MR Musha Research

30 October 2023

Musha Research Commentary

Strategy Bulletin (No. 342)

The End of the 1971Regime, Is this the beginning of the Era of the Dollar's Monopoly (1)

U.S. Pessimism, and Outstanding Strength of the U.S. Economy

Musha Research Co., Ltd.
President
Ryoji Musha
musha@musha.co.jp
http://www.musha.co.jp

Tel ＋81-3- 3740 2143
2-16-7-3912, Konan,
Minato-ku, Tokyo
108-0075,Japan

(1) Global Chaos and Growing U.S. Pessimism

The world is becoming increasingly chaotic. The postwar democracy and the international order based on international law became significantly vulnerable, with the confrontation between the U.S. and China, the growing possibility of a Chinese invasion of Taiwan, Russia's invasion of Ukraine, Hamas' attack on Israel, and Israel's counterattack. The Obama administration said that the U.S. could not stand to be the world's policeman, and the Trump administration increased its disregard for alliances by advocating MAGA. While China has been building up its military at an exceptionally rapid pace, the U.S. defense budget has been cut in half, from 7.7% of GDP during the Reagan era at the end of the Cold War between the U.S. and the Soviet Union to 3.6% of GDP in 2022.

It is indisputable that this rapid decline in the U.S. presence is the primary reason for the global chaos. In addition, political uncertainty is increasing in the U.S. ahead of the 2024 presidential election due to the fall and fragmentation of the middle class, the left-right divide, the decline of centripetal force within the Republican and Democratic parties, and a dysfunctional Congress. The theory of a declining U.S. economy is gaining strength. This is tied to the prospect of a decline in the value of the dollar. The overvaluation of U.S. stock prices by international comparisons and the speculative nature of the market, such as Bitcoin and Meme stocks, which have soared in popularity on the Internet, have led to the persistent belief (especially in Japan and Europe) that the U.S. stock bubble will burst.

This reinforcing pessimism about the United States also dims the prospects for the global economy by allowing the tyranny of China, Russia, Iran, and North Korea to gain the upper hand.

Figure 1: IMF World Economic Outlook evolution

	2022年	2023 E						2024E				
		22/7	22/10	23/1	23/4	23/7	23/10	22/10	23/1	23/4	23/7	23/10
World	3.5	2.9	2.7	2.9	2.8	3.0	3.0	3.2	3.1	3.0	3.0	2.9
US	2.1	1.0	1.0	1.4	1.6	1.8	2.1	1.2	1.0	1.1	1.0	1.5
Euro area	3.5	1.2	0.7	0.7	0.8	0.9	0.7	2.1	1.6	1.4	1.5	1.2
Japan	1.0	1.7	1.6	1.8	1.3	1.4	2.0	1.3	0.9	1.0	1.0	1.0
Emarging	4.0	3.9	3.7	4.0	3.9	4.0	4.0	4.3	4.2	4.2	4.1	4.0
Russia	-2.1	-3.5	-2.3	0.3	0.7	1.5	2.2	1.5	2.1	1.3	1.3	1.1
Ghina	3.0	4.6	4.4	5.2	5.2	5.2	5.0	4.5	4.5	4.5	4.5	4.2
India	7.2	6.1	6.1	6.1	5.9	6.1	6.3	6.8	6.8	6.3	6.3	6.3
Brazil	2.9	1.1	1.0	1.2	0.9	2.1	3.1	1.9	1.5	1.5	1.2	1.5

2) Outstanding Strength of the U.S. Economy and Rising Interest Rates

The Outstanding Strength of the U.S. Economy
The prevailing pessimism is contradicted by the outstanding strength of the U.S. economy. For example, over the past year or so, the Fed has raised the federal funds rate by a total of 5%, the fastest pace ever, and yet the U.S. economy shows no signs of slowing down at all.

