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Investment viewpoint

Could the USD stage a comeback?

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The US Dollar is worthy of investor attention, given the key role it plays in financial markets and trade. After a prolonged period of depreciation, in recent weeks the USD has strengthened. Is this the sign of a sustained shift taking hold? If so, what does this mean for investors? In this piece, we discuss the significance of the USD, the multitude of factors and influences at play and the implications for investors.

We argue that concern over the US administration's trade and fiscal policy stance is a key driving force that has, until recently, pushed the USD lower and put pressure on the currency by reducing foreign demand for US Treasuries. The prohibitively high cost of FX hedging for non-US investors in US Treasuries, especially in the context of a depreciating USD, created a vicious circle, in our view.

With some of the economic concerns now abating and US economic growth once again appearing to outpace that of other countries, we discuss how demand for both the USD and US Treasuries could see a resurgence. Any associated appreciation of the USD could act as a drag on global growth and push inflation higher. However, we believe that in the medium term, expansionary US fiscal policy and increased US Treasury issuance will continue to put downward pressure on USD.

A strengthening of the USD could increase returns on USD-denominated assets for investors whose base currency is not the USD. It could also benefit European-based exporters and European equity markets. However, it could be negative for emerging market local currency bonds and equities.


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Punching above its weight – why the USD is so important

The US Dollar is important for both financial markets and the real economy as it plays a disproportionately significant role in a variety of arenas:

- Official currency reserves – the USD accounts for 63% of global currency reserves[1]
- Inter-bank transfers – 40%[2]
- FX market turnover – 88%[3]
- Transaction invoicing – almost 45% of the extra-zone transactions of the Eurozone are in USD[4]

1 LOIM calculation based on IMF data on the currency composition of official foreign exchange reserves (COFER).
2 Source: SWIFT.
3 Source: Bank for International Settlements.
4 Source: Eurostat.

In addition, many commodities, financial instruments and benchmarks are priced in USD, making the value and returns of those instruments dependent on the value of the USD, especially for non-USD investors. Moreover, the USD plays an important role for emerging market countries, as it is the main currency used for external borrowing (both private and public), international trade and currency reserves.

Concerns over the US fiscal outlook and policies lie behind the recent depreciation

The USD has depreciated since 2017 and this depreciation can be analysed in two phases.

During the first phase of the depreciation, the decline in the USD was relatively well explained by the interest rate and growth differentials of the US versus other leading economies. On one hand, the market's reluctance to price in the full extent of the Fed's anticipated tightening, despite the strong growth of the US economy, prevented a widening of the rate differential in the first half of 2017 (see Figure 1). On the other hand, the continued acceleration of global growth meant the US economy no longer stood out as the outperformer, putting downward pressures on USD, as suggested by the "Dollar smile" framework.[5]

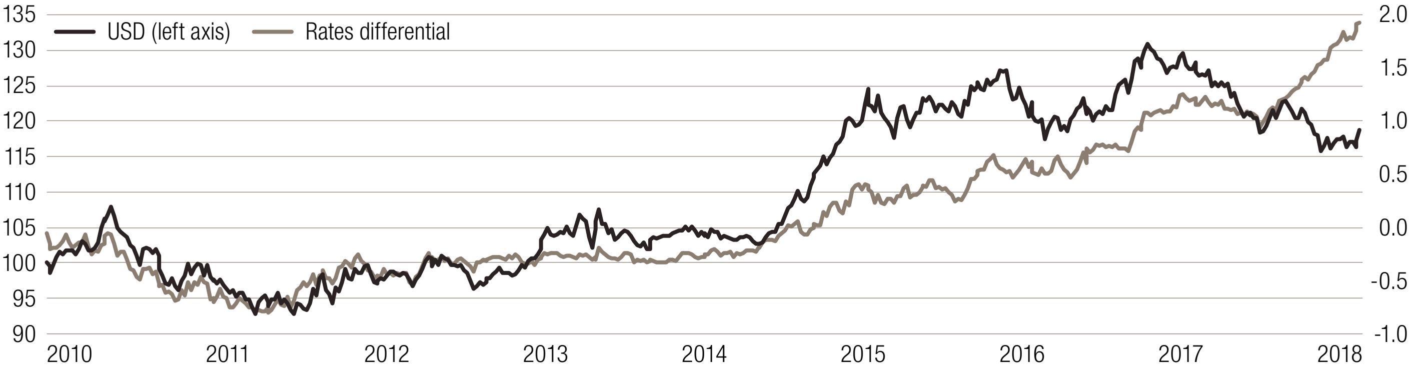
The second phase started in the autumn of 2017, when the USD began to diverge from the rates differential – depreciating at a time when the rates differential would have suggested an appreciation (also shown in Figure 1). This divergence is particularly notable in the EUR/USD exchange rate, but is also visible in most USD crosses. The timing of the divergence, starting in November 2017, is also interesting. It was around this time when the likelihood of the passing of the US tax cut bill increased substantially and the Trump administration's tone on trade gradually shifted to a more protectionist one. This suggests that USD weakness was driven by investors' concerns around political developments in the US; more specifically, their implications on the future fiscal/debt profile.

