

Long-term forces stack up against the dollar

With alarm bells ringing across financial markets in recent days, the US dollar has found its footing, reflecting its haven status whenever equities and investor sentiment take a knock. But that may prove fleeting given the longer term forces stacking up against the world's reserve currency.

Since climbing to its best level since 2002 in the wake of the pandemic earlier this year, the Federal Reserve's trade-weighted dollar index has been pressured by a combination of rising trade and budget deficits, alongside expectations that ultra-low US interest rates are set for an extended stay.

Despite rising this week, as global equities headed for their biggest weekly fall since the March turmoil, the dollar has still declined by 9 per cent from its peak in that month.

A weaker US currency acts like a safety valve within a global financial system that is heavily reliant on dollar-denominated debt and trading flows, particularly for emerging market economies. A sliding dollar also supports US business activity when interest rates are anchored near zero.

Renewed dollar weakness may well follow given the challenges facing the US economy, even in the wake of its record rebound in growth in the third quarter. Some economists believe a return to pre-pandemic US output does not beckon until late 2021.

With rising coronavirus cases hitting an embattled service sector and employment prospects, the urgency of additional stimulus looms in the wake of next week's US Presidential and Congressional elections.

"Regardless of the election outcome, the dollar has entered a cycle of relative decline," observes Marc Chandler, chief strategist at Bannockburn Global Forex. "The old meme of twin deficits is coming back. The dollar becomes a shock absorber for the economy by weakening."

The pandemic has already prompted a sharp deterioration in the US trade deficit in goods and services this year, according to official data.

As for government spending, the Congressional Budget Office projects a \$3.3tn budget deficit for 2020, constituting 16 per cent of gross domestic product and the largest amount of borrowing since 1945.

For the 2021 financial year, the CBO expects the deficit to be a still eye-watering 8.6 per cent of GDP.

Rising deficits have so far failed to push long dated US interest rates significantly higher.

This reflects expectations of a long recovery process for the US economy and jobs, as well as a Federal Reserve willing to expand its balance sheet and buy a lot more Treasury debt.

Expanding the balance sheet of the US central bank may take on greater urgency given an important aspect of the global pandemic, a rebounding Chinese economy and its currency.

The renminbi has appreciated by around 4 per cent for this year and touched a level last seen in July 2018, buoyed by a surge in exports and the inclusion of domestic bonds in important global indices.

Recent renminbi strength has been tolerated by Beijing and suggests its willingness to open up the Chinese economy to greater foreign based financial flows over the coming decade.

That long term shift may also entail Beijing moving away from owning the dollar denominated assets that have helped plug the US current account deficit.

Alan Ruskin, strategist at Deutsche Bank, identifies alternatives like gold, the euro, the Japanese yen and the Australian dollar prospering from any break in China's prior willingness "to embrace a symbiotic relationship with the US".

This does raise the prospect that further dollar deterioration and an improving global economy may ultimately trigger sharp foreign outflows from Wall Street.

After a nearly decade long rally for the dollar, global investors are overweight US equities which look expensive compared with the rest of the world.

This cuts to the heart of the debate about the dollar's ultimate course and how this plays out for the global economy and international equity markets. The bear case for the dollar reflects pressure from the twin deficits and the Fed's expanding balance sheet.

Even a moderate US economic rebound is seen sucking in more imports, boosting growth for other economies and their currencies.

The alternative scenario is for much bigger than expected US domestic growth, should there be another US fiscal stimulus and a revival of deferred spending by consumers. Under such circumstances, a broader US equity rally led by smaller and cyclical companies could ensue. There would also likely be less Fed support.

Chris Watling of Longview Economics argues the dollar could spring a surprise for bearish investors, given the scale of excess US household saving. They estimate this has risen by more than \$1tn during lockdowns.

"The US has capacity for the biggest growth rebound once the pandemic ends or a vaccine arrives. Rather than worry about twin deficits, a bigger driver of the dollar is the combination of robust growth and higher yields," he says.

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