Weekly Commentary 35

The US Economy…Houston, we have a problem…

There was not a lot of news on the US economy over the past several weeks, as all media attention was focused on the startling events regarding the US election. There was the disastrous (for Biden) debate at the end of June, then the attempt on Trump's life just a week later, and finally, the Biden announcement that he would step down, the result of an obvious internal struggle within the Democratic Party that led to a veritable coup against the old man. The last event that caused all eyes to be cast on the Nov presidential elections rather than the economy was Kamala Harris' appointment as the nominee to take on Donald Trump, in what many have said is an anointing of the VP to her next position as presidential hopeful.

But as of today, the polls indicate that she still has a long way to go to win the vote. She is at best tied in these polls in the race against Trump. Other polls suggest that Trump will win by a landslide in the electoral college. So the race is still very much up in the air.

But whether the Democrats retain the White House or they concede to the Republicans will largely be dependent on how the economy performs in the weeks ahead of the Nov elections. After all, it is all about the economy, stupid, and whether this is a year before the votes are cast or whether it is three months, the sentiment that decides who runs the show for the next four years is the same as James Carville had advised Bill Clinton in 1992. As such, all eyes are again back on the economic numbers.

After almost four weeks, news on the economy popped back up on the radar. But it was not good news for the incumbent. It appears that the economy is not doing as well as the Biden administration has been hoping for. The observation that inflation was moderating, even as unemployment data were buoyant seems to be favouring the Biden administration. Overnight, that was turned on its head, when the jobs landscape cooled. What happened? Here is a report from the Wall Street Journal:

U.S. Hiring Slowdown Hits Stocks, Fuels Bets on Bigger Rate Cut
Dow falls more than 600 points as investors worry about a weakening economy

By
Justin Lahart

Updated Aug. 2, 2024 4:29 pm ET

The Labor Department reported that the unemployment rate rose to 4.3% and hiring slowed in July. The report signals that the labor market's strength is fading.

America is still adding jobs, but no longer at a red-hot pace. That sent markets into a tailspin Friday, with the Dow Jones Industrial Average sliding more than 600 points.

Job growth slowed sharply in July and the unemployment rate rose to its highest level since 2021, the Labor Department reported. The data adds to evidence that a labor market whose strength was already fading could actually be on its way to weakness.

Hiring slowed to 114,000 jobs last month, the government said, missing expectations. The unemployment rate rose to 4.3%—its highest level in nearly three years, when the economy was still clawing its way back from the pandemic.

Stocks fell sharply after the data came out, reflecting investors' renewed worries about an economic slowdown. Everything from banking stocks to small companies took big hits, Treasury yields mostly fell below 4% and the CBOE Volatility Index, Wall Street's "fear gauge," closed at its highest level of the year.

The tech-heavy Nasdaq Composite closed in correction territory, or down at least 10% from its recent high. Disappointing earnings from big technology companies have led some investors to question whether the mania around artificial intelligence, which has fueled tech stocks this year, has gone too far.

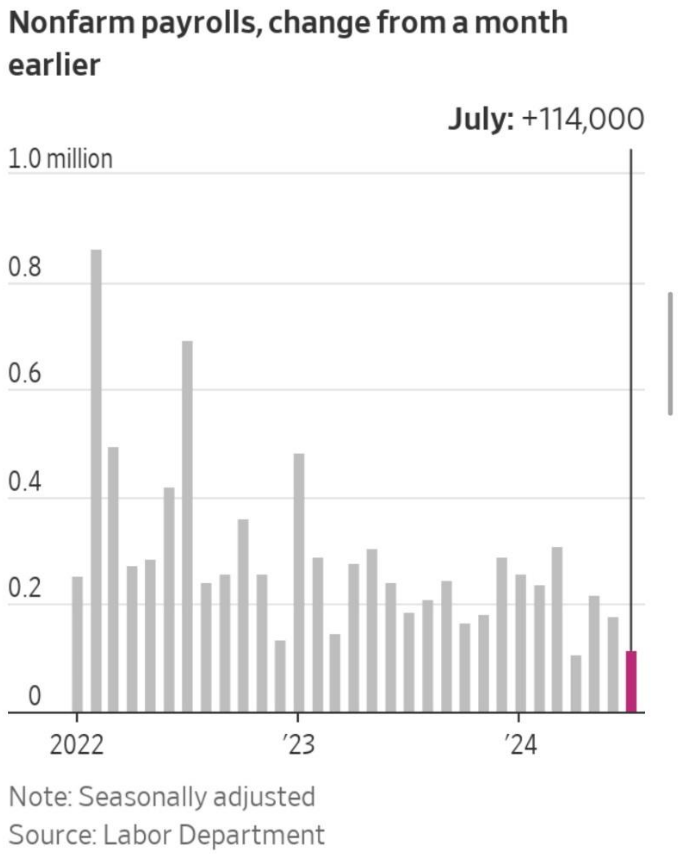
The jobs report is sure to give another spark to debates about whether the Federal Reserve is behind the curve in its handling of the economy. Fed policymakers on Wednesday kept rates where they are, but strongly implied that they would cut in September.

