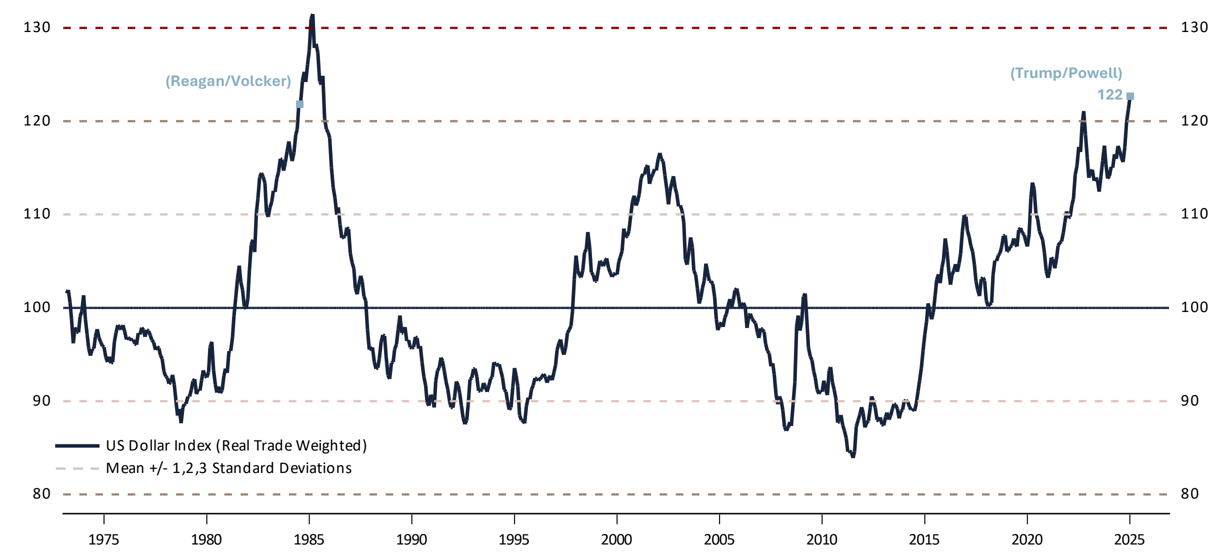
weekly investment focus

The flexiweekly that reaches new heights - published on 24 February 2025

"I KNOW WHAT YOU DID IN SUMMER 1984"

- In the United States, growth and inflation are stronger than in the rest of the world
- Nevertheless, the fiscal deficit is one of the largest
- Interest rates are therefore higher, attracting foreign capital
- As in the days of Reagan and Volcker, there's every reason for the dollar to soar

CHART OF THE WEEK: "In 97% of cases, the dollar is cheaper than it is today"



