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Dollar drops

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Global view

Other currencies are strengthening because other economies' central banks have further to go in terms of tightening.

Reserve currency

For now, and for years to come, I anticipate the US dollar will remain the dominant global reserve currency.

Dollars and sense: Where does the US dollar go from here?

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Last week was an important one for markets. The US Consumer Price Index (CPI) print showed that inflation, both headline and core, was lower than expected for June. This helped confirm our view that the US is in the midst of a strong disinflationary trend. The journey is imperfect, but it's happening.

There was a strong reaction to the CPI print, as markets anticipated that the end of the US Federal Reserve's (Fed) tightening cycle is near. Global equities rose, global yields fell, and the US dollar fell significantly. In fact, the US Dollar Index fell to a level it hasn't seen since April 2022 when the Fed was just beginning its aggressive tightening cycle.

Global central banks are in a different place than the Fed

As we have seen inflation peak in the US, we may also be past the peak of the US dollar. The US dollar is weakening as other currencies are strengthening because other economies' central banks, especially the Bank of England but also the European Central Bank (ECB), have further to go than the Fed in terms of tightening – as I mentioned last week. That sets us up for an environment in which there is greater differentiation in the near term regarding monetary policy and the economic environment of major economies.

With inflation far more problematic in the UK, the US is clearly in a very different place when it comes to anticipated monetary policy. This is also true in the eurozone, though to a lesser extent than the UK. The euro has also gained ground against the dollar recently. Although inflation isn't as much of a problem in the eurozone as in the UK, the ECB likely still has more work to do than the Fed.

Thus, it's no accident that as the dollar depreciates, it's other major currencies that have been rallying. These are the currencies against which the dollar gained the most ground as the Fed became the most aggressive in tightening compared to other major central banks in 2022.

Recent currency moves are telling us that Japan is also in a different place than the US. Surprisingly, the Japanese yen appreciated sharply against the US dollar over the past 10 days. The appreciation has been driven by a growing expectation that the Bank of Japan (BOJ) will substantially alter its current yield curve control policy – widely viewed as the first step in a BOJ tightening cycle – at its next monetary policy meeting in late July. The expectation seems to have been triggered by two factors: a recent rise in Japan's 10-year breakeven inflation rate, and an expectation that the BOJ will upwardly revise its inflation outlook for fiscal years 2024 and 2025 at its next meeting. This appreciation of the yen relative to the US dollar is obviously not just about Japan; it's also about the drop in the dollar thanks to the lower-than-expected inflation data.

What drives dollar strength?

Economics textbooks have long explained that a whole host of factors impact the relative strength of currencies. However, over time I have learned that the most important factors dictating US dollar strength are relative growth, rate differentials, and demand for the US dollar as a “safe haven” asset.

The recent drop in the US dollar largely reflects an expected end to Fed tightening in the near term as well as improving growth expectations (i.e., a growing consensus that the US will avoid a hard landing). In addition, with market sentiment more bullish and the VIX volatility index at relatively low levels, there is little demand for a “safe haven” asset such as the US dollar.

Will the US dollar remain the dominant global reserve currency?

It's worth noting that the US dollar's status as the preeminent “safe haven” asset among currencies is at least partially derived from its status as the dominant global reserve currency. That status has come into question in recent years, and it's a question I've received a lot lately given the recent emergence of challenges to US dollar dominance in trade and payments in the face of US-imposed economic sanctions.

The biggest recent challenge has been “petroyuan” — using Chinese yuan to settle crude oil trades, which enables countries to circumvent the US in oil transactions. It's a term derived from the “petrodollars” that were born in the 1970s when Saudi Arabia and other oil-exporting nations agreed to price their exports in US dollars.

When considering this issue, I like to take a historical perspective. De-dollarization of the international system has been discussed for decades but has yet to happen. The Japanese yen and the euro were both considered major challengers to dollar dominance of the global financial system in the 1980s and the 2000s, respectively, but it never came to fruition. Having said that, today de-dollarization is about geopolitics and sovereignty, not macro/financial competition. And it's driven by a national security imperative: many governments feel an urgent need to reduce exposure to US/Western financial sanctions, exclusion from the international payment system or, in a potential worst case, reserve freezes and seizures.

Whatever the drivers, historically the decline of a dominant global reserve currency has occurred over the course of decades rather than months. What's more, we're seeing attention being given to this topic — and measures being proposed to maintain US dollar dominance — as US policymakers recognize the benefits the American economy enjoys because of the dollar's global reserve status. Recently, the US House Financial Services Committee held a hearing entitled “Dollar Dominance: Preserving the US Dollar's Status as the Global Reserve Currency.” This followed the introduction of a bill earlier this year that would require the US Treasury Secretary to create a dollar strategy. Whether such legislation can get passed, let alone be successful in achieving long-term goals, remains to be seen. However, I do believe creating a dollar strategy would be a step in the right direction. For now, and for years to come, I anticipate the US dollar will remain the dominant global reserve currency.

More dollar weakness expected

As we look ahead, I anticipate the US dollar will continue to weaken as more signs point to Fed dovishness relative to other central banks, especially the Bank of England and, to a lesser extent, the ECB. The Bank of Japan is a slightly different situation. I am more skeptical about the BOJ altering its monetary policy in the near term as Japan's export environment remains quite challenging, which should prevent the BOJ from tightening its policy prematurely.

The key takeaway is that the US dollar is likely to continue weakening in the near term, and that has implications for earnings, trade and even asset performance:

- US companies that derive a large portion of their revenues from abroad stand to benefit from dollar weakening, which makes their products cheaper to foreign buyers. The US tech sector, which derives a substantial portion of its revenue from outside the US, in particular could benefit from this.
- Another potential beneficiary is emerging markets, given that US dollar-denominated EM debt becomes less onerous to service when the dollar is weaker.

In short, recent currency moves are a reminder that investment opportunities can arise in many different ways.

With contributions from Tomo Kinoshita and Arnab Das

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

The US Dollar Index measures the value of the US dollar relative to majority of its most significant trading partners.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

An investment cannot be made directly in an index.

Tightening monetary policy includes actions by a central bank to curb inflation.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

Breakeven inflation is the difference in yield between a nominal bond and an inflation-protected bond of the same maturity.

The opinions referenced above are those of the author as of July 17, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.