Some investors have started to question whether the Fed has already waited too long to trim interest rates. And while that debate may be a moot point—a cut in September looks all but guaranteed—many investors will want the Fed to cut by a half point instead of the quarter point they were expecting. Interest-rate futures on Friday went from implying a quarter-point cut in September to a half-point cut.

At the Fed's news conference Wednesday, Chair Jerome Powell said a larger half-point cut wasn't "something we're thinking about right now" but then, after appearing to have concluded his answer, he added that officials hadn't made "any decisions at all."

While the labor market was bound to cool down from its postpandemic hiring spree, the question now is whether it will keep softening right into a recession.

Friday's jobs report wasn't the only data released this week that pointed to a weakening economy. Thursday, the Institute for Supply Management reported that its measure of manufacturing employment deteriorated in July, helping spark a selloff in stocks. And after the close Thursday, Intel posted disappointing quarterly sales, and announced plans to lay off 15,000 people. Its shares fell 26% on Friday.



The recent numbers

The Labor Department said average hourly earnings were up 3.6% in July from a year earlier—above the recent pace of inflation, but the smallest gain since May 2021. The jobs count for May and June was revised down by a combined 29,000.

The jump in the unemployment rate was from more people looking for jobs, rather than people losing their jobs. The labor-force participation rate, the share of working-age people who were employed or seeking work, rose to 62.7% from 62.6% in June. Absent the increase in participation, the unemployment rate would have stayed at 4.1%.

July's job gains were concentrated in the healthcare sector, which added 55,000 jobs, construction, which added 25,000, and leisure and hospitality, which added 23,000. On the other side of the ledger, the information sector shed 20,000 jobs.

To a degree, the slowdown in job creation last month might reflect the effects of Hurricane Beryl. The hurricane made landfall in Texas on July 8, near the start of the week the Labor Department uses for its employment readings. The Labor Department said there was "no discernible effect on the national employment and unemployment data for July," but many economists questioned that.

Jefferies economist Thomas Simons noted that over a million customers in the Houston area were without power during the jobs-report survey week, and in the storm's wake, there was also a notable move up in weekly readings on initial claims for unemployment insurance filed in Texas. The Labor Department on Friday said that 461,000 people with jobs were unable to work because of weather in July. The average number of people missing work because of weather over the previous 10 Julys was 37,000. The August jobs figures could see a rebound as those storm effects reverse.

But other labor market measures are flashing warning signs.

The Sahm rule, an indicator popularized by economist Claudia Sahm, says that if the average of the unemployment rate over three months rises a half-percentage point or more above the lowest the three-month average went over the previous year, the economy is in a recession. Over the past three months, the unemployment rate has averaged 4.13%—0.53 percentage point above the three-month average low of 3.6% over the past year.

Powell characterized the Sahm rule as a "statistical regularity" on Wednesday. "It's not like an economic rule, where it's telling you something must happen," he said.

Sahm says she doesn't think the economy is on the immediate cusp of a recession. She reckons that changes in the supply of labor since the pandemic, including the recent jump in immigration, have led the Sahm rule to overstate how weak the job market is. But she worries about the direction things are heading: The unemployment rate is historically low, but it has been trending higher; the number of jobs the economy has been adding each month is still historically strong, but it has been trending down.

“We are still in a good place, but until we see signs of stabilizing, of leveling out, I’m worried,” said Sahm, a former Fed economist who is now the chief economist at New Century Advisors.

The pace of hiring has also slowed markedly, with the Labor Department on Tuesday reporting that the hires rate—the number of hires as a share of total jobs—slipped to 3.4% in June, marking its lowest level since April 2020, when the pandemic had just hit the economy. In 2019, that rate averaged 3.9%. One reason that the economy has been able to keep adding jobs despite the low hires rate is that layoff activity has been muted, too, with the June layoff rate matching its lowest level on record.

The Financial Times has a similarly dismal portrayal of the US jobs market:

Federal Reserve under fire as slowing jobs market fans fears of recession

US central bank’s decision to hold interest rates at 23-year high criticised by economists and politicians

A sharper than expected fall in US jobs growth in July has raised concerns that the Federal Reserve is moving too slowly to lower borrowing costs for Americans, risking the very recession it has been trying to avoid. The employment report released on Friday showed companies added 114,000 positions across the world’s largest economy last month, significantly lower than the 215,000 average gain over the past 12 months.

The unemployment rate rose 0.2 percentage points to 4.3 per cent, triggering the Sahm Rule, which links the start of a recession to when the three-month moving average of the jobless rate rises at least half a percentage point above its low over the past 12 months.

The data comes two days after the US central bank opted against lowering its benchmark interest rate, which has remained at a 23-year high of 5.25 per cent to 5.5 per cent since last July. In justifying the decision, chair Jay Powell said the Federal Open Market Committee wanted to see more evidence that inflation is headed back to its 2 per cent target before following through with any monetary policy pivot. (Looks like this is not going to be…)

Importantly, he stressed he “would not like to see material further cooling in the labour market”.

