Macro fundamentals point to a softer USD

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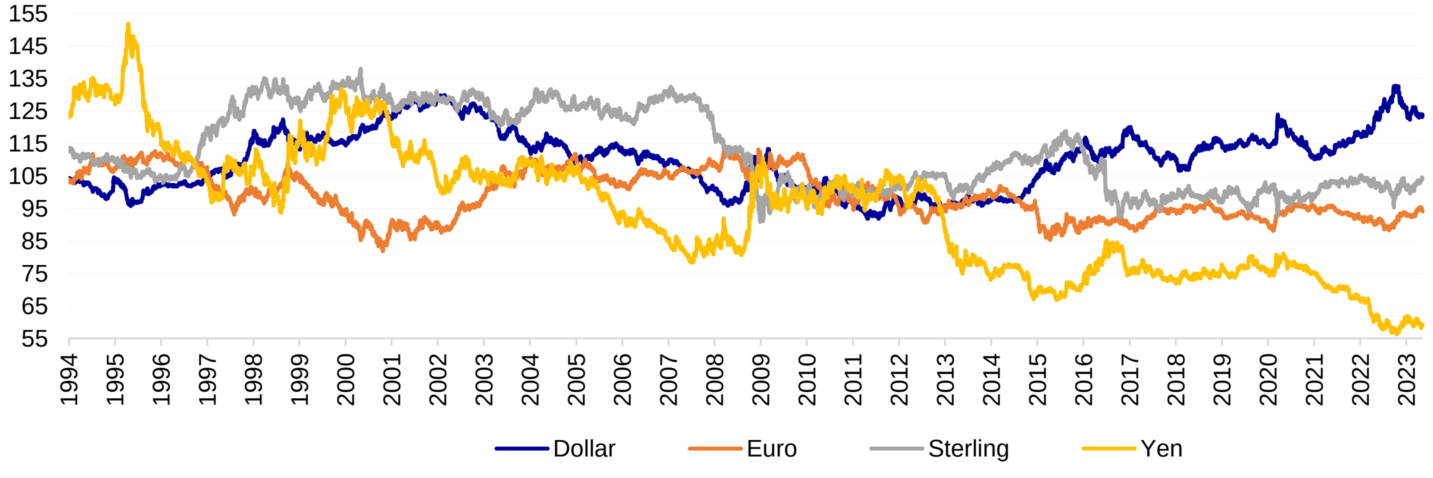
Why do we expect a soft dollar world?

- We expect the still-expensive dollar to depreciate as US inflation falls faster than other major economies, underpinning the Fed's interest rate pause as the ECB and BoE continue to tighten.
- The US current account deficit is a sizable 3.5% of GDP[1] and could grow due to investment subsidies in the semiconductor and green-transition sectors, placing structural pressure on the dollar longer-term.
- A "bumpy landing" in the West: while inflation momentum is weakening, so too is growth and with a potential mild recession on the horizon; US rates are close to their peak with more hikes in Europe.
- China's reopening recovery and relatively easy monetary policy stance should help support emerging market growth and risk appetite, pivoting capital back especially towards Asia. A weaker dollar bodes well for EM assets and currency outperformance.
- De-dollarization does not appear to be a near-term development since the pricing of international trade and FX reserves continues to be overwhelmingly denominated in USD; parallel payment systems are expected to continue developing as some governments reduce vulnerability to potential financial sanctions.
- The key near-term risks to our view include a hawkish Fed turn, escalation of banking crises to financial crisis in the US or EU and geopolitical risks.

Differences in inflation and interest rates point to future dollar weakness

The dollar reached a recent valuation high in September 2022, largely driven by differences in interest rates and bond yields. The Fed had to undertake the most aggressive monetary tightening in decades because it failed to foresee the high inflation would result from super-strong demand, as household savings and wealth ballooned during the pandemic on massive fiscal transfers (around 25% of US GDP in two years)[2] and aggressive Fed easing.

Figure 1: Dollar is off the boil but remains rich vs. history and other major currencies (index level)



Note: Chart shows JPM Real Effective Exchange Rate Indexes, deflated by CPI by trade weights. Source: Bloomberg, JP Morgan, Macrobond, Invesco. Daily data to 12 May 2023.

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Since then, the dollar has come off its highs. Due to the frontloading of rate hikes, the dynamic has shifted from the Fed being the most aggressive among tightening central banks to being one most likely to pivot.

