GMV – Is the Dollar entering a Secular Decline?

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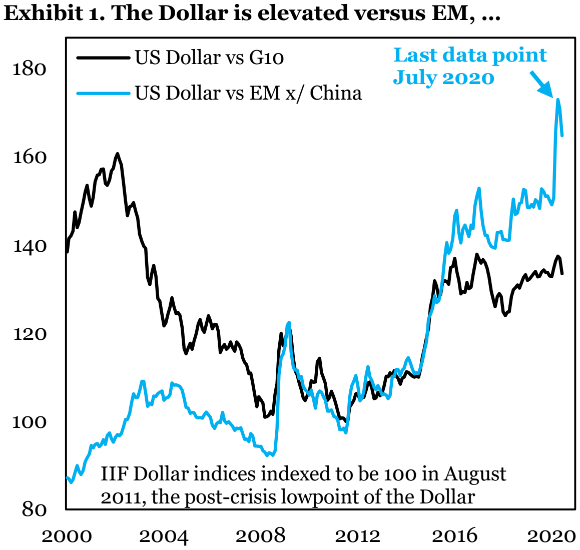
- Markets are debating whether the Dollar is entering a secular decline.
- We provide an overview of the main drivers of the Dollar in recent years.
- The Dollar has been stable against the G10 since its large rise in 2014/5, ...
- something likely to continue given that all major central banks are easing.
- In contrast, the Dollar has risen 10 percent versus EM in the past year, ...
- with lower commodity prices an adverse terms-of-trade shock for many.
- China's large 2009 stimulus lifted commodity prices, helping EM recover.
- That stimulus is now missing, limiting potential Dollar declines versus EM.
- The Dollar may one day face a secular decline, but not in the near term.

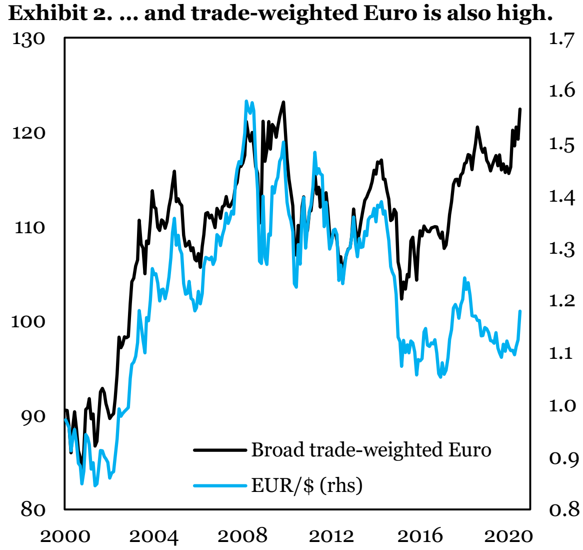
Markets are debating whether the US Dollar is entering a secular decline, with people pointing to COVID-19 as a drag on growth, US isolationism and political noise into the November election, as well as mounting questions around the reserve currency status of the greenback. Against this backdrop, we review the main drivers of the Dollar in recent years. In particular, we distinguish between the Dollar versus the G10 and the Dollar versus EM, which behave quite differently. The Dollar versus the G10 is essentially a function of monetary policy differentials and has been stable since its large rise in 2014/5. We expect that pattern to continue, since all G10 central banks are easing, with monetary policy something of a wash. The Dollar versus EM has risen 10 percent in the last year, in large part because falling commodity prices constituted an adverse terms-of-trade shock in many places. In the wake of the global financial crisis, China's stimulus lifted commodity prices, helping many EM currencies rebound. That stimulus is missing now, which is why potential Dollar weakness against EM appears capped. Overall, the Dollar may well face a secular decline one day, but we do not expect this in the near term.

Exhibit 1. The Dollar is elevated versus EM, ...