Powell made clear a rate reduction is on the table at the next meeting in September — and the July jobs report all but confirms the FOMC will deliver one — but economists say the Fed will be forced to move more aggressively than would have been the case had it started cutting rates earlier.

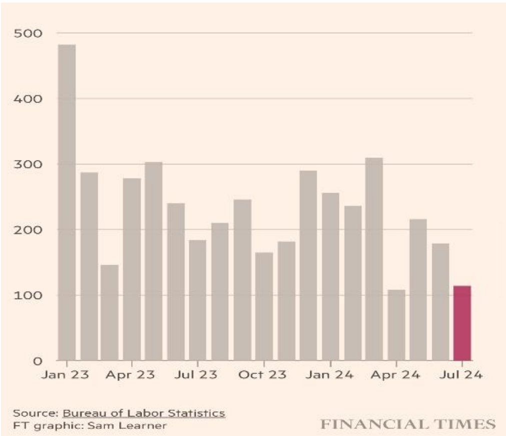
“They made a mistake. They should have been cutting rates months ago,” said Mark Zandi, chief economist at Moody’s. “It feels like a quarter-point cut in September isn’t going to be enough. It’s got to be a half-point with a clear signal that they are going to be much more aggressive in normalising rates than they have been indicating.”

Gregory Daco, chief economist at EY Parthenon, agreed the July meeting was a “missed opportunity” for the Fed, saying it would have been more “optimal” had the central bank delivered its first rate cut in June. “If you had a forward-looking perspective, you were seeing that the totality of the data was pointing towards a slowing in economic activity, a slowing in labour market momentum and ongoing disinflation, which is really what the Fed has been after.”

Economists are not the only ones to accuse the central bank of falling behind the curve. On Friday, progressive Democratic senator Elizabeth Warren — who has been a staunch critic of Powell and prior to this week’s decision urged him to cut rates — called on the chair to take imminent action.

“He’s been warned over and over again that waiting too long risks driving the economy into a ditch. The jobs data is flashing red,” she wrote on X. “Powell needs to cancel his summer vacation and cut rates now — not wait six weeks.”

In the wake of the jobs report, traders in federal funds futures markets boosted bets that the central bank would lower its policy rate more than a full percentage point this year, implying as many as two half-point cuts given there are only three meetings left in 2024. Prior to Friday’s release, market participants had priced in a total of 0.75 percentage points of cuts for the year.



Wall Street banks on Friday rapidly revised their outlooks, with JPMorgan and Citigroup officially calling for two half-point reductions in September and November followed by quarter-point cuts at every meeting thereafter until the policy rate reached a “neutral” level that no longer constrained growth.

Austan Goolsbee, president of the Chicago Fed, shared some of the concern about the labour market in an interview with Bloomberg TV on Friday, but urged against a rushed response. “We’d never want to overreact to any one months’ numbers,” he said. Fed officials and economists have taken some comfort in the fact that the world’s largest economy looks far from collapsing. Powell on Wednesday said the chances of a so-called “hard landing” — whereby getting inflation back to target prompts a recession — still remained low.

“You don’t see any reason to think that this economy is either overheating or sharply weakening, that’s just not in the data right now,” he said. In the past quarter, the US economy grew nearly 3 per cent. Moreover, consumers are still spending and employers are still hiring, even if both are happening at a slower pace.

Michael Gapen, head of US economics at Bank of America, who previously worked at the Fed, acknowledged the economy is cooling but said it was not yet cracking. But in a warning shot to the Fed, he added: “If they don’t cut rates, they do risk creating a recession that they don’t want.”

When the Fed chairman makes quotes about a particular economist’s research, it is a good time for us to pay attention to that research. Here is some background information on the Sahm indicator from Business Insider:

Surging US unemployment has triggered a recession indicator with a perfect track record

Matthew Fox

Aug 3, 2024, 12:55 AM

The Sahm rule was triggered Friday after a surprise jump in the US unemployment rate.

- **The indicator has a pristine track record of forecasting recessions over its history.**
- **Despite the rule's past accuracy, its creator says that immigration trends may be skewing data.**

A closely watched recession indicator flashed Friday after a weak July jobs report showed an unexpected surge in the unemployment rate.

The US economy added 114,000 jobs in July, badly missing economist estimates of 175,000, while the unemployment rate — which was forecast to stay flat — rose to 4.3% from 4.1%.

The Sahm rule, created by the former Federal Reserve official Claudia Sahm, triggers when the unemployment rate's three-month moving average moves 50 basis points above its 12-month low. **(With that said, this is nothing more than a trend indicator of unemployment data. At the end of the day, it is a lagging indicator. That means that when the signal is triggered, the recession is already a fact. It must be the case.)**

That rule was triggered Friday, with the moving average rising 53 basis points above that one-year trough, according to the real-time Sahm Rule Recession Indicator from the St. Louis Federal Reserve.

And that's ultimately an ominous sign for the broader US economy, as the Sahm rule has been remarkably accurate in predicting an imminent downturn.

Since 1953 and excluding today's trigger, the Sahm rule has flashed 11 times, and in 10 of those 11 times, the economy was already in a recession. The only misfire for the rule was in 1959, but even then, a recession started just five months after the Sahm rule flashed.

