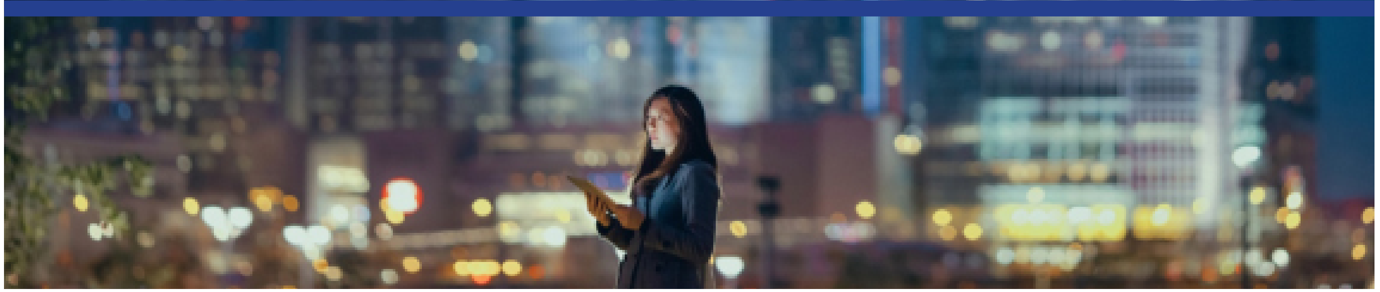

November 12, 2023

CIO Strategy Bulletin

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As Goes the Fed, So Goes the Dollar

- It is not in the Fed's interest to lower rates after a major recession is underway. Avoiding a recession in 2024 requires that the Fed not keep monetary conditions too tight for too long.
- The Fed has had four tightening or easing cycles since 2008 while the Bank of Japan (BoJ) has been static. This shows the Fed to be far more activist than other central banks.
- The Fed has a history of easing when employment growth is positive (on average, +146K positive employment for the start of easing cycles since 1980).
- We believe the US Dollar (USD) is stronger than interest rate differentials with Europe and Japan imply. Investing globally would allow USD investors to benefit from the fundamental performance of foreign shares, as well as the appreciation of their home currency versus the USD.
- On an opportunistic basis, Japanese companies could be a beneficiary of a weaker USD. Japanese tech firms providing semiconductor equipment, battery technology, robotics and automation are globally competitive in growing industries. And, Japanese banks would likely benefit from yield curve normalization.

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Why the US Dollar Remains Strong

Events in 2022 created a "perfect storm" for non-US currency markets. The war in Ukraine, political turmoil in UK, the speed and extent of the Fed's 525 bps upward rate move caused USD to overshoot. Since then, strong US labor markets, fears of sustained inflation and additional Fed tightening actions sustained the USD's value, until now.

As these events unfolded, our investment allocations did too, leaning into USD strength (please see the August 2023 Quadrant).

What Moves the US Dollar Up and Down

The Fed's policy tightening of the past 16 months will continue to have residual impact. We can see it in the most recent data. While US corporate profits are rebounding, the outlook of hiring is weakening (**Figure 1**). US employment in October gained half as much as September. More importantly, the full year-average hiring pace for 2023 was half that of 2022 (+239K on average vs +399K). Tracking data for 4Q US GDP are tentatively at 2.0% vs 4.9% in the prior quarter. This all suggests a weakening USD is before us (**Figure 2**).

The DXY Index, the measure of frequently traded developed market currencies, hit a two-decade high in 2022. This occurred when the Fed's policy rate was rapidly approaching the 4% level. Then, the USD dropped from early November 2022 to late January 2023 even as the Fed continued to raise rates. As Europe managed to secure sufficient energy supplies after ending the import of gas from Russia, the safety trade (holding more USDs) began to unwind (**Figure 3**). Today, Europe is as well placed as it can be with gas storage full ahead of the 2023 winter.