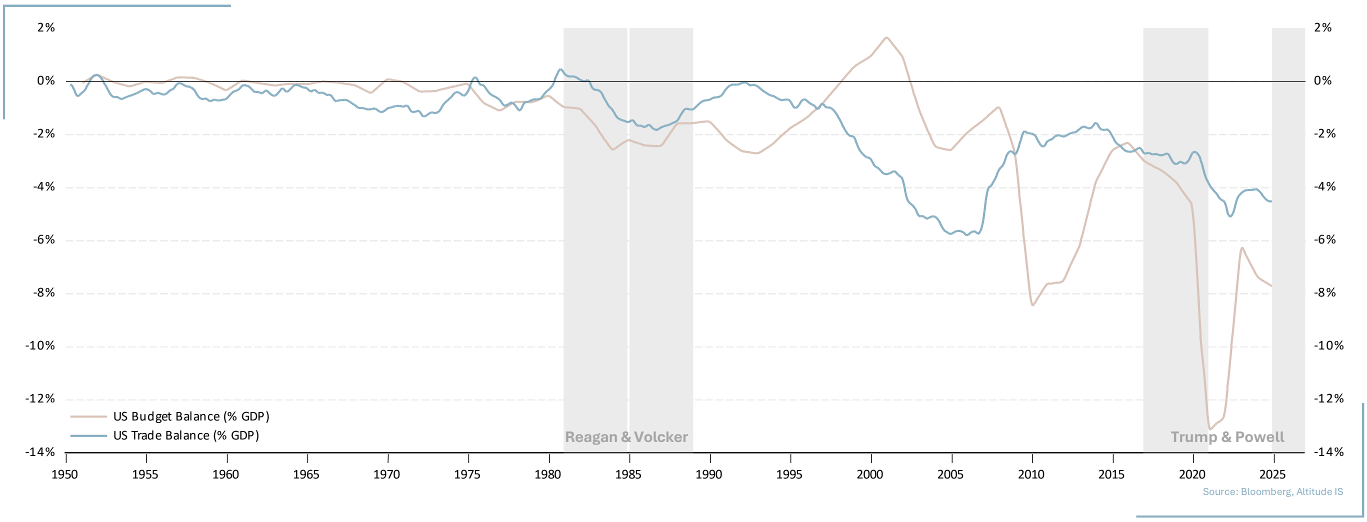
Source: Bloomberg, Altitude IS

FOREX MARKET ANALYSIS

When investors talk about financial bubbles, they are usually referring to equities, and preferably US stocks, whose valuations are in the process of breaking all-time records. Far fewer look at the speculative bubble that is forming around the dollar, either to worry about it or to profit from it. According to Fed calculations, the greenback is currently overvalued by 22% (see Chart of the Week). The dollar's real effective exchange rate, measured as a weighted index of bilateral exchange rates adjusted for inflation differentials, is more than two standard deviations from its fair value. In fact, **the one and only time the dollar has become this 'expensive' was in the summer of 1984.**

At the time, Ronald Reagan was about to be re-elected thanks to a veritable electoral tidal wave. A former B-movie actor and the oldest president in the country's history, he campaigned **under the slogan "Let's Make America Great Again".** The "Reaganomics", introduced in 1981, were popular at the time: tax cuts, deregulation, increased military expenditures and cuts in other public spending. The aim of this fiscal policy was to stimulate private investment and accelerate growth by reducing the tax burden on businesses and households. The economic and financial disruptions that the