to capital flight from expatriates fleeing political turmoil and wealthy Hong Kong citizens trying to get their money out.

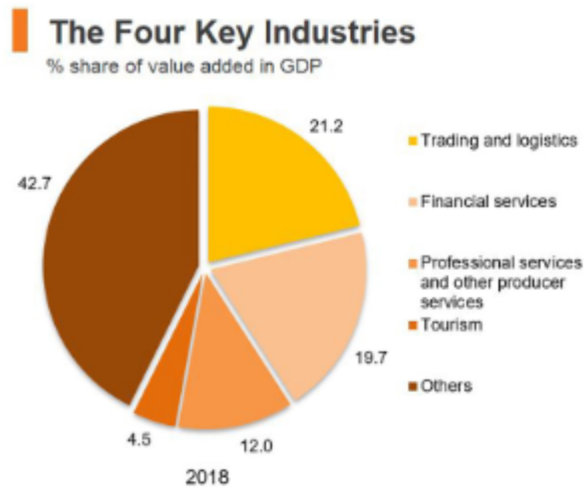


Figure 6: Hong Kong's exposure to vulnerable sectors.
Source: Hong Kong Trade Development Council

    d. Tourism. A combination of the coronavirus and political tensions will have a massive impact on this sector.
4. Highly levered banking system. Hong Kong's banking sector is one of the most levered in the world and, when considering the other stresses that Hong Kong will be facing, makes it vulnerable to a collapse.
5. Increasing Chinese encroachment on the city's governance. The British-style legal system along with an emphasis on economic freedom allowed Hong Kong to flourish. A communist Chinese government exerting increased control over the region erodes this competitive advantage.
6. People fleeing. Many Hong Kong citizens are dual passport holders and may choose to join other Hong Kong communities in cities like Sydney and Vancouver rather than live under communist Chinese rule, similarly to how many Hongkongers fled the city in the 1990s. The city is also famous for its large expat community, many of whom will be scared off by the treatment of detained foreign citizens Michael Kovrig and Michael Spavor, especially if there is reduced protection from Hong Kong's legal system. When people leave, they tend to take their money with them.
7. Capital fleeing. The reasons listed above, along with others noted on the earlier pages of this paper, are ample reasons for people in Hong Kong to want to get their money out. If there is even a hint that capital controls will be imposed on the city, people will be scrambling.

At IceCap, we believe that this is one of the greatest asymmetric risk-reward opportunities in the world today. For our long-only portfolios, we have zero direct exposure to Hong Kong, China, and emerging markets. For accredited investors, we have other opportunities.

CONCLUSION

Our view on the USD is well-documented and we at IceCap have been shouting from the rooftops about our bullishness on the USD for a while now. While there are numerous reasons to hold this view, one that does not get a lot of attention is an intentionally upwardly revalued USD used as a foreign policy tool. America has demonstrated a willingness to engage in economic warfare and has the tools, justification, and the will to implement this policy. A strong USD would harm China due to a reduction in global trade. This will have knock-on effects in global markets. The most obvious victims of this policy would be China, emerging markets, and Hong Kong.

IceCap remains positioned to protect investor capital and benefit from a surging USD. In our long only portfolios, we have zero exposure to emerging market equities and credit, while taking positions that appreciate along with the USD. This strategy has proved to be incredibly successful, allowing us to effectively protect investors' capital during the market downturn in February and March.

For accredited investors, fiduciaries, and qualified eligible persons, we have other opportunities. If you are one of the previously mentioned people and would like to know more about how IceCap is positioned to benefit from our investment thesis, please reach out to us directly.

ABOUT THE AUTHOR

Keith Oland joined the IceCap team as a Global Strategist in 2020. He has experience in Global Banking and Markets with Scotiabank and is currently pursuing a CFA designation as well as a CPA designation. Keith graduated Summa Cum Laude from Saint Mary's University in 2014 with a double major in Finance and Accounting, and a Certificate in Financial Instrument Analysis. Keith also spent two years at Carleton University in Ottawa studying Political Science, Law, Economics, and Geopolitics. While at Saint Mary's, he acted as a Research Analyst and Energy Sector Portfolio Manager with the IMPACT Fund. Always passionate about education, he has worked as a tutor for the Athletics Departments of Dalhousie and Saint Mary's Universities, been a Student Ambassador for the TMX Group's Montréal Exchange promoting financial literacy with a focus on derivatives, and spent a year teaching in Korea.

Keith is an avid adventurer who has travelled to 73 countries and is always on the lookout for experiences outdoors, ranging from skiing in the Rockies to trekking in the Himalayas. While in Nova Scotia, his home province, Keith loves playing hockey, hiking, golfing, and sailing.

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