A New Round of US Dollar Cycle and Major Assets Allocation

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Abstract

As the world's "hard currency", the appreciation or depreciation of the US dollar will have a profound impact on all aspects of the world. Under the background of the US starting a new round of quantitative easing in 2020, the US dollar is about to enter a new round of depreciation cycle, so it is worth studying how to allocate major assets. From the perspective of assets, this paper explores the relationship between the US dollar cycle and several major types of assets, and finds that the US dollar cycle is closely related to bulk assets, gold, stock markets and emerging economies.

Keywords

US Dollar Cycle; Major Assets Allocation.

1. Dollar cycle

In recent years, as the core factor leading international capital flows and asset price fluctuations, the cyclical fluctuations of the US dollar determine the direction and structure of global capital flows. As we all know, the United States became the world hegemony after World War II. After the collapse of the Bretton Woods System, although the gold standard system was disintegrated, the US dollar was still the leader of the international currency, and the international monetary system with the US dollar as the core was continued. The US dollar, which was decoupled from gold, became the representative of modern credit currency. The innovation and development of the international financial system dominated by US dollar profoundly affected the world, and the US dollar became the world currency. At that time, the Federal Reserve became the world‘s central bank, and the US dollar became the world’s "hard currency".Because the US dollar is an international reserve currency, the US must export US dollars to the world through the trade deficit.The US will adjust its monetary policy according to the changes of the economic cycle,when it is tightening monetary policy,the US wIll raise its domestic interest rate and attract the US dollar from all over the world to flow back to the US. And at this stage, the US dollar is in a strong period.At the loose monetary stage, the interest rate is lower and the US dollar is in a weak period.

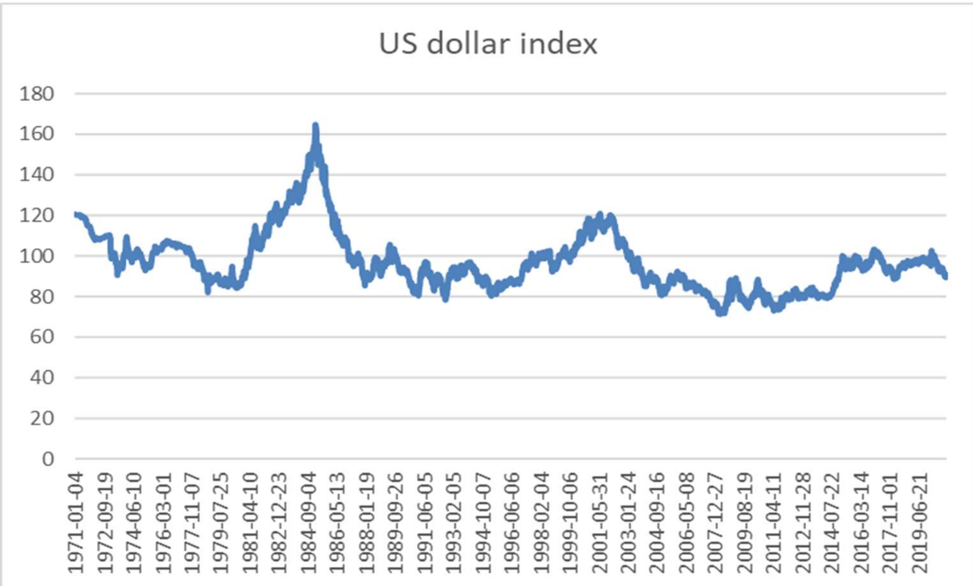

Figure 1. Dollar Index

This cyclical change can be observed in the dollar index.The dollar index can measure the exchange rate of the US dollar against a basket of currencies and comprehensively reflect the strength and weakness of the US dollar in the international monetary system. As shown in the figure 1, it can be found that the US dollar index has a six-year rise period and a ten-year decline period, while the highest point of the US dollar index is declining continuously. The highest point appeared in 1985, when the US dollar index was 165. After 17 years later, the US dollar reached the second higher point in 2002, but only 121. The third higher point came at the end of 2016, and the US dollar index was only 103. This reflects that the U.S. dollar is devaluing in the long run.In addition, the Asian financial crisis in 1997 occurred in the early stage of the rising period or the late stage of the falling period of the US dollar, which shows that the strengthening and weakening of the US dollar will have a profound impact on the fate of various emerging countries.Therefore, it is of great significance to study the dollar cycle.Recently, the US dollar index has dropped all the way from 103 points in March 2020 to about 90 points, and the RMB exchange rate has broken 7 to about 6.4, which may mean that the US dollar has started a new round of downward cycle.