Reaganomics would generate were not yet visible: deindustrialisation, widening inequalities and, above all, the creation of major budget and trade deficits (see Fig. 2). Worse still, the resulting global imbalances would successively encourage: the dollar to soar, although the Plaza Accords of 1985 were to bring it down, the repatriation of vast amounts of Japanese capital, the stock market crash of 1987, and then the bursting of the Japanese bubble in 1990.

Fig. 2 - Twin deficits in the United States



In the specific case of the dollar, the logic was as follows:

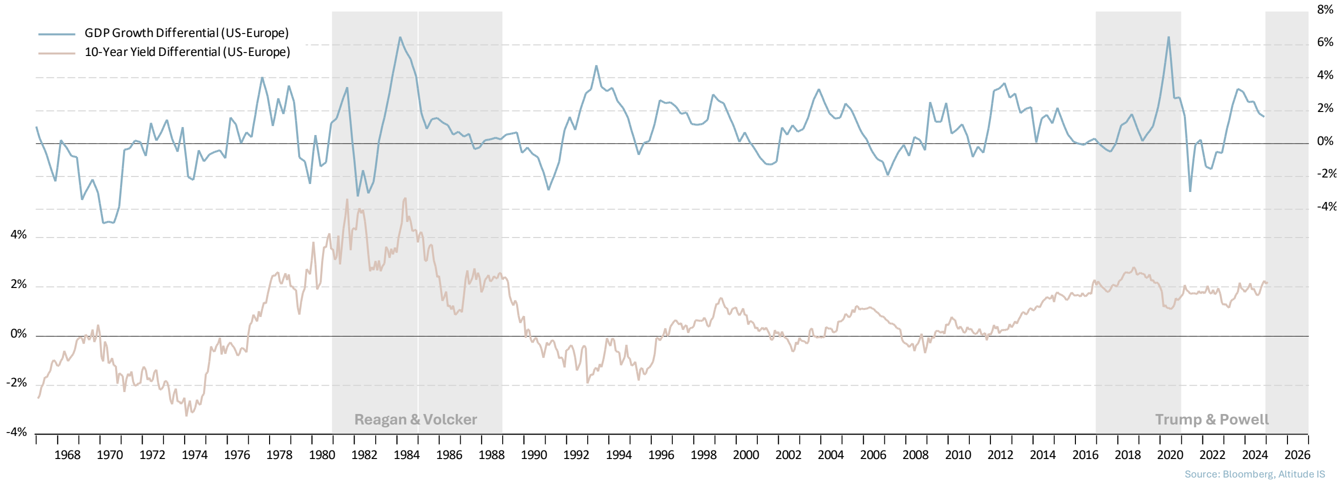
- The expansionary fiscal policy of the US administration, marked by an increase in public spending and a reduction in taxes, contributed to widening deficits. Government commitments, particularly in defence and social programmes, far exceeded tax revenues. To finance the growing debt, the US administration had to issue ever larger quantities of Treasury bills, flooding the markets with government debt securities. This imbalance between supply and demand encouraged investors to demand higher yields. This rise in interest rates made the cost of borrowing higher for the State and the private sector. This led to a downward spiral in which rising debt necessitated ever greater issuance, further amplifying the rise in interest rates and the appreciation of the dollar.

