



The Federal Reserve Crashes the Currency Party

Why Fed actions could make the U.S. dollar weaker.

September 2020

KEY INSIGHTS

- The supportive drivers for the U.S. dollar have faded.
- The Federal Reserve's stimulus actions and new average inflation target are likely to keep the dollar under pressure.
- G-10 currencies are likely to benefit the most from dollar weakness, while emerging markets are expected to be more specific.

The U.S. dollar's shine is fading. After more than a decade of appreciation, the dollar has been weakening over the past few months against other developed market currencies. During our latest policy meetings, the investment team discussed the dollar's underlying dynamics and why the currency could be facing an inflection point due to Federal Reserve stimulus measures.

The Dollar's Supportive Drivers Have Diminished

The U.S. dollar's multiyear bull run was supported by two key factors. The first was a preferential interest rate differential—the dollar benefited for years from attractive carry thanks to higher U.S. interest rates relative to peers, such as Japan, the eurozone, and Switzerland, where interest rates were negative. The second was the outperformance of the U.S. economy against other major economies, such as the eurozone.

On both of these fronts, circumstances have changed in 2020.

"Factors that have been supportive for the U.S. dollar for so long have evaporated this year, with the Fed drastically slashing interest rates to near zero and the U.S. economy suffering collateral damage due to the fallout from the pandemic," said Quentin Fitzsimmons, a portfolio manager and member of the global fixed income investment team.

The severe impact of lockdowns on the U.S.'s large services sector, combined with the challenge of controlling the virus, has meant that the U.S.'s economic recovery has so far been slower than most of its peers. This has put pressure on the U.S. dollar, which has weakened against every other G-10 currency since April.

Fed Policies Could Undermine Dollar Outlook

The Fed's recent decision to allow moderate overshoots of its 2% inflation goal to offset occasions when the

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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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Portfolio Manager

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Portfolio Manager

target is undershot could spell further trouble for the dollar. “While a lot of market participants have interpreted the recent Fed news as positive for U.S. Treasuries, I believe that a bigger effect will be felt in the currency market,” said Mr. Fitzsimmons. “The Fed has effectively affirmed an ‘ultra-low-for-longer’ interest rate strategy that skews the target range for inflation to the upside. This will likely put pressure on the dollar.”

Another potential drag on the dollar is the Fed’s stimulus programs. In response to the coronavirus pandemic, the U.S. central bank took unprecedented steps to support the functioning of markets, including cutting interest rates, boosting asset purchases, and announcing new lending programs. These measures largely remain in place and are expected to remain so for some time to come. “The Fed is committed to supplying the market with ample liquidity, which will likely keep the dollar under pressure,” said Mr. Fitzsimmons. “Fiscal deficits will likely rise as a result of the Fed’s ongoing action, and in the past, this has been negative for the currency.”

G-10 Currencies More Likely to Appreciate

The depreciation of the U.S. dollar has so far mostly been limited to developed market currencies. The euro, for example, has been a strong beneficiary of the dollar’s weakness thanks to large fiscal stimulus programs and better management of the COVID-19 situation so far, although cases are increasing again. “The euro still has some room to strengthen against the U.S. dollar

before the European Central Bank steps in with verbal intervention,” said Mr. Fitzsimmons.

Emerging market (EM) currencies have benefited less than developed market currencies from the dollar’s weakness because the fiscal situation has deteriorated in many EM countries and central banks have cut interest rates to support their economies through the pandemic. Mr. Fitzsimmons said, “Some EM countries have put fiscal discipline to one side, which has put pressure on their currencies.” The Brazilian real and Turkish lira, both of which are down sharply against the U.S. dollar this year, stand out in this regard.

The weakness of EM currencies has resulted in some very appealing valuations, but, given the heightened risks and uncertain growth environment, we believe a selective approach is necessary. “We are particularly interested in currencies that we believe display a reasonably attractive profile combined with a lower volatility structure, such as the Indian rupee, the Peruvian sol, and Chilean peso,” said Mr. Fitzsimmons.

Other EM currencies are at risk of political disruption. The Chinese renminbi, for example, is a candidate to implement a short position as a hedge against a possible rise in tensions ahead of the U.S. presidential election. “With President Donald Trump adopting a ‘blame China’ strategy as the centerpiece of his reelection campaign, further deterioration in U.S.-China relations could pose a risk for the renminbi,” said Mr. Fitzsimmons.

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