Pressure increased by weaker demand from abroad for US Treasuries

We believe that the sell-off of US Treasuries by foreigners late last year and early this year was also partly responsible for some of the downward pressure on the USD, while at the same time pushing the US Treasury yields higher.

The late-2017 decline in foreign inflows into US Treasuries, as evidenced by the Transactions in International Securities (TICs) data from the US Treasury, can be be explained in part by concerns over the US fiscal situation, current account deficit and politics. However, we believe that other factors may also have been key in reducing the attractiveness of US Treasuries to foreigners. Namely, the cost of hedging FX exposure, especially in the context of a depreciating USD.

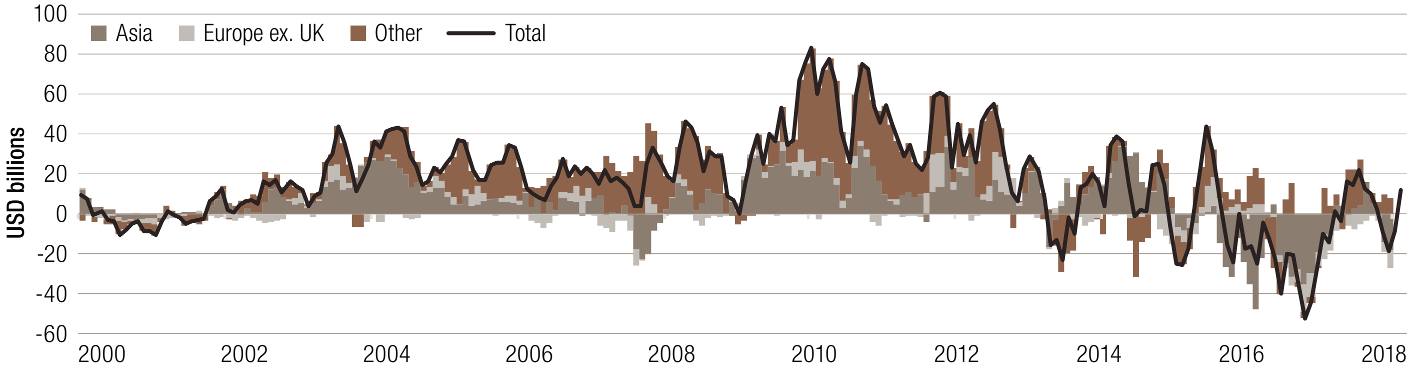
FIG. 1 USD VERSUS RATES DIFFERENTIAL (AVERAGE EUR, JPY, GBP AND CAD)



Source: Bloomberg, LOIM.
Note: The USD series is an index composed of the bilateral exchange rate of USD versus EUR, GBP, JPY and CAD.
The rates differential series is the difference between US 2-year swaps rate and the average 2-year swap rate of the Eurozone, the UK, Japan and Canada.

[5] The "Dollar smile" is framework that stipulates that the direction of USD has three states: 1) when growth in the US is stronger than elsewhere in the world, the USD appreciates; 2) when growth elsewhere is stronger than in the US, the USD depreciates; 3) when risk aversion spikes up and uncertainty increases, the USD appreciates.

