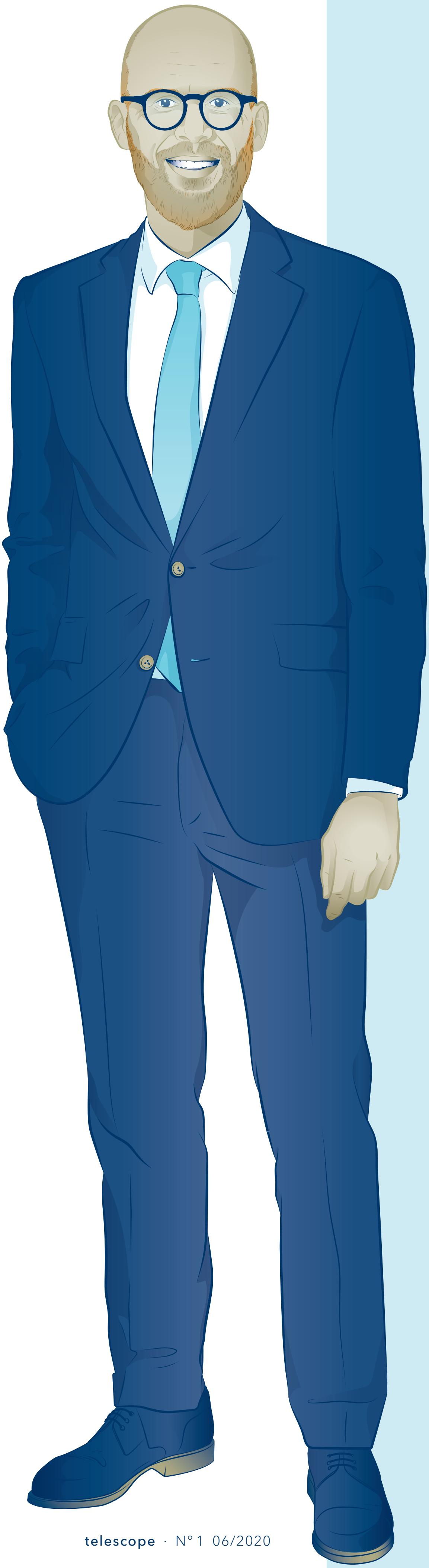
telescope N° 1
06/2020

THE WIMPY DOLLAR

As the only global currency, the dollar may remain attractive in times of crisis. But it is facing long-term depreciation.

VP BANK



THE WIMPY DOLLAR

Dear Reader

Welcome to the first edition of our newest publication, Telescope. The magazine will be published twice a year, and will take the place of Investment Views.

Why did we decide to name it Telescope? It's simple, really. Our goal with this new magazine is to do what you do with a telescope: to see objects that are far away. We want to zoom in on topics that are not yet on everyone's radar. Every edition is focussed around one central topic that has been chosen by our research team. The magazine will not only offer concrete investment ideas, but will also include expert interviews, background reports and a feature where a prominent person discusses their best and worst investments. In this edition, we asked an Olympic gold medallist – ski racer Dominique Gisin.

The first edition of Telescope is all about the US dollar and why we have good reason to believe that it is poised to mutate into a "weakling". This may seem surprising at first, since it is still strong due to the ongoing COVID-19 pandemic. However, we feel that this is simply the final surge at the end of a multi-year dollar cycle. Just because it is poised to enter a weak phase does not necessarily mean that the greenback will lose its status as the most important world currency – a claim we also address in this issue. And if you're wondering what James Bond has to do with the US dollar, well, we have an answer for that too.

I hope you find the first edition of Telescope both stimulating and enjoyable.

Dr Felix Brill
Chief Investment Officer

FIVE REASONS WHY THE DOLLAR WILL WEAKEN

The US dollar is the most important currency. However, this doesn't mean that it is strong. There are good reasons why it will lose value over the coming years.

Felix Brill

#1 The US dollar is too expensive relative to other currencies. This is according to the theory of purchasing power parity.

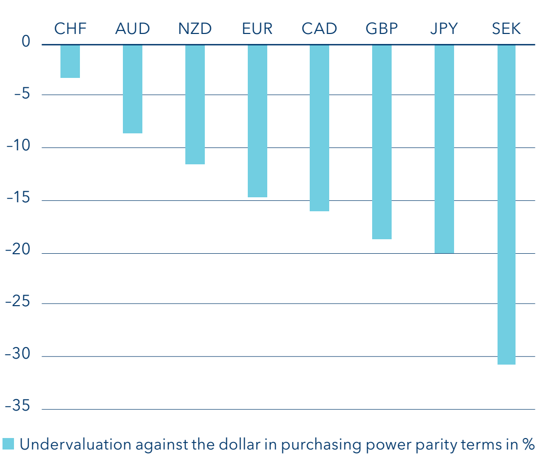
The greenback has not only increased in value during the coronavirus crisis. Essentially speaking, a period of appreciation started as far back as the euro crisis and has continued until now. Due to the recent surge in appreciation against the backdrop of the coronavirus crisis, the situation with respect to the US dollar's valuation has even been accentuated. As a yardstick for this statement, we are applying the so-called theory of purchasing power parity (→ see the workshop report on page 8). According to this theory, under the conditions of free competition and provided that the transaction costs are negligible, identical products in two countries with different currencies will sell for the same price.

At present, the US dollar is overvalued against the euro by around 15% (→ see PPP graph on page 6). This means that the EUR/USD exchange rate is also just outside the neutral zone, which marks the historically "normal" range of deviation around purchasing power parity. When this is the case, the deviation is deemed to be "significant". The US dollar is therefore currently significantly overvalued. As the graphic shows, a significant deviation can of course become even more extreme. Typically, however, marked deviations of this kind correct themselves over time. Empirical evidence is clear in this regard.

Interestingly, despite being undervalued against the US dollar by 15%, the euro is by far not the weakest of the industrial nations' 10 main currencies at this time. After the Swiss franc, the Australian dollar and the New Zealand dollar, the euro has the fourth lowest valuation against the greenback (→ see valuation graph below). The Swedish krona brings up the rear by a considerable margin with an undervaluation of more than 30%.

Overall, the picture is clear: the US dollar is too expensive across the board. There is reason to fear that the surge in the dollar triggered by COVID-19 merely was the last hurrah (→ see #4). If purchasing power parity is used as a yardstick, the probability of a normalisation and thus a depreciation of the US dollar clearly outweighs the scenario that the appreciation trend of recent years will continue. This assessment refers to a time horizon of two to three years. In the short term, purchasing power parity does not provide any reliable signals.

The dollar is overvalued against many currencies



#2 The United States have a higher rate of inflation than Europe and Japan. Structurally, the dollar is therefore weakening against these currencies over time.

The theory of purchasing power parity also provides a second reason as to why the US dollar is likely to lose value over the coming years. Purchasing power parity is not stable over time (→ see PPP graph on page 6). Since the introduction of the euro in 2002, purchasing power parity has increased from around 1.15 euros to the US dollar to 1.27 euros to the US dollar. In terms of purchasing power parity, the euro has thus gained 10% against the US dollar. This can be explained by the fact that the United States have recorded structurally higher inflation during this time.

Structural differences in inflation are typically persistent. Even if we do not know precisely how inflation will develop in different countries over the coming years, it is very likely that the differences in inflation between countries will remain relatively stable. This allows for us to anticipate the development of purchasing power parity over the coming years. Here too, the picture is clear: the purchasing power of the US dollar is likely to decrease in the next few years due to the country's higher rate of inflation.

This would make the current significant overvaluation of the greenback even greater over the coming years, even if the actual exchange rate doesn't move. The "gravitational force" and therefore the likelihood of a depreciation thus becomes ever greater over time.

// The higher rate of inflation reduces the purchasing power of the Dollar. //

#3 "Big spending" has not been a blessing for the greenback to date. But this is exactly the order of the day in the United States.