2. Classification and introduction of major assets

From the perspective of finance, there are many categories of large assets, including equity, fixed income, gold and other categories. At present, there are few studies on the definition and representative selection of large assets at home and abroad. According to the traditional classification, large assets can be divided into five categories, including equity, fixed income, bulk commodities, gold and foreign exchange. According to different standards, each major category contains many subdivisions. For example, equity assets can be distinguished according to different industries, such as medicine, science and technology, consumption and so on. Fixed income assets can be divided into credit bonds, interest rate bonds, investment grade bonds and so on according to different income characteristics. Commodities can also be divided into soybean, crude oil and so on.

Although they belong to different categories, there are many similarities in the nature of various sub categories of assets. For example, the preferred shares of some enterprises have the same nature as fixed income. Relevant studies show that the choice of market index will have an impact on the estimation of beta. Although there are thousands of different indexes in different asset markets, different indexes also represent the same type of assets. In the same kind of assets, due to the different selection of indicators and different weights, there will be very big differences between the indexes. In the past research and analysis, a variety of different indexes or portfolio can be used to represent the same category of assets, there is no clear basis to choose one. For example, in the U.S. financial market, equity assets are generally represented by the S&P 500 or the Dow Jones index, while fixed income assets are represented by a series of bond indexes such as the Barclays and Bloomberg index. Similarly, in China's financial market, equity is usually represented by SSE Composite Index, CSI 300 or CSI 500, while fixed income market is represented by China bond new composite wealth index and China bond composite wealth index.

2.1 Equity assets

China's stock exchanges include the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The market also has a variety of indexes such as the Shanghai Composite Index and the CSI 300 to represent different types of stocks in the two markets. The Shanghai composite index is the most representative index in China, and the earnings of many equity products are closely linked with the fluctuation of Shanghai Composite Index.

2.2 Fixed income assets

According to different risk characteristics and periods, fixed income assets themselves also have great differences. Equity indicators are often used by many investors as the basis for tracking and calculation, while bond market index is only used to reflect the fluctuation of bond market. Therefore, most fixed income indexes only exist in theory and have nothing to do with the liquidity of bonds. China bond new composite wealth index and China bond composite wealth index are the most commonly used indexes to reflect the trend of fixed income assets in China, and there is no great difference between them.

2.3 Commodity assets

Compared with mature financial markets such as the United States, there is a certain gap in the development of China's commodity and futures markets, which leads to some restrictions in the selection of commodity index. The common indexes in China's commodity market are Nanhua commodity index, Shanghai stock exchange commodity index and wind commodity index. Nanhua futures selected some commodities with strong liquidity and representativeness, including agricultural products, metals, energy and chemical industry, and compiled a single commodity index in Shanghai Futures Exchange and other three futures exchanges. And further give these single commodity index different proportion to calculate the Nanhua commodity index. It is more representative than the wind commodity index which only contains 43 active listed varieties.

2.4 Gold assets

In the world, the spot gold markets in London and Zurich, the gold futures markets in New York and Tokyo are the markets that have an important position and have an important influence on the determination of the world gold price. In many markets, gold related transactions are mostly concentrated in the London exchange and the New York exchange. At the same time, China's gold import and export is also dominated by the price of spot gold in London.

2.5 Foreign exchange assets

At present, the U.S. dollar is still the most important currency in international economy and finance. At the same time, China adopts the managed floating exchange rate system centered on the U.S. dollar and other currencies, which makes the U.S. dollar inevitably become the most important foreign exchange assets in China.

3. Asset allocation theory

Different investors have different investment objectives and risk preferences. Asset allocation refers to these different objectives and preferences, and different ways of fund allocation that have been defined or changed in real time. The allocation of funds to a variety of different assets, such as equity, fixed income, gold and foreign exchange, can control risks and obtain certain returns. In short, the rational distribution of funds in various ways is asset allocation.

The purpose of asset allocation is to make the funds of enterprises and individuals allocated more reasonably The allocation of resources in the whole society will be affected to a great extent by the choice of capital flow by different subjects in the capital market. Because the investors in the market are rational economic people, any capital has a clear profit motive, at the same time, social funds can flow to industries, enterprises or individuals that produce high returns on the whole. This is because there is a strong evaluation, selection and supervision mechanism in the whole capital market, which also further enables the efficient use of funds and the optimal allocation of resources in the whole society.

In order to make a better asset allocation plan to meet the needs and risk preferences of different investors, we need to carefully understand these conditions and needs of investors before making asset allocation strategies. Generally speaking, asset allocation depends on the following four factors:

First, investment objectives. If the investors mainly allocate low-risk assets such as bank deposits and bonds, their investment purpose is generally to maintain capital or obtain stable income, while the assets mainly allocate high-risk and high-yield assets such as equity, their investment purpose is mostly capital appreciation.

Second, risk tolerance. Risk averse investors usually allocate assets with lower risk, such as bonds and foreign exchange. Investors with balanced risk preference can reasonably increase the allocation of high-risk assets such as equity, while investors with aggressive risk preference can mainly allocate high-yield assets such as stocks in order to obtain higher returns.

