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# CIO Viewpoint

# How long will the US dollar's strength continue?

Investment Solutions

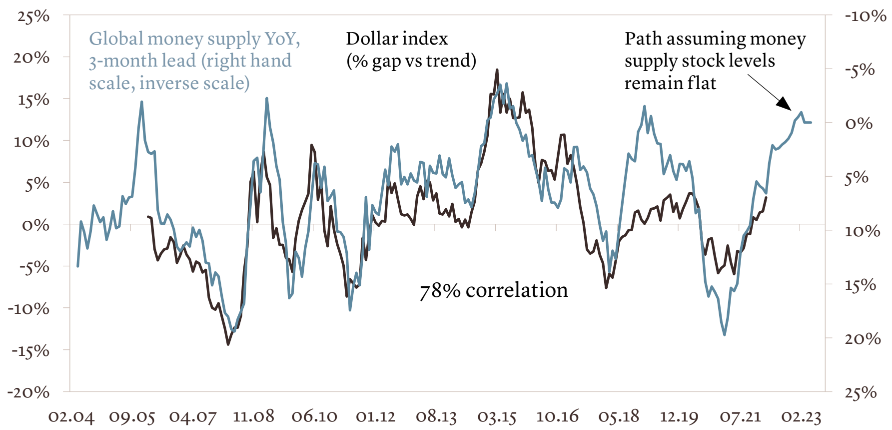
**9 May 2022**

**It is nearly two decades since the US dollar was this strong. A combination of high inflation and geopolitical instability has driven demand for the world's reserve currency. Can the dollar rise further as the Federal Reserve tackles monetary inflation, or will the post-pandemic supply shock and geopolitical rifts undermine its status?**

The dollar has gained almost 9% against a basket of currencies since Russia's invasion of Ukraine. Last week the DXY dollar index rose to 104, a level last seen in late 2002.

Central banks have an arduous path ahead in navigating monetary policy. As they grapple with the prospect of stalling economic growth and monetary inflation, central banks including the Bank of England, Reserve Bank of Australia and the Reserve Bank of New Zealand, are choosing to fight rising consumer prices by increasing interest rates to tighten liquidity conditions and destroy demand. The US dollar typically strengthens in this environment of lower global liquidity, suggesting that it will only weaken again once the outlook for world growth improves (see chart 1).

### 1. Less accommodative global monetary settings historically consistent with a stronger USD




Sources: Bloomberg, Lombard Odier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**Key takeaways**

- Investors' search for a haven from a worsening global growth and inflation outlook has pushed the US dollar to its highest levels since 2002
- Historically the dollar strengthens as global liquidity shrinks: with central banks tightening policy, we see this persisting
- No alternatives are challenging the dollar's status as the world's reserve currency
- We have taken partial profit on our dollar exposures, cutting our overweight to 3% in Swiss franc, euro and sterling-denominated portfolios.

The US Federal Reserve last week underlined its focus on fighting four-decade high inflation. Within six months, US inflation has shifted from "transitory" to "much too high," according to the Fed. As consumer price inflation intensified in 2022 and hit an annualised 8.5% in March, the Fed turned more restrictive, and the dollar strengthened. The Fed increased interest rates by 25 basis points in March, and 50 bps on 4 May. We expect another 50 bps hike each in June, July and September, with the benchmark peaking at around 3% in the first three months of 2023.

Chair Jerome Powell continues to emphasise the need to normalise monetary policy with higher interest rates to curb consumer demand and slow the economy. The challenge is that the US has a strong economy, with solid employment and growth of 3.4% in the first quarter of 2022. The job market is close to full employment, with the jobless rate at 3.6% in April. That is putting wages under pressure. Salaries have risen 5.5% over 12 months as the share of the population in work, or participation rate, fell to 62%, its lowest level in three months. The data will complicate the Fed's job, with April's headline inflation released on 11 May, expected at an annualised rate of 8.1%.

The Fed's tools to engineer a slowdown while avoiding a recession are limited. In addition to cutting liquidity through interest rate hikes, it can only taper its balance sheet through 2024 from USD 9 trillion to USD 7 trn. The process will begin in June with a monthly reduction of around USD 47 billion, rising to USD 95 bn from September.

## 'Powell shock'?

The last time US inflation was this high Paul Volcker was leading the Fed. Mr Volcker, who served two terms from 1979 to 1987 under Presidents Jimmy Carter and Ronald Reagan, was credited for taming double-digit US inflation thanks to what became known as the 'Volcker shock.' On taking office in October 1979, he warned that "the American standard of living must decline," before briefly raising interest rates to 20%.