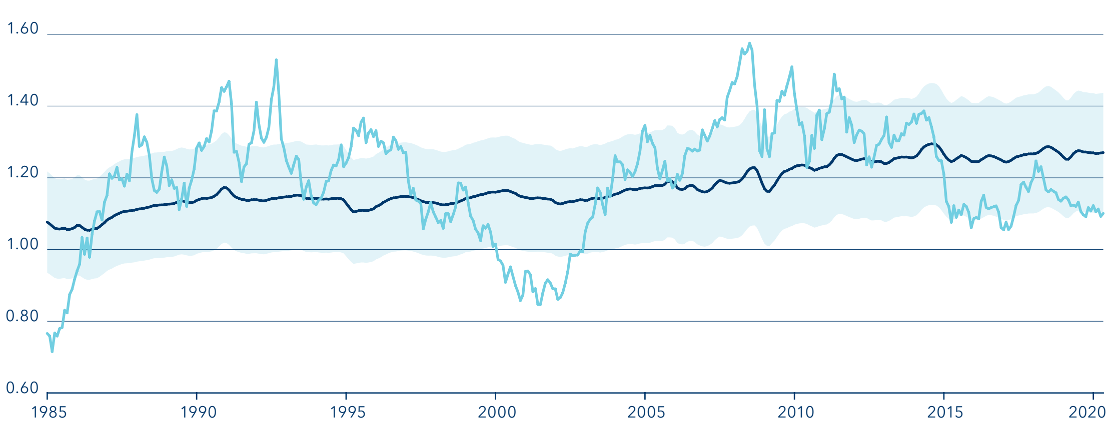
History has shown that no direct link can be identified between a country's debt and the strength of its own currency. This can be seen based on the example of the Japanese yen. With government debt well in excess of 200% of national income, the Land of the Rising Sun even puts Greece in the shade. In truth, however, the yen is by no means a weak currency. In fact, the opposite is true. The reason why the yen has tended to appreciate rather than depreciate in recent years can be explained by the theory of purchasing power parity: over all these years, Japan has had little to no inflation (→ see #2).

Debt development can, however, have an important impact on the value of a currency. This is especially the case when the debt threatens to get out of control. Many emerging markets can tell you a thing or two about this. However, the same can also be said for Europe during the euro crisis.

In addition, there is a further potentially difficult constellation for a currency. This is the case when a significant deficit in the state budget coincides with a deficit in the country's current account. Where this combination arises, we talk of a so-called twin deficit. Due to it being the most notorious, it is the twin deficit of the United States that is most likely the best known. The mere existence of a twin deficit need not be a great burden on the currency. In most cases, things only get difficult when either one or both components deteriorate significantly.

This is the case in the United States when the White House changes colour, i.e. when a Demo-

Purchasing power parity for EUR/USD



cratic President follows a Republican. The reason for this is fiscal policy (→ see "How the US President is affecting the dollar" on page 10). But watch out: public perception is deceptive. It is not the Democrats who typically engage in "big spending", but rather the supposedly fiscally sensible Republicans. Especially against the background of the economic impact of the coronavirus crisis, an expansion of new debt and the re-election of Donald Trump would probably pave the way for a weak phase in the US dollar's development.

#4 The coronavirus crisis has given the US dollar a massive boost. With the end of the crisis, it is in danger of running out of steam.

Periods of crisis are good for the US dollar. In such phases, demand for US dollar liquidity typically increases. This was the case during the global financial crisis of 2008 and 2009. And this phenomenon was once again seen at the beginning of the coronavirus crisis, especially at the beginning of March 2020 when concerns about the spread of the coronavirus hit the financial markets with full force.

The US dollar rose across the board. Measured according to the trade-weighted US dollar index in which currency performance is weighed according to trade flows, the increase between 3 and 23 March 2020 was more than 8%. Since then, the US dollar has weakened somewhat, but it is still well above the levels seen at the outset of the year. This picture is especially pronounced against the so-called commodity currencies, which suffered all the more due to the lower oil price. For example, the Canadian dollar has fallen by around 8% since the beginning of 2020. The Norwegian krone has lost 16% against the dollar, while the Russian rouble has even weakened by 20% relative to the greenback.

The comparison with the global financial crisis is revealing. Between July and October 2008, the US dollar rose by almost 20% on a trade-weighted basis. While it initially fell by 4% up to the end of 2008, it then surged by 8% by March 2009. Should there indeed be a second wave of coronavirus infections, the US dollar is likely to be boosted once more. But what will things look like subsequently?

If the pattern observed during the financial crisis is repeated, things will not look so good for the US dollar in the period following the coronavirus crisis. In any case, the high point recorded by the US dollar in March 2009 was followed by a period of weakness lasting more than two years. Within 24 months, the US dollar lost almost 20% on a trade-weighted basis. And who knows how things would have materialised going forward if the euro crisis had not reared its head at this time.

#5 There is no longer talk of divergent monetary policy. US dollar fans are therefore lacking a popular narrative of recent years.

Psychology has not been discussed so far. Exaggerations and herd behaviour are well known phenomena on the financial markets. These also include so-called narratives. These are explanation patterns that become ever more established over time and increasingly take on a life of their own.

"Divergent monetary policy" was an important market narrative of recent years. This referred to the fact that the US Federal Reserve (the Fed) was able to tighten its monetary policy thanks to an advanced economic cycle, while many other regions, and particularly Europe, continued to have to make do with zero or even negative interest rates. This interest rate advantage made the US dollar more attractive to a certain extent.

Empirically, the interest rate differential does not help in reliably predicting how an exchange rate will develop. And yet, at some point, this narrative gained so much momentum that it was no longer really scrutinised by many investors.

> // Periods of dollar weakness have been good for the global economy. //

This has now become superfluous. The Fed has reduced key interest rates to zero in the wake of the coronavirus crisis. The painstakingly built-up interest rate cushion is therefore a thing of the past. And, considering the consequences of the coronavirus, it does not look as though it could come back any time soon. Many US dollar fans will therefore be unable to call on their popular narrative of divergent monetary policy over the next few years.

Perhaps a different, US-dollar-boosting narrative will establish itself. What if the coronavirus pandemic and its consequences reignite the euro crisis? What if the recession in the industrialised nations sees the emerging markets fall into a new crisis? Such concerns could become established and make the US dollar look as solid as a rock. While these are possible scenarios, they are by no means the most likely.

Conclusion

The US dollar is a weakling and is likely to come under pressure in the coming years due to the five aforementioned reasons. Despite its importance for the global economy and the financial markets, the past has shown that the US dollar has repeatedly experienced periods of weakness.

The next one is coming, and because the US dollar plays an important role in the portfolios of most investors, they cannot be blasé about this (→ corresponding investment ideas can be found on page 22). However, periods of US dollar weakness also have their positive sides: they have typically been good phases for the global economy and the financial markets. Given all the uncertainty caused by the coronavirus, this would be no bad thing.

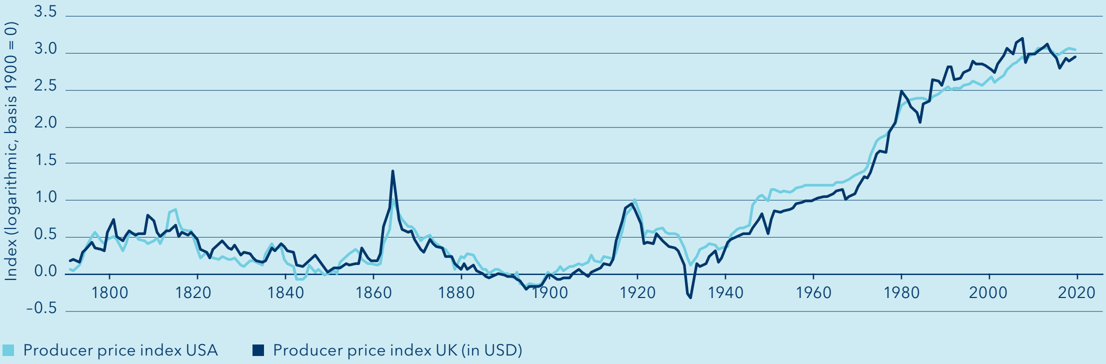
// What if the coronavirus pandemic and its consequences reignite the euro crisis? //

WHAT IS A PURCHASING POWER PARITY?

The purchasing power parity is an established method of assessing exchange rates. It allows us to identify long-term exchange rate trends and overvaluation or undervaluation of different currencies.