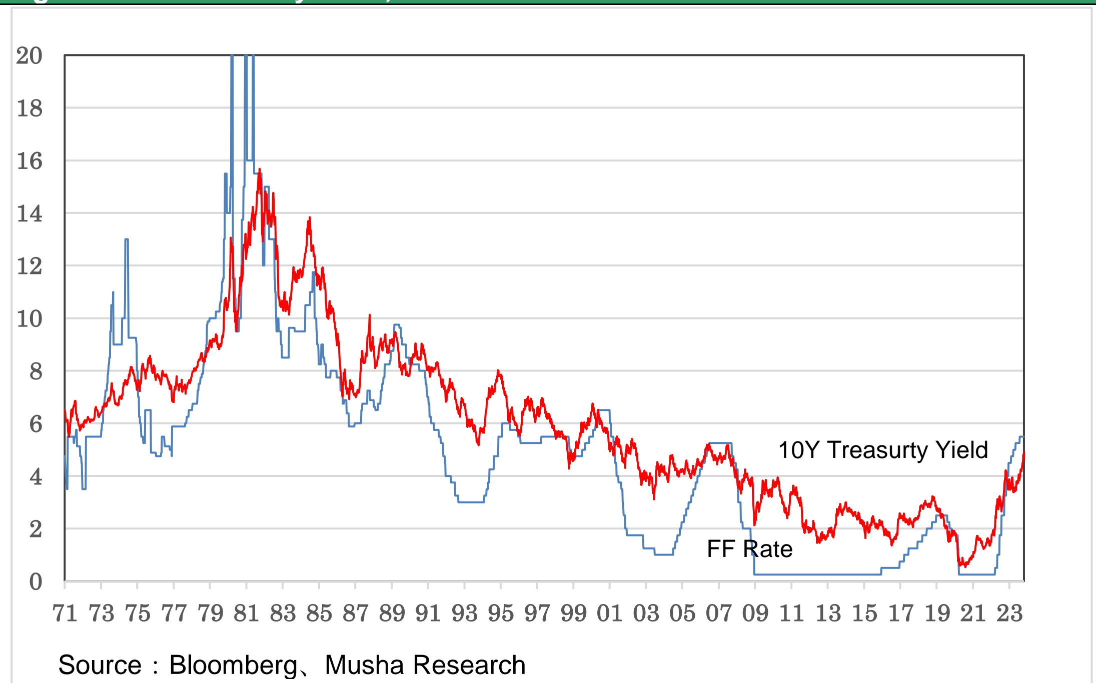
On the contrary, the IMF's forecast for the U.S. economy in 2023 has doubled from 1.0% a year ago to 2.1% most recently. While the European and Chinese economies are slowing noticeably, the strength of the U.S. economy stands out. Underlying this strength can be attributed to the new industrial revolution underway in the U.S. and the improvement in corporate earning power. The biggest driver is consumption, which accounts for 70% of GDP. Strong employment and continued growth in household wage incomes are boosting consumption.

Employment has been increasing strongly in all industries except information technology, in sharp contrast to the past interest rate hikes seen during the bursting of the IT bubble in 2000 and the GFC in 2008. An unprecedented virtuous cycle of "increased consumption ⇔ increased employment" seems to be in place. This is supported by strong corporate profits, a suppressed labor share, and free cash flow in the corporate sector, which continues to increase. Increased fiscal demand, including increased social insurance support by the government and industrial support through the Chips Act and IRAs (Inflation Reduction Act), is also contributing to this trend.

Uniqueness of the Rate Hike
The sharp rise in the long-term U.S. interest rate to 5% at one point is a cause for concern among market participants. The sharp rise in nominal interest rates amid a markedly lower rate of price increases pushed real interest rates to their highest level in 15 years. Rising real interest rates are one of the biggest concerns for equity markets and risk-takers, and it is not surprising that the market has become unstable.