Though still elevated, core inflation seems to be coming off the boil in the US. It is important to note that we are at a point where the fed funds rate exceeds US inflation.

The Fed announced its policy rate unchanged in the June FOMC meeting and updated its dot plot to show additional rate hikes before the end of the year.

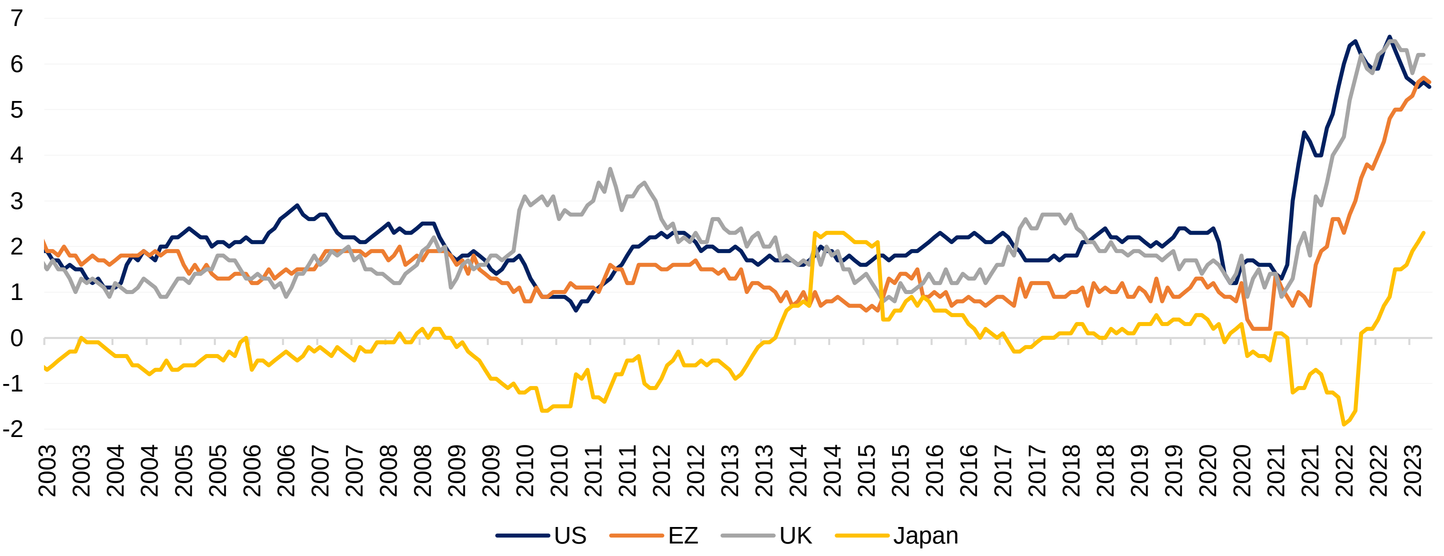
We don't believe the Fed will hike meaningfully more: PPI on a y/y basis is now negative, CPI on a y/y basis is likely to dip below 4% in June.[3] Money growth as measured by M2, has normally led CPI by 12-18 months, and M2 is now -4.6% y/y.[4] If the Fed does tighten two more times this year, it really risks overkill – and could send the economy into a hard landing.

Core inflation in some other Western economies - namely the Eurozone and United Kingdom - lags the US and may not have peaked yet. This would suggest that central banks in these economies have some catchup work to do relative to the Fed. These dynamics are likely to see the USD depreciate against the GBP and EUR.

While in Asia, Japanese growth and inflation are hitting a multi-decade high, and the BOJ could be forced to abandon its ultra-loose monetary policy later this year, which could strengthen the JPY against the USD.

Furthermore, the PBOC has recently deployed more accommodative monetary policies to prop up sluggish domestic demand – this has pressured the RMB against the USD though provides a boost to regional growth which could outpace that of Western economies over the next year.

Figure 2: US core inflation is clearly falling – not yet so clear in the UK, EZ or Japan (% YoY).