Third, the time limit of planned investment. For short-term investors with large demand for liquidity, they should increase the allocation of assets with good liquidity, such as short-term bonds, while for long-term investors, they can make long-term allocation of assets with good value growth, such as Baima shares.

Fourth, the age of investors themselves. Generally speaking, with the growth of investors' age, investors are more inclined to buy assets that are capital guaranteed and can obtain stable income. If most of the asset holders managed by the institution are older, professional investment managers will advise investors to allocate more assets to bonds and cash, and reduce the allocation proportion of equity and other high-risk assets.

4. A new round of US dollar cycle and major assets allocation

4.1 A new round of US dollar cycle and country choice

The prices of the world's major types of assets all rise and fall in the "water" of the US dollar. In the strong US dollar cycle, capital flows back from all countries to the US, and emerging economies are faced with huge capital flight pressure. Therefore, we should be vigilant against asset bubbles in emerging economies, especially those with high foreign debt, small foreign exchange reserves and weak capacity and asset allocation should shift from emerging economies to developed economies. For example, the direct cause of the Asian financial crisis in 1997 was the collapse of the Thai baht caused by the appreciation of the US dollar, which triggered the currency crisis and debt crisis sweeping Asia. Similarly, in the weak cycle of the US dollar, the asset allocation of emerging economies, especially China and India, should be increased, and the asset allocation of developed countries should be reduced.

4.2 A new round of US dollar cycle and commodity assets

The US dollar is at the core of the international monetary system, accounting for 60% of the world's foreign exchange reserves and about 40% of the international trade settlement currency market. Therefore, the US dollar is the pricing currency of the world's major commodities. Bulk commodities mainly include three categories, namely agricultural and sideline products, basic raw materials and energy commodities. These commodities are the lowest level raw material in industrial production, and the supply is limited. Therefore, the monetary effect of "rising tide and rising ship" will be reflected in the price of bulk commodities most quickly. When the Federal Reserve starts quantitative easing to stimulate the economy, commodity prices around the world will rise sharply, and when the Federal Reserve starts tightening money, commodity prices may fall.

Figure 2. Shanghai copper and US dollar Index

In Figure 2, by comparing the Shanghai copper price with the US dollar index, it can be found that the Shanghai copper price and the US dollar index will have a very obvious top back separation. For example, since 2002, the US dollar has weakened and the Shanghai copper price has strengthened; in 2014, the US dollar has strengthened and the Shanghai copper price has weakened; after April 2020, the US dollar has weakened and the Shanghai copper price has strengthened. This shows that from the metal futures prices, we can indeed find evidence that commodities and the U.S. dollar cycle show a reverse trend.

4.3 A new round of US dollar cycle and gold assets

As gold is a hard currency and it has the function of avoiding currency devaluation. Theoretically, the depreciation of US dollar will lead to the rise of gold price, while the appreciation of US dollar will lead to the decline of gold price. In Figure 3, by comparing the relationship between the London Gold and the US Dollar Index, we can also find an obvious top-back separation relationship. Of course, because gold also has the function of hedging, the reverse relationship between gold price and the US dollar index may be disturbed.

Figure 3. Gold and US dollar index

4.4 A new round of US dollar cycle and stock market

As the Fed began to raise interest rates, the US dollar strengthened and reached the end of the strong dollar cycle. It was extremely easy to pierce the bubble of the stock market, for example, the US internet bubble in 2000 was punctured at the end of the US dollar strong cycle, and so did the 2008 real estate bubble. For China's stock market, the stock market bubble often arises from the left and right sides of the bottom of the dollar's weak liquidity cycle.

Figure 4. CSI 300 index and US dollar Index

5. Conclusion

The starting point for the strength of the US dollar index in this round is mid of 2014, from about 80 to about 100 at the end of 2019. COVID-19 has become the fuse for the US dollar to weaken from strength, and the US Federal Reserve has launched a new round of quantitative easing, which is more powerful than the financial crisis in 2008. Therefore, the US dollar index is bound to open a new ten year down cycle. When the US dollar index is in a downward cycle, it has the following inspirations for investors' asset allocation of major categories.

Firstly, the depreciation of commodity prices against the US dollar is the fastest reflection. Therefore, investors should raise the allocation of commodities, and the price rate of commodities will probably remain at a high level. Secondly, due to the function of avoiding currency depreciation and risk, in a weak period in the U.S. dollar cycle, it is suggested to hold more gold than before to resist the abuse of currency by central banks. Thirdly, because in the initial stage of international capital flooding, the US dollar is still relatively strong in the stock market investment and the central bank's monetary policy space has not been completely opened, so it is not easy to appear the stock market bubble. And there will not appear stock market crash at this stage, because the US dollar is in the down cycle, the central bank monetary policy ammunition is still enough, and it can be used at the necessary time. Come on. Fourth, investors can appropriately increase investment in emerging economies, such as China and India, which are more promising because in the downward cycle of the US dollar, emerging economies are unlikely to have debt crisis and liquidity crisis.

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