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Ready, Set, Smile: Unpacking the Pace of US Dollar Strength

Stephanie Hill | Head of Index

Theodore Bair Jr., CFA | Senior Investment Strategist

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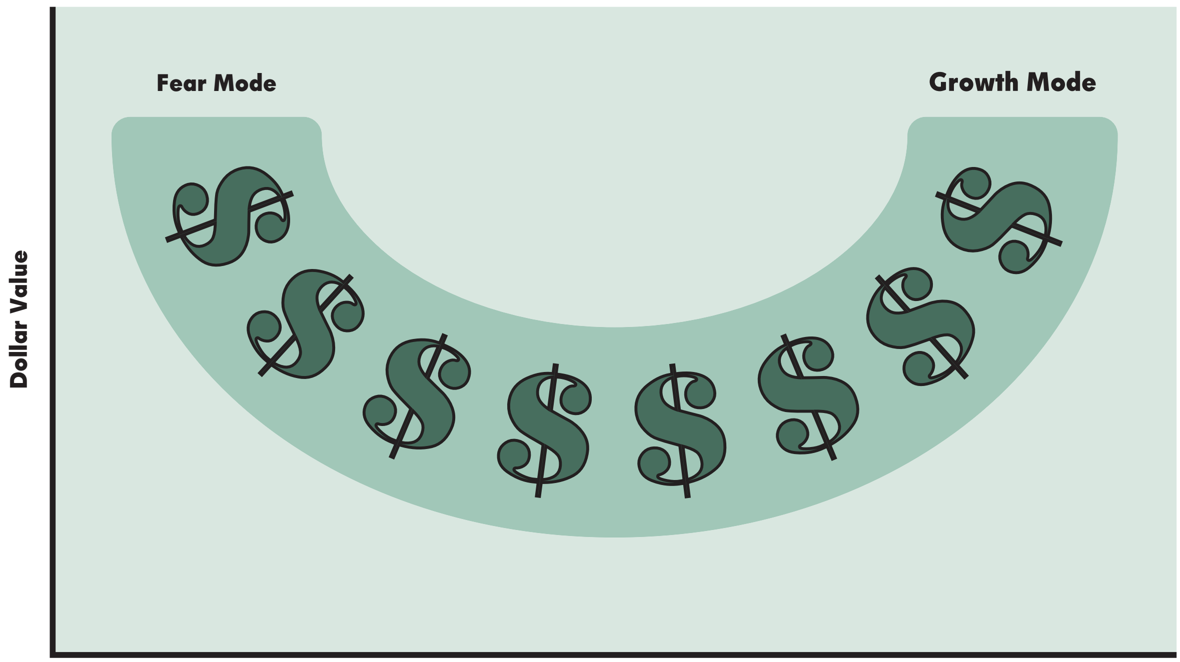
What are the forces driving US dollar strength and what is the impact on global benchmark performance in USD, local currency, and dollar-hedged terms? The dollar smile theory may give us some clues.

According to dollar smile theory, established by Stephen Jen, former economist at the International Monetary Fund and Morgan Stanley, dollar strength can arise from two main circumstances: when the US economy is very strong, and when the global economy is weak. In "growth mode", the US dollar appreciates in the case of rising US economic growth. Conversely, a global flight to quality triggers "fear mode" where risk aversion due to geopolitical uncertainty or weak global growth expectations has the same effect on dollar strength.



Perspective

The recent surge in the US dollar (USD) has far-reaching and complicated impacts since the US dollar plays a unique role in global finance as the world's dominant foreign reserve. The dollar has been historically utilized as a safe haven during times of heightened global risk from both economic and geopolitical tensions. Although dollar dominance in recent decades has been on the decline, the dollar share of central banks' foreign currency reserves still accounts for 59% as of 31 December 2021 — more than all other foreign currencies combined. Further, an estimated 50% of all cross-border loans and international debt securities are denominated in USD.[1]

The US dollar last reached 1:1 parity with the euro in 2002, coming to convergence over a period of several years when the euro was still in its infancy. In 2022, the accelerated path of tightening from the US Federal Reserve (Fed) has pushed the USD 13.8% higher than the euro within a mere 9 months to September 30. The proximity of the Russia-Ukraine conflict to European countries, rising inflation, and the slower relative hiking pace of the European Central Bank (ECB) versus the Fed have weighed on euro performance. While higher front-end European interest rates reflect an anticipated tighter path of monetary policy, it has not prevented the euro from flirting with USD parity.

