AA View

US dollar weakness has further to run

Summary

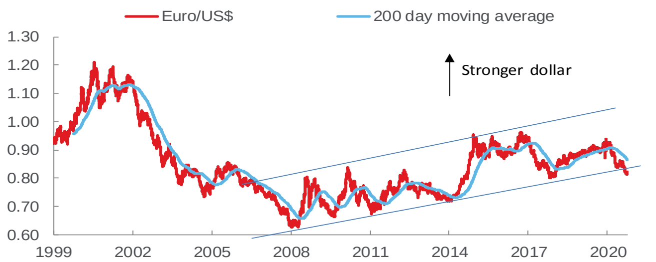
- The US dollar fell against a broad range of currencies in 2020 and appears to have broken down below its 12-year uptrend. This weakness has been in line with our expectations.
- We expect that the US dollar will remain under pressure from lower real interest rates, global growth recovery later this year and the US twin deficits.
- However, the US dollar is currently oversold which may stall further weakness in the near-term. Other risks to the weak dollar story include higher bond yields without much inflation and Eurozone hazards.
- Overall, it looks to us that the dollar is still likely to weaken further over the medium-term although the move could be less pronounced than in 2020.
- What are the action points from this? The impact of currency moves can make a big difference to overseas equity performance. We advise that US investors keep overseas equities unhedged given our expectations. Non-US investors should consider hedging dollar exposure, especially given their typically high exposure to US assets.

The US dollar fell in 2020 as we expected

The US Dollar Index, which reflects the dollar's value against a composite of major developed world currencies, fell by 6.7% over 2020. However, this period included wild dollar swings in March reflecting investor panic over the coronavirus. From its Q1 peak the US Dollar Index actually depreciated by 12%.

The dollar was weakest against the euro amongst major currencies. It now appears to have broken its uptrend that has been in place since 2008 (see chart). The dollar is now just a three percentage points away from its January 2018 $1.25 low - a level, if breached, which would take the dollar to its lowest level since the end of 2014. It is not surprising that this return pattern is mirrored in the US Dollar Index as the euro is the largest component in this index.

The US dollar has fallen below its 12-year uptrend



Source: Bloomberg. Exchange rate is quoted per US$, unlike convention

The dollar also fell against many emerging currencies. Currencies in the MSCI Emerging Equity Index rose from March 2020 lows by 11% against the US dollar to a record high whilst the Chinese yuan, the largest emerging currency exposure, appreciated by a similar extent from its May low to the end of the year.

We think that the US dollar still has further to fall

We became negative towards the US dollar in January 2019 after the US Federal Reserve (Fed) announced a change from its policy of hiking interest rates. We had felt that the reduction in the US's interest rate advantage would bring dollar strength to an end given its expensive valuation and other vulnerabilities. We may have been too early with this view but 2020 dollar weakness, triggered by further US interest rate cuts, showed our view to have been correct.

We think that the drivers of US dollar weakness have now shifted since the start of the pandemic when we last wrote on the US dollar outlook. For a start, after last year's US dollar decline, it has become less expensive. The dollar's OECD purchasing power parity[1] stands at $1.42 against the euro and $1.47 against sterling. Overvaluation against the euro has almost halved from 30% earlier this year to a more modest 16% now. Sterling appreciation against the dollar last year, despite the weak UK economy and Brexit drags, brought dollar overvaluation down to 7%, whilst overvaluation against the yen was not that large to start with but has also reduced.

We also think that the reduction in pandemic risks from the vaccine program and a likely global economic recovery beyond reduces safe-haven demand for the US dollar over the medium-term. Of course, virus risks have not disappeared entirely and may still return in the short-term in the current virus wave but the offer of ample stimulus from governments and central banks makes the US dollar less of a desired store of value.

As we see it, the three key drivers of a lower US dollar are now lower US real yields, global economic recovery and the large US twin deficits.

