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# THE WINDOW FOR GLOBAL FX TO EMERGE FROM DOLLAR DOMINANCE

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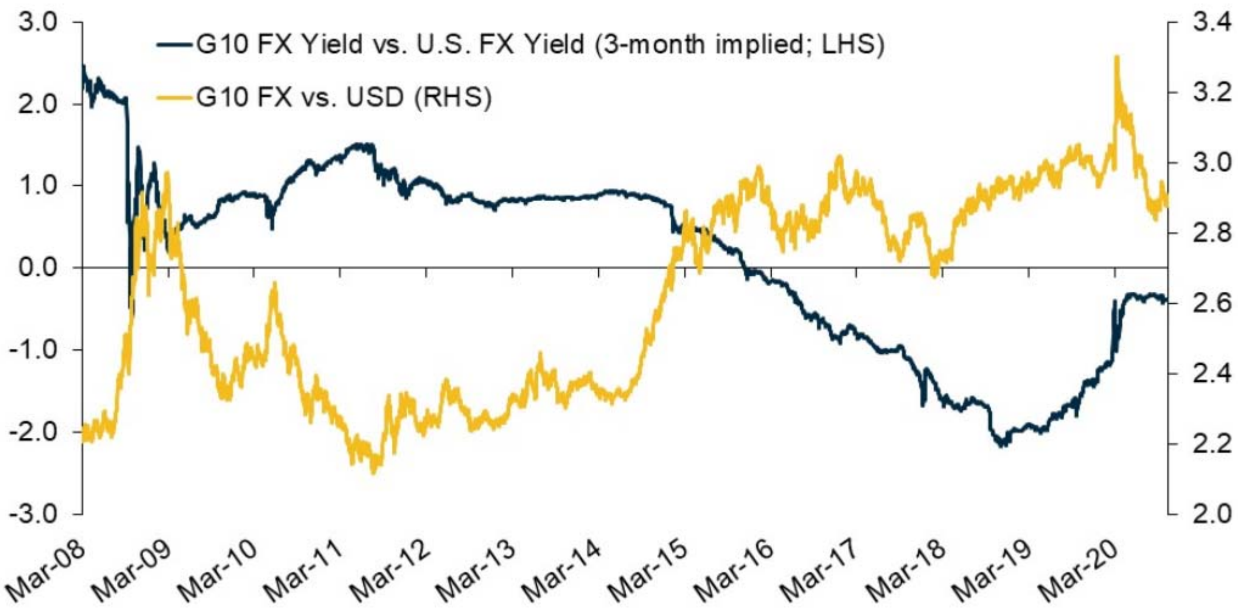
Anticipating the path of foreign exchange rates in recent years often culminated in an exercise in frustration. When it seemed that momentum was building behind G10 and EM currencies, the U.S. dollar regained, or maintained, its dominance in the global FX market. However, we see mounting indications that global currencies may have an expanding window to gradually appreciate vs. the dollar over the long term.

## A More Leveled Policy View

A stark dichotomy in global monetary policies was evident between 2014 and 2019. The Federal Reserve's balance sheet (as a % of GDP) peaked in mid-2014 shortly before its most recent rate-hiking cycle, while other major central banks generally remained in policy-easing mode. But the COVID pandemic and the globally synchronized monetary stimulus leveled the view across central bank policies. As a result, the short-term yield gap between the U.S. and the rest of the G10 closed, providing a jolt to G10 FX performance vs. the U.S. dollar (Figure 1).

