AA View

Weak US Dollar Outlook Once Virus Worries Subside

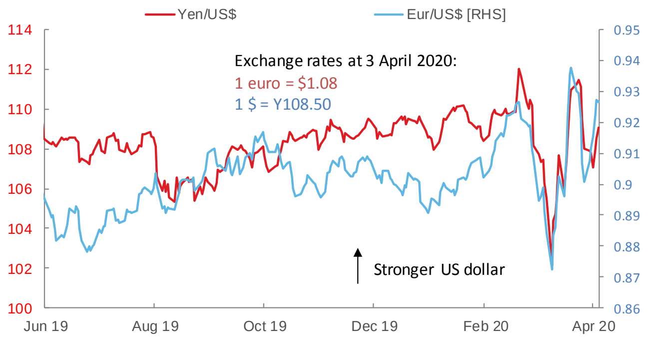
Summary

- The US dollar is currently supported by two important factors: its safe-haven status and the perception of US economic strength relative to other regions. These drivers are expected to underpin the dollar against major currencies other than the yen, until Coronavirus concerns start to fade.
- Ultimately, however, the loss of the US interest rate advantage and the US large Coronavirus-fighting fiscal package may well prove to be the impetus that brings the trend of US dollar appreciation to an end.
- We believe that the US dollar will broadly depreciate over the next few years. However, we recognise that high uncertainty around the Coronavirus continues to give the dollar support at this time. This makes a neutral rather than negative stance more reasonable for now.
- Once the economic shock from the virus dissipates, the dollar should start to fall and US investors will start to benefit from the currency appreciation that comes from their overseas equity exposures. US investors without any currency hedging in place need not take any action and those with some currency hedging in place should consider reducing their hedging ratio when the coronavirus threat reduces hopefully later this year.
- On the other hand, non-US investors, who have benefited from the double benefit of strong US asset performance and dollar strength in the past, should consider putting some currency hedging in place.

The yo-yoing dollar

The US dollar initially weakened in February and early March in reaction to the Coronavirus as US interest rate cuts were anticipated and euros and yen were bought as carry funding trades were unwound. However, as the threat of the virus intensified in March, safe-haven demand for the dollar increased and the US Dollar Index[1] appreciated by 8% in eight days to 20 March. Measures to increase dollar liquidity have since lowered the dollar by a few percent.

Dollar demand has driven currency market moves in 2020



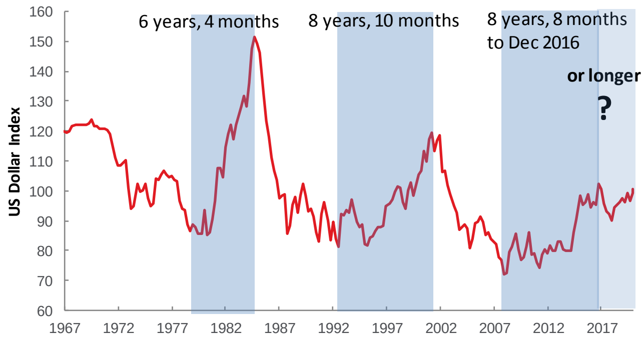
Source: Bloomberg

How has the dollar performed over a longer time frame?

The US dollar has been in an uptrend since 2008 with the US Dollar Index appreciating by 45% to a high reached in December 2016, a level that was almost reached again in March. The dollar is currently just a couple of percent below its 2016 peak and, if it exceeds that level, we will receive confirmation that the current dollar bull run, based on this dollar measure, has extended out to 12 years – much longer than the last couple of bull runs.

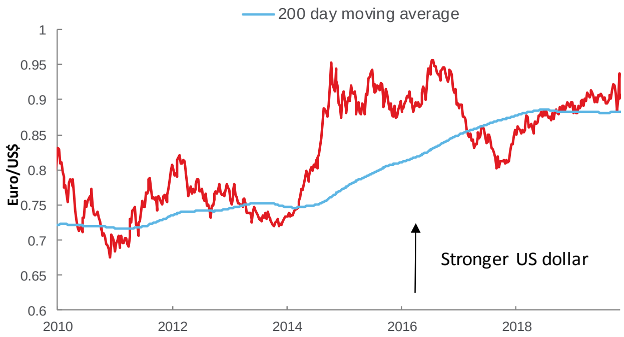
From the low to the high from 2008 to date, the dollar has appreciated most against the Australian dollar (90%) and sterling (76%), reaching fresh highs against both in March. The dollar also rose very close to, but not through, its 2016 highs against the euro and Canadian dollar last month. Yen/dollar is the only major exchange rate that remains quite a distance below its dollar peak.

