May 22, 2024

Morning Briefing

US Dollar, Gold, Brazil & MegaCap-8

Check out the accompanying chart collection.

Executive Summary: Is the world “de-dollarizing”? Such chatter abounds, but the greenback’s role as the de facto reserve currency is secure, concludes Eric. While China has been buying a lot of gold, it’s not necessarily selling US assets to do so. Indeed, foreign investors have been snapping up US Treasury bonds steadily since 2021, and foreign governments have been swapping local currencies for dollars and investing in US assets at brisk rates. … Also: Melissa’s assessment of Brazil’s investment worthiness is an optimistic one notwithstanding recent flood damage. … And: Just how mega are the MegaCap-8 stocks and how distortive are their hefty capitalizations to the indexes and sectors in which they reside? Joe’s got the data.

US Dollar I: Is China Dumping Dollars? The greenback’s role as the de facto reserve currency is the fulcrum of global trade, financial flows, and economic policy. It also drives speculation that “de-dollarization”—or the decline of the US dollar’s supremacy among world currencies—is imminent. That would mean erosion of America’s special privileges enabling cheap borrowing and large fiscal deficits.

The dollar, of course, has performed magnificently since the Great Financial Crisis, up 28.7% over the past 15 years and 16.4% over the past five. Foreigners’ demand for US Treasury securities has remained steady, as discussed in our May 14 *Morning Briefing*.

Nevertheless, concerns are mounting about the outlook for the dollar, particularly given uncertainty about China’s reserves policy and gold’s surge to new records. They hinge on the notion that capital flows into America will fade. We think such concerns are overblown and see little risk of imminent falloff in demand for US assets. Consider the following:

(1) Gold has risen to a record 11% of all global reserves, up from about 6% in 2014 (*Fig. 1*). Central bank buying has recently boosted the gold spot price to all-time highs above $2,400 per troy ounce, breaking out from a tight range of higher highs since the Great Financial

Crisis (*Fig. 2*).

(2) The price of gold has risen a remarkable nine-fold since China joined the World Trade Organization in 2001. China's need to diversify its currency holdings gained from exports is one theory for gold's rise, but China's gold holdings as a percent of its foreign exchange reserves has only recently surged. Gold now makes up a record 5.2% of China's reported reserves (*Fig. 3*).

(3) China historically held much of its foreign reserves in dollars and dollar-denominated assets. It's one of the top holders of US Treasury bonds, an easy (and safe) place to stash cash earned from exporting to America. The big question now is whether China is dumping Treasury bonds to buy gold. Bloomberg Intelligence analysts cited in a May 16 *article* apparently think so, based on flows data from the Treasury Department.

(4) China's holdings of US debt in Treasury Department data have steadily declined from above $1.2 trillion in 2017 to a recent low of $767 billion, as of the end of March (*Fig. 4*). However, China also uses Belgium's Euroclear as a custodian for its holdings: As China's Treasury holdings have fallen over the past several years, its holdings in Belgium have risen.

Brad Sester at the Council on Foreign Relations (who researches the *topic*) recently suggested that China may be diversifying into Luxembourg's Clearstream custodian or even the UK. We think China may be diversifying the composition of its US assets out of Treasuries and into other US debt (more on that later).

(5) What we can surmise is that China is buying gold—but whether it's doing so by selling US assets is unclear. For now, we're not assuming any paradigm shift for the greenback, particularly considering the dollar's strength.

US Dollar II: American Assets Still Dominant. Many pundits have pontificated that foreigners' love affair with US financial assets will wane (or already is doing so) for various reasons. A look at the data suggests the opposite:

(1) Investors abroad have been steadily buying Treasury notes and bonds since 2021 (*Fig. 5*). A slowdown in those purchases recently has been accompanied by rising purchases of US corporate bonds. The three-month sum of that bond buying recently hit $503 billion (at

an annual rate), the highest since 2007 (*Fig. 6*).

With the Treasury yield curve inverted and a general preference for longer duration assets than Treasury bills, it makes sense that investors would seek more yield from investment-grade corporates, particularly given the strength of the US economy.

(2) Treasuries are generally considered “cash” in global financial markets. But we’re seeing signs of even greater demand for US dollar liquidity. Take the Fed’s Foreign and International Monetary Authorities (FIMA) Repo Facility, for example, which provides global liquidity by allowing foreign and international monetary authorities to temporarily swap their Treasuries for cash. Balances have risen to a record $370 billion (*Fig. 7*).

The Fed also has dollar swap lines where foreign authorities can exchange their currencies for US dollars. Usage spiked to several hundred billion dollars during crises, suggesting that the dollar’s status as a haven asset is not under any threat (*Fig. 8*).

(3) If foreign governments wanted to diversify away from America, we’d expect to see the official sector back off from investing here. Instead, we’ve seen inflows from foreign official bodies grow to a recent high of $173 billion over the 12 months ended March (*Fig. 9*).