- The restrictive monetary policy adopted by the Federal Reserve also played a decisive role. Since the early 1980s, under the leadership of Paul Volcker, the US central bank had been trying to curb the inflation inherited from the oil shocks of 1973 and 1979. To achieve this objective, the Fed adopted a strategy of high interest rates. In 1984, interest rates on 10-year Treasury bonds exceeded 13%, a particularly attractive level for investors from all over the world (see Fig. 3). To buy these bonds, investors had to convert their national currencies into dollars, which helped to increase demand for the US currency and, consequently, its appreciation.

- The dynamism of economic growth in the United States was already contrasting with the gloomier situation in the other major developed economies, notably Europe (see Fig. 3) and Japan, where growth was moderate. Faced with this economic divergence, international capital flowed into the United States, contributing to the appreciation of the dollar

- <u>Speculation reached fever pitch</u>. In the early days of 1985, a few days after being sworn in for the second time, President Reagan declared that the rise in the dollar simply reflected "the strength of the American economy" (and confidence in the President). He added that the idea of central bank intervention was totally out of the question. This speech heightened speculative fever among currency traders. In twelve trading sessions, the dollar appreciated by 7.5%, taking its annual rise to 37%.

Fig. 3 - Growth and interest rate surplus/deficit in the United States

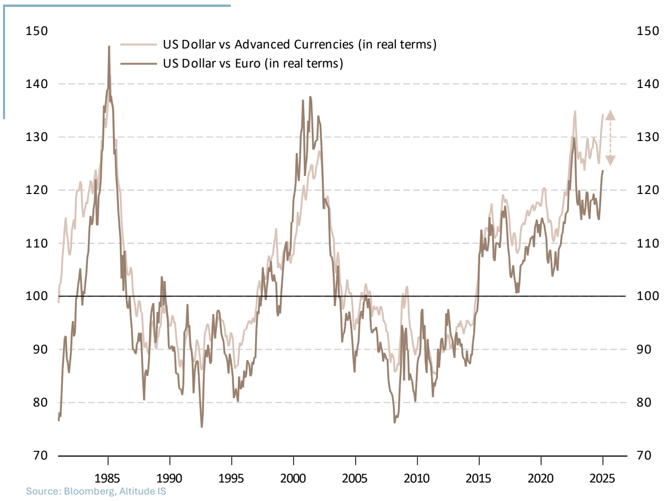


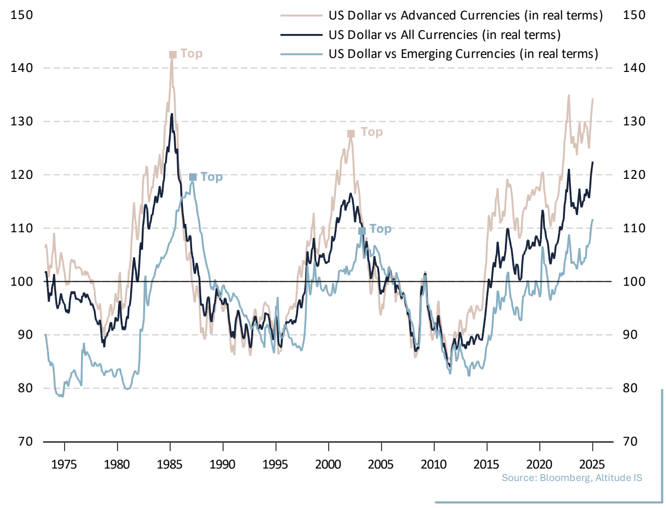
To put an end to the dollar's overvaluation, the world's five richest countries (the United States, Japan, France, Germany and the United Kingdom) **will have to agree** to a concerted rebalancing of parities, in other words, a sharp depreciation of the dollar. For the record, the central banks did not wait for the signing of the Plaza Accord on 22 September 1985 to intervene and sell dollars on a massive scale. Seven months earlier, on 26 February 1985, Paul Volcker justified the powerful intervention by the US central bank (which Reagan had ruled out a month earlier) by stipulating that the Fed would not intervene at all... except in the case of "disorderly markets". The greenback peaked that day. It traded briefly against 1.05 pounds sterling, 3.44 deutsche marks, 10.61 French francs and 263 yens. It would never again return to these levels, but it would take three weeks for traders to give up speculating on the dollar's rise and cut their losses. **To reproduce such a level of overvaluation, all other things being equal, the dollar would have to appreciate by a further 10% compared with the current rate,** i.e. an exchange rate between the euro and the dollar of 0.93, for example.

Comparison is not reason enough, but sometimes history repeats itself. The economic policy being implemented by "Donald in 2025" bears some similarities to that pursued by "Ronald in 1985", particularly in terms of budgetary and trade decisions. While President Reagan did not impose tariffs, he did impose quotas on Japanese car imports to protect American industry. At the same time, like Paul Volcker, Jerome Powell is applying a restrictive monetary policy, with high interest rates, insisting on the need to keep inflation under control. **Once again, the attractiveness of US assets is fuelling the inflow of foreign capital and accentuating the dollar's appreciation well beyond its fundamentals.**

The economic consequences are likely to be severe in every corner of the world. The United States could see its trade deficit widen further, despite the introduction of customs duties, against countries with weaker currencies. Europe and Japan could find it increasingly difficult to sell their debt where relatively low yields appear less attractive, which would accentuate their financial fragility. Emerging countries that have borrowed in dollars will have to bear a higher cost of servicing their debt. The weakest among them could find themselves in a critical situation, with repayments becoming unsustainable. **It remains to be seen whether,** as in 1985 with the Plaza Accords**, international intervention will be necessary to reverse the trend.**

Fig. 4 & 5 - Dollar exchange rate (adjusted for inflation)





There are several options open to investors:

- Those with a short investment horizon and who believe that the peak of 26 February 1985 can be reached will certainly choose to buy dollars in an attempt to capture the remaining 10% of appreciation. They will be joined by those who are sceptical about the comparison, since the depreciation of the British pound after Brexit and the structural devaluation of the yen since Japan began monetising its debt have – it is true – created an analytical bias (see Fig. 4).

