Five U.S. Dollar Themes to Watch

The currency has remained resilient despite the slowing U.S. economy.

September 2019

KEY INSIGHTS

- Interest rate cuts are usually associated with currency depreciation, but this is not always the case with the U.S. dollar.
- A key factor in determining the value of the dollar is how U.S. growth compares with that of other countries.
- The U.S. dollar's status as a safe-haven asset remains intact.

The U.S. dollar has proved resilient so far this year despite the U.S. economy slowing. During our latest policy meetings, the investment team discussed the dynamics driving the currency. Below, Quentin Fitzsimmons, a portfolio manager and member of the global fixed income investment team, outlines the five key themes that we believe investors should monitor.

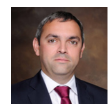
1. Interest Rate Cuts Do Not Always Trigger U.S. Dollar Weakness

The Federal Reserve (Fed) cut interest rates in July for the first time since the global financial crisis and followed it up with a second cut in September; some market participants expect a further cut in December. Interest rate cuts are usually associated with currency depreciation, but that has not always been the case for the U.S. dollar. In fact, during the last four U.S. rate-cutting cycles, the dollar has only weakened on one occasion (see Fig. 1). With that in mind, going underweight the dollar because the Fed is expected to cut could be a dangerous game. There are many other factors that need to be taken into consideration.

2. Growth Differentials Influence the U.S. Dollar More Than U.S. Growth Itself

The dollar has remained strong this year despite the slowing U.S. economy. This is because the way the U.S. economy performs relative to other countries influences the currency more than U.S. growth per se—and in 2019 so far, European growth has disappointed more than U.S. growth. Italy's economy, for example, stagnated in the second quarter, while the UK experienced a contraction in the three months to June. Perhaps more importantly, in Germany—Europe's largest economy—the manufacturing sector is suffering a recession as trade tensions weigh on export demand. Unless the differential between the two major economies reverses, it is difficult to see how the dollar can significantly weaken against the euro.

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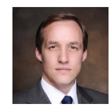
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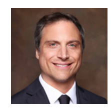
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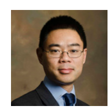
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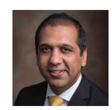
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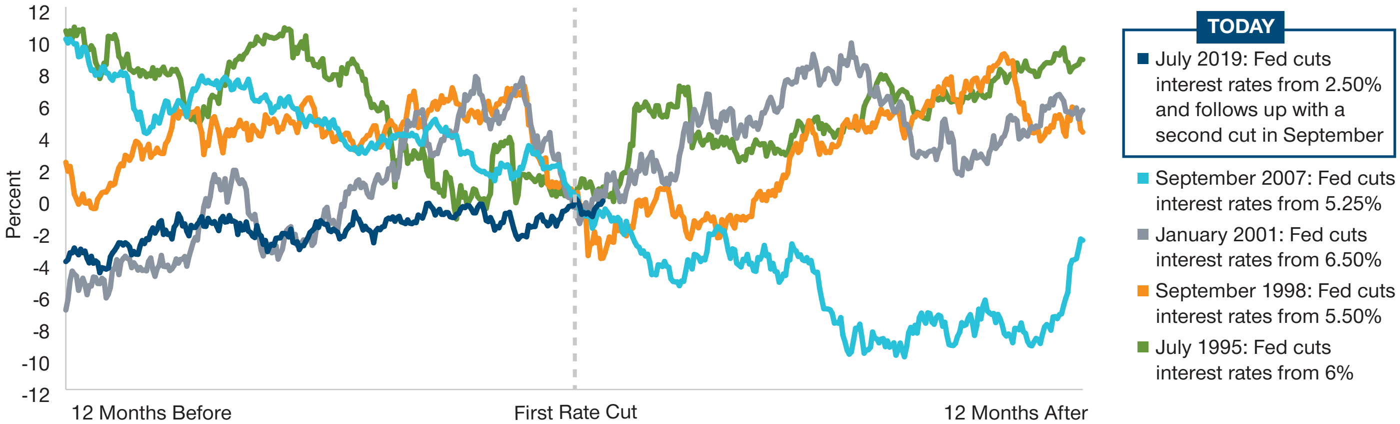
Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

(Fig. 1) U.S. Dollar Behavior Around Rate Cut Cycles

% Move in the U.S. Dollar Before and After First Rate Cut by the Fed

As of September 13, 2019



Source: U.S. Dollar Spot Index, analysis by T. Rowe Price.

3. The U.S. Dollar Remains Attractive From a Carry Perspective

In the developed market space, investors can earn one of the highest carry rates by the U.S. dollar. Even if the Fed's cuts in July and September are followed by others, the dollar is likely to remain attractive for some time from a carry perspective as U.S. interest rates are so much higher than places such as Japan and Switzerland, where rates are negative. That said, when hedging costs are taken into account, U.S. dollar-based assets can be less appealing for foreign investors. On the surface, for example, U.S. 10-year Treasuries appear much more attractive than 10-year German bunds, but that yield advantage effectively disappears if the cost of hedging dollars back to euros is taken into consideration.

4. Tariffs and Trade Wars Create Currency Volatility, not Direction

The impact of tariffs on currencies is difficult to assess. While protectionism should be supportive of the local economy, an efficient market will simply undo the impact to the terms of trade caused by a tariff, sometimes encouraging the protected country's currency to actually appreciate. Indeed, this may have been an unintended consequence of President Trump's strategy. Following a particularly difficult round of tariff negotiations, Chinese authorities recently let the renminbi fall to its weakest level against the dollar in more than a decade but kept its value versus a broad basket of other currencies relatively unchanged. Currencies are increasingly being used as political tools, and as the trade negotiations between the two sides go on, we may not have seen the last of the measures. Against this backdrop, volatility is expected, and perhaps the best way to benefit from this is through the use of currency options.

5. The Dollar's Safe-Haven Status Remains Intact

During times of stress, investors flock to the U.S. dollar—a trend that looks unlikely to change anytime soon. The U.S. dollar is where liquidity ends up being trapped in this low-yield environment. This trend is amplified by the inversion of the U.S. Treasury curve as parking cash in money market funds has become much more attractive now. Although the Swiss franc and the Japanese yen have been well bid this year as uncertainty has increased, the U.S. dollar remains king for investors looking for safety. This is unlikely to change.

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