Global Connections

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The Dollar, Iran and Points in Between

I had the eye-opening experience of spending a week in Iran recently, and what a week it was. As an American, the gap between what passes for common knowledge about Iran and the on-the-ground reality seems as wide as a country closed for 35 years would suggest – HUGE. While I was in Iran, the S&P moved less than 1%, but there was lots of action in the currency and commodity space, and that has generated some fresh USD thoughts. Dollar first, then Iran.

Regular readers know my view that the USD is not a one-way bet and consequent suggestion that non-US developed market (DM) equity positions include both hedged and unhedged vehicles. The asset allocation bias to non-US DM equity has been longstanding (see "2015 Outlook – Tough Choices Ahead," published on December 2, 2014), and a pullback post strong Q1 performance should not come as a surprise. These markets, led by Japan and Europe, are in the early stages of relative outperformance, a trend that is likely to last years.

Dollar Takes a Summer Vacation

The argument that the USD may well take the summer off (see Jay Pelosky in this Bloomberg TV video clip from April 24, 2015) has several underpinnings. First is the sense that the Fed and US Treasury have reached their near-term limit of USD strength given that such strength has clearly affected the manufacturing side of the US economy. Q1 GDP data makes that very clear, reinforcing the view that the strength or lack thereof in the domestic side of the US economy would dictate the Fed's appetite for USD strength. If consumption was strong, then the dollar could rise; weak consumption would imply less room for the dollar to run. Recent data (consumer confidence, durable goods orders) suggest that Q1's weak GDP report will likely be followed by a weak Q2, leading the Fed and US Treasury to jawbone against the dollar's rapid rise.

Other major Central Banks may also have reason to favor a stable to slightly weaker USD. Think of the ECB and its concerns over a possible disorderly Greek exit and what that might mean for the euro. Ditto the Bank of Japan (BOJ) and its desire not to have Japan labeled as a currency manipulator in the Trans Pacific Partnership (TPP) talks. US trade promotion authority legislation speaks directly to the issue of currency manipulation. Finally, and by no means least importantly, the Peoples Bank of China (PBOC) has little appetite for further USD strength given the upward drag such exerts on the semi-pegged yuan. Dollar strength raises the pressure on Chinese policymakers to consider the likelihood of a controlled Chinese devaluation. Such a devaluation (2015 top tail risk) would further amplify the global deflation threat via the rest of Asia's need to reprice and the impact of such regional repricing on the global manufacturing channel.

Should financial flows ebb, then fundamental trade flows would likely reassert themselves, further supporting a dollar pullback. This is especially true versus the euro, given Europe's huge current account surplus. While the euro bounce has been swift, there is likely further to go, perhaps to the 1.15 level versus the USD. The widening current account deficit (ex-petroleum products) in the US also suggests further USD strength may be hard to generate in the near term. Combine that with the large profits that stand ready to be booked and one can sell the dollar today and go away! Of course one would need to be back by fall, when events could give the dollar a lift.

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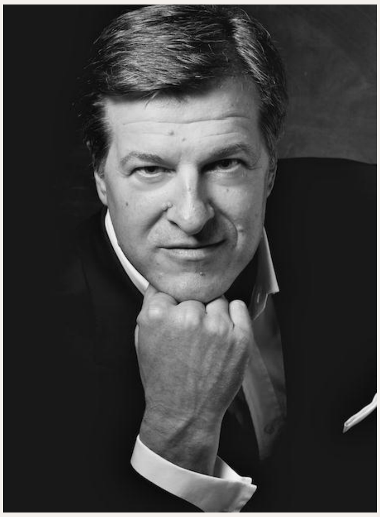

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Dollar Pullback – Portfolio Implications

A dollar pullback driven in part by the sense that the Fed may not raise rates until late 2015 or even 2016 suggests that the US equity market, the year's big laggard, may have a near-term relative catch-up opportunity. The strong dollar has been a big part of the pared-back earnings outlook, which in turn has kept the equity market in check. A short-term dollar reversal could lead to a sharp relative pop in US large caps versus the non-US DM equity markets. Suggested ways to participate would be to take profits on hedged European equity positions and add to US large caps. Note that this is a tactical move for one to two quarters; the strategic call of non-US DM markets asserting global equity leadership remains very much in place. Tactical traders may look to participate in this move; larger asset owners may choose instead to add to non-US DM equity positions on weakness.

The commodity markets have also been active in April, with iron ore and oil both up roughly 20%, perhaps further signaling a dollar hiatus. Whether one should hop on the commodity train is a question worth pondering, as bombed-out markets like Brazil, Chile, Australia and the Gulf States have enjoyed significant currency and equity market rallies. Emerging markets broadly, up 13% YTD, have had a stealth rally, assisted by red-hot China and a sharp bounce in Russia, but they are missing such former stars as India and Mexico. Yield plays in the energy sector have been the preferred commodity exposure – that remains the case.

