THE US ELECTION:

The financial officer's guide to US Dollar volatility

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moneycorp

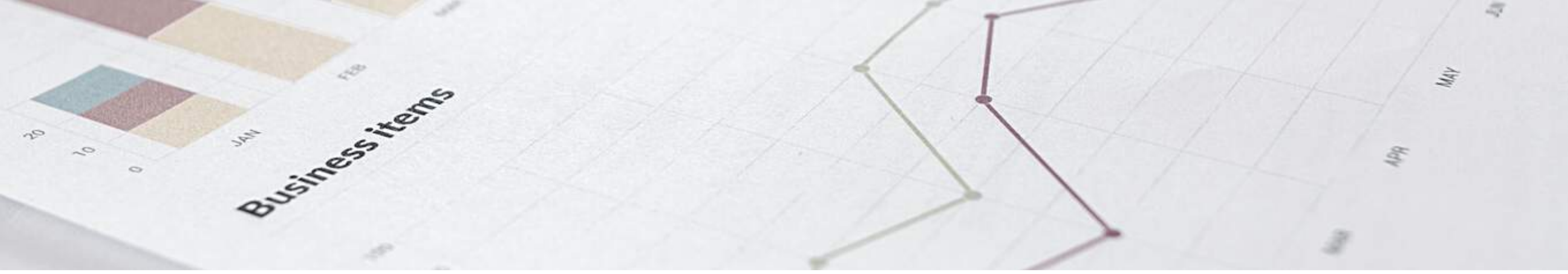
INTRODUCTION

The U.S 2020 presidential election holds special importance for the domestic and global investor communities and those who are exposed to FX markets such as fund managers, institutional investors, and corporations.

With conflicting opinions on how well the US government handled the containment of the virus, the US has been placed under a microscope by foreign leaders. Since the onset of COVID-19, the economic outlook has been pretty dismal; current-dollar GDP decreased 34.3 percent in the second quarter of 2020 to a level of $19.41 trillion (Source: BEA.Gov). With high unemployment, trade wars with China, and beyond, we may not see the spotlight being lifted anytime soon.

With the presidential election just around the corner, you may be asking yourself "how will the USD be affected?" Read our exclusive guide to learn more about US Dollar volatility and how your business can protect itself.

Contents



OVERVIEW: THE USD AND ECONOMY

Over the past three months, the tech-heavy NASDAQ has endured high volatility, which connotes a market affected heavily by consumer confidence. Investors have sought higher returns amid low-interest-rate environments, as well as an incipient resumption of global economic activity that was already underway. The tech sector has been hurt relatively less by the current COVID-19 crisis in comparison to consumer sectors such as airlines and energy. Against this backdrop, where the risk-on sentiment prevailed, the Dollar Index recorded its two-year low (Fig. 1).

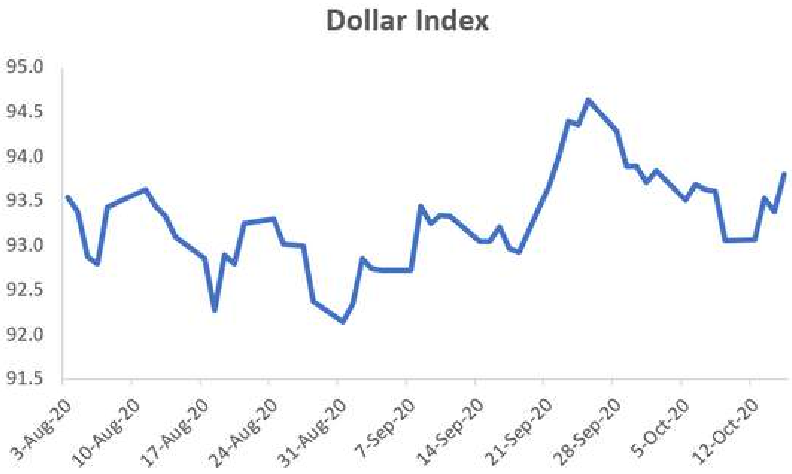


Figure 1. Dollar Index[1]
Source: Bloomberg

However, the domestic and international economic environment has been turned upside down in a relatively short time. The economic aid package for those affected by the COVID-19 pandemic ended abruptly in mid-August. Since then, the White House and Democrats have only just been able to reach an agreement on a new fiscal stimulus, albeit still requiring Senate approval.