This is the first time since the Volcker shock of 1980 that long-term interest rates have risen following with the FF rate level, resulting in a flattening of the inverse yield condition. As Chart 2 shows, the flattening of long- and short-term interest rates in the past has been achieved when short-term rates have been lowered due to the economic downturn caused by monetary tightening. What does this singular rise in long-term interest rates mean? It can be assumed that both Volcker shock and this time, long-term interest rates rose as the market, unsure of the central bank's intentions, followed the central bank's hawkishness. In both cases, the market was losing for the central bank's true intentions.

Figure 2: 10Y Treasury Yield, FF rate

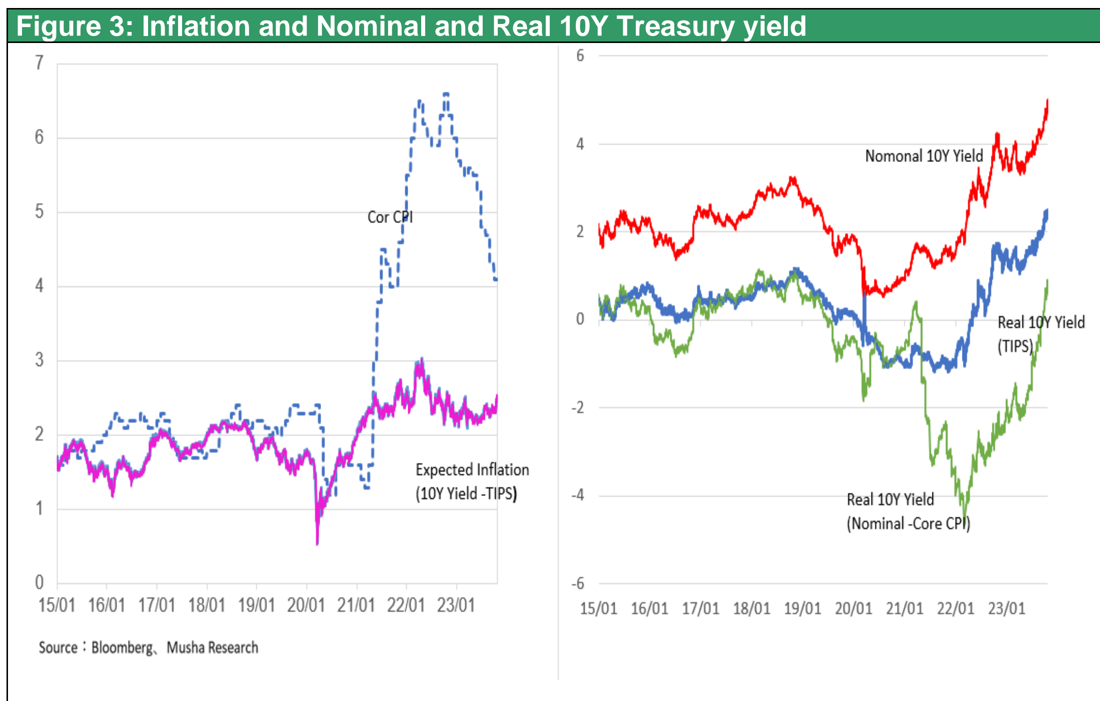


Source：Bloomberg、Musha Research

However, the crucial difference between the Volcker era and the current one is the severity of inflation: while inflation in the Volcker era was above 10% for more than two years, CPI growth this time around has been limited, falling sharply from a peak of 9.1% in June 2022 to 3.7% in September of this year. Average hourly

earnings (AHE), the Fed's primary focus, was 4.2% y/y in September, but was subdued at 3.3% quarter by quarter ago and 2.5% month-over-month (both annualized). In addition, as seen in Chart 3, the expected inflation rate (nominal 10-year bond yield minus TIPS), which the financial market has factored in, has remained stable at 2.5% plus or minus 0.5%, almost unaffected by the price volatility of the past two years. In other words, the market continued to view inflation during this period as temporary due to supply chain disruptions and the war in Ukraine and it was mostly correct. Musha Research's observations were consistently correct in this regard.