Lower US real yields

US inflation expectations picked up in a series of steps in 2020. The massive amount of Covid-relief stimulus from the US government and the Fed that was announced in March started to raise inflation uncertainty and longer-term inflation expectations have been moving higher since then. This was then followed by the Fed's move in September towards average inflation targeting, implying more inflation tolerance even above the 2% target. More recently, Biden's presidential election win and pledge to expand stimulus after his Senate victory appears to have stoked inflation expectations further.

Typically, rising inflation leads to interest rate rises but we think that the Fed will not hike rates for a while to come and will aim to cap treasury bond yields in order to keep debt servicing costs at manageable levels. This means that exchange rates will become more dependent on changes in inflation and inflation expectations rather than interest rate moves.

On actual US inflation, our view is that it will remain low for the next year or two given the virus' impact on growth but we do expect a move back to the 2% target. US real (inflation-adjusted) interest yields are likely to therefore remain negative for a while which is a drag on the dollar. Indeed, US real interest rates have now flipped into a real rate discount with the Eurozone, as we cautioned in our April US dollar note. In the Eurozone, inflation expectations have remained high even though actual consumer price inflation has turned negative. We see a risk in Europe that deflationary forces start to move inflation expectations down which would support Eurozone real yields relative to the US and help to depress the US dollar.

Global economic recovery

The impact of the virus on growth across countries is now a function of the speed of the vaccination process as well as the rate of cases. We expect global growth recovery in the second half of this year and the consequent improvement in the global trade environment should be more supportive to more open economies such as the Eurozone and Japan than the US. US exports account for just 12% of US GDP whereas both Germany and Japan are large exporters with strong trade links with China which has already recovered from the virus growth shock. We therefore think synchronised global economic growth will be negative for the US dollar, as was the case in 2017.

We expect that UK economic growth to continue to lag as, although a Brexit deal was reached at the last hour, the UK economy still faces headwinds and the 'thin' deal leaves continuing uncertainty, red tape and room for UK/European Union (EU) conflict down the road which cloud the UK economic outlook. This constrains the size of the post-Brexit sterling bounce we are expecting.

Deterioration in the US twin deficit

The US twin deficits exploded last year with the budget deficit moving to 15.8% of GDP and the external (or current account) deficit heading down to 3.4%.

On the one hand, even though budget deficits have increased everywhere due to the pandemic, US government spending has been particularly high. The consequent high debt load creates a drag on longer-term growth prospects as well as potential inflationary consequences which are both negative for the dollar.

On the other hand, the US current account deficit has reached its highest level since 2008 as the pandemic took its toll on US exports whilst expansive government spending supported US

[1] One metric, amongst many, of currency equilibrium towards which currencies are expected to mean-revert over the long-term.

demand for foreign manufactured goods. This trend in the current account means that the US is increasingly dependent on foreign inflows and this supports our view that the dollar may need to fall to attract inflows if US interest rates remain too low to attract investment. The US current account deficit stands in contrast to the 2.2% Eurozone and 3% Japanese current account surpluses (as % of GDP, based on OECD Q3 2020 figures) which creates natural inflows to their currencies.

Currencies are typically not that sensitive to the size of these budget and trade imbalances over shorter time scales. However, we think that US asset returns and the dominant global role of the US and the dollar may increasingly come under pressure. If US-China relations sour further, which still remains on the cards under President Biden, there is the additional risk that Chinese investors may invest less in dollar-denominated assets than in the past, creating less demand for US dollars.

Could the dollar decline stall?

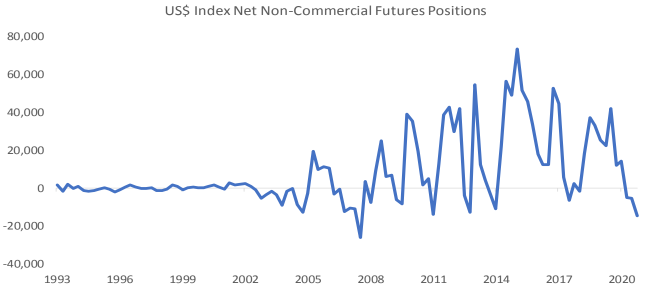
Whilst we think that the US dollar is most likely to depreciate over the next few years, uncertainties over growth and inflation in the wake of the unprecedented easy global monetary and political policy due to the pandemic mean that the outlook is not that clear.