The American economy witnessed a growing rate of claims for unemployment benefits and a deterioration in economic activity due to the paralysis of the international trade market. At the same time, Europe was impacted by a second wave of COVID-19 forcing France, the United Kingdom, Spain, the Czech Republic and others to adopt new lockdown measures to contain the spread of the virus.

The perception of a global economic recovery faded as investors started to move towards safe assets that have a safe-haven status, such as JPY, CHF and of course the USD. In this risk-averse environment, the dollar became the main refuge asset for market participants strengthening against a broad basket of major currencies.

[1] The US Dollar index measures the value of the U.S. dollar relative to a basket of major 6 currencies: EUR, JPY, GBP, CHF, CAD and SEK.

HOW THE US DOLLAR HAS REACTED TO ELECTION-RELATED NEWS SO FAR?

The US Dollar Index has steadily declined (Fig. 4) this year, obviously not just because of the election. That being said we are seeing USD movement as investors turn to the polls for trade fodder. The "debate" heard around the world sent anxiety shockwaves through the markets as Biden and Trump took off the gloves rather than addressing the nation's major challenges. A delay in the announcement of a president could cause an ugly transition which raises concern from leaders around the world. Traders sold off the dollar for other traditional safe-haven currencies immediately after the debate and we saw JPY and CHF bump up higher (Fig. 5).

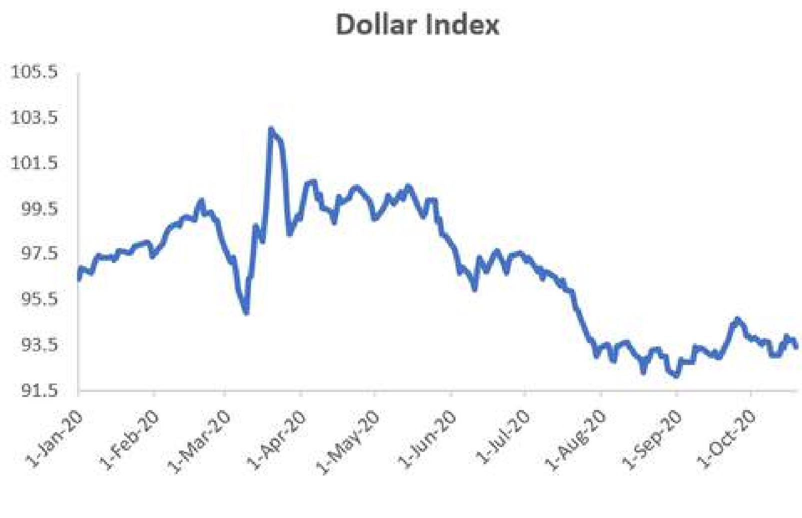


Figure 4. Dollar Index has declined over 2020
Source: Bloomberg

Trump has stated in the past that he'd prefer a weaker dollar. In fact, as recently as September of this year there were fears that the EU may be willing to enter into a currency war with the U.S as both regions fight for exports. That being said, despite the pandemic, the president has been able to rally markets to all-time highs and many believe that a Trump re-election will mean a longer bull run for US stocks which could ultimately bode well for the greenback.

Biden's foreign policies and pledges to world causes such as climate change will undoubtedly help support currencies such as the EUR. Biden even offered Brazil 20Bn to stop the "destruction" of the Amazon (which was quickly declined by Bolsonaro). So it is no surprise that as Biden gains more power in the polls, the USD has dropped off against its peers.

With a few days to go before the November 3rd election, Joe Biden is slightly ahead of President Donald Trump by 11% nationally (Fig. 6), according to polling averages.