Trend-followers and opportunistic capital looking for beat-up opportunities mean things move fast when they move; to chase is a different story and depends in part on one's sense of the demand outlook. The US and China remain key; if they retreat from their willingness to allow others to devalue against them, that would imply continued global economic weakness and hence unsustainable commodity price pops. However, there may be work worth doing in some commodity-related markets that have improving fundamentals: Australia, Chile and Mexico stand out.

Iran – Arrested Development

The trip to Iran was a once-in-a-lifetime one and serves as a useful reminder that when presented with a once-in-a-lifetime opportunity, one should grab it with both hands. As part of group of roughly 20 folks, mostly American but some not, I had the opportunity to visit a large portion of the country, traveling via bus from Shiraz in the south-central part of the country to Esfahan, one of Iran's most beautiful spots and third largest city, to Qom, the center of theological learning, and then on to Tehran, the country's capital and a bustling city of roughly 14 million residents.

A bus trip over 1,500 kilometers led one to conclude how dry and mountainous the country is. Much as an airplane trip across China reveals how uninhabitable much of the country is and how food needs will need to be met via imports, a trip through Iran demonstrated how heavily urbanized the society is, as there was nothing for hundreds and hundreds of kilometers.

Friendly Folks

A second striking thing about the trip was how friendly the people were to our group of Americans. Beginning with the customs officer in Shiraz whose welcoming was warm and heartfelt – "Welcome, welcome to Iran, we are very happy to have you here" – to folks in the streets, elevators, restaurants, business meetings and everywhere in between. This included when several of our party asked to join in a hard-fought volleyball game in Tehran's Laleh Park and were openly welcomed; as a New Yorker, I am not sure the Central Park welcome would have been quite as warm.

A large, urbanized country with friendly people sets the stage for some comparative analysis of Iran versus other emerging countries in transition in years past. Iran does offer some of the same characteristics as Indonesia in 1988, Brazil in 1990 or Russia in 1993: a state-controlled economy suffering from brain-drain, immature capital markets and underutilized labor pools. However, Iran also possesses some unique characteristics that may trigger an accelerated transition if a nuclear deal comes to fruition.

Opining on the prospects for such a deal is not in this report's purview. Spending time on the ground, however, makes it clear that Iran is at the negotiating table for a number of reasons. Chief among them is the economy. Years of economic mismanagement, US troop presence on two of Iran's borders and attendant security spending, economic sanctions and the collapse in oil prices have brought Iran's economy low.

Economy in Tatters

Former President Ahmadinejad's eight years in office included a populist approach to economics that led to money printing, inflation of upwards of 40% per annum, currency collapse, a depleted treasury and a building boom as investors rushed to property in an effort to protect against inflation (capital has limited inflation hedges in a closed economy). This is true even with the oil spike to $150 per barrel.

Fast-forward to 2013 and current President Rouhani, who was elected on a platform of economic stabilization and interaction with dignity in regards to the West. Both are related, and progress has been made on both fronts. Tight money has brought down inflation to under 20%, and the currency has stabilized at an internationally competitive level (five-star hotels in Esfahan cost $130 per night). The cost however, has been steep: an economy that has been in deep recession and a building bust that has left Tehran's wealthier neighborhoods replete with half-finished buildings (for the old-timers, think Bangkok circa 1998).

Building Boom Frozen in Mid-Build

Ordinarily such an apparent building bust would imply a banking-sector bust and thus a continued economic implosion. It is not clear that such is the case here, though, as most argued that the building boom was financed by private capital pools rather than via the banking sector. Common practice is for well-to-do Tehranis to sell the family home and the land beneath to a developer, who builds a 12-15 story apartment building on the site with the proceeds of the apartment sales split between the two parties. Given the uncertainty surrounding sanctions and the weak economy, the story goes that it's better to sit with a half finished building that can be finished quickly and sold as new rather than finishing it now and having to wait years for it to fill up.

Of course this is one line of thinking; others note the significant amount of commercial space coming on stream in Tehran and the likelihood that banks, indirectly or directly, have significant real estate exposure. Publicly the banks are estimated to have roughly 20% in non-performing loans; unofficial estimates are much higher.

Engagement

Progress on the engagement front has been made as well. While the final outcome of the nuclear talks remains an open question, Iran certainly hopes that a deal can help restore access to capital and its economy to growth. There is precedence for such a deal: Ayatollah Khomeini's "poisoned chalice" deal to end the Iraq-Iran war or the current Supreme Leader's call for "heroic flexibility" in the negotiations. It seems clear that Iran's leadership recognizes that economic growth and youth employment are critical to remain in power.

In meetings with industrialists as well as religious, in cities across the country, similar hopes were discussed: first a nuclear deal that would restore access to international capital and in particular access to the SWIFT payment system as well as the ability to export more oil. Secondly, the US and Iran would work together to defeat terrorism in the Gulf, cooperation that would signal Iran's return to regional prominence and provide the US with an opportunity to balance between Saudi Arabia and Iran. Furthermore, these examples of cooperation would build political support for opening the economy to international and US capital in particular.

It is hard not to think that 18 months of negotiation (the longest in nearly a century for US policymakers) has yielded a real opportunity to reset relations, a change that could be beneficial for Iran, the Gulf region, the US and the West.

