CIO Office Viewpoint

Why the US dollar may be stronger for longer

Investment Solutions

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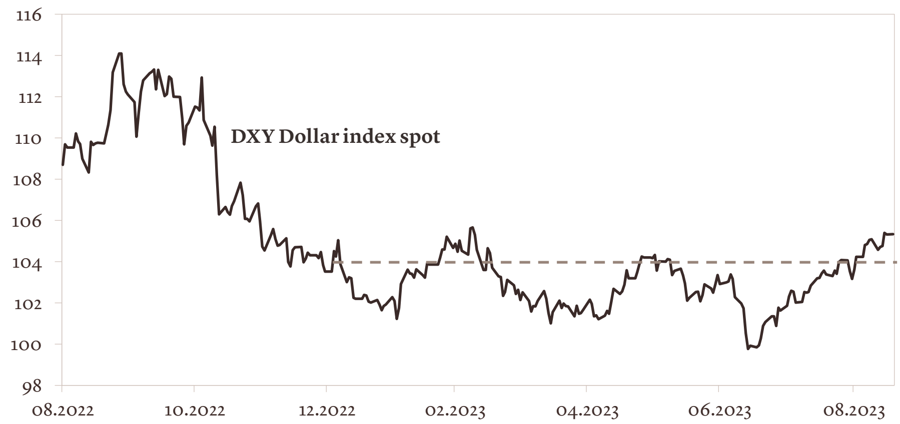
If the US economy has surprised investors with its resilience, the dollar has also confounded early-2023's expectations that it would weaken. As long as US growth as well as yields outpace much of the rest of the world, we see the dollar's strength against other major currencies persisting, at least for another three to six months.

In October 2022, the dollar reached a two-decade high against other major currencies. Earlier this year, a number of US economic indicators, from slowing gross domestic product (GDP) to moderating inflation and falling energy prices, pointed to peak interest rates and a weaker dollar. As the Federal Reserve increased its benchmark interest rate instead, investors anticipated a US recession, and the American currency did decline. Then, starting in mid-July 2023, it began to rally. The DXY index, which compares the dollar against a basket of six currencies including the euro, sterling and Swiss franc, has risen 5% over the last two months, though it is not far from the levels at the beginning of 2023 (see chart 1).

What changed? The US's better-than-expected growth, supported by higher wages and a strong labour market, explains much of that bounce while the likelihood of a severe recession kept receding. Meanwhile, China's growth disappointed with little prospect of major policy support while the eurozone's biggest economy, Germany, dipped into recession and France recorded barely positive quarterly output.

1. The US dollar has appreciated since July, back to early-2023 levels



Sources: DXY index, Bloomberg

Key takeaways

- The US economy has proved more resilient than expected, fuelling appetite for American financial assets
- The positive growth divergence and higher yields on offer in the US are two key factors supporting the dollar
- We expect the US currency to appreciate against the euro, taking the EURUSD exchange rate towards 1.04 over the next three-to-six months. By the end of 2023, we think that GBPUSD may reach 1.20, and USDCHF trade around 0.92
- Pockets of relative strength against the dollar can be found in higher carry currencies with supportive fundamental stories, such as the Brazilian real.

This growth divergence is consistent with modest dollar strength (see chart 2). The factors supporting the dollar look likely to remain in place through the rest of 2023. Historically, the US currency weakens when global growth appears healthy and US growth lags peers. Conversely, it strengthens when the global economy is slowing or when the American economy, including appetite for its financial assets, outperforms others.

From slowing to slower

The easier victories of the Fed's fight against inflation are most likely behind us. The 15-month fall in headline inflation from 9% to 5% was largely helped by post-pandemic supply chains normalising and declining energy prices. Last week's US data for August seemed to confirm that while price rises continue to slow, the pace is weakening. Core inflation – excluding volatile food and energy prices – was 4.3% higher in August than the same month a year ago, compared with 4.7% in July. For inflation to fall sustainably below 3% will take longer, in part because the next phase depends on the price of services slowing, which are both a larger share of the US economy, and stickier than prices for goods.

In comparison, core inflation in the eurozone remains persistently high. In August, prices were 5.3% higher than a year earlier, changing little since March 2023's high of 5.7%. In response, the European Central Bank (ECB) raised its benchmark policy rate again last week, by 25 basis points to 4%, citing rising energy prices. The ECB decision balances too-strong inflation with weaker economic activity, as evidence accumulates that growth is falling and prices - slowly - declining. In recent months, recession in Germany has been offset by growth in more service-oriented economies including Spain and Italy, where indicators are starting to signal a broader slowdown. The ECB also revised down its expectations for core inflation, saying it will not get close to its 2% target before 2025.