**FIGURE 1: THE DISSIPATING U.S. YIELD ADVANTAGE PROVIDED A BOOST TO G10 FX PERFORMANCE VS. THE U.S. DOLLAR**

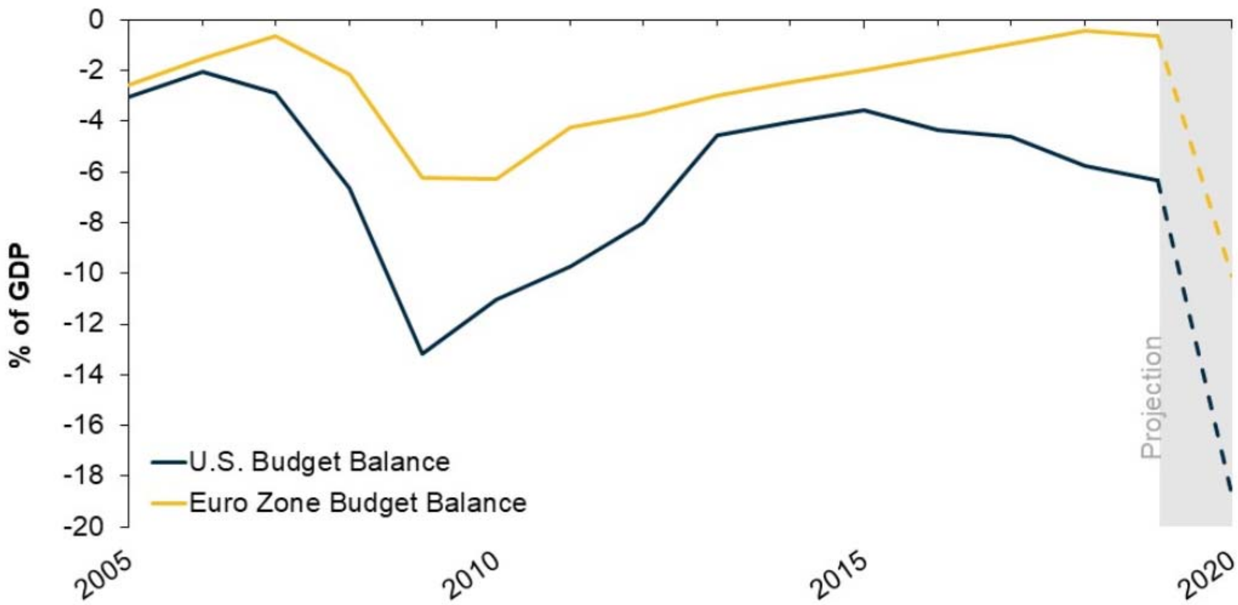



Source: Bloomberg as of October 2020

And the view may stay relatively level going forward. Core PCE inflation could temporarily rise above 2.0% in early to mid-2021, lifted by base effects, but the Fed is likely to look through the increase and keep the Fed funds rate at its current near-zero level through at least 2023.

In addition to keeping the Fed funds rate steady, the Fed's balance sheet may continue to expand amid a U.S. fiscal backdrop that has been deteriorating since 2016 (in contrast to the euro zone's improvement from 2010 through 2018). More recently, conditions in the U.S. and Europe have taken a precipitous turn for the worse, with substantial stimulus efforts to mitigate the effects of the COVID pandemic (Figure 2). Given Chair Powell's comments about the importance of additional fiscal stimulus, the Fed seems poised to readily monetize an increasing portion of Treasury issuance in the years ahead. The Fed's accommodative approach, underscored by its recently unveiled flexible average inflation targeting framework, may apply subtle pressure to the dollar over the long term.