Figure 1: Fed Tightening is Now Severe Enough to Weaken US Labor Markets: Fed Funds Rate vs Unemployment Rate (%)

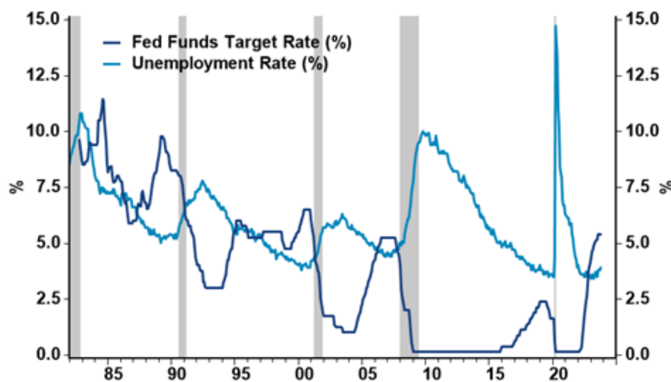
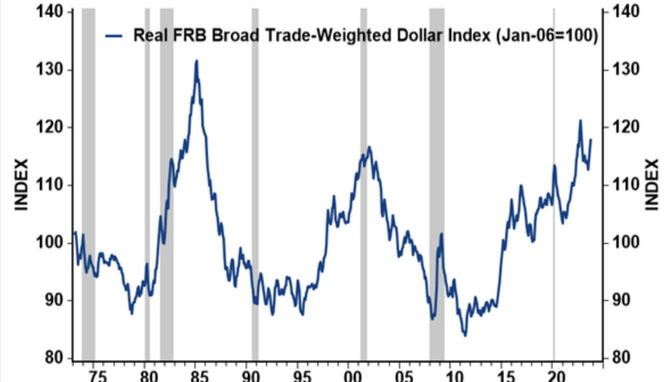
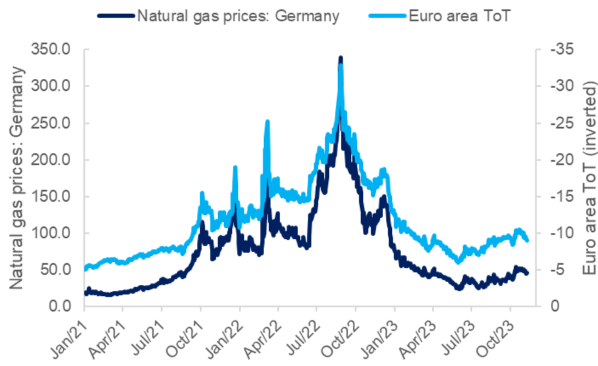


Figure 2: 2022 saw the Inflation Adjusted US Dollar Index hit Its Second Highest Level in History



Source: Haver Analytics as of November 8, 2023 . Grey area are periods of recession. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future returns. Real results vary.

Figure 3: German Natural Gas Price vs European Terms of Trade Index (Import Prices relative to Export Prices)



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Why and When the Fed Will Ease

After reaching a global peak of 8.7% in 2022, the rate of inflation is coming down across the world. While inflation has not reached the 2% target, we have a high level of confidence that core inflation measures will slow in the coming year. Routinely lagging components of the CPI are only beginning to moderate (**Figure 4**). Even in the rapidly growing services sector, wage growth is slowing (**Figure 5**).

So, when will the Fed act to reduce rates?

It is not in the Fed's interest to lower rates after a major recession is underway. To avoid a recession in 2024 requires that the Fed not keep monetary conditions too tight for too long and to recognize that its tools operate with a long lag. Interest rate changes do not fully impact the economy for 12-18 months. So, the Fed must anticipate changes to the economic outlook well ahead of time and set monetary policy parameters accordingly.

What does the US economy look like when the Fed is about to ease?