Will the dollar uptrend extend?



Source: Bloomberg

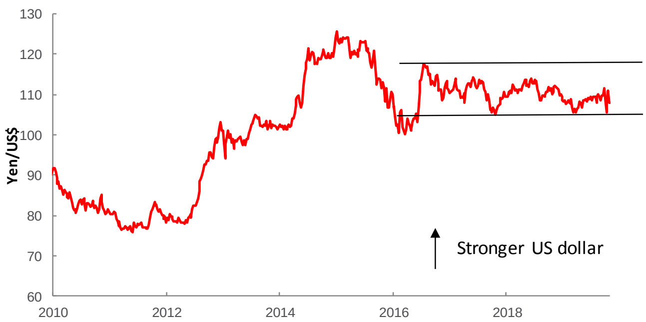
2016 US$ high against the euro is key resistance level



Source: Bloomberg

The US dollar actually fell close to its 2016 low of Y100 in March as the yen received stronger safe-haven support than the dollar and ended March at similar levels to the start of the month.

The yen tested US$ lows in its 3-year trading range in March



Source: Bloomberg

[1] The US dollar value against its major trading partners as calculated by Intercontinental Exchange Inc. US.

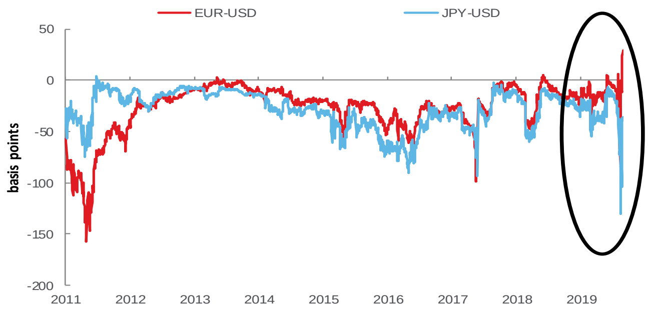
Which drivers are currently supporting the US dollar?

There are two key supports to the US dollar: its safe-haven status and US economic growth advantage over other regions.

Safe-haven status

The US dollar is considered a safe haven due to its role as the world's reserve currency and its dominance in cross-currency borrowing and international trade. Coronavirus concerns this year have caused investors to seek the safety of the US's deep and liquid money and capital markets. This high demand for dollars has led to a dollar shortage and US money market stress which was temporarily seen in the move down in the cross-currency basis[2].

Cross-currency basis swaps indicated a shortage of dollars



Source: Bloomberg, 3 month basis swaps

The dollar shortage caused the currency to soar in March particularly against currencies of commodity-producing economies and those with significant dollar-denominated debt and large current account deficits.

The US Federal Reserve (Fed) has a responsibility to maintain easy access to dollars and Jerome Powell, the Fed chairman, swiftly pledged limitless support to keep dollar funding markets functioning. It opened swap lines with other central banks, flooded the repo market with liquidity and it will provide loans to large companies by buying their commercial paper. These actions have since reduced the upward pressure on the dollar.

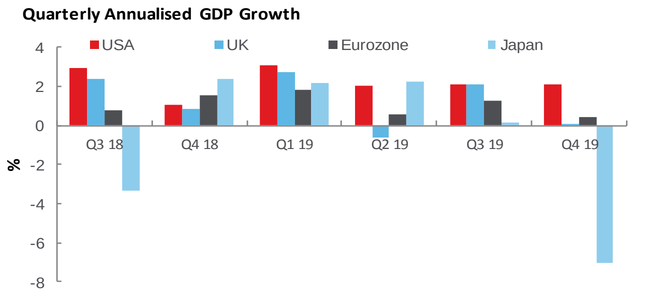
Whilst it appears that the risk of a serious stress in the banking system and a lasting liquidity crunch has been averted due to the actions of the Fed and also other central banks, we expect that global liquidity will remain fragile and dollar borrowing demand high as the virus remains tough to beat. A similar lack of liquidity occurred after the 2008 global financial crisis, causing the dollar to appreciate then, although banks are better capitalised today and are less likely to add to liquidity problems. We therefore do not expect the US dollar to rise anywhere near the 25% appreciation of the US dollar in the year to April 2009 but it seems likely that the dollar will stay firm, especially through any upcoming periods of market turbulence.