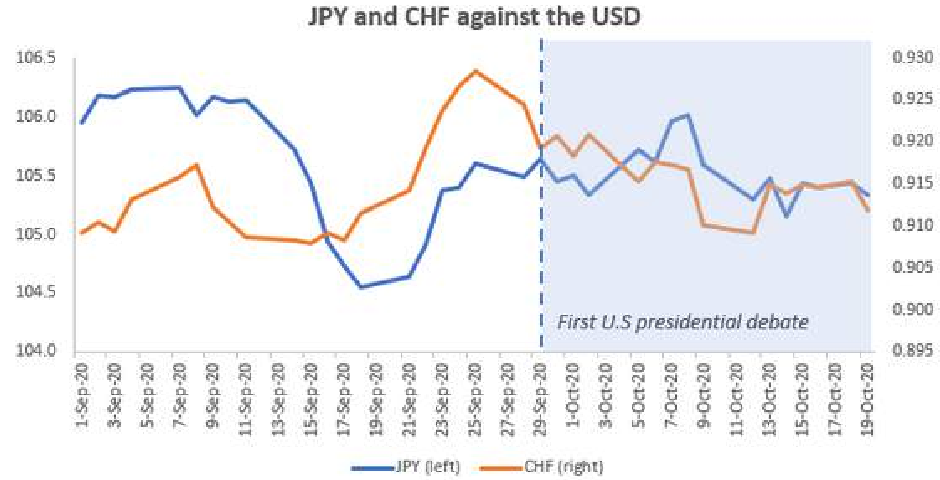


Figure 5. JPY and CHF after the first debate on September, 28th
Source: Bloomberg

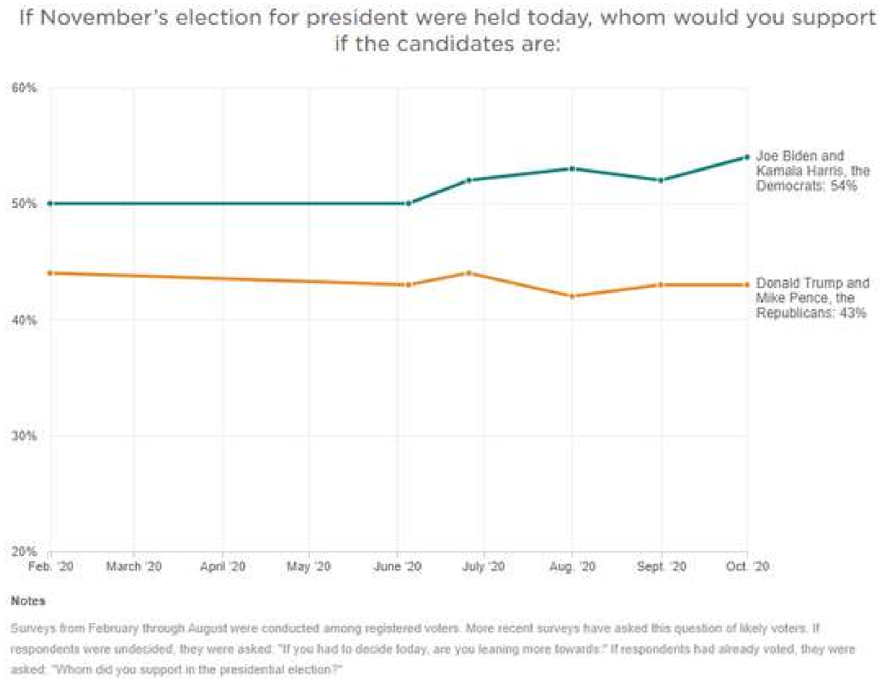


Figure 6. A snapshot of current polling
Source: NPR/PBS NewsHour/Marist poll of 896 U.S. likely voters conducted Oct. 8-13. The margin of error for the sample is 3.8 percentage points.