- Those with a longer-term view will opt for a mean-reversion strategy, selling their dollars to buy other currencies. If they observe how, in 1985 and again in 2001 when the internet bubble burst, the 'major' currencies appreciated 14 and 23 months before the emerging currencies (see Fig. 5), they will once again favour the currencies of the developed countries. **Those with the strongest fundamentals will fare better: the Swiss franc, sterling, the Singapore dollar... and gold.**

Fig. 6 – EM relative performance vs dollar

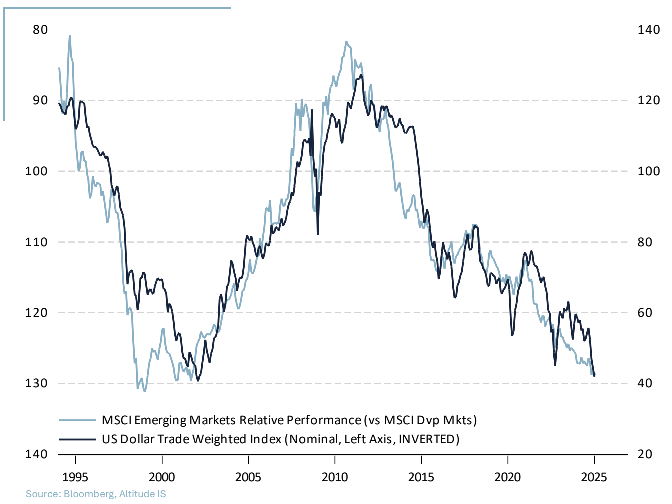
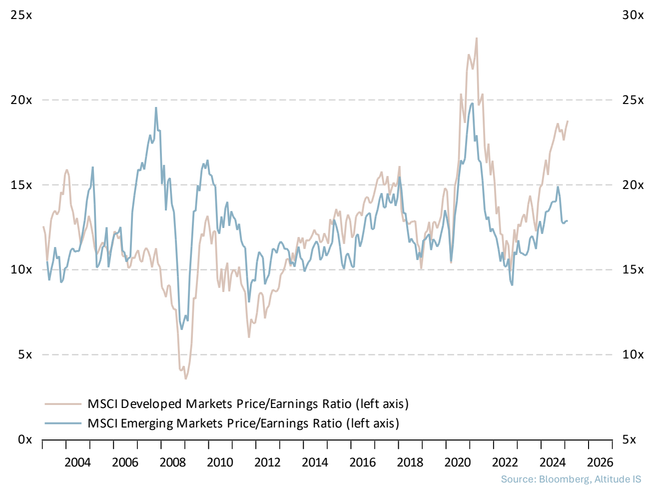


Fig. 7 - Valuation ratios: EM vs DM



- Those who prefer equity markets will benefit from the historical correlation between the relative performance of emerging markets and movements in the dollar (see Fig. 6). After several years of disappointing performance, emerging markets, and more specifically China, appear to be on the verge of a historic rebound. Factors other than a weak dollar are supporting this trend reversal: economic recovery, controlled inflation, attractive valuations (see Fig. 7) and favourable technical indicators. Of course, there is a risk of a false start, but missing the first wave of outperformance often proves costly, as it is the most lucrative.

- On a less serious note, for music lovers, the best-selling single in 1984 was Prince's "When Doves Cry". He gave way to George Michael's "Careless Whisper" in 1985. In 2024, the best-selling single was Teddy Swims' "Lose Control". At the start of 2025, "Die With a Smile" by Lady Gaga & Bruno Mars tops the chart. In both eras, it seems hard to escape the tragedy of fate. Let's just accept the inevitable.

Conclusion:

The dollar is appreciating for very similar reasons to 1984. There is nothing to suggest that this excess will disappear immediately: there is still a 3% probability that the greenback will appreciate by a further 10%. Donald Trump's fiscal and trade policies, like Jerome Powell's monetary policy, will continue to attract capital flows to the United States.