Having said that, we do not expect the dollar's safe-haven status to cause appreciation against the yen as Japan is a large creditor with a net external asset position. This arises due to the value of Japan's overseas assets being larger than the value of its domestic assets that are owned by foreigners which trumps the dollar's safe-haven status.

Economic growth outlook

The US economy was much stronger than both the Eurozone and Japanese economies before the spread of the Coronavirus.

Non-US economies were already faltering before this year



Source: Factset

France, Italy and Japan may have already entered a technical recession (two quarters of contraction) in Q1 2020 after they saw their economies shrink at the end of last year. The US-China trade conflict hurt these open economies more than the US which is relatively insulated from manufacturing global supply chains. This feature should also help protect the US from the collapse in global growth this year, although it remains exposed to the severe impact of the virus on its domestic economy and the effectiveness of virus containment.

Lockdowns imposed by governments around the world to tackle the spread of the virus have caused business activity to crash. The global economy is set to enter a recession this year, compared with 2.9% growth in 2019. No economy will be spared and this type of synchronised global weakness tends to mean that the US dollar will outperform.

A final point to make is that the US has been able to offer greater monetary and fiscal support than other economies which should soften the virus impact on US consumers and businesses. The Fed cut rates by 1.5% in the last two months and offered unlimited quantitative easing. US interest rates were higher than in other regions and the Fed's balance sheet is smaller than that of other central banks (one fifth the size of Japan's as a percentage of GDP) giving more room to the US to

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[2] The cross-currency basis is the difference between the observed level of currency hedging costs and the theoretical level based on interest rate differentials between two countries. Increased demand for US dollars raises the cost of borrowing dollars and moves the cross-currency basis down. This adds to the cost of currency hedging US assets to non-US investors but benefits US investors who are hedging overseas assets.

offer this stimulus. Fiscal easing has also been greater in the US than in other countries at more than 10% of GDP.

That is not to say that European Central Bank (ECB) actions have not been large nor unprecedented. It has started a €750bn pandemic emergency bond-buying plan, scrapping previous issue and issuer limits, and Eurozone governments have also increased spending. However, challenges that arise from the Eurozone's fragmented structure and the lack of consensus in the European Union to issue joint European debt bonds limit the help that it can offer to member states to cope with the impact of the coronavirus. The virus therefore has the potential to re-ignite a Eurozone crisis which could trigger euro weakness. At this stage, however, we are not putting much weight on this scenario in our outlook but there is a risk that Eurozone political problems contribute to the US dollar support that comes from stronger US economic growth and policy support.

Which factors act against the US dollar?

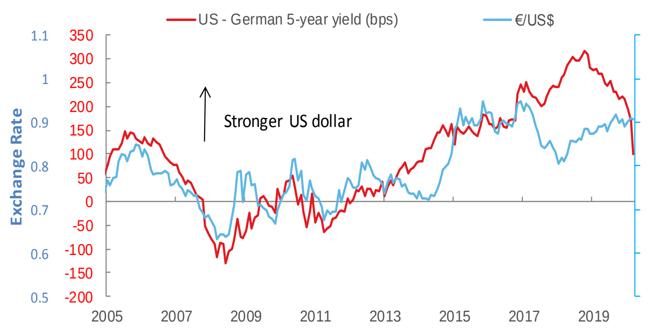
Monetary and fiscal implications

Though all the stimulus coming through from the US central bank and US administration appear dollar-supportive for now, we think that, down the road, it has the potential to undermine dollar support.

The US dollar's strength over the last decade has been in large part driven by its positive interest rate differential with other regions. US interest rates and bond yields have, however, fallen significantly since the end of 2018 which has closed the gap with lower rates in non-US markets. Outside of crisis conditions, this would ordinarily weaken a currency. We saw this impact on the US dollar at the end of February and indeed the turnaround in Fed policy from rate hiking to rate cutting at the end of 2018 was the trigger for us to move from our neutral US dollar stance versus the euro to a marginally negative one early last year.