Table 3: Triggering of Sahm indicator coincides with recession

Dates Sahm indicator triggered, US unemployment rate & recession

Sahm >0.50...	Sahm	U-rate %	Recession starts...	
Nov 1953	0.63	3.50%	Jul 1953	4 months prior
Oct 1957	0.50	4.50%	Aug 1957	2 months prior
Nov 1959	0.60	5.80%	Apr 1960	5 months later
Mar 1970	0.77	4.40%	Dec 1969	3 months prior
Jul 1974	0.60	5.50%	Nov 1973	8 months prior
Feb 1980	0.53	6.30%	Jan 1980	1 month prior
Nov 1981	0.60	8.30%	Jul 1981	4 months prior
Oct 1990	0.53	5.90%	Jul 1990	3 months prior
Jun 2001	0.50	4.50%	Mar 2001	3 months prior
Feb 2008	0.53	4.90%	Dec 2007	2 months prior
Apr 2020	4.00	14.80%	Feb 2020	2 months prior
Aug 2024	0.40	4.10%	-	-

Source: BofA Global Investment Strategy, Bloomberg

Bank of America

"The triggering of the Sahm rule and increase in the unemployment rate will add to concerns that the economy is weakening more than expected in the second half of 2024," Bill Adams, an economist at Comerica Bank, said in an email to Business Insider. "Our assessment of the risk of a recession over the next 12 months is higher than it was before these data were released."

But Sahm herself wrote in a Substack post last week that "the rise in the unemployment rate is not as ominous as it would normally seem."

She said earlier this year that if her rule was to ever fail in predicting a recession, this might be the time.

That's because much of the rise in the unemployment rate over the past year hasn't been driven by job layoffs but by an increase in labor supply due to immigration trends

"The Sahm rule is likely overstating the labor market's weakening due to unusual shifts in labor supply caused by the pandemic and immigration," she said.

Sahm added: "Dramatic shifts in the labor force, including the plunge in participation early in the pandemic and then the jump in immigration in recent years, are likely affecting the change in the unemployment rate in a way that would not be typical in prior business cycles."

The former Fed official did say that the risk of a recession in the next several months was elevated but that should force the US central bank to cut interest rates, which could alleviate some recessionary pressures.

While Sahm may not be concerned about an imminent recession this time around, investors sure are, with the stock market plunging more than 2% on Friday following the weak jobs report.

Investors are panicking. Here is a report from the Economist:

Why fear is sweeping markets everywhere

American and Japanese indices have taken a battering. So have banks and gold

Aug 2nd 2024

How quickly the mood turns. Barely a fortnight ago stockmarkets were on a seemingly unstoppable bull run, after months of hitting new all-time highs. Now they are in free fall. America's nasdaq 100 index, dominated by the tech giants that were at the heart of the boom, has fallen by more than 10% since a peak in mid-July. Japan's benchmark Topix index has clocked losses well into the double digits, dropping by 6% on August 2nd alone—its worst day since 2016 and, following a 3% decline on August 1st, its worst two-day streak since 2011. Share prices elsewhere have not been bludgeoned quite so badly, but panic is sweeping through markets (see chart 1). Wall Street's "fear gauge", the vix index, which measures expected volatility through the prices traders pay to protect themselves from it, has rocketed to its highest since America's regional-banking crisis last year (see chart 2).

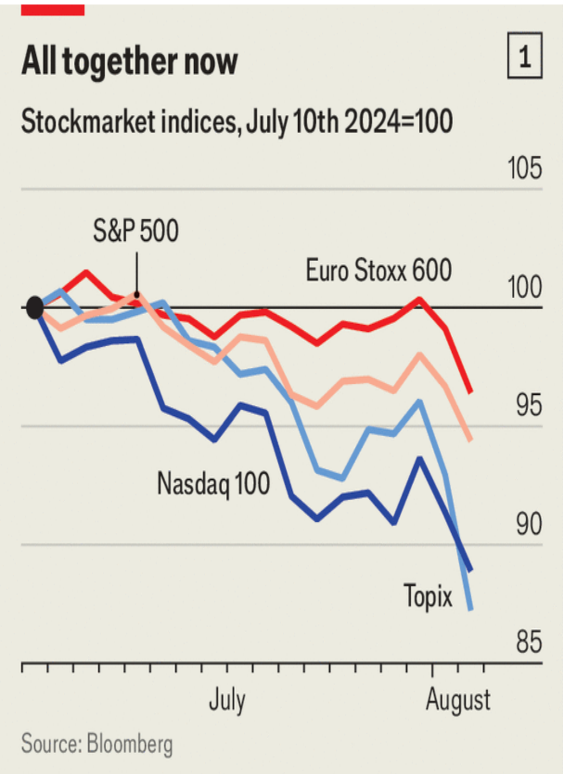


Chart: the economist

Look beneath the surface, at individual sectors and firms, and the mood is even wilder. The Philadelphia semiconductor index, which tracks companies in the chipmaking supply chain globally, has fallen by more than a fifth in a matter of weeks. Arm, one such firm, has lost 40% of its market value. The share price of Nvidia, the previous bull run's darling, has been flailing. In the three days from July 30th it dropped by 7%, soared by 13%, then dropped by 7% again. On August 2nd the value of Intel, another chipmaker, plunged by more than a quarter. And it is not just the semiconductor industry. The kbw index of American banking stocks has fallen by 8% in a matter of days. The prices of Japanese bank shares have plummeted, too.

