

USD—Unused Implement in the Trade Toolkit

US President Trump's focus on trade and "leveling the playing field" has been intense and is ongoing. Yet two years into his administration's term, the US trade position remains weak, with the US recording the highest trade deficit in 10 years and the widest goods deficit with China on record in October. The data suggest that net trade undercut growth significantly in Q3 and will be a further drag on growth in Q4. Historically, the trend in the USD tends to affect export growth significantly. The USD seems an obvious lever on which the White House could pull to boost trade. However, we rather think the exchange rate will be left untouched in the trade toolkit.

The US trade performance is deteriorating. The October trade report reflected flat exports over the prior month (USD211bn), despite record shipments in energy, industrial and consumer products. Imports rose slightly (+0.2%) over September to USD266.5bn. The unadjusted trade gap with China widened to USD43.1bn—a record—reflecting Chinese importers snubbing US soybeans, among other things.

The 12-month average trade deficit stands at -43.5bn, the widest since 2013, while the 5-year average deficit stands at -50.2bn, the widest since 2009. Both averages stood at -41.7bn and -46bn respectively 12 months ago. Tariffs and the synchronized slowing in global growth help account for some of these trends in US trade and while they may moderate or reverse in the future, little change is likely to emerge in the near-term.

Trade was a significant drag on US Q3 growth, with net exports reducing GDP by a little over 1.9 percentage points in the quarter. That is a huge drag growth. By our reckoning, you have to go back to 1984 to see anything similar or worse. No quarter in more recent times has seen anything close to that sort of negative impact from trade. It is certainly exceptional and possibly a one-off but the weak October report data suggests that net exports are likely to weigh on growth again in the last quarter of the year to some extent at least, accentuating the moderation in the US economy that appears to be underway now.

Given the US Administration's focus on trade—and its tendency to boost the positive impact of its policies on the economy—this may be bothersome, especially as progress on lifting exports is likely to be impeded to some extent at least by the relative strength of the USD. History shows that the USD's broader performance does tend to influence US exports over time and this relationship suggests that an "easy" win for the White House would be to talk the USD lower—the one lever on trade that the president has yet to tug clearly on to gain an advantage for the US.

Of course, it is not quite as simple as that. President Trump—and to some extent Treasury Sec. Mnuchin—have had a flexible perspective on the USD. The president has variously remarked that the dollar was "too strong", a "disadvantage" or that he would prefer an exchange rate that was not too strong. Conversely, the president has also suggest that he "(ultimately)... wants a strong dollar" and praised the "cherished" dollar when talking about foreign investment "pouring" into the US.

Various administrations and their respective Treasury Secretaries have endorsed a "strong dollar policy" with varying degrees of conviction. Those that are less enthusiastic about it have tended to ignore it altogether rather than offer up an alternative. Any clear, obvious and—importantly, for this administration—consistent move away from the strong dollar policy message would very likely prompt a swift drop in the USD.

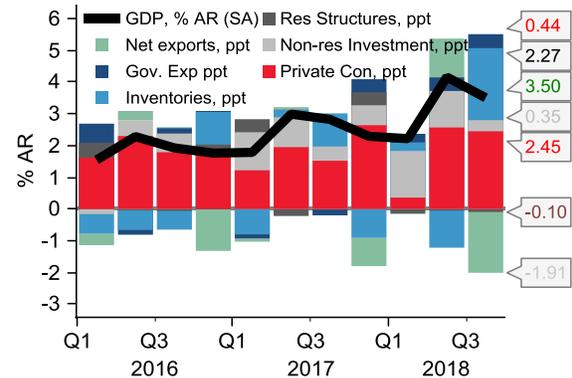
We think there are a number of reasons why the USD is likely to remain locked away, untouched, in the US trade toolkit, however. Firstly, this administration—like many others before it—has been at the vanguard of promoting market-determined exchange rates. President Trump has been critical of FX manipulation, which talking

FOLLOW US ON TWITTER @SCOTIABANKFX

Shaun Osborne
Chief FX Strategist
461.945.4538
shaun.osborne@scotiabank.com

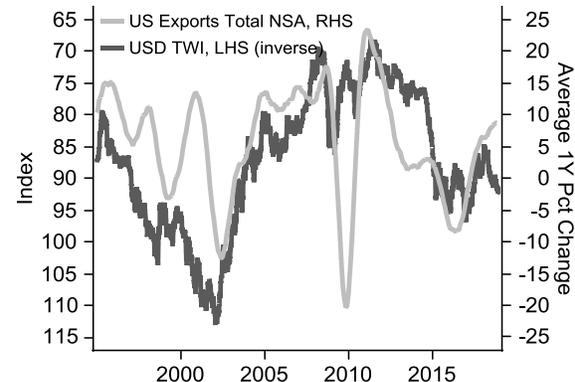
Eric Theoret, CFA, CMT
FX Strategist
416.863.7030
eric.theoret@scotiabank.com