Felix Brill

The purchasing power parity in the long run



This graph shows the producer price indices of the USA and UK since 1791 on a logarithmic scale. The UK time series has been converted to USD, the base has been set at zero in 1900.

The purchasing power parity (PPP) is based on the "law of one price", which says that, under the conditions of free competition and provided that the transaction costs are negligible, identical products in two countries with different currencies will sell for the same price. The ideas behind purchasing power parity can be traced all the way back to famed British economist David Ricardo (1772–1823).

A distinction is typically made between absolute and relative purchasing power parity. We use relative PPP (→ see for example page 6). This assumes that product prices will change symmetrically, taking into account exchange rates, but that price levels may differ. One well-known example used to illustrate absolute purchasing power parity is the Big Mac Index, which was invented by the British weekly newspaper "The Economist". As well-known as McDonald's famous double-decker hamburger is, and even though it is identical from one country to the next, it is extremely difficult to trade – a key prerequisite.

Empirical evidence

Purchasing power parity has been addressed by countless economists. "The Purchasing Power Parity Debate" by Alan und Mark Taylor, published in 2004 ("The Journal of Economic Perspectives"), offers a good overview of the literature on the topic. Purchasing power parity can be very clearly demonstrated if the observation period is long enough.

Moreover, producer price indices (PPI) should be used to assess purchasing power parity because these indices primarily cover goods that are highly tradable. The graphic demonstrates how close the relationship between relative price trends and exchange rate trends has been over the past two centuries.

Producer prices in the US and the UK have developed in an extremely similar manner in both countries over the entire time period. However, the graphic also clearly shows that there have been some periods of major divergence. This is also confirmed by the results of Taylor and Taylor's study.

Practical use

We update our estimates of purchasing power parity in the main currencies on a monthly basis using producer price indices and nominal exchange rates. It is important to note, however, that PPP estimates are subject to some uncertainty. The starting point and length of the observation period both play an important role.

To account for this uncertainty, we include not only the development of the exchange rate and our estimate of the PPP in our illustrations, but also what is referred to as a "neutral range" around the PPP. This neutral range is defined as a standard deviation of the percentage deviation of the exchange rate from PPP. The neutral range allows us to determine whether a deviation from PPP is "significant" while taking into account the necessary degree of uncertainty. The greater the deviation from PPP, the more interesting it could be to bank on the resolution of this incorrect valuation.

HOW THE US PRESIDENT IS AFFECTING THE DOLLAR

The president of the United States holds enormous power. But he does not have the power to directly influence the value of the US dollar. However, with considerable budget deficits, he may manage to do just that.

Thomas Gitzel

Seven is a very special number – sometimes it's a lucky number, sometimes it's an unlucky one. According to the Bible, God created the world in seven days, and there were Seven Wonders of the Ancient World. The number also has a significance in the fairy tale "Snow White", where the mirror on the wall knew that Snow White, with her seven dwarfs, was the "fairest of them all" – much to the chagrin of the evil queen. In libraries, the number seven appears much more frequently in book titles than the numbers six or eight. The same applies in dictionaries in terms of words that start with numbers.

// The dollar is moving in a roughly seven-year cycle. //

When we look at the historical development of the US dollar, we see a roughly seven-year cycle on average, even if it has not adhered as closely to this average in recent years. Is it magic, or is there something more behind this trend?

Some suspect that these cycles are related to the length of time that any US president can hold office. Since each president can only serve for a maximum of eight years, it may be that foreign exchange markets start looking towards the future before the election of a new president. In fact, since the mid-1980s, the peaks and valleys of the US dollar's value have moved in sync with which political party held the office of the president (→ see graph on the next page). We can see, therefore, that whether a Republican or Democrat is in office has an impact on the value of the dollar.

The two parties' reputations in terms of economic policy can be deceptive

Since the Second World War, most US presidents have been elected to two consecutive terms in office. And, with a few exceptions, the parties have switched back and forth from 1945 to the present: a Republican president followed by a Democrat and vice versa. Since the two camps differ in terms of their economic policy agenda, the dollar cycles may actually be affected by the ruling political party.

After all, Republicans allegedly favour a more conservative – and even restrictive – fiscal policy, while Democrats are associated with a more liberal approach to government spending. However, upon closer inspection, the opposite appears to be true. A study by the economists Fabrizio Zilibotti and Andreas Müller and the economic researcher Kjetil Storesletten demonstrated that, compared to Democratic administrations, Republican administrations have consistently increased government debt since the

Second World War. In any case, the widely held view that Republicans pursue a fiscally conservative agenda in terms of debt policy cannot be confirmed.

The deficit also impacts the dollar

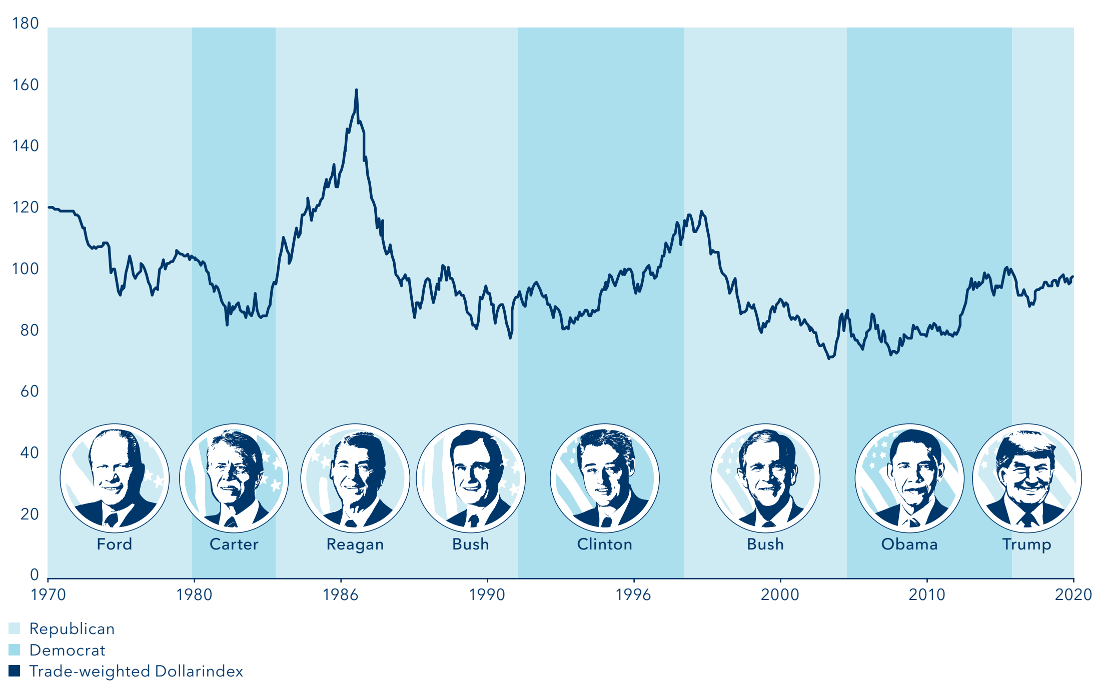
The economists' analysis shows that switching from a Republican to a Democratic administration is associated with an annual reduction of the government debt (in relation to the gross domestic product, GDP) of 1.8% on average. Democratic presidents tend to raise taxes. The resulting revenues increased relative to GDP over the course of Democratic administrations by an average of 0.8%.

This means that when the White House is in Democratic hands, the debt level falls, whereas it rises during Republication administrations. This is not without consequences for the currency. A significant federal budget deficit coupled with a current account deficit in terms of trade with foreign countries – a phenomenon known as twin deficits – can act as a burden on the currency. The current account is the difference between the export and import of goods, services, and certain capital gains and transfers.