Euro-US Dollar

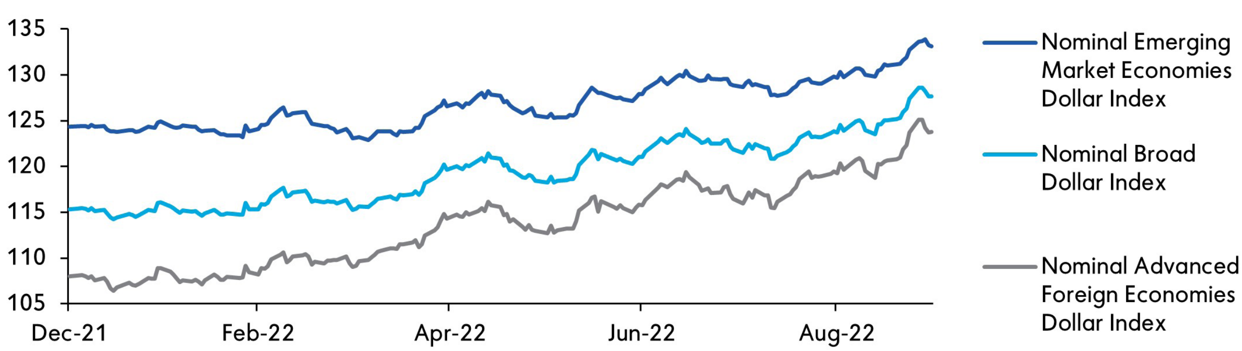
Note: Yellow diamond indicates last time the Euro and US Dollar were at parity, November 2002. Source: Bloomberg. As of September 30, 2022. Firm analysis.

First In, First Out?

The Fed was one of the first developed market central banks to begin aggressively raising rates to combat domestic inflation woes. Dollar bulls may see this as a sign that the Fed will be able to navigate a soft landing without sparking a recession and the US may be able to resume normal economic growth before other developed markets. However, inflation remains stubbornly entrenched in the US economy, so the path toward a terminal rate may take longer than expected. Mid-October inflation data told a sobering story with core CPI, which excludes food and energy, at 6.6% from a year ago, its highest level since 1982. Annual headline CPI increased to 8.2% from a year ago, higher by 0.1% versus expectations.

Despite stubborn inflation, the US Federal Reserve's broad dollar index appreciated 14.62% versus advanced economies and 10.69% versus emerging ones. The Fed's broad dollar index expresses the value of the dollar relative to a trade-weighted basket of 26 foreign currencies, including the euro, the Japanese yen, the British pound, the Canadian dollar, Swedish krona, and Swiss franc. The dollar has appreciated markedly versus almost every major currency. Remarkably, the Brazilian real and Mexican peso are the only currencies that have not seen depreciation versus the dollar since the year began. These are idiosyncratic stories, as Brazil's central bank responded early and aggressively to rising inflation, tightening monetary policy ahead of the Fed. This proactive monetary policy, alongside the success of recent fiscal reforms and stronger terms of trade, have supported Brazil's exchange rate despite relentless dollar appreciation elsewhere around the globe.

Foreign Exchange Rates



Source: Federal Reserve Board 2022. As of September 30, 2022.

How has the strong dollar impacted global benchmark performance? The MSCI Europe benchmark, which represents 15 developed equity markets has fared markedly better in local currency versus the same benchmark denominated in USD. Looking at the currencies that make up the basket that comprises the Fed's broad dollar index, we see similar local versus USD differences.