The next chart shows how the rate differential has closed over that time against German 5-year yields, as an example. US 5-year yields peaked above 3% at the end of 2018 and are now 275 basis points lower, whereas German yields had already turned negative by the end of 2018 and are now just 50 basis points lower.

The US interest rate advantage has shrunk



Source: Bloomberg

The US interest rate premium (or advantage) has consequently fallen from more than 3% to 1%. Half of that move occurred since February.

We suspect that, without a strong interest rate advantage, US bonds, and consequently US dollars, will be in less demand by investors than in the past. The non-bank financial sector outside the US has built up large dollar asset positions over the last decade – particularly Asian insurance and pension plans. Both China and Japan have been large purchasers of US treasuries attracted by higher US yields, resulting in all-time high amounts held outside the US. Eurozone companies have bought a lot of US credit since 2015 too as domestic yields turned negative. Repatriation of these assets would put downward pressure on the US dollar.

Furthermore, we think that inflation expectations may start to build earlier in the US than elsewhere as a result of greater crisis-fighting policy easing and the potential stronger and swifter recovery in the US. As policy interest rates are unlikely to be raised for the foreseeable future and the Fed may purposefully keep bond yields low by shifting to yield curve control (capping 10-year yields), inflation arising from fiscal spending could mean that the higher US real interest rate (interest rate minus inflation) could flip into a real rate discount with the Eurozone. US real yields have already moved below Japanese real yields! Effectively, a weaker dollar could duly play its role in the reflationary exercise for the US, helping to heal the economy and assisting the US government to pay back its debt (in a similar fashion to World War II financial repression).

Expensive valuation

The US dollar appears expensive. See the chart below which shows it against trading partners' currencies, adjusted for inflation. Another valuation measure, OECD purchasing power parity, estimates that fair value for the US$/euro exchange rate is $1.40, implying that the euro is currently 27% undervalued against the US dollar. The yen is only slightly undervalued by this measure and other major currencies lie in-between but all appear undervalued.

This stands in stark contrast with the undervalued dollar at the time of the global financial crisis before it appreciated so steeply. Current overvaluation will cap further dollar appreciation in the long term.

The US real effective exchange rate is near historic highs

Source: Citi Broad Real Effective Exchange Rate Index, against more than 50 currencies

Low oil price

The US has become the largest oil producer in the world and this year's sharp move down in the oil price is hurting the US economy more than the economies of the Eurozone, UK or Japan which are all oil importers. The US shale oil industry is unprofitable at current low levels and bankruptcies, loan defaults and job losses are likely. However, the oil and gas industry is still a small part of the US economy and there are some compensating benefits for consumers from a low oil price. More critically, the lower oil price will increase the US current account deficit which is a generally negative development for the US dollar against the current account surplus currencies of the Eurozone and Japan. Oil production had previously helped to curb the deficit to its current 2.3% of GDP, down from a peak of 6.3% in Q4 2005.

How should portfolios be positioned vis-a-vis the dollar?

The last twelve years of US dollar strength have reduced the return of overseas assets to unhedged US investors. This has acted as a discouragement to diversify investments outside of the US. However, we think that the tide may be starting to turn. We expect that, once the economic shock from the virus dissipates, US investors will start to benefit from the currency appreciation that comes from their overseas equity exposures. We therefore suggest that US investors without any currency hedging in place need not take any action and those with some currency hedging should consider reducing their hedge ratio when the coronavirus threat reduces hopefully later this year.

On the other hand, non-US investors who have benefited from the double benefit of strong US asset performance and dollar strength in the past, should consider putting some currency hedging in place.

Our conclusion

2020 will be full of uncertainties. Not only do we not know how the coronavirus will pan out, but there is a US election towards the end of the year. The coronavirus has boosted President Trump's chances of re-election to date which is typical for a sitting government during a crisis. However, with eight months still to go before the election, the President's popularity may fall as a US recession takes grip. Whilst Trump's re-election would probably be the most favourable outcome for the dollar given his business-friendly credentials, a Joe Biden Democratic win is unlikely to put that much downward pressure on the dollar.

The length and severity of the virus and economic recession have their part to play in the US dollar's fortune. At the moment, we are assuming that the virus will impact the global economy and investor sentiment well into the second half of this year. This turns us neutral on the dollar for the moment. However, we continue to think that it will move lower over the next few years.

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Aon's Global Asset Allocation Team

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