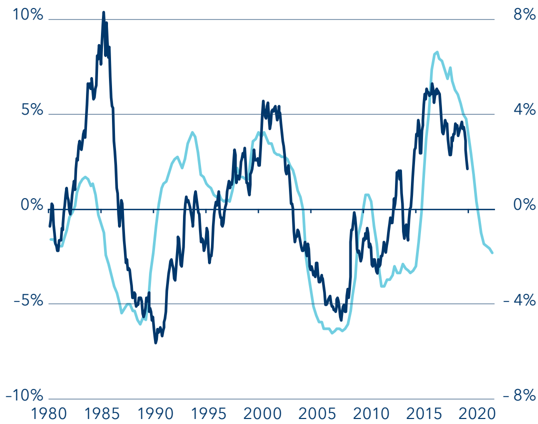
// The US is notorious for its deficits. With one exception only, it has not had a budget surplus since the 1980s. //

Because trade makes up the greatest portion of the current account, a deficit generally means that a national economy is importing more than it is exporting, and that it is not earning enough to pay for all these imports. Greatly simplified, this means that countries with a current account deficit are incurring debt abroad. The US is

US Presidents since 1970 and the dollar



EUR/USD and twin deficit



■ US twin deficit in % of GDP, 5yr change, 2yr lead (incl. IMF forecast)
■ US trade-weighted dollar, % appreciation p.a. over 5 years (rhs)

notorious for its deficits. With the exception of 1991, it has not had a budget surplus since the 1980s. If, in addition to the current account deficit, there is also a negative balance in the federal budget, this effect is then amplified because public consumption further increases the foreign import of goods and services.

If a national economy demands more foreign goods than it produces, corresponding foreign exchange is required in order to foot the bill. The purchase of foreign exchange weakens a country's currency. While, given the role of the US dollar as the leading world reserve currency (→ see "Why the dollar is the only world currency" page 23), this mechanism may be less pronounced in the US than in emerging nations, it is still demonstrable. Shifts in the twin deficits generally occur two years before corresponding changes are seen in the value of the dollar (→ see graph above).

A relevant conclusion especially in an election year

If the combined deficit of the current account and federal budget expand, the US dollar will lose value. And so it all comes full circle: the terms of office for the presidency and the different approaches to fiscal policy do, in fact, have an impact on the value of the US dollar. This conclusion becomes even more relevant given that, with Donald Trump, the White House is currently occupied by a Republican who is running for re-election in autumn and who pursues an extremely liberal spending policy.

Given the economic impact of the coronavirus crisis, Trump will be forced to massively increase the already enormous amount of debt. For this reason, we can safely assume that the dollar will once again follow its standard pattern and lose value over the medium term. However, given the deep recession looming as the result of the coronavirus, Trump's re-election is far from certain. How people are doing financially plays a major role in how they vote.

Nevertheless, even with a Democrat in charge, an expansive US fiscal policy will be necessary for a longer period of time to cushion the effects of the coronavirus crisis. For the 2019 financial year, the US budget deficit was already high at 4.7% of the GDP, and may balloon to nearly 12% this year as the result of relief measures. Even someone like Joe Biden, Trump's Democratic challenger in the upcoming election in autumn, will not be able to do much to counter a weak US dollar. After all, with the country currently at sixes and sevens, fiscal consolidation may be a long way off.

// Even someone like Joe Biden, Trump's Democratic challenger in the upcoming election in autumn, will not be able to counter a weaker US dollar. //

FORT KNOX: WHERE THE US KEEPS THE GOLD PORTION OF THEIR CURRENCY RESERVES

Clifford Padevit

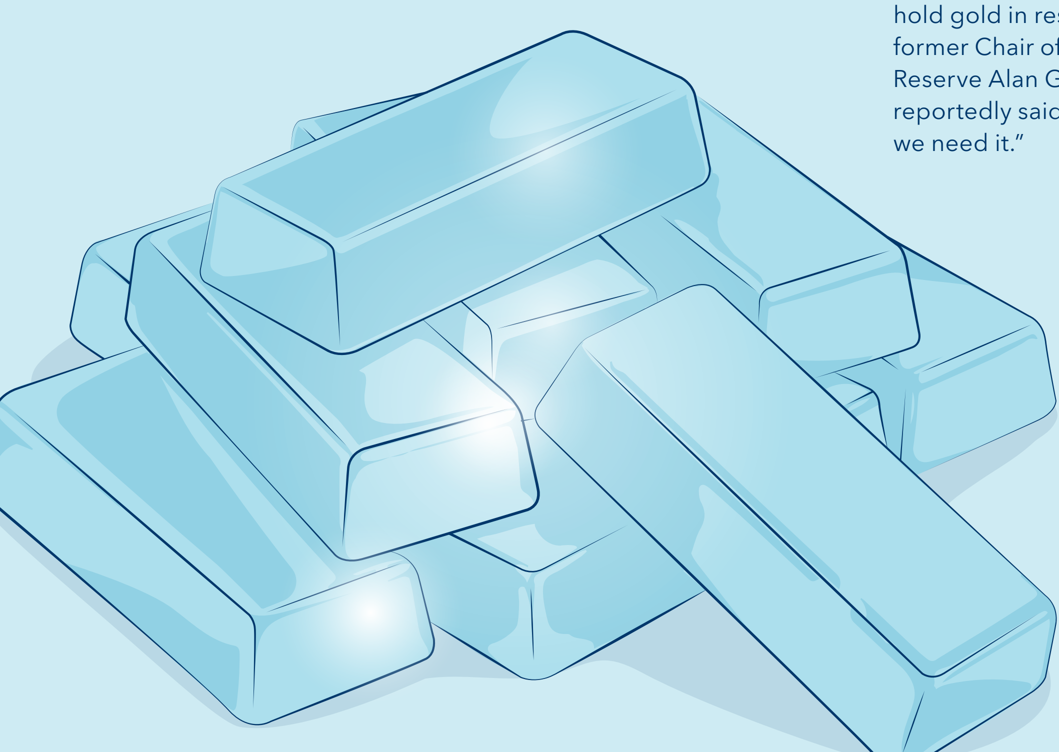
It is probably thanks to the film character James Bond that Fort Knox in the US state of Kentucky is so well known. In the film Goldfinger, the supervillain of the same name hatches a plan to rob the US gold stock. The plan would have worked if it hadn't been for the top agent 007.

In reality, Fort Knox is actually a rather boring place. For years, no more gold has been transferred to or transported from here. The only gold that ever leaves the site are extremely small quantities for testing purposes. Even for the guards, the site's own United States Mint Police, their day-to-day activities must be pretty monotonous. After all, no visitors are allowed.

However, the United States Secretary of the Treasury, Steven Mnuchin, who also heads the authority that produces dollar coins and notes, insisted on visiting Fort Knox in 2017 together with some selected politicians. This was the first time since 1974 that individuals without permanent access authorisation had been granted this privilege. Mnuchin tweeted happily afterwards: "Glad gold is safe."

Fort Knox is the biggest of the three US gold stores by some distance. In total, some 147.3 million ounces (an ounce corresponds to 31/1,000 of a kilogram, meaning a total of around 4,583 tonnes) are bunkered here and thus approximately 60% of the entire state stock domestically. The rest is distributed between locations in Denver (Colorado) and West Point (New York). In the books, the gold is valued at USD 42.22 per ounce. However, the market price currently stands at just over USD 1,700.

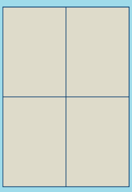
The United States use the gold as a currency reserve, despite the fact that the dollar has no longer been tied to the value of the precious metal since 1971 and fixed exchange rates were abolished in 1973. Nevertheless, the United States still keep large quantities. In addition to the domestic reserves, there are also small reserves abroad. Overall, the United States possess more than 8,100 tonnes of gold and is thus the nation with the highest gold reserves in the world. Why is this? When posed with the question of why the United States still hold gold in reserve at all, the former Chair of the Federal Reserve Alan Greenspan reportedly said: "Just in case we need it."



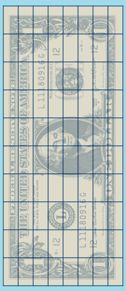
ALL ABOUT THE DOLLAR

A normal sheet of paper can be folded around 400 times before it tears. A dollar note can be folded up to 8,000 times.

= 100 folds



400 folds



8'000 folds

2/3 of all **$100** notes are outside the U.S.A.

Currency in circulation (2018)

Note ($)	Number of notes (in billions)	Value (in USD billions)
1	12.4	12.4
2	1.3	2.5
5	3.1	15.3
10	2.0	20.1
20	9.4	188.5
50	1.8	89.2
100	13.4	1,343.5
Total	43.4	1,671.9

25 **years** is the average lifespan of a coin.