2020 ELECTION AND ITS POTENTIAL IMPACT

The result of the U.S election may have several new implications on U.S fiscal stimulus, taxation, public investment and regulation. Therefore, any change in the direction of these policies will have an effect on major pairs such as GBP, EUR, and safe-haven JPY, Investors will either seek refuge in stronger currencies or increase their appetite for risky assets (Fig 10).

If Trump wins

The trade wars against China and the EU that Trump is promising to continue, coupled with America's withdrawal from the Trans-Pacific Partnership, could likely have strengthening effects on the USD. US-based exporters such as car manufacturers who seek to benefit from Trump's America First policy (AFP), could cause demand for the USD to increase. The AFP, combined with further restrictions on immigration, will present more employment opportunities for American citizens.

Implementing the AFP will also help the U.S. improve its current trade deficit, which has recently increased by 18.9% to $63.6 billion, the highest since 2008. Through protectionist policies such as the AFP, the US trade deficit could likely diminish. This would ultimately reduce the supply of US dollars in the global economy and thus appreciate the US dollar.

However, Trump's desire for a weak US dollar in order to support US manufacturers will be difficult to obtain. Taking a stronger stance against major counterparts by increasing trade friction will likely price the US out of the market. The AFP may therefore have an adverse effect on the competitiveness of US exporters in the global markets e.g. the number of US farmers filing for bankruptcies in 2019 has increased by nearly 20% from the previous year as a result of losing China as a trading partner (Forbes, 2019).

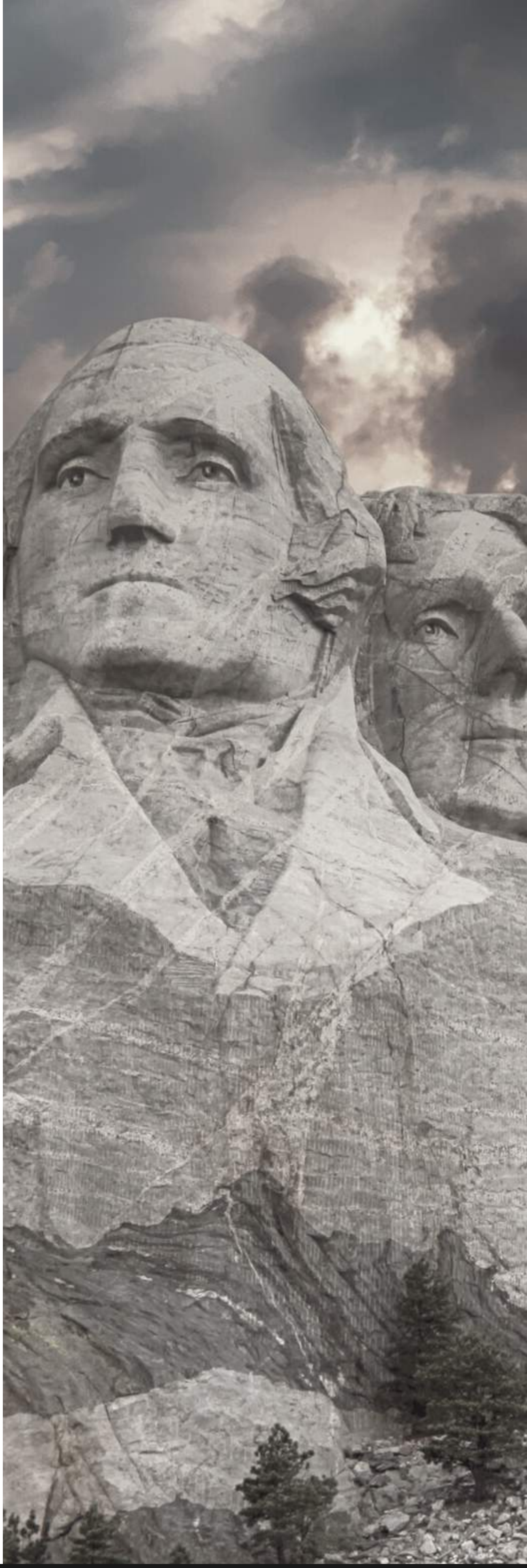
Moreover, should Trump win the election, stock markets are expected to strengthen due to Trump's track record since 2016 and corporate taxes remaining low at 21% (Fig 11). This will increase the demand for US investments and strengthen the US dollar.