Figure 3: Inflation and Nominal and Real 10Y Treasury yield



Rising U.S. long-term interest rates may indicate an increase in the U.S. potential growth rate.
The Fed has lost sight of a sustainable neutral interest rate level (natural rate of interest) and is therefore groping for data dependence. This is exactly what Chair Powell meant in his August speech in Jackson Hole when he said, "We are navigating by the stars under a cloudy sky.

If the potential growth rate of the U.S. economy is being raised by technological innovation, the MSSE (Modern Supply-Side Economics) advocated by Treasury Secretary Yellen, and high-pressure economic policies, then naturally the reasonable neutral interest rate will become higher, and upward pressure on interest rates will intensify.

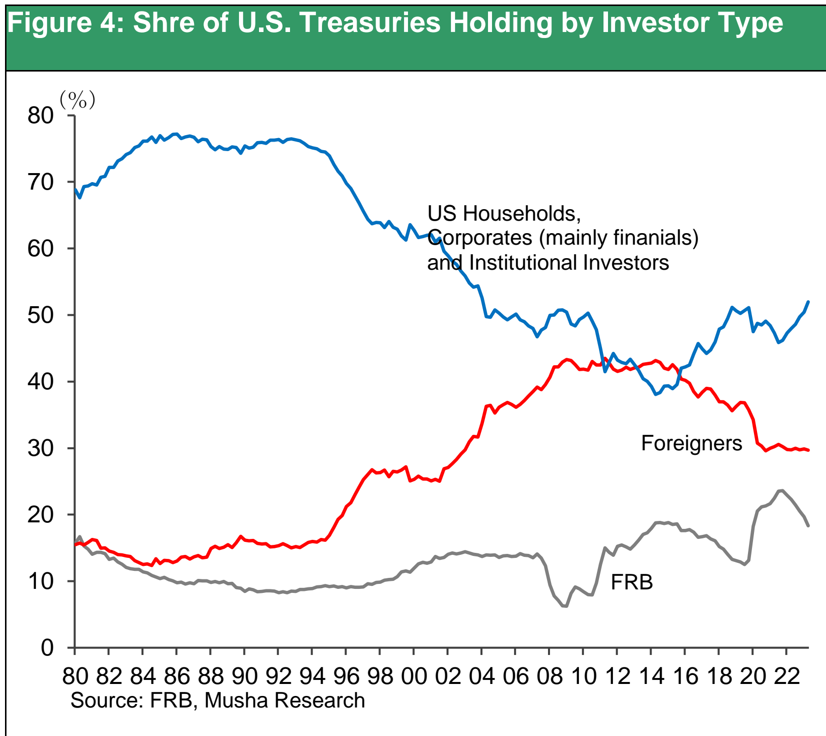
Thus, is the current rise in the U.S. long-term interest rate a good rise backed by higher potential growth or is it a bad rise due to inflationary pressures, declining confidence in U.S. finances, et.? And are they temporary or sustainable? The authorities and the market are in a state of flux, as they do not know the correct answer.

Although it is uncertain at this point, Musha Research dares to believe that the rise in long-term U.S. interest rates is a good thing and that it is sustainable to some extent. As mentioned above, inflation is almost under control. Negative factors such as the declining confidence in the dollar and crowding out due to the budget deficit are not consistent with the reality of the current appreciation of the dollar and the ample savings and aggressive investment in US government bonds (through MMFs) by the US private sector (see Chart 4). Uncertainty about inflation and interest rates will disappear in a few to six months. If this is the case, interest rate cuts, even if limited, are on the horizon. One aspect of a rate cut would be to increase investment in supply capacity and reduce inflationary pressures. The channel of increasing housing supply through interest

rate cuts are effective in suppressing housing prices. Also based on the MSSE theory, interest rate cuts assumed to be effective in suppressing wages through increase capital investment and labor substitution that create downward pressure on wages.

