The U.S. Dollar Has Turned. Now What?

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What has happened? Since September 26, the U.S. dollar has lost 13% against the Euro, around 10% against the Japanese yen and nearly 11% against a basket of developed market currencies, as per the Dollar Index. During the same period, the EMFX index – a popular currency measure - has gained nearly 5%, dollar denominated emerging market sovereign fixed income has returned approximately 9.75%, while emerging market local currency bonds have yielded around 14%.

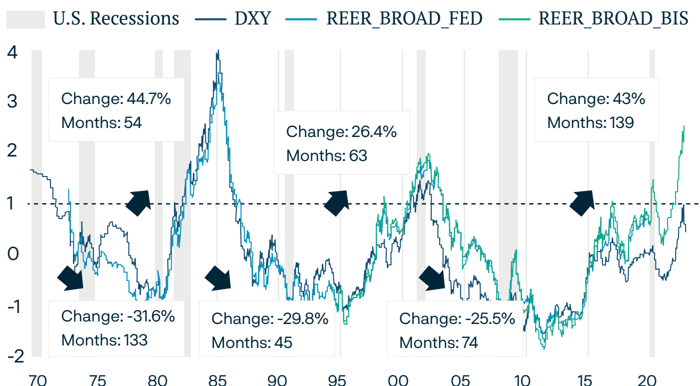
This correlation - lower U.S. dollar, higher returns in emerging market assets - is well known. Historically, the trajectory of the dollar has been one of the main determinants of EM assets returns. Using data from 1970 through 2014, a report by the International Monetary Fund concluded that real GDP growth in emerging markets accelerates during periods of dollar depreciation. The main transmission channels are through an income effect owing to the impact of the U.S. dollar on financial conditions in emerging markets and global commodity prices.

How have U.S. dollar cycles looked in the past? Since 1967, the dollar has experienced three multi-year periods of appreciation and three periods of depreciation. The average appreciation cycle has taken 85 months, during which the U.S. Dollar Real Effective Exchange Rate, or REER, had increased by 38%. On the other hand, the average depreciation cycle has lasted 70.3 months, with the REER typically falling by 28.9%. Therefore, in past economic cycles, the dollar has tended to shift approximately an average of 30% over periods of five to seven years. *Please reference Figure 1.*

Which macroeconomic determinants could propel a multi-year dollar weakening cycle? To answer this question, we reviewed current market consensus and internal estimates for five key macroeconomic and financial variables that affect the trajectory of the Real Effective Exchange Rate according to another IMF study. The sign of the macro variable's impact on REER is in parentheses below:

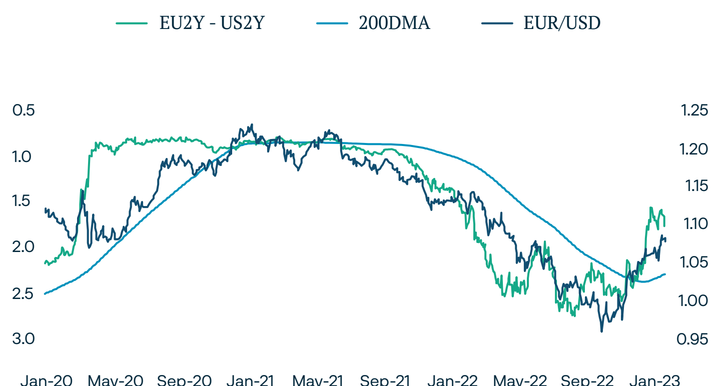
1. US GDP growth below average (-): Bloomberg consensus expects the U.S. economy to expand only 0.5% in 2023 down from 2.0% in 2022.
2. Inflation falling (-): Bloomberg consensus expects inflation in the U.S. to come down from 8.0% in the fourth quarter of 2022 to 3.8% in fourth quarter of 2023.
3. Fiscal deficit decreasing (-): Bloomberg consensus expects the U.S. deficit to improve from -5.5% of GDP to -4.5% of GDP.
4. Current account deficit percentage above 10-year interest rates (-): Bloomberg consensus expects the U.S. current account to remain in deficit at 3.4% of GDP in 2023.
5. Lower Fed Funds Rate relative to foreign interest rates (-): The combination of an increasingly dovish Federal Reserve and a hawkish European Central Bank, or ECB, has led to compressing spreads between U.S. and European yields. Declining inflation in the U.S. supports risk-taking in the short term. Supply-side and volatile factors – ranging from lower commodity prices, the normalization of the supply chain, and a shift in spending from goods to services – has precipitated this drop in inflationary