FIG. 2 FOREIGN INFLOWS INTO US TREASURIES



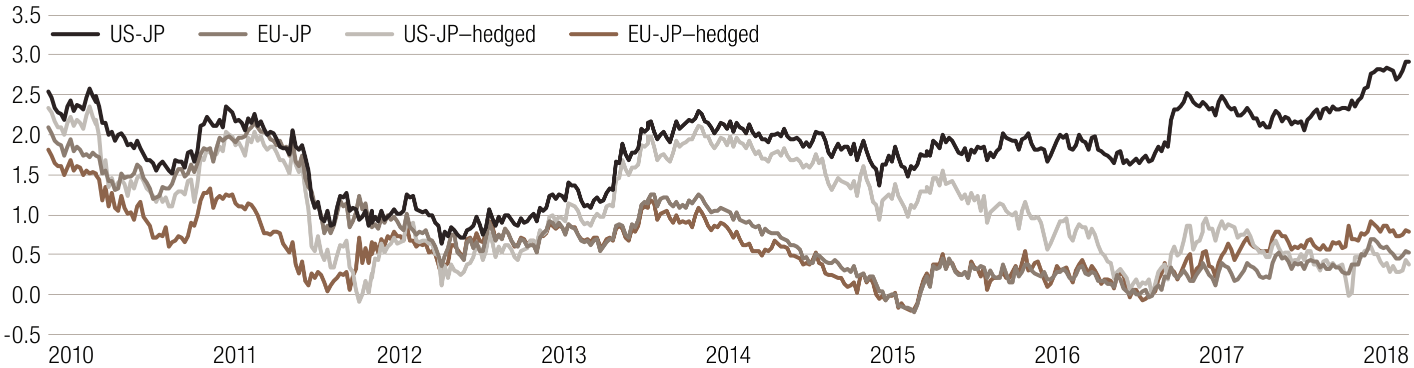
Source: US Treasury.
Note: Expressed as a 3-month moving average.

FX hedged returns unattractive for some investors

Fixed income investors will often hedge (partially or fully) the currency exposure associated with their foreign bond exposure and this is especially true when the currency in question has been depreciating. However, as the cost of hedging is closely linked to the short-term rate differential, the increase in short-term rates in the US – especially LIBOR – has pushed up the cost of hedging. As a result, the hedged rate differential offered by US Treasuries has become much less attractive to investors. The flatness of the US yield curve also exacerbates the situation.

As an example, a European investor who is choosing between investing in 10-year US Treasuries versus equivalent Bunds would earn about 240bp more investing in the US Treasury than in the Bund, excluding FX changes. However, an investor who is concerned that a weakening USD may eat up this excess return will hedge the FX exposure. In this example, the cost of hedging using FX forwards amounts to about 285bp, meaning the investor that fully hedges would actually end up losing money on the investment.[6] The situation is the same for investors in Asia, especially Japan, who are seeing better returns in European sovereign bonds, especially non-core bonds, than in US Treasuries, once hedging cost are taken into account.

FIG. 3 RATES DIFFERENTIAL, HEDGED VERSUS UNHEDGED



Source: Bloomberg, LOIM.
Note: The hedging cost is based on the 3-month FX forward annualised. The rate differential is based on the yields on 10-year bonds, using Bunds for the Eurozone.

[6] We make the assumption that an investor uses the 3-month forward to hedge the position.

Is the unhedged yield proving too attractive to ignore?

The recent stabilisation in the USD and slight reduction in US Treasury yields coincides with data for February showing the strongest foreign inflows into US Treasuries in more than six months. This is unsurprising given that investors' typical behaviour in periods of increased risk aversion is to buy US Treasuries and the USD. However, in recent weeks the USD has seen a broad-based appreciation despite a reduction in investors' risk aversion. Does this herald a shift in investor behaviour? The recent decision by some big Japanese life insurance companies (Dai-ichi Life, Daido Life Insurance Co. and Fukoku Mutual Life Insurance Co) to increase their non-hedged exposure to foreign bonds could explain some of the USD appreciation.

As discussed earlier, high hedging costs have likely dissuaded foreign investors from buying US Treasuries. However, if these investors now see cause to actively reduce their hedging ratio or decide to no longer hedge their USD exposure so that they can fully take advantage of the much higher yields, US Treasuries become a more attractive investment. This could lead to greater foreign inflows into USD. The subsequent stabilisation in the USD could, in turn, lead other investors to reduce their hedging ratio. A virtuous circle.

What does it mean for the outlook for USD and US Treasury yields?