Chart: the economist

The things that are—or, at least, were—doing well are the boltholes investors dash to when terrified: gold, the Japanese yen and American Treasuries. Troublingly, though, even the gold price cratered on August 2nd, with a peak-to-trough drop of more than 2%. Gold is usually a hedge against exactly the sort of chaos in the air just now. That its price was driven down suggests investors may have been selling not because they wanted to, but because they had to raise cash quickly to meet margin calls elsewhere. If so, there is a risk that other fire sales and a self-reinforcing doom loop may follow.

Three developments have combined to tip investors over the edge. The first is a dawning realisation that artificial intelligence (ai), and especially the chipmaking industry that powers it, has been imbued with unrealistically high hopes. The biggest swings in American share prices came during a ten-day period in which five tech giants—Alphabet, Amazon, Apple, Meta and Microsoft—released results that left their shareholders crestfallen. Even Alphabet and Microsoft, whose revenues beat analysts' expectations, saw their share prices fall the day after they reported. Those of Amazon, which undershot such expectations, were punished far more. The across-the-board battering suggests investors' former euphoria over all things ai is evaporating.

That has an immediate knock-on effect for chipmakers which, if ai investment retrenches, may not be facing limitless demand for their products after all. In fact, recent weeks have given such firms far more to fear than a mere change in animal spirits. On July 17th Donald Trump sent semiconductor stocks into a tailspin by suggesting Taiwan should pay for its own defence against China. tsmc, which makes the vast majority of the world's most advanced chips, is based in Taiwan and so would be vulnerable to a Chinese invasion. The Biden administration is also planning new curbs on exports of chipmaking equipment to China. With the twin threats of faltering demand and worsening geopolitics, it is little wonder that chip stocks are plunging.

As tech firms have stumbled, so has America's economy—the second development to give investors an attack of the vapours. Until recently "bad news is good news" was the mantra of the market. Any hint of slowing growth or a weaker labour market was good for asset prices, since it meant inflation was likely to stay quiescent and allow the Federal Reserve to cut interest rates more swiftly. But by the time America's jobs report was released on August 2nd, the mood had shifted: bad news is now bad news.

The report revealed that the unemployment rate rose to a three-year high of 4.3% in July, while the economy added just 114,000 jobs, against a consensus forecast beforehand of 175,000. In other words, the risk of a recession that many thought had been avoided has just risen. Accordingly, traders began placing bets that the

Fed would cut rates by half a percentage point at the central bank's next meeting in September, to stave off such a slowdown. That is despite Jerome Powell, the Fed's chairman, having dismissed the suggestion that rate-setters were considering such a move at the last meeting only days ago. Treasury yields plummeted, with the two-year rate falling to 3.9%, more than a percentage point below its level at the end of April. Weeks ago such a reduction in borrowing costs might have boosted stocks. Now investors seem to fear the downside of slowing growth, and its implications for company earnings, more than they long for cheaper money.

The third force roiling markets is the strength of the Japanese yen. In recent weeks it has strengthened against a trade-weighted basket of currencies at close to its fastest pace in two decades. In part, this is because of the Bank of Japan's surprise decision to raise interest rates by a tenth of a percentage point on July 31st. A rising yen automatically depresses Japanese share prices, as many of the country's largest globetrotting firms, such as Hitachi, Sony and Toyota, make their earnings overseas in foreign currencies.

Some of the decline in Japanese stocks may be explained by this effect. Probably more important, though, is the unwinding of popular trades linked to a weak yen and ultra-doveish monetary policy. The combination of the two made it possible to borrow cheaply in yen, convert the proceeds to dollars and invest in Treasuries, yielding far more than it cost to service the debt—a "carry trade". But with Japanese interest rates rising and American ones falling, the trade has fading attraction. Worse, the yen's rapid strengthening raises the dollar cost of paying back the debt, pushing the trade into the red. The violent moves of the past few weeks will have forced many investors to close their positions, and possibly also to fire-sell other assets, adding to instability in both domestic and global stocks.

As ever at the end of a turbulent week, the first question now is whether—somewhere amid the chaos—an asset's price has swung sharply enough to imperil an outfit that is heavily exposed to it. On that front, the decline in the gold price, and those of bank stocks, is ominous. The other, linked question is whether next week will be better or worse. Assuming no big investor decides it is time for a sell-off that will be up to the collective mood. Going on recent form, it isn't good.

The other issue that is paramount on investors' minds is whether the expected interest rate changes due to the expectations of recession and the Fed's reaction to such expectations would crash the dollar. There has been a lot of commentary on how the dollar would react to the formation of BRICS or of how the economic sanctions on countries which the Americans don't like may lessen its desirability of its being used as an international store of value and for use in trade. The decline in its use would lead to a falling dollar.