Source: Macrobond, Invesco. Monthly data through April 2023 as at 12 May 2023

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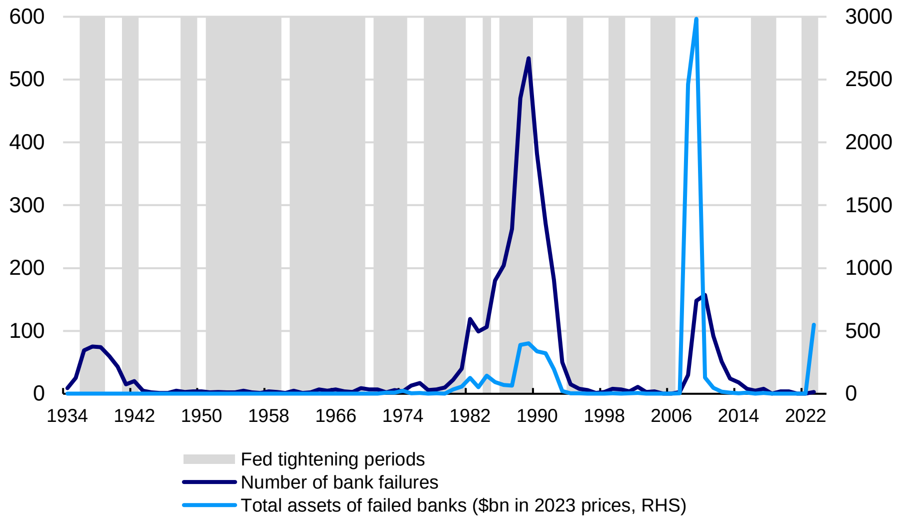
From a historical perspective, the dollar also remains richly valued, especially given current macro fundamentals and likely policy differences going forward between the Fed and other major central banks. We expect further dollar depreciation over the course of the year which could ultimately prove supportive of select risk assets.

To sum, a weaker dollar environment could be beneficial to risk assets in DM where monetary policy is tightening, such as in the UK, EU and potentially Japan. When it comes to EM, a softer dollar is more of a mixed bag, since some countries such as China are loosening policies.

Banking stress implications

While the regional banking crisis in the US has subsided, it has contributed to a drainage in liquidity and a rapid tightening in lending conditions. While the number of bank failures may be limited to three, the asset base associated with them is significant (see Figure 3).

Figure 3: US bank failures and Fed tightening



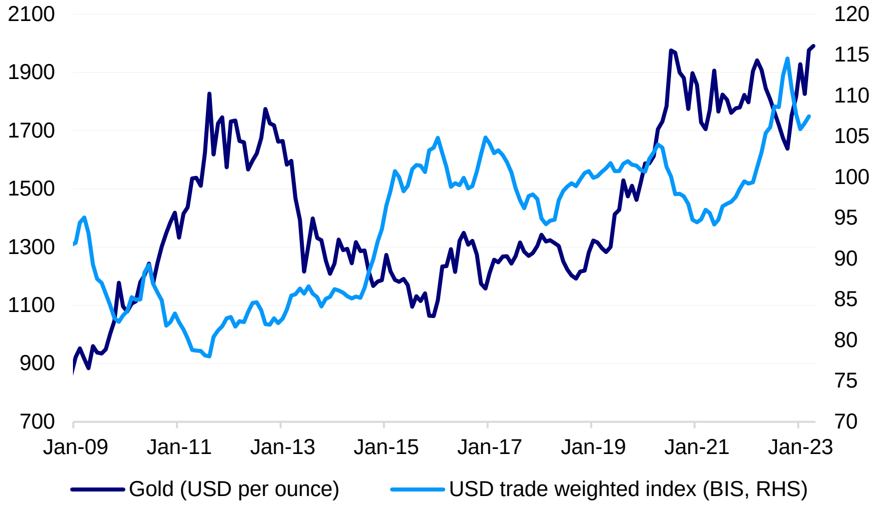
Note: Based on annual data from 1934 to 2023 (as of 11 May 2023). Total assets are expressed in 2023 prices by deflating with the US consumer price index. Source: Federal Deposit Insurance Corporation, Global Financial Data, Refinitiv Datastream and Invesco

This helps explain why the Fed and the FDIC have reacted so quickly to stem the crisis. Indeed, it looks likely that the banking crisis has been contained and is no longer a major issue in market views about monetary policy. That said, continued use of the Bank Term Lending Facility signals that the sectors woes are not completely behind us.

Gold's recent momentum – the "anti-dollar"

Gold is close to its all-time high ($2063, reached on 6 August 2020).[5] There is a natural inverse relationship between the value of the US dollar and the price of gold (see Figure 4). Because gold is priced in US dollars, movements in the dollar change the price of gold when expressed in other currencies.