It looks a lot like it does now. The Fed typically eases when unemployment is still low and inflation still above target. Headline US monthly jobs in the six months before the Fed typically commences easing has averaged +146K jobs. The recent October 2023 payrolls headline was +150K. Therefore, a Fed rate cut cycle commencing in early 2024 (from the last Fed hike in July 2023) would require the US labor market to weaken further over the coming months.

Figure 4: US CPI Core Ex-Shelter vs CPI Shelter Y/Y

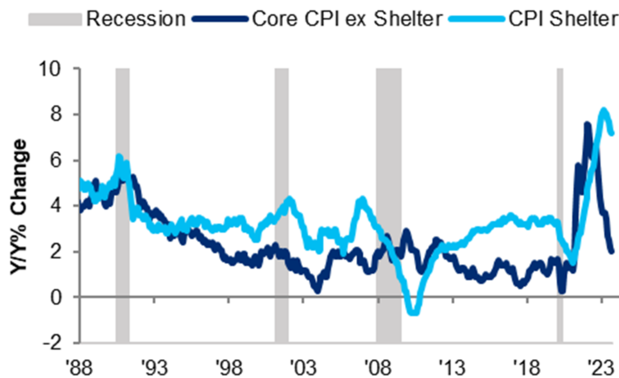
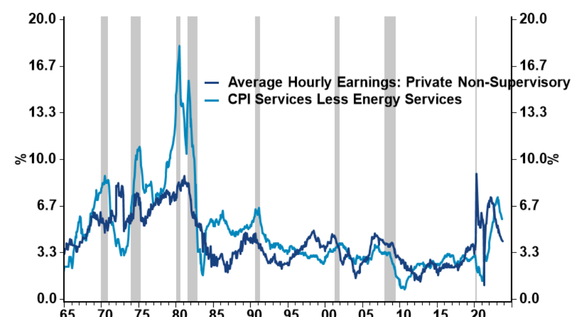


Figure 5: US CPI Core Services vs Services Wages



Source: Haver Analytics as of November 2, 2023. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future returns. Real results vary.

And Then, What Will the Dollar Do?

For a sustained USD decline, two seemingly contradictory events must occur. The Fed will need remain activist and vigilant. And the economy must slow, but not too much.

For the moment, a Fed pause with US bonds trading in a range of 4.5% to 5.0% may prevent the USD from rising further, but it may not generate a meaningful decline. Yet, a significant slowing in US employment gains would change the picture for both bonds and currencies.

Typically, the European Central Bank Doesn't Follow the Fed

Comparing employment data across regions, the US has the most dynamic and flexible labor market among major economies. As such, US monetary policy is unusually dynamic relative to others. While the Bank of Japan has not had a policy interest rate above zero since 2008, the Fed has overseen four easing or tightening cycles over the same period.

The European Central Bank (ECB) routinely lags the Fed in both cutting and raising rates (**Figure 6**). But oddly just now, markets essentially expect the Fed and ECB to stay in lock step going forward, with the ECB matching any future Fed rate cuts (**Figure 7**). While this expectation might be dismissed as a minor faux pas, it comes at a time when the Euro is historically weak and the USD strong, "overshooting" the levels real interest rates would imply.

In essence, if the ECB doesn't ease monetary policy, real interest rate differentials suggest the Euro could gain perhaps 10% against the USD within the coming two years. Changes in currency values impact local fundamentals as well as global investor investors flows. Exchange rates are not the primary reason to invest in equities. But a rise of 10% would boost European equity returns measured in USD by the same amount, assuming all else constant.