(4) America’s $1.1 trillion trade deficit inherently demands investment flows into the country (*Fig. 10*). The current account (trade) and financial account (investment) must balance, and many countries find it both simple and beneficial to park earned dollars from exports to the US in American assets.

As global central banks begin cutting rates, higher interest rates in the US (thanks to the strength of its economy) will only encourage more investment in the US.

Brazil: This Too Shall Pass. Melissa and I expect Brazil to recover from its “Hurricane Katrina moment.” In recent weeks, torrential rain and huge floods have displaced more than 500,000 people in southern Brazil. Authorities say that it could take weeks for the floodwater to recede. The government is sending billions of dollars in aid to the region.

The downpour didn’t do any damage to Brazil’s MSCI stock price index. As of Monday’s close, the index trades 22.9% lower in local currency than its recent peak on June 7, 2021 (*Fig. 11*). The index’s forward revenues, forward earnings per share, and forward profit margin all have fallen from recent highs as well (*Fig. 12*, *Fig. 13*, and *Fig. 14*).

A beacon of hope in a sea of troubles, company fundamentals are expected to stage a substantial turnaround this year. Analysts' consensus revenue forecasts for companies in Brazil's MSCI index collectively indicate growth of 3.2% projected for 2024, which would follow a 9.8% revenue decline in 2023 (*Fig. 15*). Expected earnings growth of 0.9% in 2024 compares with a decline of 22.3% in 2023 (*Fig. 16*). Valuations are under pressure from some commodity price weakness, but the index's forward P/E of 7.6 as of Monday's close is attractively near historical lows (*Fig. 17*).

The country's economy is highly sensitive to fluctuations in commodity prices, which have been weak since mid-2022. However, commodities prices may have found a bottom in January. Whether their recent rebound is fleeting or sustainable is *debatable*. Rising copper prices usually reflect an improving global economy, in which case we can expect commodity prices generally to follow suit. This would boost Brazil MSCI's forward profit margin, which is highly correlated with commodity prices given that Brazil is a major exporter and runs a trade surplus (*Fig. 18*). (Major exports include energy and oil seeds.)

We don't see the temporary flood damage to soybean crops—which affects only a small share of Brazil's overall output—or investors' concerns about turnover at the helm of Brazil's largest state-run energy firm as major negatives. The latter in fact could be a net positive if it accelerates investments in Brazil's energy projects.

Here's more:

(1) *Growth on balance*. For an emerging economy, Brazil's real GDP growth has been lackluster (*Fig. 19*). It was up only 2.2% y/y in Q4-2023 and fell 0.1% q/q that quarter. But supportive fiscal and monetary policy combined with a turnaround in commodity prices could mitigate the flood effects, buoying the Brazilian economy out of a potential recession.

(2) *Exports demand*. The yearly percentage change in the 12-month moving average of Brazil's exports sank from near 40.0% in February 2022 to below 1.0% in November 2023, and recently turned up toward 3.0%. The unsmoothed yearly percentage change can be volatile, but it rose to 14.1% in April from a 6.5% decline in April 2023 (*Fig. 20*).

China is Brazil's top export destination, followed by the European Union. Recent economic downturns in China and Europe depressed demand for Brazil's products in recent months. However, China's recent stimulus efforts to revive its property sector could boost aggregate demand, as we recently discussed. "Green shoots" in the European economy could indicate a broader recovery there, similarly supporting demand for imports from Brazil.

(3) *Soybean supply*. Brazil's *second largest export by value* in 2023 was oil seeds ($53.03 billion). That's mostly composed of soybeans. The largest was mineral fuels, oils, and distillation products ($55.17 billion). On the supply side, soybean production cuts usually occur because of bad weather, but higher prices for soybeans could boost production by increasing Brazilian farmers' incentive to increase crop volumes.

While up to 80% of unharvested soybeans crops could be damaged in areas most affected by the flood, we calculate that only about 3% of the nation's total soybean output is at risk. That's based on estimates cited in a May 3 Reuters *article* pegging the at-risk amount at 5 million tons and the 155 million-ton output for the 2023/24 cycle estimated by the US Department of Agriculture.

Potential production losses for Brazil, the world's largest soybean producer, bolstered soybean futures prices in recent weeks. Global soybean futures spot prices (in US cents per bushel) fell from mid-2022 through April of this year but now may have bottomed (*Fig. 21*). Potential strikes from Argentinian soybean farmers also impacted prices in recent weeks.

(4) *China's ahoy*. China is both the *largest importer* of Brazilian products (receiving more than 30% of Brazil's total exports) and the world's largest soybean importer. China increasingly has preferred Brazilian soybeans over US ones, likely owing to US-China trade tensions. If China *retaliates* on recent US tariffs with import tariffs on US-sourced soybeans, then China's dependence on Brazilian soybeans will increase.

Brazil's total exports to China by value rose to $104.32 billion in 2023, a 16.3% increase from 2022. China *imported* 99.4 million metric tons of soybeans in total during 2023, an increase from 2022's 91.08 million metric tons.