We expect that the dollar's decline will slow from 2020's pace and that the US dollar may find some support from the following three causes. Even so, this remains in our view a declining dollar path.

Dollar is oversold

The overwhelming market consensus is that the dollar will continue to depreciate and the chart below also shows that speculative positions are at extremes of dollar negativity - offset largely by bullish positions in the euro. Historically, this speculative investor indicator has been a good contrarian short-term indicator, signalling a turning point in the dollar. If the current virus wave gets much worse and investors waver from their stance of seeing through near-term bad news, any dollar correction may also be supported by safe-haven flows.

Speculators are extremely negative on the US dollar

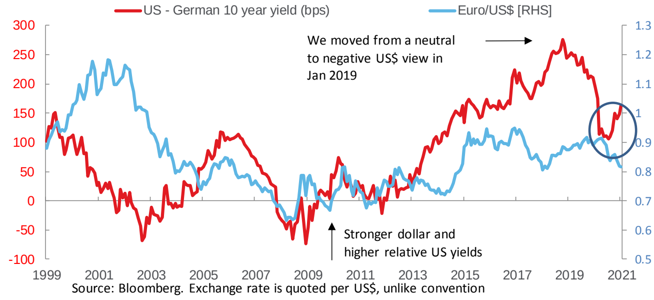


Source: Bloomberg Commitments of Traders report

Rising US treasury yields

US treasury yields have been rising since last summer as inflation expectations climbed. 10-year treasury yields as high as 1.5% are not impossible in the near-term after breaking up above 1% last week. As the vaccination program allows global economic recovery to take hold around the world, investors will start to question whether the US or other countries will tighten monetary policy first. The Fed does not currently expect to raise interest rates through 2023 but there is a risk that the markets start to think that rates will need to be raised sooner even if economic slack keeps actual inflation low. Rising interest rates relative to other countries' rates tend to provide positive support to a currency, encouraging investor inflows, as can be broadly seen in the euro/US$ chart below, although, admittedly, this did not hold true in 2019.

US yield advantage has stopped shrinking



Source: Bloomberg. Exchange rate is quoted per US$, unlike convention

Re-emergence of some Eurozone risks

The rare lack of political tension between EU member states over 2020 helped the euro to remain strong for most of the year. The European Central Bank (ECB)'s Pandemic Emergency Purchase Programme, which increased to €1.85tn over the year, was a welcome support to the Eurozone economy. But more than that, it signalled a reduction in Eurozone break-up risk as it was a meaningful step towards fiscal union. Brussels also temporarily suspended its fiscal rules and announced a joint fiscal stimulus package which further left little cause for discord between EU member states. Even Brexit trade negotiations with the UK, although difficult, resulted in a positive agreement in the end without trade tariffs and quotas. However, as the region's political and economic challenges for policy-making remain for such a large and disparate group of countries, we would not be surprised to see that conflicts flare up again once virus troubles subside.

Will the ECB prevent the euro from appreciating further? The ECB is reluctant to see further euro strength as a strong euro hurts Eurozone exports and threatens to sustain deflationary forces which will hold back economic recovery. ECB president Lagarde has said that she is monitoring the euro exchange rate 'carefully' with this in mind and is prepared to ease monetary policy further. The Bank of England is also keeping open the possibility of cutting interest rates to negative levels. Even though Brexit risk has been removed, the fast spread of new virus variants in recent weeks has made some action a bit more likely.