Figure 6: Historically the Fed leads, and ECB follows in rates cycle

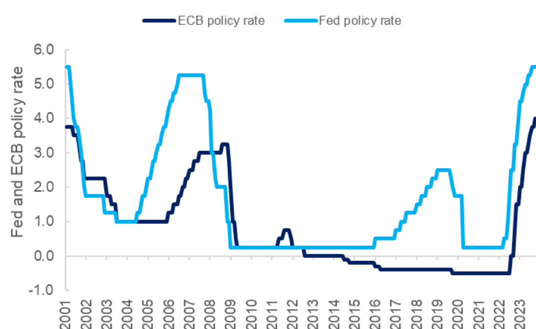
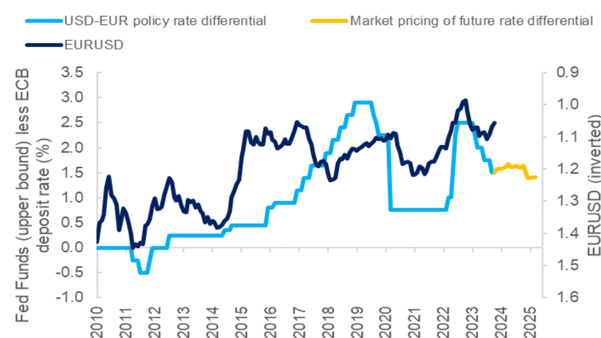


Figure 7: Fed – ECB rate differentials vs EURUSD spot as Nov'23



Source: Bloomberg as of November 8, 2023.. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

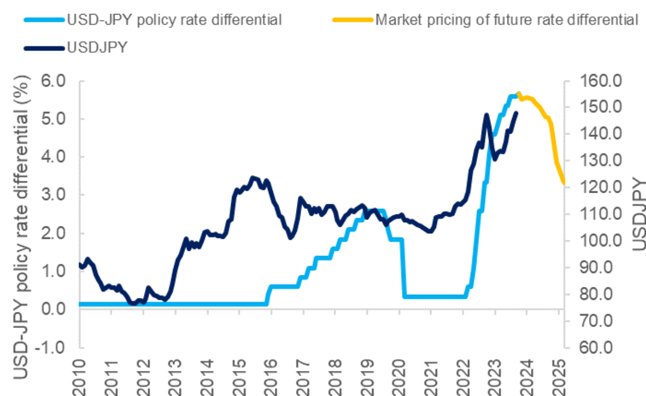
Yen vs Dollar – Suffering the Big Short

Once the strongest currency in the world during its decades of deflation, the Japanese yen (JPY) has been the world's weakest developed market currency, falling 22% against the USD since the Fed's first rate hike in March of 2022. We see the Fed swerving from a monetary policy path that would ultimately prove deflationary, like Japan's. We see Japan swerving from an inflationary monetary policy, even if very gradually.

Figure 8 illustrates the market implied path for US and Japan policy rates. It points to reversal of the JPY depreciation driven by expectations for both central banks. With the JPY at the weakest nominal level against the USD since 1990, we believe it is asymmetrically priced with JPY appreciation likely in the year to come.

One way to realize JPY appreciation is to invest in strong Japanese assets which might generate positive returns even if the currency does not boost returns further. Japanese tech firms providing semiconductor equipment, battery technology, robotics and automation are globally competitive in growing industries. For positive influence from JPY strength – if driven by Japanese monetary tightening – Japanese banks would likely benefit from yield curve normalization.

Figure 8: US and Japan Policy Rate Differential, Market Pricing of Future Path and USD/JPY



Source: Bloomberg through Oct. 12, 2023. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only

Portfolio Implications

We believe the USD is stronger than interest rate differentials with Europe and Japan imply. Investing globally could allow USD investors to benefit from the fundamental performance of foreign shares as well as the appreciation of their home currency versus the USD.

If the USD weakens over time, it will largely reflect our views about US rates and weakening inflation. For the moment, we remain overweight Asian emerging markets excluding China (October 2023 GIC Asset Allocation). We also believe that Japan, could be an opportunistic “add” to portfolios in the near term.

We can also see a potentially stronger period ahead for world financial markets more broadly, assuming US labor markets slow, interest rates peak and corporate profits bottom. If so, the USD will likely resume declines and we would broaden our global equity allocations to more of the world. In all cases, we will be looking to industries and sectors where growth will be driven by technology and demographics.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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