History of American currency

1776 The first $2 notes are Continentals and are nine days older than America. On 25 June 1776, the Continental Congress authorises issuance of the $2 denominations in "bills of credit" for the defence of America.

1861 First greenbacks introduced. In order to finance the Civil War, Congress authorises the U.S. Department of the Treasury to issue non-interest-bearing demand notes. These notes earn the nickname "greenbacks" because of their colour. All U.S. currency issued since 1861 remains valid and redeemable at full face value.

1862 First legal tender. Congress passes the Legal Tender Act authorising the use of paper notes to pay the government's bills.

1869 Centralised printing of U.S. notes. The Bureau of Engraving and Printing (BEP) begins engraving and printing the faces and seals of U.S. banknotes. Before this, U.S. banknotes were produced by private banknote companies and then sent to the BEP for sealing, trimming and cutting.

1889 Names added to portraits. Legislation mandates that all banknotes and other securities containing portraits include the name of the individual below the portrait. This is why we know to this day what George Washington looked like (on the $1 note).

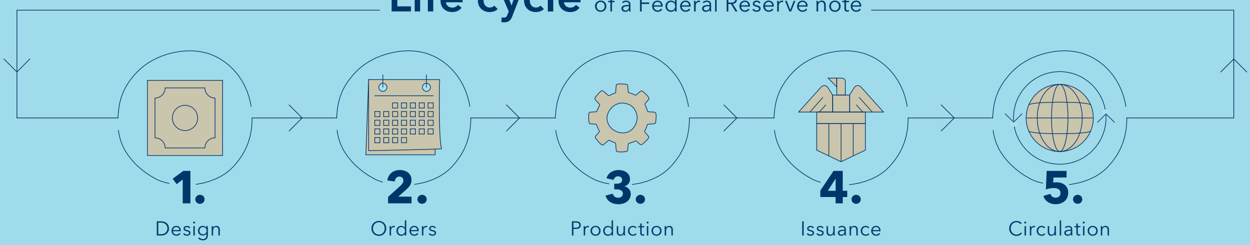
1913 Federal Reserve Act. The Federal Reserve Act of 1913 establishes the Federal Reserve as the nation's central bank and provides for a national banking system that is more responsive to the fluctuating financial needs of the country. The Federal Reserve Board issues new currency called Federal Reserve notes.

1929 Standardisation of design In an effort to lower manufacturing costs, all Federal Reserve notes are made about 30% smaller. In addition, standardised designs are introduced for each denomination, decreasing the number of designs in circulation and making it easier for the public to distinguish between genuine and counterfeit notes.

1800

1900

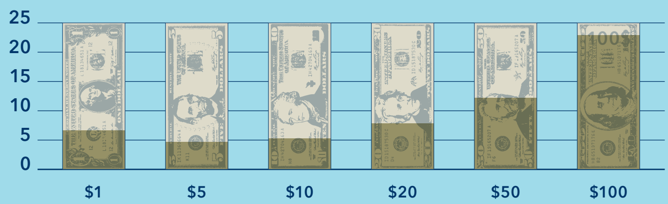
Life cycle of a Federal Reserve note



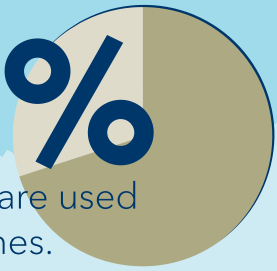
97%

of U.S. currency in circulation consists of Federal Reserve notes.

Average lifespan of a note in years



More than **70%** of newly printed notes are used to replace damaged ones.



1996 First redesign for 70 years. In the first significant change since the 1920s, U.S. currency is redesigned to incorporate a series of new counterfeit deterrents. Issuance of the new banknotes begins with the $100 note in 1996, followed by the $50 note in 1997, the $20 note in 1998, and the $10 and $5 notes in 2000.

1957 "In God We Trust" added Following a 1955 law requiring "In God We Trust" on all currency, the motto first appears on bank-notes on series 1957 $1 silver certificates, then on series 1963 Federal Reserve notes.

1990 A security thread and micro-printing are introduced on Federal Reserve notes to deter counterfeiting by copiers and printers. The features first appear in series 1990 $100 notes. By series 1993, the features appeared on all denominations except $1 and $2 notes.

2003 redesigned $20 note

2004 redesigned $50 note

2006 redesigned $10 note

2008 redesigned $5 note

2013 redesigned USD $note

2016 A woman replaces Jackson on $20 note. The Treasury Secretary of the Obama administration, Jacob Lew, unveils plans to put abolitionist Harriet Tubman on the $20 notes, which feature former President Andrew Jackson. The Trump administration delays the plan. Tubman would be the first woman honoured on paper currency since Martha Washington, the wife of George Washington, in the late nineteenth century.

2000

"THE RENMINBI WON'T RIVAL THE DOLLAR ANY TIME SOON"

China is not yet ready to internationalise its currency. That is the view of the British economist and book author George Magnus. He thinks the dollar will continue to dominate international trade.

Interview: Clifford Padevit

After the financial crisis of 2008/09, the internationalisation of the renminbi was on the agenda of Chinese authorities, but they kept delaying it. The currency is still only 2% of total currency reserves worldwide and is not broadly used in international trade. On top of that, China restricted capital outflows in 2016. So is the internationalisation still the agenda?
I think it has gone off the boil. The Chinese have other fish to fry. And there are some economists and academics that quite specifically say that it is a distraction for China to even consider the steps it would need to make the internationalisation more acceptable.

Even so, what would be the way for the renminbi to become international?
There is only one way to have a truly international currency. Foreigners have to be able to own your currency. We only know two ways foreigners can build up claims on you: One is, if you run continued current account deficits, so you import more than your export, so you pay out into the world more renminbi than you are receiving in foreign currency.

And the second?
You have to allow capital outflows, so that capital can flow from the host country to the rest of the world to balance the current account surplus. The strategies that lead to these outcomes are things the Chinese communist party doesn't want to do and doesn't approve of. So they don't really want to run current account deficits because they think it would make the currency unstable. And if you have a surplus of savings at home over investments you will always have a current account surplus. Even though the Chinese surplus is much smaller than it used to be, it is still a surplus.

There seem to be a number of economists who argue that China has to open its capital account because the country will run current account deficits in the future and will need capital inflows. You don't subscribe to that view apparently?
No. National income accounting dictates that the difference between savings and investment is reflected dollar for dollar or renminbi for renminbi in the current account surplus or deficit. If you have a surplus of savings over investments you will have a surplus in the current account, if you have a surplus of investment over savings you have a deficit, that is economic law. So the question is, would China follow policies that lead to significant changes in savings relative to investment.

Would they?
Well, we know that the Chinese Government has been allowing the investment rate to come down. But the kinds of things that would change domestic savings would be tax reform, social security reform, income redistribution, privatisation, more consumption friendly policies, opening up the service industries – these things are just not on the agenda of the government.

One would have thought, that if the internationalisation of the renminbi would be sup-

ported by the one belt one road initiative?
Yes, but most of the transactions are denominated in dollars. And most of the value of the belt and road projects are financial loans rather than foreign direct investments. So the three development banks, the Agricultural Bank of China, the Exim Bank and the China Development Bank lend dollars to recipient countries. The same is true for the Asian Infrastructure and Investment Bank which is the Chinese sponsored multilateral institution modelled after the World Bank. But the AIIB makes most of its financing in dollars as well.

Economically, China is a powerhouse. But its currency isn't. So the dollar remains the one global currency. What made the dollar so dominating?
It is a combination of the depth and breadth of the dollar financial market. There is no substitute for the US Treasury bond market. There is no substitute for the swap arrangements which the Fed makes available to other central banks including Emerging Markets. There is no substitute for the range of debt market denominated in US dollars. Also, people still believe the dollar markets have integrity, openness, transparency and they work. And there is a fundamental believe in the Federal Reserve System. And thirdly and fourthly, there is inertia and a lack of substitute.

Any chance for another currency to take on the dollar, the euro maybe?
The euro is the secondary reserve currency to the US dollar. It still lacks the features of US markets. All other currencies, including the renminbi, are a long long long way behind. That doesn't mean that US dollar will never be dethroned. But it would have to be a very serious event after which people no longer trust US institutions including the central bank. That would lead people to diversify their currency holding. But I don't think the renminbi would be a huge beneficiary to be honest.