Figure 4: Gold and trade weighted US dollar



Note: Past performance is no guarantee of future returns. Monthly data from January 2009 to April 2023. "USD trade weighted index (BIS)" is the US Effective Exchange Rate Narrow Index as provided by the Bank for International Settlements (BIS). Source: BIS, Refinitiv Datastream and Invesco

In addition to a dollar hedge, gold has been viewed as a so-called "safe haven" asset. When the price of gold is rising, central banks and other investors may be tempted to hold even more gold, rather than US dollars, in the belief that gold will continue to go up (momentum trade).

On this basis, the recent gold price momentum could further the selling of the dollar, especially considering that the record central bank purchases of gold that occurred in 2022 may have been partly encouraged by geo-political considerations (see the next section).

Dollar depreciation – not "De-dollarization"

We believe investors should focus on macro forces for dollar depreciation rather than "de-dollarization" of the global economy or financial markets – even though we are in one of those periods when doubts about the dollar dominance of the international system bubble up.

We do expect a partial de-dollarization of international payments but expect the dollar to remain the most important single currency for payments, for pricing and for central bank FX reserves.

Geopolitical frictions make today's de-dollarization debate more significant than were the rise of Japan and the yen and creation of the euro as challenges to the dollar.

The West's freezing of about half of Russia's central bank international reserves and exclusion from SWIFT has stoked concerns that the US's increasing use of financial sanctions could be used against other governments. Above all, US-China tensions are clearly a major geopolitical and geo-economic consideration.

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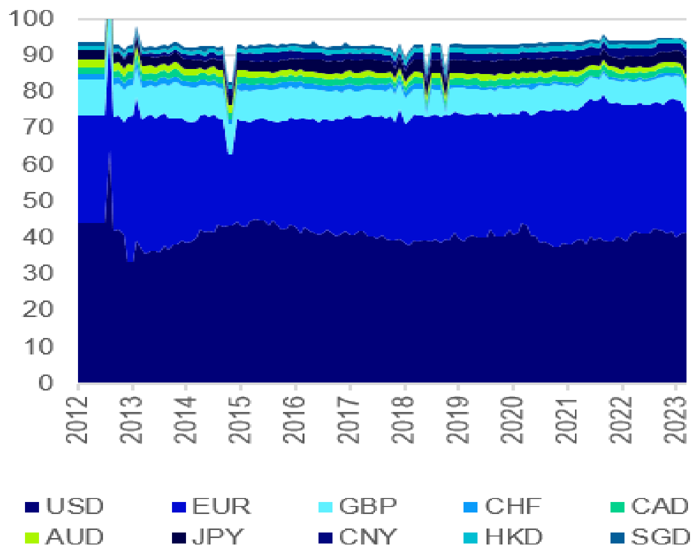
China is developing its international payments system and digital currency; has taken steps toward renminbi (RMB) internationalization; and is now the largest international economic partner for over 100 countries. Put together with US-China tensions, the case for de-dollarization looks strong.

Announcements and anecdotes nonetheless suggest that several major economies in the "Global South" are now queuing up to shift away from the dollar as fast as possible.

Russia is said to be trading oil with China in RMB. Saudi Arabia is said to be trading with China in RMB. Brazil's re-elected President Lula has complained that having to use the dollar keeps him awake at night and seems prepared to use RMB, as well as proposing an alternative BRICS currency.

Figure 5: Dollar's share of payments roughly stable; RMB's low share has room to grow



Source: IMF, Macrobond, Invesco. Quarterly data through 4Q-2022 as at 28 April 2023.

These anecdotes are compelling, but do they add up to significant financial implications? We'd say no, at least not yet.

The dollar share of international payments remains roughly stable at around 40%, while the euro accounts for some 30% of extra-Eurozone transactions.[6] Meanwhile, the dollar's reserve share is up significantly from its post-2008 lows – largely at the expense of "unallocated reserves."

The data don't indicate a substantial or rapid movement away from the USD. Especially with the CNY still not fully convertible, what is driving the narrative around it being the key competitor to the USD?

The likely answer is that the de-dollarization story today is about geopolitics, sovereignty and insulation from Western financial sanctions, not macro or financial competition.