Benchmark	YTD Performance % (Local Currency)	YTD Performance % (USD)	Difference %
MSCI Europe	-17.16	-28.83	+11.67
MSCI UK	-1.30	-18.65	+17.35
MSCI Japan	-7.47	-26.38	+18.92
MSCI Sweden	-25.72	-39.40	+13.68
MSCI Switzerland	-20.08	-26.02	+5.94
MSCI Canada	-11.77	-18.89	+7.12

Source: MSCI. Firm analysis. As of September 30, 2022.

Would a currency-hedged benchmark more closely capture the local currency return? Hedged currency benchmarks work by systematically removing the currency volatility and combining the underlying benchmark performance with currency forward contracts, thereby hedging exchange-rate risk. As shown below, the 100% hedged to USD versions of the local currency benchmarks preserved more of the return profile compared with local currency versions.

Benchmark	YTD Performance % (Local Currency)	YTD Performance % (Hedged USD)	Difference %
MSCI Europe	-17.16	-15.84	-1.32
MSCI UK	-1.30	-0.71	-0.59
MSCI Japan	-7.47	-6.01	-1.46
MSCI Switzerland	-20.08	-18.72	-1.37
MSCI Canada	-11.77	-11.22	-0.54

Source: MSCI. Firm analysis. As of September 30, 2022.

What Now?

Our outlook anticipates that dollar strength will endure for some time. We see very few potential short-term catalysts that could trigger a sustained decline in the value of the dollar against its major currency pairs. With market expectations for another Fed rate hike of 75 basis points in November and market expectations of a 50 to 75 basis-point hike in December, the Fed is on a determined path to higher rates. It is also along that path than many of its peer developed market central banks, like the ECB.

The Eurozone is staring down potential recession this winter as higher energy costs weigh heavily on the region, which is directly exposed to the effects of Russia's invasion of Ukraine. Eurozone inflation remains on an upward trajectory, with annual inflation reported at 10.7% in October, up from 9.9% in September. Given the more dire growth outlook, the ECB will struggle to outpace Fed tightening, thereby keeping interest rate differentials wide in support of a stronger dollar.

Stephanie Hill
Head of Index

As Head of the Index business, Stephanie is responsible for managing all aspects of the index business including portfolio management, asset retention and growth, business strategy and profitability. In her role, she oversees the heads of equity and fixed income index portfolio management, working closely with them to develop index investment staff into roles of increasing responsibility.

Previously at the firm, Stephanie was responsible for co-heading the index division, focusing on business development as well as articulating Mellon's index strategies to clients and prospects. Prior to joining the firm, she was a strategic product innovator within the iShares division at BlackRock, working to design and develop new ETF products and business solutions. Prior to joining iShares, Stephanie worked as a senior institutional strategist responsible for equity index and active quantitative investments within BlackRock in San Francisco and New York. Before joining BlackRock, she held investment-focused roles of increasing responsibility at Merrill Lynch Investment Managers. Stephanie has been in the investment industry since 1999.

Stephanie earned an MFA from New York University and a BA from the University of California at Berkeley. She is a member of Women in ETFs, Renaissance Entrepreneurship Center Women's Leadership Council and FTSE Russell Global Advisory Committee.

Theodore Bair Jr., CFA
Senior Investment Strategist

Ted is a senior investment strategist, responsible for articulating the firm's index strategies to clients, prospective clients and consultants to help grow and retain Mellon's index business. He works closely with sales and client service staff worldwide to guide the messaging and positioning of index strategies and to develop product solutions for client portfolios.

Previously, Ted oversaw attribution and risk analytics for Mellon's Active Fixed Income division. Prior to that, Ted held roles of increasing responsibility in fixed income trading and portfolio management for Mellon Bond Associates, followed by roles as a senior portfolio manager and investment strategist for Standish Asset Management and Cash Investment Strategies. Ted has been in the investment industry since 1995.

Ted earned a BA in finance from Westminster College and an MBA in finance from the University of Pittsburgh. He holds the CFA® designation and is a member of the CFA Institute and CFA Society Pittsburgh.

Endnotes

1. IMF, How Countries Should Respond to the Strong Dollar. October 14, 2022.

Disclosure

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