If Biden wins

In the event that Biden wins the election, certainty is likely to return to the US. The US dollar could therefore weaken under a Biden presidency due to investors selling out of the safe-haven currencies, inclusive of the JPY and CHF. Given the Democrats promise to safeguard current trade partnerships this will resolve US trade tensions. Furthermore, the US dollar weakening could likely be exacerbated by Biden's proposal to increase corporate taxes to 28%. Although increasing government revenue and improving the deficits, this may lead to stunted economic regrowth. Higher taxes will drive foreign investment and manufacturing out of the US, which will cause the US dollar to weaken.

Biden's immigration policies could, in the short term, increase unemployment rates. However, in the long term, granting legal status to undocumented immigrants will increase the total labor supply, tax revenue, and GDP. Moreover, immigrants statistically have more children, which will result in a younger population long term. Currently experienced by Japan, an ageing population can result in a decreasing labor market and overall economic decline.

Biden taking office could also have a positive impact on the EUR, as the Democrats are willing to support initiatives such as the UN climate backed Paris Agreement. As a result, investors may start to look outside of the US for opportunities and move out of their USD positions.



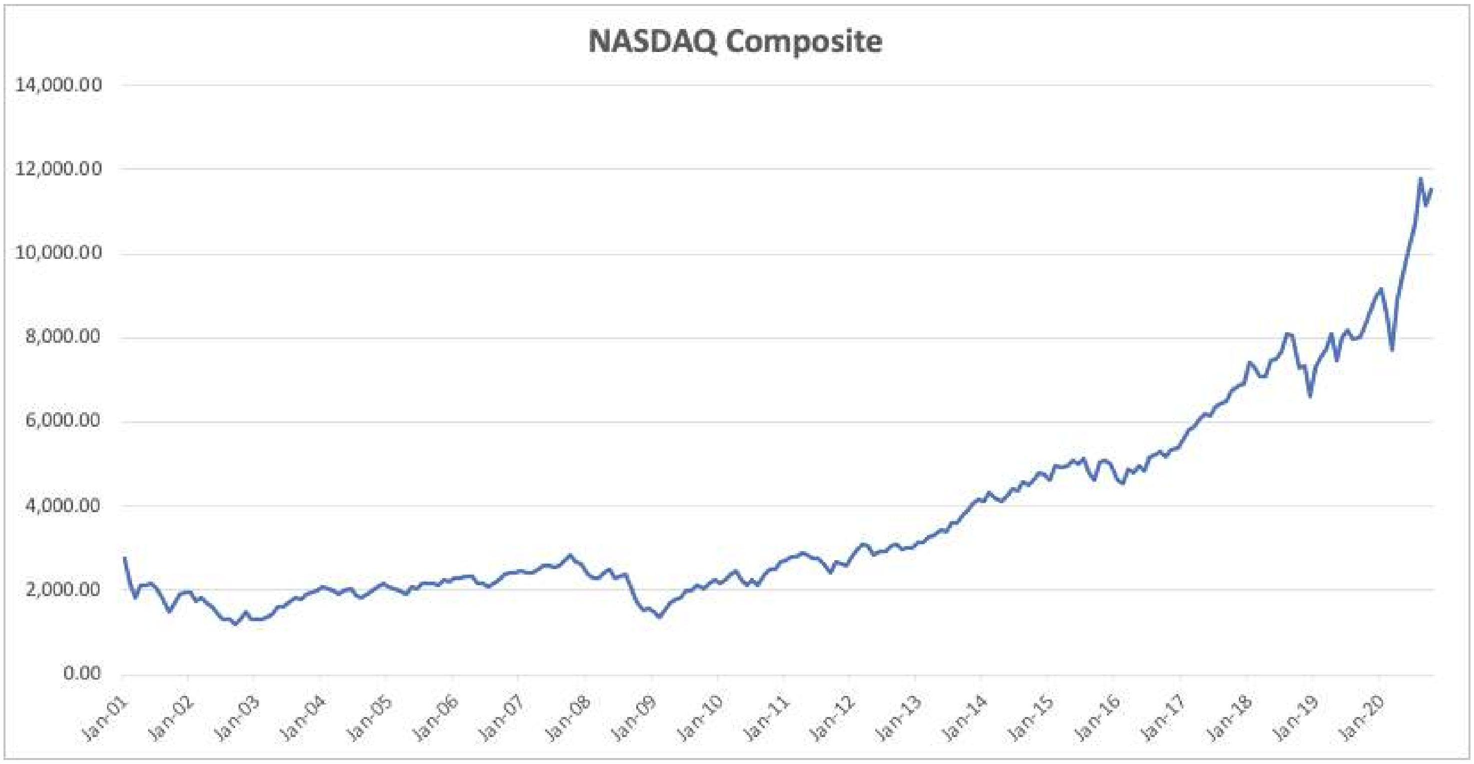


Figure 11. NASDAQ performance
Source: Investing.com

A Close Vote

In the event of a close vote, it is likely Trump will attempt to contest the result on the basis of voter fraud and/or cheating using mail ballots. This type of uncertainty and confusion can cause a lack of confidence in a region (for example, the British Pound slumped following the announcement of a hung parliament in 2017). Uncertainty can cause currencies to plummet and it wouldn't be a surprise to see people seek refuge in other traditional safe-haven currencies such as the CHF and JPY. This could cause them to appreciate in the short term until US political uncertainty has settled.

Therefore, from the perspective of the U.S dollar, a close vote could indeed be the worst-case scenario as prolonged uncertainty will mean a delay in action, something a fragile COVID-19 affected economy could certainly do without.

HOW BUSINESSES CAN PROTECT THEIR BOTTOM LINE