Building Blocks

Should a deal be reached, Iran has a number of positive inputs to build upon. These would include the following:

– Human capital of 80 million well-educated and very young (60% under 30) people.

– A deeply rooted bazari (business) culture.

– Huge natural-resource base, with top-5 oil and gas reserves.

– A cheap currency.

– Significant knowledge, access and capital via its diaspora; virtually everyone we met had a family relation living in the West.

The combination of a young, well-educated, Westernized and tech-savvy population with tremendous natural-resource wealth gives one a sense of the unique nature of the Iranian opportunity.

The tech sector brings a number of these building blocks together. Our meetings included several groups from Iran's one-hundred-plus tech incubators, many affiliated with local universities. Smart phones are ubiquitous in Tehran while 3G service extends through a good part of the country. Engineers are relatively inexpensive, with starting salaries of roughly $25k per annum. Several meetings included pitch sessions by the local Groupons, Kayaks, Ebays etc. – the lack of foreign competition has meant that local entrepreneurs can take already proven ideas and localize them. Sanctions have given this sector room to grow; domestic VC and PE funds, while small, are active. Upon opening, this space could be very active and attractive.

Needs

As one would expect, Iran also has great needs, especially in terms of capital. Estimates suggest $1trillion in capital requirements for the oil and gas sector, transport, infrastructure etc. The oil and gas sector alone is estimated to need $400 billion to upgrade and expand production. The suggestion that the oil will flow as soon as the deal is signed seems far-fetched. The bus trip to Tehran was taken in part because of the lack of flights between Shiraz and Tehran, akin to having one flight a day between Atlanta and New York City. The number of new planes needed is estimated at somewhere between 300-500 units. These sectors are government-controlled and as such any engagement would need to include local partners.

Other sectors that seemed like opportunities include tourism and clean energy. Solar and wind would seem ripe for development in the south and central parts of the country. Visits to World Heritage Sites such as Persepolis, the 2,500-year-old cradle of Persian culture, and other sites such as the Blue Mosque and Imam Square in Esfahan suggest tourism could boom in the years ahead. Much as Chinese tourists are flocking to Japan, Iran could be a destination spot for tourists from the Gulf as well as India.

Capital Markets

The capital markets are also ripe for expansion. The stock market has roughly 300 listed companies, is somewhat commodity-heavy (top-ten stocks are oil-gas, mining and telecoms), trades $100 million per day with a market cap/GDP ratio under 30%. Free float is very limited at roughly 20%, however, and while valuation seems cheap at roughly 6x earnings, one-year bank deposits yield 23% – stocks should be cheap. It's important to note the lack of global custody and the inability at present to deal with any Iranian bank due to sanctions. On the demand side, poor performance by frontier markets (down close to 20% past one year, up 3% YTD) suggests that demand could be significant should Iran open up.

Runway to Transformation

While it is hard to quantify stock market upside, the fundamental case for Iran rests on two points. First, a nuclear deal would cement President Rouhani's reelection hopes, providing a six-year runway to utilize the building blocks noted above and transform Iran's economy and regional standing. Secondly, Iran is not the only potential capital market opening in the Gulf – Saudi Arabia has announced its stock market will open to offshore investors this June. Imagine the effects of dual capital-market openings in Iran and Saudi Arabia on the prospects for regional economic integration in the Gulf (see "The Tri Polar World 2.0 – A New Global Growth Model," published on March 26, 2015). The UAE is only a 50-minute flight from Tehran. Growth and employment opportunities would soar, and the prospects for violence and extremism would shrink. That's not something one reads in the newspaper.

While Iran's opening may take years and be subject to fits and starts, one should go check it out if the opportunity presents itself. When there, don't miss the ruins of Persepolis, for they tell the tale: stone carvings thousands of years old depict the Persian Kings as walking and riding by themselves in a signal that they were strong enough to protect the people. Today strength in leadership is defined by the economic opportunity provided to the people – a lesson that does not appear to be lost on Tehran. Failure to come to a deal means another Middle East missed opportunity, something we in the US have had plenty of experience with in years past. Let's hope it doesn't come to that.

Jay Pelosky is Principal of J2Z Advisory, LLC, a global asset allocation and portfolio strategy consultancy for institutional investors. Jay advises clients and invests personally based on insights gained from 30 years of financial market experience in over 45 countries. For the past decade, he has invested his own capital in a global, multi-asset, ETF-based Asset Allocation strategy. He sits on the board of Franklin Holdings (Bermuda) Ltd. and serves on the advisory board of Carmel Asset Management. Jay teaches a graduate level course, The Art and Practice of Global Investing, at The George Washington University and is a founding member of the New America Foundation's World Economic Roundtable. His formal Wall Street career spanned twenty years and included positions on both the buy-side and sell-side. At Morgan Stanley, he launched the Firm's global asset allocation and global equity strategy research products. He also formed and co-chaired the research department's asset allocation committee. Jay created the firm's Global Emerging Market Strategy (GEMS) product and initiated its equity investment, research, and strategy efforts in Latin America.

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