**FIGURE 2: THE COVID-INDUCED CLIFF IN THE U.S. BUDGET BALANCE**



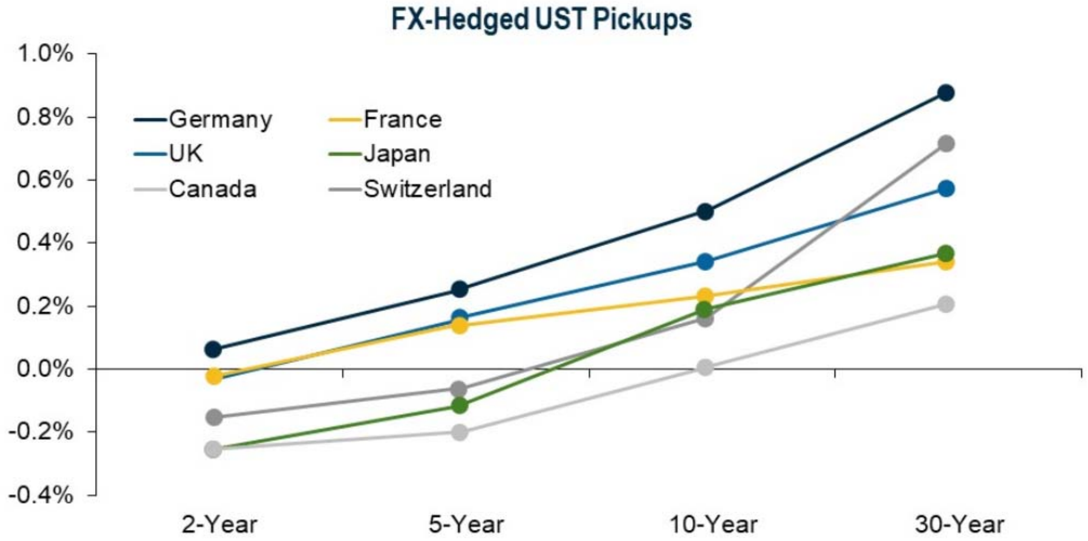

Source: IMF as of November 2020. Note: 2020 data are based on IMF projections.

As the U.S. emerges from perhaps the most sudden and severe economic recession in history, its current account deficit also appears poised to deteriorate and prevent the dollar from appreciating. For one thing, given the huge capital cuts that the U.S. shale fracking industry has made (as well as potential regulatory headwinds), it is very unlikely that U.S. shale production will support the petroleum trade balance to the same extent as in prior years. And given the expectations for a deterioration in the ex-petroleum trade balance, we expect the U.S. current account deficit to widen somewhat in the years ahead.

### The Pickup in FX Hedged Yields and Opportunities Outside of the U.S.

Although longer-term U.S. interest rates declined sharply during the COVID crisis, the U.S. yield curve remains relatively steep. Hedging costs for many international investors over the past several years were high as the Federal Reserve's short-term policy rate was the highest among developed world economies. As a result, some international investors preferred to take advantage of the steepness in the U.S. yield curve by buying U.S. fixed income on an unhedged basis. Now that the Federal Reserve has reduced the policy rate down to 0.25%, hedging costs for many international investors are low, which may encourage dollar selling to hedge existing U.S. fixed income investments.

**FIGURE 3: THE INCREASINGLY ATTRACTIVE YIELD PICKUP ON FX-HEDGED TREASURY PURCHASES**




Source: PGIM Fixed Income and Nomura

The United States' declining net international investment position to more than -50% of GDP reflects the years of rising international demand for U.S. assets, yet investors may be increasingly interested in European and EM assets, potentially at the cost of some of their U.S. holdings. In Europe, issuance as part of the recovery fund and pan-European unemployment benefits (SURE) is expected to reach €200-€250 billion per year over the next two years. This would be more than Germany's annual Bund issuance of about €150 billion at yields likely wider than those on French government bonds. Euro area residents, reserve managers, and sovereign entities may increase their euro area assets as a result. And if emerging market economies again widen the growth differential to developed markets—our estimates for EM and DM growth in 2021 is 4.6% and 7.2%, respectively—yield-seeking investors may turn to emerging market assets to the benefit of EM FX as well.

In terms of how our view of EM and G10 currencies affects our FX positioning, we believe that currencies underwent a period of consolidation since August 2020, and we've added exposure in EM and G10 in Asia and Europe vs. the dollar. Although we generally believe Latin American currencies will continue to underperform, we've added additional exposure to the Mexican peso as well. Beyond FX positioning, a scenario of gradual appreciation among EM and G10 currencies will likely affect asset allocation decisions across a number of sectors, including local currency bonds.

The risks to the view that global currencies may finally be in a place to gradually strengthen against the dollar include a faltering economic recovery that tightens financial conditions, and an acceleration in U.S. inflation over the long term.

While these risks, amongst others, are tangible and could lead to volatility across various USD pairings, we believe the recent emergence of several factors, including those detailed above, should hold the window open for global currencies to gradually emerge from the prolonged period of dollar dominance.

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