

## THE STRONG DOLLAR – ARE WE AT A TURNING POINT?

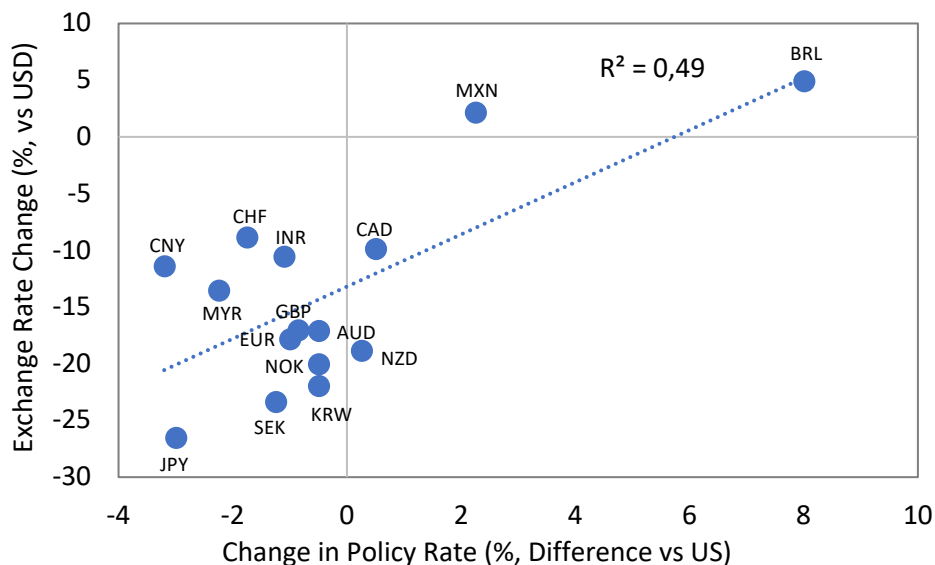
The US dollar plays a unique and key role in global trade, banking and investment. It is the currency against which most people value other currencies, including their own. Furthermore, throughout Latin America, it is often seen as a safe haven and a “hedge” against domestic uncertainty and volatility. Its value therefore matters. Whilst there are a variety of methodologies to value the US dollar, it is universally accepted that it has been through an extended period of meaningful overvaluation. Recent declines suggest that may be coming to an end.

The US dollar exchange rate has generally been on an appreciating trend since 2014. If we take a broad indicator of the real exchange rate - calculated by the Bank of International Settlements (BIS) - the USD strengthened by some 35% from the end of September 2014 to the end of October 2022. A large proportion of that rise occurred in the most recent 18-month period. Over this more recent time period the Dollar gained around 17% against the Euro and the British pound, and an exceptional 26% against the Japanese yen.

### Drivers of USD Strength

The world economy has been hit by two major shocks in recent years, the Covid-19 pandemic and the invasion of Ukraine. Both have contributed to a significant rise in inflation that eventually elicited a monetary policy response across the globe. Perceptions about the relative speed of adjustment in the US relative to other countries may have contributed to the Dollar’s rise. Chart 1 suggests a widening policy rate differential to the US has generally been associated with a depreciation in that country’s exchange rate. Notwithstanding this, the magnitude of the moves would appear excessive. Despite larger increases in interest rates over the period, the likes of the Canadian and New Zealand dollars have depreciated by some 10% and 20% respectively, and we have seen moves of over 15% in the likes of the Australian dollar, Norwegian krone and Korean won in response to relatively limited policy rate divergence.

Chart 1. Policy Rate and Exchange Rate Changes (May 2021 – October 2022)