However, I have made the point in many commentaries that this is unlikely to happen in a couple of years or even in a couple of decades. The greatest impact on the direction of the US currency will be how US interest rates will move. Morgan Stanley wrote about this in a recent article:

Is the U.S. Dollar's Dominance Under Threat?
May 9, 2023

While the dollar's pre-eminent role in global trade and finance could diminish with time, recent fears about its demise seem overblown.

Christopher K. Baxter

Recent geopolitical tensions have stoked fears of "de-dollarization" and may help bolster the status of other currencies.

However, the U.S. dollar remains the world's primary way to buy, sell and estimate the value of goods and services.

Supplanting it as the dominant global reserve currency would likely take decades.

The U.S. dollar has long dominated global trade and finance. It serves as the primary medium to buy and sell goods, as well as a safe haven for foreign reserves for financial institutions and businesses around the world.

Its dominant status gives the U.S. some big economic advantages. Because international trade is largely denominated in U.S. dollars, U.S. companies and consumers are generally less likely than their international peers to face foreign-exchange transaction costs or risks from shifting exchange rates. In addition, strong global demand for dollar-denominated U.S. securities, such as Treasury bonds, historically has allowed the U.S. government to borrow at relatively low interest rates to fund its spending needs.

Emerging Concerns
However, some investors fear that the U.S. dollar might lose the primacy it has held since supplanting the British pound as the world's top reserve currency after World War II. Recently, such concerns have flared up amid geopolitical tensions that may bolster other currencies, such as the euro, the Chinese renminbi or even a proposed common currency among the so-called BRICS nations of Brazil, Russia, India, China and South Africa.

The idea of "de-dollarization" has been on the radar for at least 20 years—and, indeed, the dollar's share of reserve currencies has gradually declined as foreign central banks have diversified. In theory, increased competition from other currencies could hurt demand for the U.S. dollar, potentially causing its value to decline in foreign-exchange markets and reversing some of the advantages its dominance has conferred on U.S. institutions and investors.

Threats Seem Exaggerated
However, the U.S. dollar's incumbent role in the global economy is unlikely to be seriously challenged any time soon for four key reasons:

- **The U.S. dollar remains the world's dominant "medium of exchange,"** or means of buying and selling goods. In March, for instance, the Society for Worldwide Interbank Financial Telecommunication (SWIFT) reported that the U.S. dollar was the most commonly used currency on its global payment system, accounting for 41.7% of payments, followed closely by the euro. By comparison, the Chinese renminbi was used in 2.4% of SWIFT payments, despite China accounting for a relatively larger percentage of global trade.

- **The dollar also remains the primary "unit of account" globally**, meaning it serves as the standard way that trading partners measure the market value of goods and services being exchanged. According to the Federal Reserve, from 1999-2019, the U.S. dollar accounted for 96% of trade invoicing in the Americas, 74% in the Asia-Pacific region and 79% in the rest of the world. The only exception was in Europe, where the euro is the primary invoicing currency, given frequent trading between EU partners. (Yet over this period, the dollar has risen trendwise – this means that the direction of the dollar does not react to its use as a reserve currency.)

- **The U.S. dollar is widely viewed as a reliable "store of value,"** or safe haven. In large part because of this stability relative to other currencies, the greenback accounts for nearly 60% of foreign reserves (i.e., the currencies held by central banks to help manage their nation's monetary system and exchange rate). While the U.S. dollar's share of central bank reserves has declined over time, it still dwarfs the shares of all competitors. What's more, according to the Brookings Institution, more than 65 countries peg their currency to the U.S. dollar.

- **There is currently no viable alternative**. Other currencies have been discussed as potential competitors to the U.S. dollar, but none comes close to posing a credible threat—at least, not yet.
    - **The euro** is the world's second-largest reserve currency, but ranks a distant second, accounting for 21% of foreign reserves versus the dollar's nearly 60%. Key factors inhibiting the euro's broader use: According to the National Bureau of Economic Research, there is an inadequate supply of high-quality, euro-denominated assets that international investors and central banks can use as a store of value, and no eurozone-wide "safe" government-backed asset.
    - **China's renminbi** accounts for a very small portion of foreign exchange reserves, and Chinese policymakers' control over the exchange rate makes it unlikely to quickly gain traction.
    - **Gold** is time-consuming and expensive to move, thus making it less than ideal as a medium of exchange or unit of account.
    - **A BRICS common currency** is still very hypothetical. BRICS nations may find it challenging to coordinate across central banks and could ultimately prove unwilling to exchange their U.S. dollar reliance for a potentially volatile currency that could struggle to achieve broader adoption.

Given these circumstances, it would be hard to break away from the dollar-centric system. It is entirely possible that multiple major reserve currencies will emerge, based on trading relationships—for example, the euro in Europe, the renminbi in Asia and the U.S. dollar in the Americas—but it would likely take decades to fully supplant the global primacy of the dollar.