Risk appetite and the many faces of the US dollar

Equally important is investors' appetite for financial assets, in other words sentiment and flows of capital. Demand for dollars from foreign investors has played a part in the currency's strength. With the S&P 500 recording a 17% gain year to date, international capital flows into US markets rose by a net USD 148 billion in June, after a net outflow in May of USD 162 bn. In contrast, foreign flows into European equities have been diminishing while European fixed-income investors have begun seeking higher yields abroad. Real yields, adjusted for inflation, have risen faster in the US than comparable sovereign debt. Ten-year US government paper now yields 4.3% in nominal terms, compared with 2.7% for the equivalent German Bund, and 3.2% for French government debt.

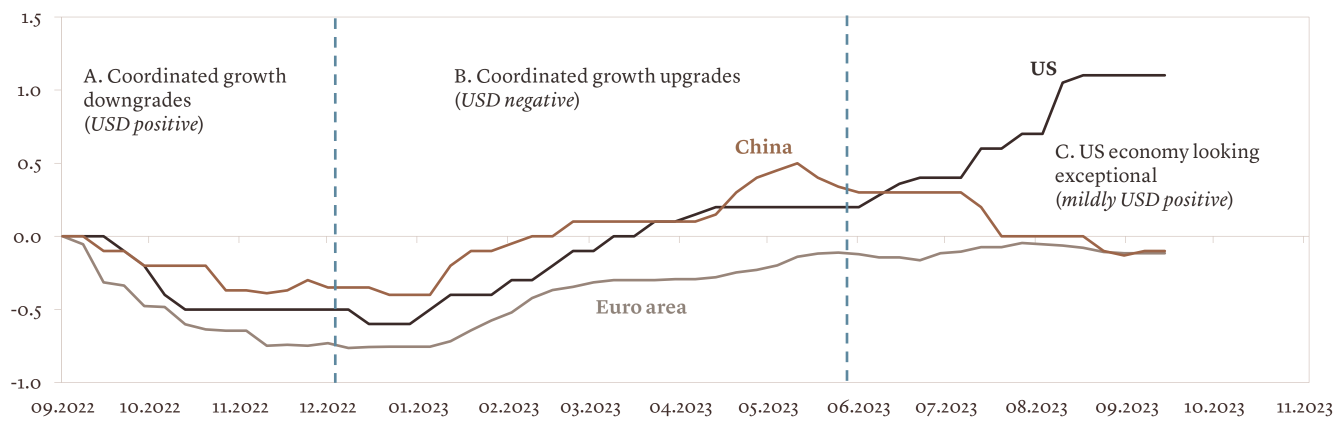
We reduced our expectations for the dollar's weakness against the common European currency in May, and then again in August. In the wake of the ECB's policy rate announcement, the euro fell from 1.07 to 1.06 against the dollar. However, we believe there is still scope for sentiment to deteriorate further and expect euro-dollar to move down towards the 1.04 level in the months ahead.

The dollar's strength has implications for other major currencies. While investors have re-priced higher their expectations for peak interest rates in the US, they have lowered their outlook for the UK since July. We think that sterling can decline to 1.23 against the dollar, and may reach 1.20 per dollar by the end of 2023. Any downgrade to the UK's growth outlook would weigh even more on the pound as investors' long sterling positioning, which remains significant, would intensify that pressure.

Closer to home, we believe the Swiss National Bank (SNB) will maintain its preference for a strong franc at its 21 September meeting, given the country's still – relatively - high inflation. The central bank, whose inflation target is between 0% and 2%,

2. Three phases of growth: resilient US economy diverges from eurozone and China

Changes in consensus 2023 GDP forecasts over 12 months



Sources: Bloomberg, Lombard Odier

assumes that prices will accelerate from their August level of 1.6% to more than 2% in 2024. Given that the SNB uses the franc as a monetary policy tool, we expect it to continue to lean on its foreign exchange reserves to maintain its 'strong franc' strategy, thus helping to dampen inflationary pressures. At the end of 2023, we see the franc trading close to current levels, at around 0.96 per euro, with risks to the downside. Given our expectation for a stronger dollar until year-end, we expect the franc to trade at 0.92 per dollar, from around 0.89 today.

Within emerging markets, we remain cautious on the Chinese renminbi as monetary policy will remain accommodative to support growth, and so weigh on the currency. On the other hand, we believe the currencies offering higher real yields than US assets, such as the Brazilian real, will remain well supported.

Overall, we have a bias to be modestly overweight the US dollar for the coming three to six months. As the Fed's interest rate hikes filter into the US job market, inflation slows and the chances of a soft landing increase, growth divergence with the eurozone and China could widen somewhat further. While there is no denying that the dollar is overvalued from a long-term perspective, investors seem clearly more focused on growth and the yield differential.

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