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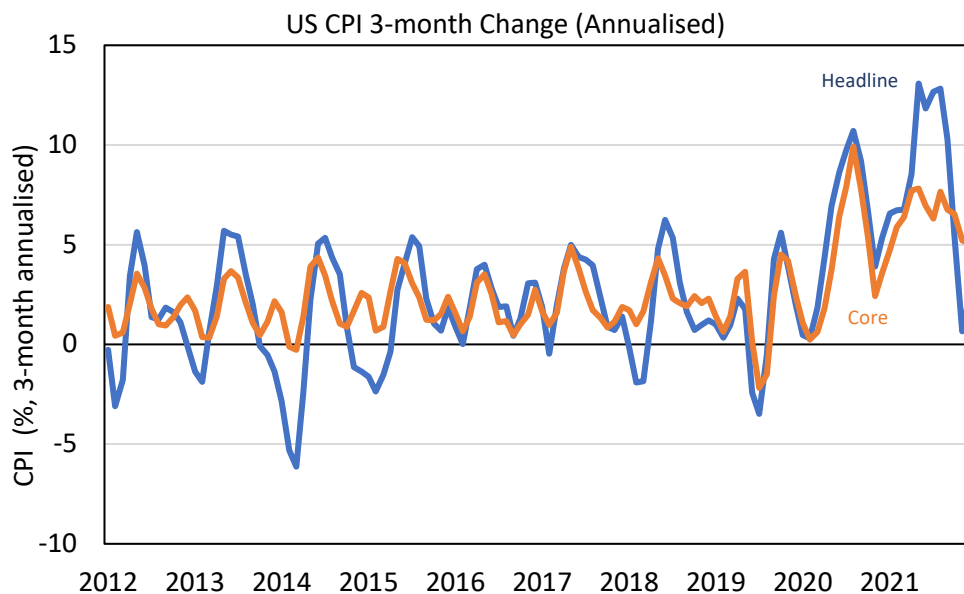
Source: Bloomberg, Colchester Global Investors.

Further short-term support for the US dollar has been changes in the terms of trade associated with the invasion of Ukraine and the resulting spike in food and energy prices. Since the beginning of 2022, the US economy has experienced a terms of trade improvement<sup>1</sup>, whilst major economies such as the Eurozone and Japan have experienced a deterioration. The US improvement is partly a result of its recent transition to being a net exporter of energy, notably of natural gas. A final potential support for the US dollar has been the elevated level of geopolitical risk and uncertainty engulfing the world over the past 18 months. This may have fuelled some “flight to safety” demand for the Dollar.

### Are we at peak inflation? What does that mean for the USD?

To the extent that some of the run up in the Dollar has been driven by expectations about US Federal Reserve tightening, one may expect an easing in inflation to prompt revisions in that expected policy path relative to the rest of the world. Indeed this appears to be the case. In early November, US inflation slowed more than forecast, raising hopes that the Fed may slow the pace of rate hikes, and this shift in investor perception resulted in the Dollar experiencing its largest two day drop since 2008<sup>2</sup>. Does this represent the beginning of the end of the strong US dollar?

**Chart 2. US Inflation showing Signs of Weakening Momentum...**



Source: Bloomberg, Colchester Global Investors. Data as of November 2012 to October 2022.

Much of the reversal in headline inflation in recent months is driven by declines in commodity prices. Having peaked in June at around \$120 per barrel, oil prices are now trading around \$80 per barrel. Natural gas prices in Europe have fallen even more from their highs, whilst prices of commodities such as wheat and copper have also declined. Given the negative impulse to the exchange rates of commodity importing economies for much of this year resulting from a deteriorating terms of trade, this shifting backdrop may add to the weakening pressure on the US dollar.

<sup>1</sup> Source: BIS.

<sup>2</sup> The US Dollar Index (USDX) fell 3.9% in between the 9<sup>th</sup> and 11<sup>th</sup> November. Source: Bloomberg.