Source: Haver, IIF

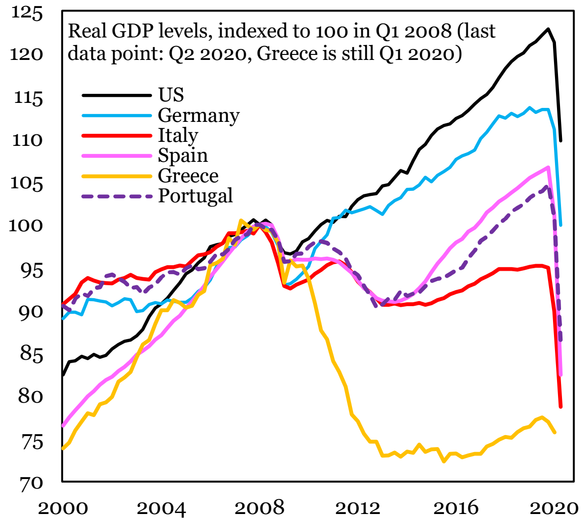
Exhibit 2. ... and trade-weighted Euro is also high.



Source: Haver, IIF

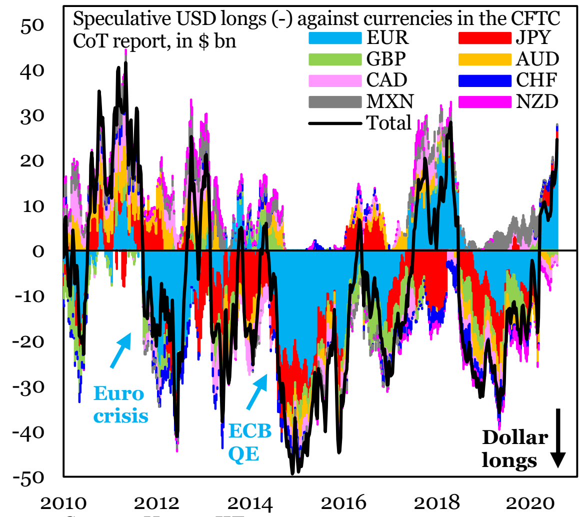
In the past year, the Dollar is essentially flat against the G10, while – even with recent declines – it remains 10 percent up versus non-China EM (Exhibit 1). Dollar strength is at odds with all the recent handwringing around reserve currency status of the greenback, which we see as misplaced. At the same time, it is worth reviewing the principal drivers of the Dollar in recent years, to see whether conditions for a secular decline are building. As far as the G10 are concerned, much attention is focused on the Euro, which is far stronger than EUR/$ at current levels suggests. That is because EUR/$ has risen against an elevated Dollar, so that the Euro is near its 2008/9 highs in trade-weighted terms (Exhibit 2). More fundamentally, COVID-19 has hit the Euro zone hard. For all the negative headlines, US GDP remains 10 percent above its 2008 level. Germany is now level with 2008, while Italy and Spain are 20 percent below (Exhibit 3). On our estimates, Euro zone output gaps were large prior to COVID-19 and are now far larger, so that deflation risk is more acute than in the US. Coupled with extremely elevated Dollar short positioning in the CFTC data (Exhibit 4), there is little reason to expect meaningful Dollar weakness near term. Overall, we expect the Dollar to continue treading water against the G10, an extension of the pattern in recent years.

Exhibit 3. Euro zone output gaps have grown, ...



Source: Haver, IIF

Exhibit 4. ... and speculative positioning is short Dollars.



Source: Haver, IIF

The story is quite different for EM. Even with the recent sell-off, the Dollar remains 10 percent above its level one year ago. In the wake of the global financial crisis, China's large infrastructure stimulus in 2009 caused a large rebound in commodity prices, which helped many EM currencies recover. That stimulus is missing now, which in our view limits the potential for Dollar weakness against EM. Our valuation model also sends mixed signals. While it points to large undervaluations in places like Brazil and Chile, it continues to flag big overvaluations for Turkey, Egypt, Argentina and Ukraine (Exhibit 5, column 11). Even in EM, therefore, conditions are not yet conducive for a material Dollar weakening cycle.