Composition of US GDP Growth



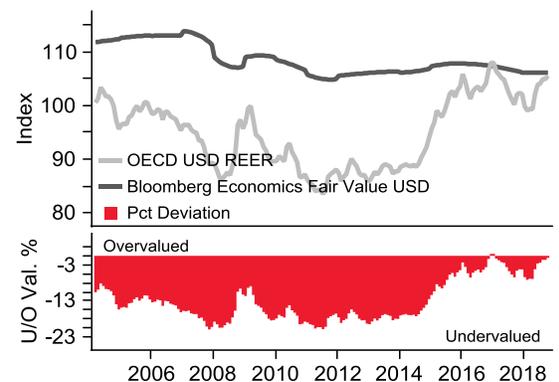
Source: Macrobond, Scotiabank FICC Strategy

Strong USD Will Slow Exports



Source: Macrobond, Scotiabank FICC Strategy

USD Close to Long Run Equilibrium



Source: Macrobond, Scotiabank FICC Strategy

This report is intended for gbmreports@konradgroup.com. Unauthorized distribution of this report is prohibited.

down the USD would clearly represent. The US also remains bound by the G7 agreement to avoid competitive devaluations. Secondly, there is the risk of “blowback” or unintended consequences which might result from a weak dollar policy—such as higher inflation, capital flight—which might overshadow the original problem of a weak trade position. Finally, establishing what the appropriate level for the USD might be is not obvious.

In broad terms, for example, the OECD’s Real Effective Exchange Rate (REER) index for the USD is close to the longer run REER fair value estimate for the USD developed by Bloomberg. The USD is somewhat overvalued against some of the major currencies in PPP terms but the more egregious currency undervaluation issues largely reside in the EM FX space. Any readjustment here will likely have to occur over the longer run and reflect a sustained improvement in domestic (i.e., non-US) fundamentals rather than simple US jaw-boning the USD lower.

IMPORTANT NOTICE and DISCLAIMER:

This report is prepared by Scotiabank as a resource for clients of Scotiabank for information and discussion purposes only. This report should be considered a marketing communication and has not been prepared by a member of the research department of Scotiabank, it is solely for the use of sophisticated institutional investors, and this report does not constitute investment advice or any personal recommendation to invest in a financial instrument or “investment research” as defined by the UK Prudential Regulation Authority or UK Financial Conduct Authority. This document has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and the information contained in this publication is not subject to any prohibition in the EU on dealing ahead of the dissemination of investment research. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from publically available sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness and neither the information nor the forecast shall be taken as a representation for which Scotiabank or any of its employees incur any responsibility. Neither Scotiabank nor its representatives accept any liability whatsoever for any loss arising from any use of this report or its contents. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instruments and has no regard to the specific investment objectives, financial situation or particular needs of any recipient. It is not intended to provide legal, tax, accounting or other advice. Scotiabank and/or its respective officers, directors or employees may from time to time take positions in the products mentioned herein as principal or agent. Directors, officers or employees of Scotiabank may serve as directors of corporations referred to herein. Scotiabank may have acted as financial advisor and/or underwriter for certain of the corporations mentioned herein and may have received and may receive remuneration for same. This report may include forward-looking statements about the objectives and strategies of Scotiabank. Such forward-looking statements are inherently subject to uncertainties beyond the control of Scotiabank including but not limited to economic and financial conditions globally, regulatory development in Canada and elsewhere, technological developments and competition. The reader is cautioned that the member's actual performance could differ materially from such forward-looking statements. Past performance or simulated past performance is not a reliable indicator of future results. Forecasts are not a reliable indicator of future performance. You should note that the manner in which you implement any of strategies set out in this report may expose you to significant risk and you should carefully consider your ability to bear such risks through consultation with your legal, accounting and other advisors. Information in this report regarding services and products of Scotiabank is applicable only in jurisdictions where such services and products may lawfully be offered for sale and is void where prohibited by law. If you access this report from outside of Canada, you are responsible for compliance with local, national and international laws. Not all products and services are available across Canada or in all countries. All Scotiabank products and services are subject to the terms of applicable agreements. This report and all information, opinions and conclusions contained in it are protected by copyright. This report may not be reproduced in whole or in part, or referred to in any manner whatsoever nor may the information, opinions and conclusions contained in it be referred to without in each case the prior express consent of Scotiabank. Scotiabank is a Canadian chartered bank.

If you are affected by MIFID II, you must advise us in writing at trade.supervision@scotiabank.com.

™Trademark of The Bank of Nova Scotia. Used under license, where applicable. Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotia Capital Inc. and Scotia Capital (USA) Inc., Scotiabank Europe plc, Scotiabank (Ireland) Limited - all members of the Scotia-bank Group and authorized users of the mark. The Bank of Nova Scotia is incorporated in Canada with limited liability. Scotia Capital Inc. is a member of the Canadian Investor Protection Fund. Scotia Capital (USA) Inc. is a broker-dealer registered with the SEC and is a member of FINRA, NYSE, NFA and SIPC. The Bank of Nova Scotia is authorized and regulated by the Office of the Superintendent of Financial Institutions in Canada. The Bank of Nova Scotia is authorized by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorized by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

To unsubscribe from receiving further Commercial Electronic Messages click this link: www.unsubscribe.gbm.scotiabank.com.