(5) *Oil tensions*. After months of tensions with the government, the CEO of Brazil's Petrobas recently was replaced by a former oil & gas regulator whose views are more aligned with those of President Luiz Inácio Lula da Silva ("Lula"), Reuters *reported* last week. Investors believe the swap is a way for Lula to take greater control over the state-run oil enterprise, a negative for Petrobas stock. Its share price plunged on the news.

As we see it, the turnover could be a net positive for the broader Brazilian economy if it accelerates the oil giant's investments. Newly appointed CEO Magda Chambriard supports increased production in refineries and gas as a financing mechanism for Brazil's green energy transition efforts. The company's five-year plan includes $17 billion in refinery investments and $9 billion in natural gas and alternative energy projects, *noted* Brazilian Energy Insight.

(6) *Monetary policy.* Earlier this week, the central bank cut its main interest rate 25bpts to 10.5%, following six consecutive 50bpts cuts from 13.75% in August 2023. If the flood damage reverses inflation's downward trend as we expect, the monetary easing could stall.

Since August 2023, Brazil's CPI has been cooling toward the central bank's 3.2%-4.0% target band. It's down from a recent peak of 5.2% y/y in September 2023 to 3.7% y/y in April (*Fig. 22*).

(7) *Fiscal policy*. Brazil's fiscal policymakers have added to the country's debt in an attempt to support growth. Back in 2003, the net debt relative to GDP was only 40%. It neared 70% during March, and that doesn't include the latest flood support (*Fig. 23*).

CNN *reports* that Lula has pledged to disburse nearly $10 billion in rebuilding funds, and is seeking additional aid from the International Monetary Fund and World Bank.

Strategy: MegaCap-8 Still in the Driver's Seat. The S&P 500's price index is up 11.2% ytd through Friday's close, making new record highs again for the first time since the end of March. So too is the MegaCap-8 group of stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla). Their collective market capitalization has outperformed the index with a gain of 17.9% ytd; it was at a record high on Friday. The group's gigantic market cap has continued to push the S&P 500 price index higher—as it has been doing since the pandemic—but less so this year. Without the MegaCap-8, the S&P 500 would be up 9.6% ytd instead of 11.2%.

Still, the MegaCap-8 commands an outsized market-capitalization share of the S&P 500 and its Growth index, as well as the sectors that house them. Most are still near their record-high shares, with the exception of the Consumer Discretionary sector, as Joe discusses below:

(1) *MegaCap-8's shares of the S&P 500 and its Growth index are near record highs.* The MegaCap-8's aggregate free-float market cap accounts for 28.2% of the S&P 500 index's market cap and 51.1% of the S&P 500 Growth index's (*Fig. 24*). Those aren't far below their respective record-high readings of 29.2% and 52.7% during the April 16 week.

(2) *MegaCap-8's sector shares mostly near records too.* The Communication Services

sector contains Alphabet, Meta, and Netflix. Those three MegaCap-8 members account for 51.5% of the sector's market capitalization as of Monday's close, which is just a hair below its record high 51.6% on April 18 (*Fig. 25*).

The Information Technology sector has benefitted from the AI-investing theme and now has the highest MegaCap-8 market-cap contribution among the three sectors that house members of the group. Tech's MegaCap-8 members are Apple, Microsoft, and Nvidia. Together, their aggregate capitalization accounts for 61.4% of the sector's, not far below their record high of 61.8% on May 3. Tech appears to have taken the lead in this respect from Consumer Discretionary for good.

There are two MegaCap-8 companies in the Consumer Discretionary sector, and their share of the sector's market capitalization has fallen sharply from an eye-popping 74.4% on September 20, 2022. Amazon and Tesla are still whoppers, though, with a combined market cap that currently represents 53.7% of the sector's capitalization.

At a 51.5% market-cap share in the Communication Services sector, the capitalization of MegaCap-8 members Alphabet, Meta, and Netflix are just a hair below their record high of 51.6% on April 18. But they've been on a mostly steady winning streak over the past 18 months, causing their share of the sector's market cap to more than double from a low of 24.6% on November 3, 2022.

Calendars

US: **Wed:** Existing Home Sales 4.21mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes. **Thurs:** New Home Sales 674k; Kansas City Fed Manufacturing Index; Initial Claims 221k; M-PMI & NM-PMI Flash Estimates 50.1/51.5; Natural Gas Storage; Bostic. (FXStreet estimates)

Global: **Wed:** UK Headline & Core CPI 2.1%/3.6%y/y; UK PPI Input & Output Prices 0.4%0.4%m/m; UK RPI 3.3%y/y; Japan M-PMI 49.7; European Central Bank Non-monetary Policy Meeting; Germany Buba Monthly Report; Lagarde; Breeden. **Thurs:** Eurozone, Germany, and France M-PMI Flash Estimates 46.2/43.2/45.8; Eurozone, Germany, and France NM-PMI Flash Estimates 53.6/53.5/51.8; UK M-PMI & NM-PMI Flash Estimates 49.5/54.7; UK Gfk Consumer Confidence -18; Eurogroup Meetings; Pill. (FXStreet estimates)

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