Exhibit 5. FEER Valuation Model for EM Currencies: Model Inputs and Estimated Misalignments for 2020

	(1) C/A (% GDP)	(2) YGAP (% GDP)	(3) YGAP* (% GDP)	(4) REER (% 2017)	(5) YGAP (% GDP)	(6) YGAP* (% GDP)	(7) REER (% GDP)	(8) C/A Adj. (% GDP)	(9) IMF (% GDP)	(10) IIF (% GDP)	(11) Misal.^ (%)
CEEMEA											
CZK	-0.9	-1.0	-5.6	4.9	-1.1	6.6	-1.0	3.7	...	2.0	3.5
HUF	-1.5	0.5	-5.7	-4.9	0.6	7.5	2.5	9.0	...	7.0	3.9
PLN	0.2	-0.5	-5.8	0.9	-0.4	4.3	0.0	4.2	-2.3	2.0	7.2
TRY	-2.5	-3.0	-5.2	-21.7	-1.3	1.9	2.3	0.4	-1.6	1.8	-9.5
RUB	1.5	-3.0	-5.2	-7.9	-0.9	2.2	0.5	3.2	3.1	3.0	1.3
ZAR	0.2	-5.0	-4.9	-14.0	-2.3	2.2	3.0	3.1	0.5	4.0	-5.2
SAR	-1.2	-3.0	-5.3	0.1	-1.4	3.5	-0.2	0.7	...	2.0	-4.8
EGP	-3.8	-4.0	-5.4	42.8	-0.9	2.0	-4.0	-6.7	...	-4.5	-13.8
UAH	1.9	-3.0	-5.5	22.3	-2.1	4.4	-5.3	-1.1	...	1.0	-6.4
LatAm											
ARS	1.0	-9.0	-6.8	-21.5	-2.0	1.4	1.0	1.4	-2.5	2.5	-13.5
BRL	-1.0	-8.0	-6.4	-30.9	-1.6	1.2	2.3	0.9	-2.9	0.3	8.8
MXN	1.5	-6.0	-5.4	-7.7	-3.3	2.8	1.6	2.6	-2.6	2.0	3.1
CLP	0.4	-5.0	-6.1	-17.6	-2.3	2.8	4.0	5.0	...	3.0	10.5
PEN	0.1	-2.0	-6.8	1.4	-0.7	2.5	-0.4	1.5	...	1.0	3.3
COP	-2.4	-2.0	-12.3	-11.5	-0.6	3.1	1.4	1.4	...	1.0	4.2
ECS	-4.1	-8.0	-4.6	2.7	-3.0	1.8	-0.7	-6.0	...	-2.5	-22.1
EM Asia											
CNY	1.2	-6.0	-3.7	0.6	-1.8	1.2	0.0	0.7	-0.4	-0.5	8.6
INR	0.3	-1.0	-4.6	-3.5	-0.4	1.4	0.1	1.5	-3.4	1.0	3.8
KRW	3.4	-1.0	-4.5	-6.2	-0.6	3.1	1.9	7.8	2.7	5.0	9.9
MYR	-0.1	-2.0	-3.6	-2.7	-1.9	4.0	2.3	4.3	-0.2	3.0	2.9
THB	3.5	-0.5	-3.8	7.7	-0.5	3.9	-2.3	4.6	0.1	3.0	3.9
IDR	-1.7	-0.5	-4.1	-1.2	-0.2	1.4	-0.4	-0.9	-0.9	-0.5	-2.9
PHP	-0.8	0.5	-3.9	8.1	0.3	1.8	-1.8	-0.6	...	-0.5	-0.5
TWD	10.6	-1.5	-4.2	2.4	-1.3	4.3	-1.4	12.3	...	9.0	7.8
PKR	-2.1	-3.0	-5.3	-22.3	-0.5	1.5	0.5	0.5	...	1.0	-4.3

^ Estimated FEER misalignment, where -ve signals overvaluation (needs to fall) and +ve signals undervaluation (needs to rise).

Source: Haver, IIF