Because of a lack of trust in China?
As much as anything, I think having a truly international currency is not only about market features and market operation, it is really about having transparent and open institutions and the rule of law. China offers none of those things. I am not saying that the renminbi won't be as big as the Swiss Franc or the Yen or Sterling in global currency terms. But it won't rival the dollar anytime soon.

CV

George Magnus is an independent British economist and book author. He is 70 years old and a research associate at Oxford University's China Centre as well as at the School of Oriental and African Studies in London. His views appear regularly in written and social media, radio and TV. George used to be the chief economist of UBS, the Swiss Bank. His recent book is titled "Red Flags: why Xi Jinpings's China is in Jeopardy" and has been published by Yale University Press. His views can also be found on his website:

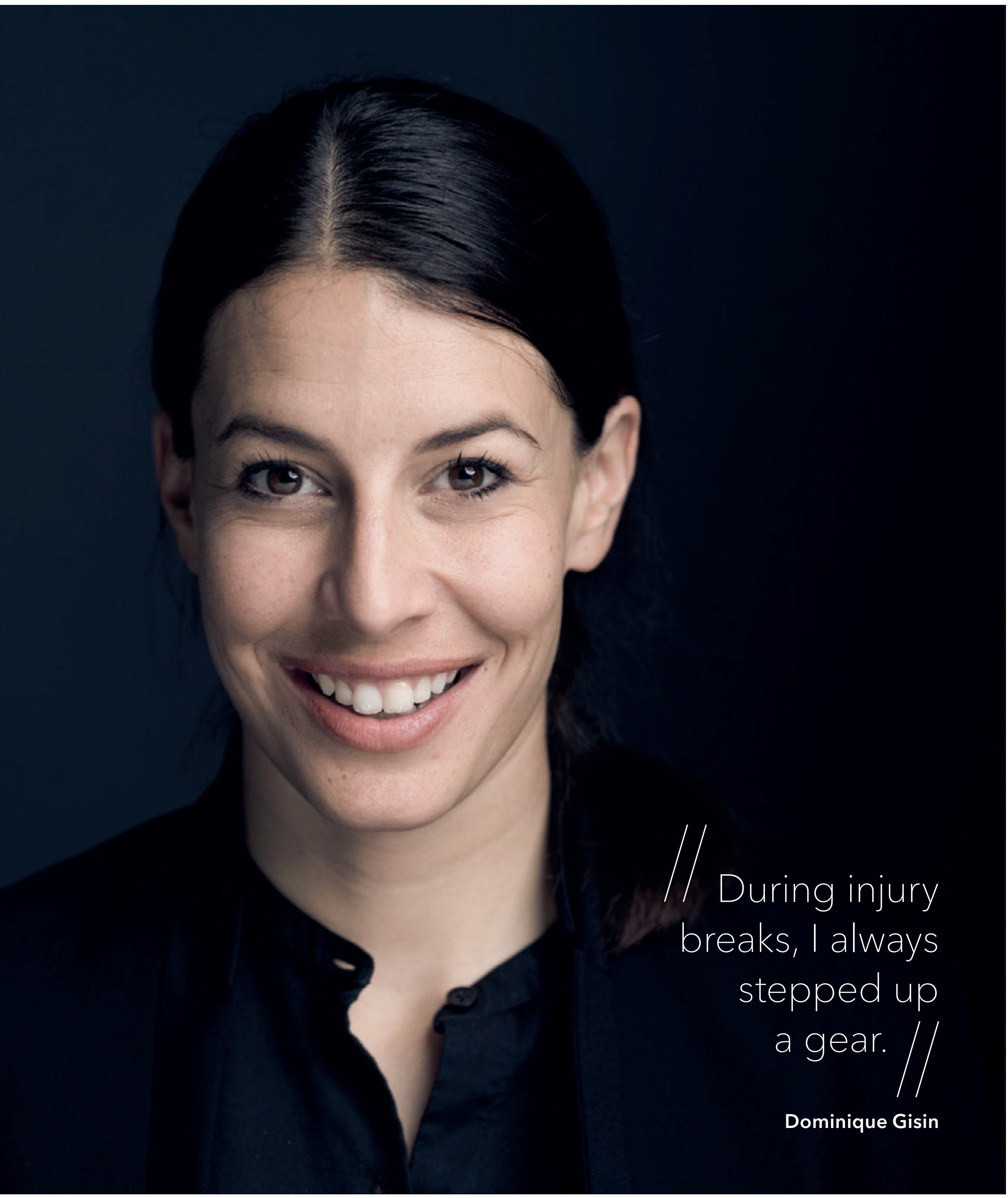
www.georgemagnus.com

Note: The views and opinions expressed in this article are those of the interviewee and do not necessarily reflect the opinion of VP Bank.

DOMINIQUE GISIN

The Olympic champion in the Alpine downhill event at Sochi 2014 knows how to cope with setbacks.

Clifford Padevit



// During injury breaks, I always stepped up a gear. //

Dominique Gisin

"If my career was a film, people would say the story is unrealistic," says Dominique Gisin. But the story is true. Gisin fell during the downhill skiing at the 2010 Olympics in Vancouver, but she returned in Sochi in 2014 to win and share the gold medal with the Slovenian athlete Tina Maze, who registered the same time. It is the highlight of her career, and when she tells the story it almost sounds as if she can still hardly believe it herself. So much work had gone into this victory and so much suffering with several injuries to her right knee. And her story has touched hundreds of people, as evidenced by encounters on the street and countless letters.

Even after her sporting career, which she ended five years ago, the 35-year-old is still giving it everything. She is a delegate of the Board of Directors at the Swiss Sports Aid Foundation, is an ambassador for the Swiss Red Cross and, as a native of Engelberg, sits on the Board of Directors of the local mountain railways. She supported her younger sister, Michelle, who is also a skier, and played a great role in her becoming Olympic champion in Alpine skiing combined two years ago. She is also acquiring her licence as a commercial pilot and holds talks on how to stay on top of things and achieve goals. Living a quiet life isn't her thing. During the lockdown, she is therefore resuming her studies in Physics at the Swiss Federal Institute of Technology (ETH) Zurich and is on course to gain her master's degree. And she is supporting Engelberg's initiative to give away 1,000 weeks' worth of holidays to healthcare staff as thanks for their work during the coronavirus crisis.

It is not easy to keep pace with everything that Gisin is doing. And it was no different for her opponents on the slopes.

My best investment

"The time and energy to do everything during an injury lay-off to ensure that I could quickly perform at my optimum once more."

How this situation came about

"I suffered several serious injuries. While other athletes may perhaps have seen this as an opportunity to go on holiday or complete a language stay, I always stepped up a gear," says Gisin. She gives the example of the knee injury she suffered at 17 in which everything but her cruciate ligament was either torn or broken. There were no instructions whatsoever with respect to how the knee should be rebuilt following such a complex injury. And this was precisely at a time when it was a matter of qualifying for the national squad.

Was it worthwhile?

"100%. Everything that I went on to achieve in my sporting career after this knee injury would no longer have been possible without such an investment. And I got a great deal back from it – not only from a health perspective, but also financially."

My worst investment

"From a purely financial perspective, the expenditure for my commercial pilot licence has probably not paid off. I won't be getting that back."

How this situation came about

"Flying is my passion and getting my private pilot licence initially was a good way of maintaining a balance, building towards something. It was the commercial pilot licence for flying alone with instruments that was especially expensive. If I were to add up all the costs for the training, I would probably feel sick (laughs). Depending on the aircraft type, an hour in the air can cost up to CHF 600 and then there are the costs for the flying instructor on top of that. It may well be the case that my training cost CHF 50,000. As I had more frequent interruptions, it was probably more expensive than for others."

Has any good also come out of it?

"I can now fly from A to B, even in bad weather. And I have also flirted with the idea of becoming a professional pilot, but things are not looking so good in that regard at the moment."

THE GREAT POWER OF THE DOLLAR

The ability to use your own currency as an accepted means of payment around the world is one of the main advantages of a world currency. It also allows the US to achieve its political goals with a different kind of power.