In 2022, the Fed's switch from quantitative easing (QE) to tapering while raising the cost of borrowing, called quantitative tightening (QT), has been sudden, taking around three months. The fear among investors is that QT comes too late, leaving the Fed with no choice but to raise rates so quickly that there is no time to observe the economic impact of each hike, with the risk that the economy falls into recession.

The Fed has historically never managed to slow the US economy by four percentage points without triggering a recession. The central bank faces a choice between risking a recession or leaving inflation above its targets, well into 2023. Between the two options, we expect the Fed to choose to combat inflation.

## Short and long term

When global financial liquidity and economic growth is above average, demand for the dollar slows. However, more immediately, the dollar looks supported by the worsening prospects for Europe's economies and declining global growth as China's Covid lockdowns create new supply shocks.

## 2. EURUSD scenarios

| | | Baseline | Risk scenarios | |
|---|---|---|---|---|
| Scenarios | Ceasefire | Prolonged conflict | War intensifies | Global escalation |
| EURUSD assumption | 1.09 | 1.06 | 1.00 and below | 0.95 |
| Most preferred FX | EUR, AUD, Emerging market FX (Central and Eastern Europe) | USD, LatAm FX/CAD | USD, CHF | USD, CHF, JPY |
| Least preferred FX | | EUR, GBP, JPY | EUR, GBP, JPY | EUR, GBP, Emerging market FX |

Source: Lombard Odier

Our expectations for the dollar at the start of the war were based on a prolonged conflict in Ukraine that would limit energy supplies without seeing oil and gas flows interrupted. Now that the war is intensifying, with Russia cutting off gas supplies and the EU's planned embargoes on Russian oil imports, the risks of an economic slowdown in Europe have increased.

The combination of these factors is fuelling demand for dollars. If the war escalates further, we would expect the euro-dollar to fall to below parity (see figures 2 and 3).

In the context of the Fed's aggressive rate hiking cycle, slowing global growth and rising risk aversion, we remain positive on the dollar. That said, in light of the 5% gain in the dollar index over April, we recently chose to take partial profits and reduced our overweight allocation to the US currency to around 3% across Swiss franc, euro and sterling portfolios. Historically, such rapid rises in the dollar against other major currencies are often followed by periods of flatter performance.

In the longer term, perhaps in 2023, once global growth begins to recover and the Fed is able to moderate its aggressive hiking cycle, we could expect to see a weaker dollar from admittedly strong levels.

## Reserve currency

The US dollar is still the world's predominant currency for trade settlement, financial transactions and as a reserve asset. In 2021, the dollar accounted for more than 40% of international payments, the euro for 37% of the total and sterling for 6%. China's renminbi, in comparison, was used for around 3% of global transactions, according to SWIFT data.

In the wake of the war in Ukraine, some investors question the long-term future of the dollar as the world's reserve currency. Sanctions imposed on Russia by the US and its allies, which included blocking the Russian central bank from accessing its currency reserves, revived a discussion about alternatives. China, India or Brazil, for example, may look for alternatives to the dollar for their trade flows.

The problem with that suggestion is that there are few challengers. Since 2009 for example, the dollar's share in global reserves has fallen from 65% to 58%. However, so has the euro's share, once considered a credible threat to the dollar's dominance. The single currency has seen its proportion dwindle from 28% to 20% over the same period.

Meanwhile, the Chinese currency's share of allocated reserves has doubled since 2017, but remained low at 2.8% in the last quarter of 2021, according to International Monetary Fund data. While the renminbi may offer a credible challenge to the dollars' dominance, its capital markets remain relatively closed with few assets denominated in its currency for international investors to buy.

For now, it is difficult to see the dollar slipping from its dominant currency position, even if the West's rift with Russia becomes permanent, and the world increasingly multi-polar.

### 3. Our US dollar outlook vs major currencies

| | Current spot | Q2 22 | Q3 22 | Q4 22 | Q1 23 |
|---|---|---|---|---|---|
| **EURUSD** | 1.05 | 1.04 | 1.03 | 1.02 | 1.02 |
| **GBPUSD** | 1.249 | 1.24 | 1.23 | 1.22 | 1.22 |
| **USDCHF** | 0.983 | 0.975 | 0.963 | 0.951 | 0.946 |
| **USDJPY** | 130 | 132 | 135 | 135 | 133 |

Source: Lombard Odier

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