This assessment is correct. The mechanics of international payments are not likely to get simpler and while there will be more such non-dollar payments, it will not become so large that they will completely eclipse the dollar. For the next 10-20 years, the dollar based system will certainly not be smaller than the Euro based system. As such, if Euros are not on a definitive downtrend, while should the US dollar be? In other words, all currencies are driven by many factors and the demand for its use for trade and store of value purposes do not determine their direction entirely. As a matter of fact, the most important determinant of currency direction is probably the interest rate differential. Hot money tends to flow to the currency with the higher interest rate as investors seek higher returns. In the current environment, we may see the Dollar ease off against major currencies when US interest rates lead the downward slide in domestic interest rates. However, every country wants to follow the US lead quickly, as all countries are pressured by high interest rates. So it is very likely that the onset of recession in the US will lead to competitive lowering of interest rates over the next few months, in turn leading to a ratcheting of exchange rates downwards until a the new equilibrium is reached.

Therefore, the question of whether one should dump the dollar should have an easy answer. If investors are looking to diversify, then a rising dollar will mean that dollar holdings will make sense. If on the other hand, the dollar falls, then the objective of diversification is suitably achieved.

I would also like to add a comment on how the threat of a US recession will affect the US election. Will the onset of recession mean that Trump will become the next president in the US? Clearly, the conventional wisdom is not wrong, as most voters will decide who they want as leader of their country based on bread and butter issues. But it will not be the only issue for the Americans this November. Geopolitical issues, especially wars, will also have an impact.

The NYT has the following report:

Netanyahu, Defiant, Appears to Have Gone Rogue, Risking a Regional War

Ignoring the efforts of President Biden and the condemnation of many allies, the Israeli prime minister is forcing the pace of the war and feeding the revolt of the far right.

By Steven Erlanger

Steven Erlanger, a former bureau chief in Israel, has spent many weeks there and in the West Bank since Oct. 7.

Published Aug. 2, 2024Updated Aug. 3, 2024, 4:35 a.m. ET

As the Biden administration and its allies try to secure an elusive cease-fire in Gaza, Israel appears to have gone rogue.

Benjamin Netanyahu, Israel's prime minister, came to Washington last week to give a defiant speech. Despite international condemnation, he vowed to continue the war against Hamas in Gaza and the West Bank, where Israel is killing and imprisoning scores of Palestinians each week, without any clear idea of its endgame.

The assassinations of senior Hezbollah and Hamas figures abroad have now sharply raised the risks of a larger regional war as Iran, Hamas and Hezbollah prepare retaliation, analysts say.

But the deaths of Fuad Shukr, a senior Hezbollah commander, and Ismail Haniyeh, the political leader of Hamas, will not change the strategic quandary Israel faces over how to end the war, govern Gaza or care for the civilians there. They are more likely to intensify the conflict than diminish it, making progress on a Gaza cease-fire even more difficult.

Israel says it does not want to occupy Gaza, but has no other solution to provide order; Hamas refuses to surrender, despite the thousands of dead. While Washington sees a cease-fire followed by a regional deal as an answer, Mr. Netanyahu is contemptuous of the idea. He believes only force will compel Hamas to concede and restore Israel's strategic deterrence toward Iran and its proxies, especially Hezbollah.

Absent a clear goal in the war, however, Mr. Netanyahu's defiance is dividing Israel from its allies and the country itself. It has further shaken trust in his leadership. It is fueling suspicions that he is keeping the country at war to keep himself in power. It is intensifying a deep rift inside the society — about the fate of Israeli hostages, the conduct of the war and the rule of law — that is challenging the institutional bonds that hold Israel together.

"Israel's international image continues to take hits since October — despite nine months of war, its military objectives are unmet, and its reputation socially and domestically is also damaged," said Sanam Vakil, a Middle East analyst at Chatham House.
Image

To form a government and stay in power, Mr. Netanyahu has empowered deeply religious, pro-settlement far-right politicians who oppose a Palestinian state of any kind. He has given powerful roles to Itamar Ben-Gvir, a convicted criminal, who now heads the police and is influential in how the West Bank is run, and to Bezalel Smotrich, the finance minister.

Both men have moved to weaken the Palestinian Authority, support expanding settlements in the West Bank and oppose any deal with Hamas — while putting their own followers into key positions in the Israeli bureaucracy.

They represent a populist revolt against the country's traditional democratic ethos and institutions, including the army and the judiciary. Much like former President Donald J. Trump, Mr. Netanyahu, despite his long period in power, rides that anti-elitist wave, arguing that he is the only politician who can stand up to the United States and the United Nations and prevent a sovereign Palestine dominated by Hamas.

"We're in a very dangerous process that can cast a shadow over the basic DNA of this country," said Nahum Barnea, one of Israel's most prominent journalists and commentators. "Cultural confrontation is fine, but not so fine with politicians who are messianic or radical populists and not only become part of the government but hold crucial posts there."

The far-right politicians have an agenda, he said: "They want a real revolution in our regime and in our values."

The most visible recent example came this week, when protesters massed outside two military bases to support soldiers who had been arrested on suspicion of torturing and sodomizing a Palestinian prisoner at Sde Teiman, a military jail.