Figure 1: The U.S. dollar and economic cycles



Source: TRG, Bloomberg

Figure 2: Rate differentials have turned against the U.S. dollar



Source: TS Lombard, Bloomberg

pressures. On the other hand, demand factors point towards a slow convergence. In particular, the labor market remains tight and salary pressures remain high. While these demands determine inflation in the medium term, many expect inflation data will continue to surprise downwards during the first semester given volatile components behind the numbers. This gives the Fed time to assess whether its monetary policy is consistent with a gradual return to targeting inflation. Rate differentials between Europe and the U.S. across the curve have all gained upside momentum, crossing their 200-day moving average and signaling likely appreciation in the euro, *as illustrated in Figure 2.*

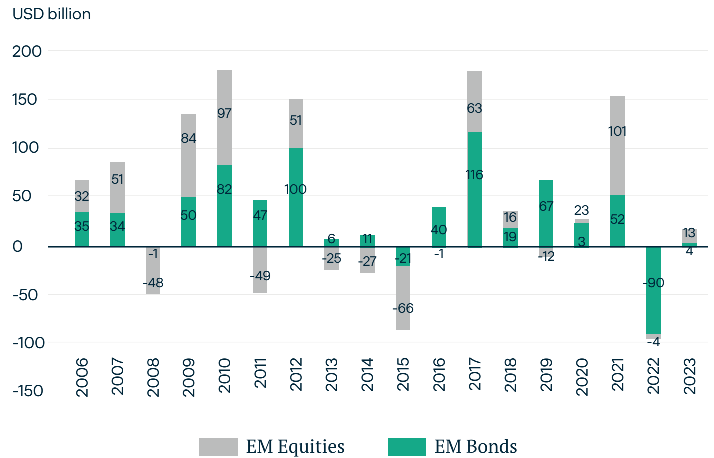
In sum, the most relevant macro determinants of the U.S. Real Effective Exchange Rate point to dollar weakening. Historically, these dollar weakening cycles last several years, but present intermittent periods of dollar strength. This highlights the benefits of active management.

Technicals, including positioning and valuations, seem to support further dollar weakening ahead.

Positioning in emerging market debt seems low given the large size of outflows experienced in the asset class last year. Additionally, emerging market foreign exchange and rates valuations remain historically attractive. Real rates across the EM complex offer significant carry over U.S. equivalents. *See Figures 3 and 4.*

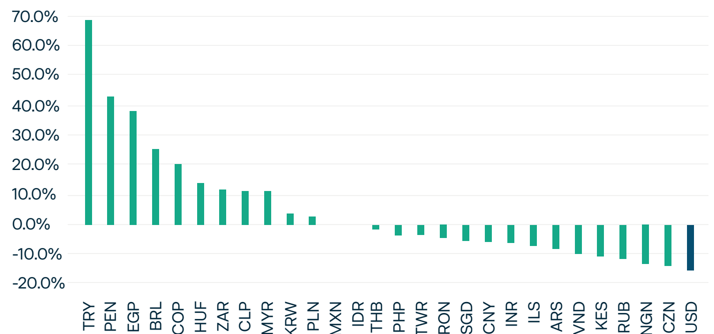
Bottom line, the confluence of macro trends and economic data point to a further demise of the U.S. dollar and tailwinds to emerging market assets. China reopening has boosted sentiment while growth forecasts in developed economies remain cautious. In the past, periods of widening growth differentials between developed and emerging countries have led to weakening developed market currencies, and increased risk taking and capital flows to emerging markets.

Figure 3: Annual emerging market bond and equity fund flows



Source: JP Morgan

Figure 4: REER spot versus 15-year average



Source: TRG, Bloomberg

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