Gerd Hübner

For the citizens of Cuba, things are tough at the moment. According to news reports, petrol and food are scarce. Hunger and poverty is widespread. The reason? In the past year, the US government has reversed its policy of easing tensions with Cuba – a policy that was introduced by Donald Trump's predecessor Barack Obama – and has instead announced tighter sanctions. According to acting US Secretary of the Treasury Steven Mnuchin, the US was responding to the Cuban government's oppression of its people and its support for other dictatorships in the region, especially Venezuela.

It is practically impossible for Cuba to bypass these sanctions, which effectively cut the country off from the US dollar. This has to do with the role of the dollar as the world's reserve currency. In financial terms, very little would be possible around the world without the US dollar. More than 60% of global currency reserves are held in dollars (→ see "Why the dollar is the only world currency" page 23). With just 20%, the euro lags far behind in second place.

Moreover, the US dollar is involved in 88% of all foreign exchange transactions. Not since the British pound has there been such a dominant currency. The function of the US dollar as a reserve currency goes back to the Bretton Woods system, which involved fixed exchange rates and convertibility of gold into dollars (→ see the info page 21).

// Not since the British pound has there been such a dominant currency. //

Political power through sanctions

Even though the Bretton Woods system collapsed in 1973, the dollar has remained a world currency. As a global reserve currency, the dollar is available in sufficient quantities around the world and can be converted into every other currency. Moreover, the US is a political and economic world power with highly developed financial markets. The dollar also enjoys a high level of international acceptance (→ see the expert interview page 16).

Because, given the widespread use of the dollar, the US knows about nearly every international financial transaction. So the country is able to use the dollar for political purposes. The reason for this are clearing houses.

Clearing houses are responsible for settling and processing

US financial market activities as well as payment transactions that involve the US dollar. There are only two dollar clearing houses around the world. One is Fedwire, which is run by the US Federal Reserve and has more than 6,000 member banks, while the other is Clearing House Interbank Payments System, or CHIPS, which has around 60 major banks as members.

Access to the dollar is a matter of life or death for banks

Only banks that are members of one of these two clearing houses may carry out US dollar transactions. That means that without access to clearing and settlement processes, financial market participants cannot settle or process their transactions or payments in US dollars. In a report submitted to the Swiss Parliament, the Swiss government concluded that the only way to limit a country's dependence on the US financial system is to forego US dollar financial market activities and transactions entirely. But this is something that the vast majority of banks cannot afford.

This is why it is so important for financial institutions who are suspected of violating US sanctions not to lose this access to clearing houses. One spectacular example of this is what happened to BNP Paribas in 2014. The international French banking group agreed to pay a fine of USD 8.9 billion for processing financial transactions for countries that were subject to US economic sanctions. According to the US Department of Justice, between 2004 and 2012, BNP moved more than USD 8.8 billion through the US financial system on behalf of sanctioned countries.

> // Given the widespread use of the dollar, the United States know about nearly every international transaction. So the country is able to use the dollar for political purposes. //

Another example is the Russian billionaire Viktor Vekselberg. His Swiss bank accounts were frozen in 2016 because the US imposed sanctions against individuals linked to Russian president Vladimir Putin. As reported by the "Neue Zürcher Zeitung" newspaper, this freezing represents a violation of Swiss law. The fact that the Swiss banks did it anyway once again demonstrates the power of the United States or, rather, of the dollar.

For this reason, banks are careful not to violate any of the US government's sanctions with every transaction. The key aspect here is the US Treasury Department's Specially Designated Nationals and Blocked Persons List, or SDN list for short. This list contains all countries, companies or individuals deemed detrimental to the national security of the United States.

Having your country's currency serve as the international reserve currency comes with enormous economic advantages. Thanks to the popularity of the dollar, the US is not only able to exercise political influence, but can also use its currency as an additional means of making its voice heard.

INFO

The **Bretton Woods system** is an international monetary management system that was established and introduced in 1944. The system involved fixed exchange rates tied to the dollar as well as the convertibility of the dollar to gold. This turned the dollar into a reserve currency.

The United States unilaterally abandoned the gold standard in 1971, effectively bringing the system to an end. Most of the world's currencies have floated since 1973.

WHAT SHOULD INVESTORS DO IF THE DOLLAR WEAKENS?

Bernd Hartmann, André Rheinberger

01

Currency hedges for non-US dollar investors

For investors whose reference currency is not the greenback, a weaker US dollar leads to currency losses for investments that are denominated in US dollars. Not holding any US investments would represent a short-sighted perspective, as the IT sector, for example, is dominated by US companies.

Export-oriented US companies become more competitive at an international level when the US dollar is weaker. The foreign profits of these companies are worth more upon being repatriated. With forward currency transactions or currency-hedged fund tranches, investors can exclude or reduce currency fluctuations.

02

Regional diversification for US dollar investors

Investors with the US dollar as their reference currency should be careful not to limit their portfolio allocation too much to the US dollar market. During stock selection, companies with pricing power are to be given preference, as these are able to offset cost fluctuations.

Investments in other countries also help to increase diversification. This is primarily advisable for equity investments, as because with high-quality bonds, currency developments quickly overshadow coupon payments.

03

Emerging market bonds

An important portion of emerging market financing takes place in US dollars. If the US dollar falls in value, this reduces the debt burden of the creditor. The improved affordability has a positive effect on debt or quality ceteris paribus. This increases the attractiveness of emerging market bonds.

04

Emerging market equities

In terms of their real economic importance for the global economy, emerging markets are under-represented in many equity portfolios. In the case of a weaker US dollar, a situation that favours the emerging markets from a structural perspective, the incentive increases to adjust regional diversification.

05

Gold

Most of the production costs of gold are not incurred in dollars. If the greenback weakens, the costs converted into USD rise, which increases the price of gold. As a result, the precious metal, like other commodities, is negatively correlated to the USD. However, it is primarily the diversification characteristics as an investment independent of economic cycles that speaks in favour of gold.

WHY THE DOLLAR IS THE ONLY WORLD CURRENCY

The supremacy of the US dollar is unmatched. There is no currency that is accepted anywhere near as widely as the greenback.

Thomas Gitzel

The coronavirus crisis is making clear that the US dollar remains the world's most important currency. Whenever there are tensions on the financial markets, the equity markets fall, there is a lack of liquidity in the money markets or the risk premiums of corporate and emerging market bonds rise, the US dollar appreciates. As a "safe haven", it is much coveted during such phases. However, there is more that makes the US dollar a reserve currency.

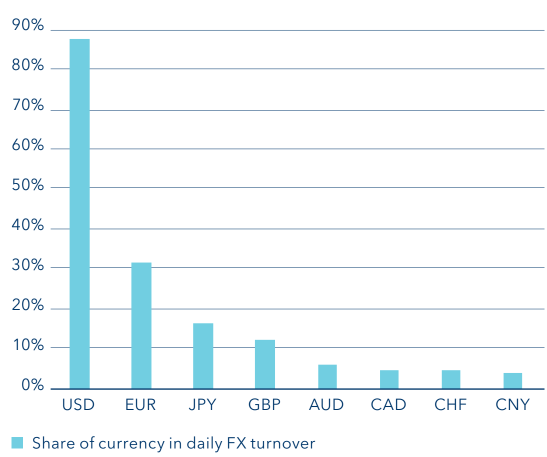
A reserve currency stands apart due to the fact that it is accepted as the most important international transaction, investment and reserve currency. To this end, it must be exchangeable into other currencies without restriction and be globally available to a sufficient extent that it can meet the global demand for liquidity. It is therefore primarily the sheer size of the currency area that makes the greenback so important. According to the Bank of International Settlements, the central bank of the central banks, the US dollar was involved in almost 9 out of 10 foreign exchange transactions (88%), while the euro, as the second most important currency, was used in just under one-third (31%) of all currency exchanges. With a current share of 4%, the Chinese renminbi appears well down the rankings in eighth place.

Financial market plays a major role

The availability of a currency is therefore a necessary condition to enter the rank of a reserve currency. However, this is not enough on its own – the financial market must also be open, while being deep and well developed at the same time. Capital must therefore be able to flow in and out of the affected currency area on an unhindered basis. Economists refer to a country as having a liberalised capital account.