Hundreds of protesters, including at least three far-right legislators from the ruling coalition and soldiers in uniform, gathered outside that jail and a second base where the men had been brought for interrogation. Dozens of protesters surged into both bases, brushing aside guards, while Mr. Ben-Gvir's police forces arrived late and in small numbers.

Hours later, Mr. Netanyahu criticized the protests, but also seemed to justify them, comparing them to the months of anti-government demonstrations against his effort to diminish the power of the judiciary and the Supreme Court in favor of Parliament.

"State institutions are being challenged even by people in uniform," said Natan Sachs, the Israeli American director of the Center for Middle East Policy at Brookings, a centrist research institution. "It's a symptom of something very worrying, a challenge not just to the institutions but to the connective tissue of a society that has always been closely knit despite its fissures."

"People are very much on edge," said Shalom Lipner, a former prime ministerial aide from 1990 to 2016 and senior fellow at the Atlantic Council, also a centrist research institution. "And not just about how others look at Israel, but Israelis themselves are frightened about what this means for the country itself. If this is how we behave, how is this project sustainable?"

To be sure, while a sizable majority of Israelis want Mr. Netanyahu and his far-right coalition gone, a sizable majority also wants Hamas defeated and dismantled as the power in Gaza, to ensure that what happened on Oct. 7 can never happen again. There is widespread agreement that Israel must remain strong and has the right to attack its stated enemies.

But there is inevitable disagreement about the best way to attain a more lasting peace, with many fearing that an independent Palestinian state of the kind the Israeli elite had hoped to negotiate would be dominated by more extreme factions, like Hamas.

The revolt against the elites has been building for years. It was most visible in the proposed new law that would have diminished the power of the judiciary system and the Supreme Court in favor of Parliament, which prompted nine months of street protests and highlighted the divisions in the country.

The Hamas attacks on Oct. 7 pulled the country together, even as they absorbed the shock of a huge failure of the intelligence services and the military, largely sacred institutions. But the long war has also pulled the country apart, with the far right trying to weaken key institutions and infiltrate them. Discipline in the army has also suffered.

And even as the army leadership tries to maintain its standards, Mr. Ben-Gvir and Mr. Smotrich label those who want to punish the abusers of Palestinian prisoners as traitors.

Although representing a minority, the two men have become the face of Israel to the world nearly as much as Mr. Netanyahu, his own image tainted by his political dependency on them and his toleration of their actions and excesses.

There has always been a tension between the rule of law and Israel's security and counterterrorism operations, said Dahlia Scheindlin, an Israeli pollster and analyst.

"Israelis have become habituated to the idea that law is selective," she said. "There are too many who are above the law, like the settlers, who are beyond the law, like the ultra-Orthodox and the security forces, and who are pushed out of the law, like the Palestinians and many Arab citizens of Israel, who in the past were often under martial law."

The protests at the military bases were the "closest I've ever experienced to state breakdown," Ms. Scheindlin said, calling the internal divisions on display a victory for Hamas and Hezbollah.

There are many Israelis "who have no belief in diplomacy but think of Israeli security only in terms of pre-emption, intimidation and deterrence, and who think that they must always have the back of the military in the face of an implacable cruel enemy you're always confronting," said Bernard Avishai, an Israeli American analyst. "So anything you do to the enemy is justified."

There were violent protests by settlers and the right against the army in 2005 over the forced withdrawal of Israelis from settlements in Gaza and the West Bank. But many Israelis point to a later controversial episode as the real turning point for the country.

In 2016, an Israeli soldier, Elor Azaria, killed an incapacitated Palestinian who had attacked an Israeli with a knife. Despite angry protests, he was convicted of manslaughter but served only half of his 18-month sentence. He was considered a hero by people on the right, while those on the left argued he deserved a harsher sentence.

Mr. Azaria has since supported soldiers accused of beating Palestinian prisoners and has been the target of sanctions imposed by the United States.

"After Azaria, the lines were drawn," said Mr. Avishai. Settlers and those who favor force over diplomacy were mobilized against "the statists," like the military chiefs and the current minister of defense, Yoav Gallant, "who feel that national morale is a function of the rule of law and that the army must observe international law," he said.

The statist view is "disappearing under Netanyahu, and the cultural war is fundamental now," he said. "A continuing war of attrition and pre-emption in Gaza and elsewhere is good for them politically."

In the protests on Monday, he said, "for the first time you have violence between these two rival conceptions of Israel's future."

(Back to the question of whether the Israeli war in Gaza will affect the US elections. This probably ranks deeper in the consciousness of American voters that the Ukraine war does. The Israeli lobby is very powerful in US politics, and it has deep pockets. As such, this is a potent force. Yet at the same time, the Palestinians also have a voice in some key battleground states such as Michigan. So this issue will cut both ways on the choice between Trump or Harris. It depends on what they say in the coming three months. If they say the wrong things, then it will hurt them, and as I see it, Harris is more likely to make mistakes on these issues, and on the economy, given that she has no strong views on either, than Donald Trump ever will.

If you are betting on these elections, bet with Trump.)

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