Summary of our US dollar view

The strength of the global economic recovery out of the pandemic slump and its impact on inflation and yields across regions are key determinants of the direction of the US dollar. We assume that there will be some degree of global reflation which is more likely to be negative for the US dollar. However, the 2013 'taper tantrum' reminds us that the process of reflation is unlikely to be smooth with setbacks along the way for currencies.

The US dollar is currently overdue for some consolidation but the **euro** exchange rate of $1.25 provides the next target for the weakening US dollar. Over the medium-term we expect the dollar to depreciate beyond this level on the back of not only cyclical factors but structural ones too, such as current account and fiscal balances.

US structural imbalances are less marked compared to the UK which also suffers from a current account deficit, but we think that some of **sterling**'s weakness since the Brexit referendum will be retraced even though the weak UK economy and continued Brexit drags will limit the bounce.

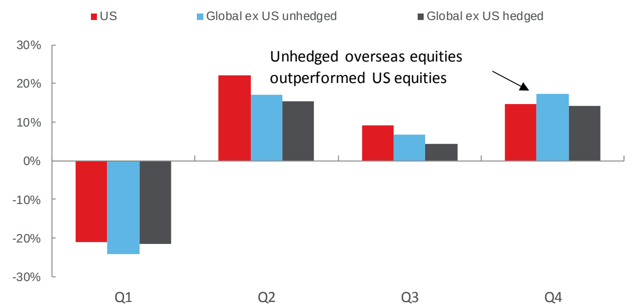
Price deflation in Japan will keep upward pressure on the **yen**. However, new Prime Minister Suga's concern over sustained deflationary risks and consequent policy steps should help cap yen gains. ¥100 provides a key yen support level against the US dollar.

[Latest exchange rates as at 15/1/2020: €1.2094, £1.3606, ¥103.81]

How currency moves influence hedging decisions

The impact of the weaker US dollar after Q1 last year can be seen in the next chart by the outperformance of unhedged (in blue) over hedged (in grey) overseas equities in US$ terms. US equities (in red) still continued to outperform overseas equities over most of the year. However, the weaker dollar made all the difference in the fourth quarter as unhedged overseas equities outperformed both US and hedged overseas equities.

Weaker dollar in 2020 improved US investors' overseas equity returns held on an unhedged basis



Source: Bloomberg, MSCI ACWI IMI net total return indices

Our view that the US dollar will continue to weaken provides a headwind to continued strong US equity returns relative to other equity markets. This occurs at a time when we think that US equity outperformance is already challenged on a number of fronts such as expensive valuations.

We advise US investors to keep overseas equity exposure unhedged. After years of US dollar strength when currency moves reduced the return from overseas equities, we think that there will now be a currency tailwind from overseas exposure.

On the other hand, non-US investors who have benefited from the double gain of strong US asset performance and dollar strength in the past, should consider putting some currency hedging in place. This is particularly important given the high weight of US assets in portfolios.

Emerging currencies are not covered in this note but we advise both US and non-US investors to keep emerging equities unhedged as we expect emerging currencies to appreciate over the medium and long-term, in line with an expected catch-up in emerging equity performance.

Contacts

Lucinda Downing
Aon
Retirement and Investment
Global Asset Allocation Team
+44 (0)20 7086 9440
Lucinda.downing@aon.com

Aon's Global Asset Allocation Team

Where are we in the economic cycle? What is the relative value of different asset classes? How are technical factors, such as regulation, impacting prices? Aon's Global Asset Allocation team continually asks and answers questions like these. We use insights to help clients make timely decisions.

With over 160 years of combined experience, the team is one of the strongest in UK investment consultancy today.

Our experts analyse market movements and economic conditions around the world, setting risk and return expectations for global capital markets.

The team use those expectations to help our clients set and, when it is right to do so, revise their long-term investment policies.

We believe that the medium term (1–3 years) has been under-exploited as a source of investment performance. Maintaining medium term views that complement our expectations for the long term, we help our clients to determine when to make changes to their investment strategy.

Empower Results®