On the other hand, the more traders pull on the rubber band, the more its resistance will increase and the faster it will return to its natural equilibrium position. Investors need to choose their investment horizon carefully, because the losers of the summer of 1984 were the big winners of the spring of 1985.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2025 Year-to-Date (%)	2024 (%)	2023 (%)
Equities							
World (MSCI)	874.5	52.43	-1.1%	1.3%	4.1%	18.0%	22.8%
USA (S&P 500)	6 013	46.09	-1.6%	-0.5%	2.4%	25.0%	26.3%
USA (Dow Jones)	43 428	39.14	-2.5%	-1.2%	2.3%	15.0%	16.2%
USA (Nasdaq)	19 524	45.46	-2.5%	-1.1%	1.2%	29.6%	44.7%
Euro Area (DJ EuroStoxx)	558.3	67.84	-0.3%	5.6%	10.8%	10.2%	19.5%
UK (FTSE 100)	8 659	54.19	-0.6%	1.6%	6.3%	9.6%	7.7%
Switzerland (SMI)	12 949	71.87	0.8%	6.9%	11.6%	7.5%	7.1%
Japan (Nikkei)	38 777	45.34	-1.0%	-0.6%	-2.8%	21.3%	31.0%
Emerging (MSCI)	1 147	73.44	2.0%	6.2%	6.9%	8.0%	10.2%
Brasil (IBOVESPA)	127 128	56.19	-0.9%	3.1%	5.7%	-10.4%	22.3%
Mexico (IPC)	53 739	62.51	-0.6%	6.5%	8.6%	-11.0%	22.4%
India (SENSEX)	74 566	34.57	-0.8%	-0.6%	-3.4%	9.6%	20.3%
China (CSI)	3 970	62.90	1.0%	3.9%	1.3%	18.2%	-9.1%
Com. Services (MSCI World)	133.5	51.83	-2.4%	4.3%	6.9%	31.9%	38.1%
Cons. Discretionary (MSCI World)	428.5	43.82	-2.7%	-1.2%	1.6%	20.7%	29.5%
Cons. Staples (MSCI World)	286.1	67.19	0.6%	5.7%	5.0%	4.7%	3.2%
Energy (MSCI World)	251.0	50.49	0.2%	-1.7%	5.1%	2.9%	6.0%
Financials (MSCI World)	190.9	53.81	-1.2%	2.3%	6.4%	25.1%	16.4%
Health Care (MSCI World)	370.5	59.32	1.3%	3.3%	6.3%	1.5%	4.1%
Industrials (MSCI World)	391.5	48.83	-1.0%	-0.6%	4.1%	12.8%	22.5%
Info. Tech. (MSCI World)	779.4	50.07	-1.5%	0.3%	1.4%	31.9%	51.4%
Materials (MSCI World)	326.6	56.06	-1.2%	1.8%	6.8%	-7.7%	12.6%
Real Estate (MSCI World)	983	57.79	0.1%	1.4%	3.3%	-0.4%	5.3%
Utilities (MSCI World)	167.0	62.89	1.3%	0.8%	4.3%	12.9%	1.6%
Bonds (Bloomberg)							
World (Aggregate)	3.65%	60.82	0.1%	1.3%	1.6%	-1.7%	5.7%
USA (Sovereign)	4.36%	61.87	0.3%	1.1%	1.3%	0.6%	4.1%
Euro Area (Sovereign)	2.77%	51.93	-0.3%	0.6%	0.0%	1.9%	7.1%
Germany (Sovereign)	2.30%	51.95	-0.2%	0.6%	-0.4%	0.6%	5.6%
UK (Sovereign)	4.54%	51.34	-0.5%	0.6%	0.7%	-3.0%	5.6%
Switzerland (Sovereign)	0.70%	28.51	-0.8%	-1.3%	-1.8%	5.4%	7.9%
Japan (Sovereign)	1.20%	24.08	-0.4%	-1.5%	-2.0%	-2.1%	0.9%
Emerging (Sovereign)	6.86%	59.91	-0.1%	1.1%	1.9%	7.0%	11.0%
USA (IG Corp.)	5.22%	61.63	0.3%	1.3%	1.5%	2.1%	8.5%