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Then there's the all-important question of central bank reserves – would reserves shift away from the dollar or the currencies of other countries that have frozen Russia's reserves?

The world's largest reserve holders are not necessarily aligned against the US and therefore are arguably as or more likely to stick with the dollar as to move towards the RMB. In order, the top-10 reserve holders are China itself (which has already been diversifying away from the dollar), Japan, Switzerland, India, Russia, Taiwan, Hong Kong, South Korea, Saudi Arabia, Brazil.[7]

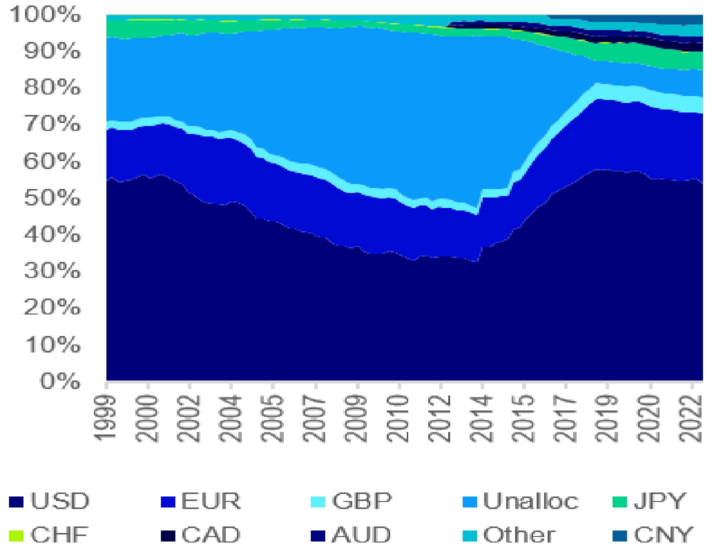
From this view, genuine de-dollarization is still not a major near-term possibility. What's more likely is a continued further fragmentation of international payments into other currencies including CNY.

We believe the US would need to lose both its economic heft and leading global role of its financial markets for depth and liquidity, for the dollar to be dethroned as the leading international currency.

Geopolitical maneuvering may play a role in such changes, especially if countries continue to try to protect their international transactions from the dollar and the euro.

But we believe geopolitics is unlikely to be sufficient until and unless China or other countries have convertible currencies and deep, liquid, open capital markets to compete fully with the dollar (or euro, sterling, yen for that matter).

Figure 6: Dollar share of global reserves down from peak – but also up from lows



Note: Unalloc refers to unallocated or unspecified currencies in reserves; these seem to have been mainly dollar, euro and sterling reserves in that order, when allocated from the mid-2010s. Source: IMF, Macrobond, Invesco. Quarterly data through 4Q-2022 as at 28 April 2023.

Conclusion: Macro fundamentals rather than event risks point to a softer dollar

Foreign exchange markets over the past year have been dominated by shifts in interest rate differentials. The Fed's most hawkish tightening path in decades drove the dollar to expensive levels.

But as it has become clear that the Fed has reached the end of its tightening cycle while the ECB and BOE haven't, the dollar has started to come off the boil.

While we believe that investor focus on foreign exchange should be squarely on global macro factors, we do acknowledge the risks to this view. US event risk could cause market discontinuities.

If the US banking crisis returns, it could cause a global risk-off movement in which EM and other risk assets suffer. Ironically, this could also see the dollar rally.

If the US fails to lift its debt ceiling and chooses to prioritize debt payments while cutting other budget spending, there could be a severe economic downdraft, which, if it causes global recession, could lead to dollar strength.

Going forward, we expect the dollar to weaken for a variety of reasons: the US current account deficit remains high and the dollar remains expensive, gold momentum is attracting buyers and the regional banking crisis is provoking an implicit easing from the Fed.

We believe the de-dollarization theme is important, but do not expect it to be a major driver of currencies or other asset prices.

Reference:

1. Source: U.S. Bureau of Economic Analysis (BEA). Data as of June 2023.
2. Source: International Monetary Fund. Data as of June 2023.
3. Source: Federal Reserve, Data as of May 2023.
4. Source: Federal Reserve, Data as of May 2023.
5. Source: Bloomberg. Data as of June 2023.
6. Source: International Monetary Fund (IMF) Direction of Trade. Data as at June 2023.
7. Source: Bloomberg Intelligence. Data as of June 2023.