Unlike the Great Depression of the 1930s, when excess supply was left unchecked, the current U.S. economy is beginning to experience a virtuous cycle in which productivity gains from the new industrial revolution (i.e., increased supply) are compensated by strong demand creation.

Figure 4: Shre of U.S. Treasuries Holding by Investor Type



Source: FRB, Musha Research

(3) Possibility of the arrival of an era of dollar appreciation to counteract U.S. pessimism

Possibility of U.S. Economic Strength Overcoming U.S. Pessimism
Whether this strength of the U.S. economy can boost the U.S. presence and accomplish the restructuring of the world order is the focus of debate here. Musha Research asks how strong is the U.S. economy? If this strength is to lead to the reconstruction of a U.S.-led world order, what paths can be envisioned? To do so, historical retrospection is indispensable.

The Second Postwar Regime that Began in 1971
The framework of the current world economic and political order, which can be called the second postwar regime, was formed by the two Nixon shocks in 1971. Now it is crumbling with a resounding crash. The first of these was the restoration of diplomatic relations between the U.S. and China. Communist China was invited into the world order, and the world's largest people, 800 million at the time, became a member of the global market economy, but the U.S.-China confrontation put it against the wall. The second Nixon shock was the cessation of the dollar-gold compatibility, after which the U.S. continued to increase its trade deficit and its external debt ballooned.

From a Dollar Excess to a Dollar Shortage
This dollar-dripping system is the essence of modern globalization. The dollar glut benefited U.S. citizens by continuing to stimulate consumption, and benefited foreign countries by increasing their exports to the U.S. The dollar glut also benefited Japan, Asian NIEs, and China. The Asian era, which began with the takeoff of Japan, Asian NIES, and China, was the result of the Nixon Shock. However, this too has hit its limits: U.S. dependence on goods imports, which was 10% in 1970, has reached 80-90%, and there is no more room to increase imports. On the other hand, U.S. services exports and income balance surpluses

have begun to increase significantly. The biggest bright spot in the global economy is not Asia or the Global

South, but cyberspace. In this rapidly developing mass of knowledge, cyberspace, Internet, and AI, etc., the U.S. companies has almost monopolized global demand and they are lifting the price of its use. Europe and Japan are trying to penalize the monopoly of Internet platform providers, but since there are no alternative suppliers in their countries, this is a futile attempt.

If this is the case, the U.S. current account deficit will begin to decline, the supply of dollars will slow down, and an era of dollar shortages will arrive. In addition, the economic growth rate of the U.S., the home of innovation, will begin to outpace that of other countries, and resulting high interest rates will encourage the concentration of capital in the U.S.

The resulting dollar appreciation will strengthen the financial power of the hegemonic U.S. and will be a driving force for the restructuring of the world order. In the next few articles, we will examine whether the assumption that a strong dollar is the key to the restructuring of the world order is valid.

Figure 5: End of NIXON SHOCK Era and Dollar weakness

© Copyright 2023 Musha Research Co., Ltd. Although the information contained herein is based on sources that Musha Research believe reliable, Musha Research do not make any representation or warranty, express or implied, with respect to the fairness, correctness, accuracy, reasonableness or completeness of the information and opinion herein. Musha Research is not responsible for any losses or damages incurred by your relying on such information and opinion. The analyses or opinions contained herein may be based on assumptions that if altered can change the analyses or opinion expressed. Nothing contained herein shall constitute any representation or warranty as to future performance of any financial product, credit, currency rate, interest rate or any other market or economic measure. Furthermore, past performance is not necessarily indicative of future results. Musha Research has no obligations to update, modify or amend this document or to notify a reader in the event that any matter stated herein changes or subsequently becomes inaccurate. When you analyze risks and issues on investment, finance, tax, law and/or accounting contained herein, you should take steps to ensure that you understand