Businesses who are exposed to foreign currency risk can protect their financial health by hedging against spot market volatility. Hedging future cash flows can provide a company with certainty of profit forecasts and remitted earnings. Should the U.S dollar move in an adverse direction and a business were to remain unhedged, this could be detrimental to the profitability of a business.

Furthermore, with hedging strategies in place, not only can companies protect receivables or payments against market volatility, but also maximize its profit by taking advantage of the structure and movements of the FX market.

Types of Solutions

There are four basic types of derivatives used in FX: forward, futures, options and swaps. A derivative contract is a contract whose value is determined from an underlying asset (e.g. stocks or currencies). Thus, its value is “derived”.

Forward Contracts

A forward is an agreement between two parties to buy a specified amount of one currency and sell a specified amount of a second currency on a specific value date. Once settled the provider will deliver the bought currency to the hedger's account of choice. The forward rate of the contract is determined largely by the interest differential between the two currencies and the length of the contract, and may be less than or greater than the current spot rate. There are some emerging market currencies (e.g. BRL, INR, PHP, MYR) for which regular two-way settlements are not available. For these currencies, Non-Deliverable Forwards (aka NDFs) are used. Their basic structure is the same, except gain/losses are netted and settled in USD.

Option Contracts

An option is the right - but not the obligation - to buy a specified amount of one currency and sell a specified amount of a second currency on a specific value date. There are two types of “vanilla” options: call options and put options. This right comes at the cost of a premium (when buying an option). Options are often used in combinations of two or even three options (some bought, some sold) to achieve specific results. Determining the most cost-effective option configurations and parameters can be a complex task.

Swaps

A swap is a multi-legged agreement between two counterparties to exchange financial instruments, cash flows or payments at multiple intervals. The simplest swap format is used to roll a forward to a later date. It consists of a spot transaction linked to a forward. More complex swaps (their structure is derived from interest rate swaps) manage multiple periodic future flows, and are most commonly used to manage foreign currency debt.

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