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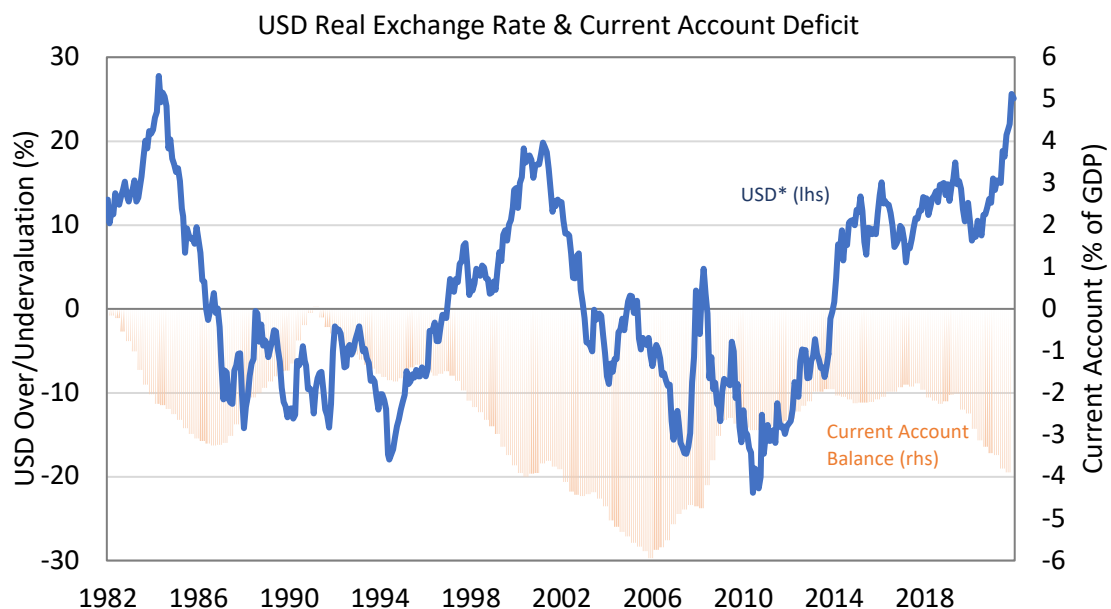
Whilst we do believe that the Dollar is extremely overvalued (more about that below...), a word of caution may nonetheless be appropriate about the turnaround in both US inflation and the Dollar observed in November. US inflation may well have peaked, but core (excluding food and energy) CPI continues to run at a pace above the Fed's target, and policymakers have been clear that a slowing of the pace of tightening does not necessarily lower the terminal rate i.e. the rate at which the Fed will end its tightening cycle. Furthermore, geopolitical risks persist, from Ukraine to Taiwan.

As asset allocators and long-term investors however, we need to look beyond near-term risks and second-guessing of central banks deliberations and take a broad view of the global investment landscape. At Colchester we do so through a value lens, utilising the theory of relative purchasing power parity (PPP), to assess currencies. The key conclusion is that real exchange rates are likely to mean revert over a long-term time horizon. We are also cognizant that the further and longer a currency moves away from fair value, the greater the likelihood of an adjustment back, and the faster the speed of that move.

### The Dollar is Overvalued

As mentioned, our currency valuation framework is based on the theory of relative PPP which states that exchange rates and inflation rates should equal out over time. This implies a mean reversion of the real exchange rate over the medium-long term. Applying this framework to an assessment of the US dollar and measuring it against a basket of major currencies, we can see in Chart 3 that it has appreciated significantly over recent years. We estimate the Dollar to be more than 20% overvalued relative to a basket of major global currencies at present. Such overvaluation is bringing the Dollar close to the levels observed in the mid-1980's, a period in which the US trade deficit soared, and ultimately the five largest industrialised countries agreed to intervene in a coordinated fashion to weaken the Dollar<sup>3</sup>.

**Chart 3. USD Real Exchange Rate Rose to Levels close to the Highs of 1985**



<sup>3</sup> The Plaza Accord. At a meeting in the Plaza Hotel in New York, officials from the US, UK, Germany, France and Japan agreed to a plan to weaken the USD exchange rate.

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Source: Bloomberg, Colchester Global Investors. Data as of November 1982 to October 2022 (current account data to Q2:2022).

USD real exchange rate over/undervaluation is the average relative to a basket of major currencies (EUR, JPY, GBP, AUD and CAD).

An overvalued real exchange rate is not a purely academic concept, it has real world implications for investment and spending, and for economic indicators such as the aforementioned trade deficit and the current account. The global economy today has changed dramatically since the 1980's, but similarities between now and then are visible. As shown in Chart 3, as the Dollar has soared since 2020, so has the US current account moved further into deficit. The strength of the Dollar is also resulting in spillover effects across capital markets and global economies. Apple recently announced that the strong Dollar was a significant headwind for its Q4 earnings<sup>4</sup>. The IMF has noted that the sharp appreciation of the Dollar has "sizeable macroeconomic implications for almost all countries"<sup>5</sup> reflecting the dominance of the Dollar in trade and finance.

It is clear to us that the US dollar reached unsustainable levels of overvaluation in recent months. This is a strong indication – based on economic theory and historical evidence – that the currency will depreciate over the medium term. The sell-off observed in November may or may not prove to be the turning point, but we would certainly expect a meaningfully weaker US dollar to materialise over the coming years. Perhaps surprising to some, such a conclusion, suggests that asset allocators holding the Dollar as their safe haven or diversifying asset may inadvertently be exposing themselves to significant downside risk as the Dollar corrects.

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<sup>4</sup> Financial Times, 28<sup>th</sup> October 2022.

<sup>5</sup> How Countries Should Respond to the Strong Dollar, IMF Blog, 14 October 2022.

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