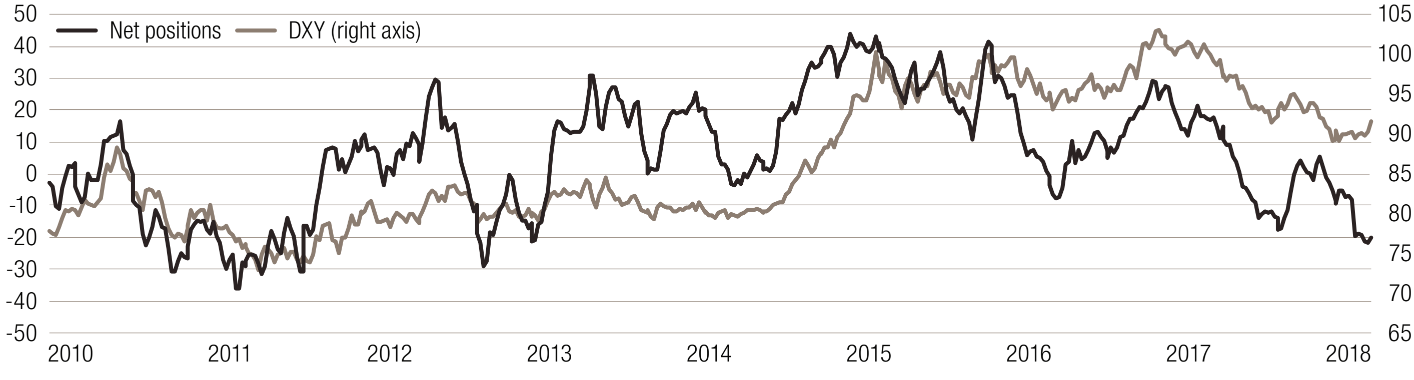
If the change in direction we are seeing in the USD is due, as we suspect, to a return of foreign investors, this could mean a continued appreciation of the USD. And with foreigners potentially absorbing a greater share of the increased US Treasury issuance associated with looser fiscal policy, the financing of the US economy's current account deficit could be assured.

Moreover, recent changes to the macro environment – with concerns mounting over the strength of global growth, in contrast with resilient US data – suggest a narrowing of the US economy's growth differential, which could also provide support for the USD. And given investors are generally very short the USD, according to the latest Commodity Futures Trading Commission data (see Figure 4), a stabilisation and/or an appreciation of the USD could lead to a short squeeze, as investors are forced to cover their short positions, pushing the USD higher.

A return of foreign investors to US Treasuries would also affect Treasury yields. With net issuance of US Treasuries likely to reach about USD 0.5 trillion, according to the lasted Congressional Budget Office forecast, and the Federal Reserve becoming a net seller of US Treasuries after years of being a net buyer, pressure on yields will be on the upside, in our view. However, if foreign investors, attracted by the higher unhedged yield, become big buyers of US Treasuries, this could somewhat contain the increase in yields.

Therefore, in the short term we could see an appreciation in USD. However, the medium term outlook for USD remains linked to the government debt dynamic and the current account deficit; a continued increase in the US government's indebtedness and in US Treasury issuance in conjunction with a current account deficit will continue to put downward pressure on USD, in our view. Moreover, with the current US administration's explicit preference for a weaker USD, we would question how long an appreciating USD would be tolerated before measures are taken.

FIG. 4 USD POSITIONING AND USD INDEX (DXY)



Source: CFTC, Bloomberg, LOIM.
Note: Net positions is for non-commercial users.

A strong USD could negatively affect global growth

Given the USD's importance in cross-border transactions, global trade and financial markets, changes in its value tend to have global repercussions, in terms of both growth and inflation. A recent National Bureau of Economic Research paper by Boz et al. (2017)[7] shows that the bilateral exchange rate of a country's currency against the USD has a disproportionate impact on the country's foreign exchange pass-through to inflation[8] and its effect on the country's external trade. Moreover, they find that the value of the USD can be a key predictor of world aggregate trade volumes, and estimate that a 1% appreciation in the USD against all currencies leads to a decline of between 0.6% and 0.8% in global trade volumes. This means that an appreciation of the USD could be a drag on global growth, with the extent of that drag depending on the magnitude of the USD appreciation.

On the inflation side, a stronger USD would increase inflationary pressures globally by pushing up import prices. Moreover, this impact could be even more important if commodity prices remain high despite the stronger USD, something we believe likely since the recent increase in commodity prices is mainly the result of supply and demand-related factors rather than the numéraire effect from the weaker USD.[9] And stronger global inflation could bring forward some of the expected reduction in monetary stimulus outside the US if the impact on inflation is significant enough and judged to be lasting. In contrast, in the US a stronger USD would reduce some of the inflationary pressure coming from higher commodity prices and reverse some of the impact of the past USD depreciation, although with US wage growth accelerating, we think it is unlikely to alter the direction of US monetary policy unless we see a sizeable tightening of financial conditions.