It must be possible to invest in the interest rate and stock markets without government controls. The US and its currency the US dollar meet this criteria, unlike the Chinese renminbi, for example (→ see the expert interview page 16). The interest rate, bond and equity markets also perform a beacon function on the financial markets with their size and accessibility.

Share of currencies in international FX transactions



In order to ensure trust and international acceptance as a reserve currency, the reference currency country must also assure the internal stability of the currency's value through monetary and fiscal policies geared towards price stability on a sustainable basis, possess a high degree of macroeconomic stability and play a significant economic and political role in the global economy.

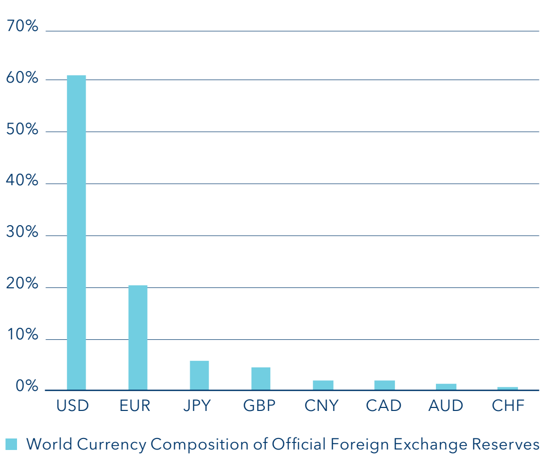
Due to the sharp rise in government debt in the US – also against the backdrop of the trillion-dollar coronavirus rescue packages – doubts may arise as to whether the US dollar can defend its role as the most important currency. However, the US can look back on a unique success story when it comes to stability.

While massive currency devaluations have been encountered in almost all regions of the world, the US has maintained a clean slate. Although the US has also suffered severe economic crises in recent years, the US Federal Reserve and the various governments have ensured reliability and stability over the long term.

The economists Steve H. Hanke and Nicholas Krus from the Johns Hopkins University in Baltimore (US) provide evidence with their comprehensive database on instances of hyperinflation. During the investigation period since the mid-eighteenth century, there have been 56 cases of hyperinflation. This is said to be the case when an inflation rate of 50% or more is recorded on a monthly basis. While neither the US nor the UK can be found anywhere on this list, it does contain Germany, France, China and Russia. This stability is supported by the country's political and military dominance. This dominance continues to set the US apart, even if the gap to ambitious China is becoming smaller.

The US dollar therefore possesses all of the important qualities needed to be a global reserve currency. It thus comes as no surprise that the bulk of global currency reserves is held in US dollars. According to the International Monetary Fund (IMF), it is 62% of worldwide currency reserves. The euro follows a long way behind in second place with a share of 20%.

Dollar is leading by quite a margin



How long will the US dollar's dominance last?

It is not set in stone that the US dollar will always remain the number one reserve currency. Up to the middle of the 1920s, the British pound was the dominant reserve currency. Only then did the US dollar become a real competitor. Until the end of the Second World War, the British pound and US dollar were the world's reserve currencies. The triumphant march of the US dollar began at the end of the war.

In the form of China, a new political and economic superpower is now emerging. The suspicion therefore suggests that the days of the US dollar's predominance are numbered. However, the greenback will continue to dominate for a very long time to come. As we have shown, a liberalised capital account is a fundamental condition for a reserve currency. This means that capital can flow in and out of the currency area unhindered. Significant inflows and outflows of investment funds can lead to a massive appreciation or depreciation of a currency, having a corresponding impact on inflation and the competitiveness of the national economy. In the worst-case scenario, a significant capital withdrawal can lead to insolvency and bring down governments. A state thus also relinquishes a good chunk of political control. Authoritarian governments find this difficult. This is because, ultimately, the free movement of capital requires an open and liberal state system.

Precisely because the Chinese state relies very heavily on control, it is not foreseeable that the government in Beijing will allow the free movement of capital (→ see the expert interview page 16). One of the key prerequisites for a reserve currency is therefore lacking. For this reason, in particular, the renminbi will not dethrone the US dollar any time soon.

FEAR OF A REPEAT

Bernd Hartmann

The coronavirus and the corresponding wide-reaching impacts of the related containment efforts have abruptly upended all of our lives. Looking to the future, the dominant question is whether we will experience a second wave of infections. Experience from earlier pandemics demonstrates that this is entirely likely until a vaccine can be discovered. However, no one can say whether and to what extent a second wave will hit us.

Investors are currently grappling with a similar issue. If we once again look to the past, we see that a second economic and market setback often follows the initial, major setback before a long-term recovery can begin.

No recovery expected before the fourth quarter

Both of these aspects have spooked investors – a fact that becomes clear when we look at the extreme market fluctuations. And the shock has not subsided yet: stock markets have experienced much more rapid losses than in earlier bear markets. This correction was followed by an extremely strong recovery; half of the losses could be recouped in just one month.

Government relief programmes and generous stimulus packages from central banks have allowed investors to overlook the bad news in terms of economic growth. Since financial markets anticipate future events, it is not necessarily unusual for them to recover before the real economy does. However, the economy currently finds itself in the midst of a downturn. We may reach rock bottom in the second quarter. But we do not expect a real recovery to set in before the fourth quarter.

The time between now and then will serve as a major stress test for countless companies. They must be able to overcome liquidity shortages if they're going to survive. Despite the support from the central banks, which are intervening on the market to keep financing costs low, not every company will make it. Until the economic recovery truly takes hold, bankruptcy and growing political dissonance may result in further setbacks.

Stay the course

In this market environment, investors should position themselves broadly. As part of an individual investment strategy, they should invest in equities and corporate bonds. When choosing investments, investors should focus on high-quality companies. They are better equipped to weather economically difficult months and should then be able to profit from the economic upswing after the storm passes. Long-term investments in major trends such as the digital transformation, which has been further accelerated by the coronavirus crisis, should also be part of equity allocation.

The current widening of spreads provides investors with a good opportunity to reinvest cash from bonds that are due for repayment. We recommend sticking with solid qualities and not relying too heavily on the purchasing programmes of the central banks. We currently consider strategies that take measured risks, resulting in an attractive opportunity/risk ratio, to be particularly interesting. These include risk-optimised equity strategies or convertible bonds. Non-cyclical investments such as gold or insurance-linked securities currently provide vital stability for portfolios and should therefore also be included.

> // Despite the support from central banks, not every company will make it. //

IMPRINT

CIO Office · VP Bank Ltd
Aeulestrasse 6 · 9490 Vaduz
T +423 235 61 73 · F +423 235 76 21
cio-office@vpbank.com

Editorial staff
Dr Felix Brill, Chief Investment Officer
Dr Thomas Gitzel, Chief Economist
Bernd Hartmann, Head CIO Office
André Rheinberger, Head of Group Investment Advisory
Clifford Padevit, Head Group Investment Communications
Christina Strutz, Office & Publication Manager
Felipe Gomez de Luis, Head of Marketing Communications & Branding
External: Gerd Hübner, freelance financial journalist

Design and illustrations
Lieu Nguyen, Senior Visual Designer
Katja Schädler, Visual Designer

Publication rhythm
Semi-annual

Publication date
1 June 2020

Editorial deadline
11 May 2020

Sources for charts
Page 5: Refinitiv Datastream, VP Bank
Page 6: Refinitiv Datastream, VP Bank
Page 9: Federal Reserve Bank of St. Louis, OECD, U.S. Bureau of Labor Statistics, VP Bank
Page 11: Bloomberg, VP Bank
Page 12: Bloomberg, Refinitiv Datastream, VP Bank
Page 23: Bank for International Settlements (BIS), VP Bank
Page 24: International Monetary Fund (IMF), VP Bank

Sources for info graphic
https://money.visualcapitalist.com
https://www.uscurrency.gov
https://www.federalreserve.gov

Fotos
Page 17: © René Ruis, Keystone-SDA
Page 18: provided by Dominique Gisin

Printed by
BVD Druck+Verlag AG, Schaan

FSC www.fsc.org MIX Papier aus verantwortungsvollen Quellen FSC® C013308

SWISS CLIMATE CO_2 NEUTRAL GEDRUCKT SC2018121202

VP BANK