Euro Area (IG Corp.)	3.11%	61.25	0.2%	1.2%	0.8%	4.7%	8.2%
Emerging (IG Corp.)	6.44%	76.28	0.3%	1.4%	1.9%	7.0%	6.7%
USA (HY Corp.)	7.23%	63.80	0.0%	0.5%	1.6%	8.2%	13.4%
Euro Area (HY Corp.)	5.86%	80.74	0.1%	1.3%	1.5%	8.2%	12.1%
Emerging (HY Corp.)	8.28%	62.60	-0.1%	0.9%	2.1%	14.9%	13.1%
World (Convertibles)	455.2	51.73	-1.1%	0.5%	3.4%	9.4%	12.3%
USA (Convertibles)	615.2	47.06	-1.6%	-0.5%	2.8%	10.1%	14.6%
Euro Area (Convertibles)	245.2	62.91	-0.1%	3.7%	5.4%	14.7%	7.3%
Switzerland (Convertibles)	248.7	54.48	-0.1%	2.0%	3.3%	-10.5%	5.8%
Japan (Convertibles)	228.7	65.17	0.7%	2.2%	0.9%	6.4%	7.6%
Hedge Funds (Bloomberg)							
Hedge Funds Industry	1 634	81.98	n.a.	1.5%	1.5%	11.1%	7.8%
Macro	1 360	68.42	n.a.	1.4%	1.4%	7.3%	1.6%
Equity Long Only	2 217	70.35	n.a.	0.0%	0.0%	12.3%	15.9%
Equity Long/Short	1 709	80.41	n.a.	1.9%	1.9%	14.0%	7.7%
Event Driven	1 739	74.50	n.a.	0.9%	0.9%	8.6%	7.3%
Fundamental Equity Mkt Neutral	1 659	95.49	n.a.	0.6%	0.6%	12.2%	6.6%
Quantitative Equity Mkt Neutral	1 705	88.84	n.a.	2.5%	2.5%	9.8%	7.8%
Credit	1 613	96.60	n.a.	1.0%	1.0%	8.5%	8.1%
Credit Long/Short	1 637	100.00	n.a.	0.5%	0.5%	10.1%	11.2%
Commodity	1 831	87.88	n.a.	1.6%	1.6%	15.5%	7.3%
Commodity Trading Advisors	1 358	55.07	n.a.	1.3%	1.3%	7.8%	-3.6%
Volatility							
VIX	18.21	59.42	23.3%	20.9%	5.0%	39.4%	-42.5%
VSTOXX	16.47	50.31	3.8%	6.6%	-3.1%	25.3%	-35.0%
Commodities							
Commodities (CRB)	551.1	n.a.	-0.3%	2.0%	2.7%	5.1%	-8.0%
Gold (Troy Ounce)	2 941	n.a.	1.5%	6.1%	12.0%	27.2%	13.1%
Silver (Troy Ounce)	32.63	n.a.	0.9%	6.7%	12.9%	21.5%	-0.7%
Oil (WTI, Barrel)	70.58	n.a.	-0.2%	-7.0%	-1.6%	0.1%	-10.7%
Oil (Brent, Barrel)	75.03	n.a.	0.0%	-6.6%	1.2%	-4.6%	-4.5%
Currencies (vs USD)							
USD (Dollar Index)	106.31	38.05	-0.4%	-1.1%	-2.0%	7.1%	-2.1%
EUR	1.0506	58.48	0.2%	0.1%	1.5%	-6.2%	3.1%
JPY	149.53	66.58	1.3%	4.3%	5.1%	-10.3%	-7.0%
GBP	1.2657	62.51	0.3%	1.4%	1.1%	-1.7%	5.4%
AUD	0.6375	61.98	0.3%	1.0%	3.0%	-9.2%	0.0%
CAD	1.4188	59.01	0.0%	1.1%	1.4%	-7.9%	2.3%
CHF	0.8969	60.02	0.4%	1.0%	1.2%	-7.3%	9.9%
CNY	7.2449	60.46	0.3%	-0.1%	0.8%	-2.7%	-2.8%
MXN	20.393	52.05	-0.5%	-0.6%	2.1%	-18.5%	14.9%
EM (Emerging Index)	1 754.7	67.26	0.3%	1.0%	1.6%	-0.7%	4.8%
XBT	95 838	n.a.	-0.5%	-8.8%	2.3%	120.5%	157.0%

Source: Bloomberg, Altitude Investment Solutions

Total Return by asset class (Negative \ Positive Performance)

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