Investment implications of a strong USD

The direct impact of the stronger USD would be in the form of an increase in return on USD-denominated assets for investors whose base currency is not the USD. Investments in commodities by non-USD denominated investors would also gain from a strong USD since commodities are priced in USD and have been mainly pushed higher due to supply constraints (Russian sanctions, risk of Iranian sanctions and pipeline constraint in the US) and demand growth (robust global growth and geopolitical risk), as previously mentioned, rather than the numéraire effect (ie, value of USD).

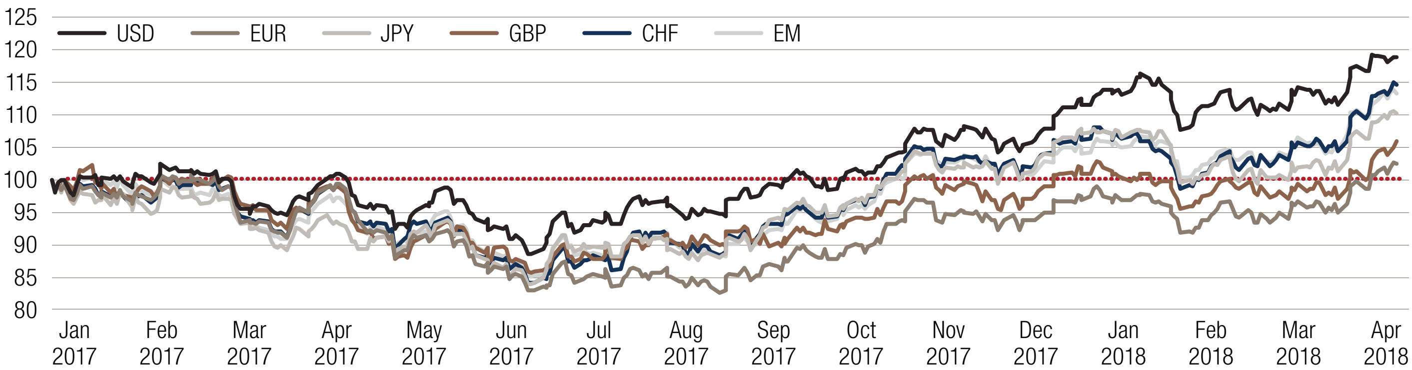
A stronger USD would also be positive for European equity markets, in our view, as it would improve the profitability of exporters by increasing the value of their foreign revenues. This would mark a reversal of some of the drag we have seen on European equities over the past year, and would be particularly positive for the exporters.

However, a USD appreciation could be negative for assets that are reported in USD but not originally valued in USD. For example, emerging market assets – both local currency bonds and equities – which are more sensitive to the USD dynamics than to movements in US yields per se. Emerging market equities and bonds have a very strong negative correlation to the USD because of the associated depreciation in the local currency.

For emerging market equities, a stronger USD would also negatively impact companies that have borrowed in USD, by increasing their borrowing costs. While this could be offset somewhat by stronger foreign currency revenues for exporters, the impact would remain negative overall, in our view.

However, it is important to note that emerging markets are now at a very different starting position compared with that of the 2013 taper tantrum. Emerging market fundamentals are stronger and real rates in emerging markets are now 2.3% higher than in advanced economies. This compares to a differential of close to zero at the start of the taper tantrum. For this reason, we continue to hold a positive view on emerging market assets, specifically equities and local currency debt. We believe the current appreciation trend in the USD will stabilise in the near future and we expect underlying emerging market fundamental strength to shine through.

FIG. 5 IMPACT OF FX ON COMMODITY PRICES (GCSI VALUED IN DIFFERENT CURRENCIES AND REBASED)



Source: Bloomberg, LOIM.

[7] Boz, E, G Gopinath and M Plagborg-Moller (2017), "Global trade and the Dollar," NBER Working Paper 23988.
[8] The exchange rate pass-through is the elasticity of local inflation to a change in the exchange rate.
[9] The numéraire effect is the fact that when the value of the USD changes, commodity prices will move in the opposite direction to keep commodity prices expressed in other currencies unchanged, all else being equal.

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