MACKENZIE
Investments

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The US dollar remaining dominant doesn't mean it won't depreciate

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While the US dollar's impending demise makes for catchy headlines, there are no realistic challengers to its supremacy. First, for all the talk of developing countries wanting to break free of the US dollar's grip, no emerging market currency issuer has the potential to substitute for the US. Second, if sanctions against Russia in 2022 did degrade the US dollar's status as a safe asset, other non-US advanced economies also participated. Therefore, investors and reserve managers can't shift from the US dollar to the euro or yen to insulate their portfolio from future sanctions. Finally, gold and other commodities are too illiquid and volatile to make up a large portion of reserves in a financialized world.

The US dollar is not dominant because global trade is denominated in US dollars; it is dominant because profits from global trade are recycled into US dollar assets. If Saudi Arabia begins selling its oil in yuan instead of dollars, Saudi Arabia ends up with a bunch of yuan. What will it do with all those yuan? Most likely sell them for dollars, to buy US dollar assets. To break the cycle, Saudis would have to want to buy Chinese assets, and China would have to let them do it.

Having its currency as the global reserve currency is not all rosy; it comes with steep costs. The country of monetary hegemony must run unbalanced trade, selling assets (land, bonds, stocks, etc.) to finance imports. Currently, the US's exorbitant privilege does allow it to borrow abroad at advantageous rates. But the resulting overvaluation of the US dollar crippled the US manufacturing sector over the past few decades. It's inevitable: as the financial safe haven, the US must either run huge fiscal deficits, build up consumer debt or accept elevated unemployment. For many countries, that trade-off is politically unthinkable.

HIGHLIGHTS

The US dollar is at no serious risk of losing its status as the global reserve currency.

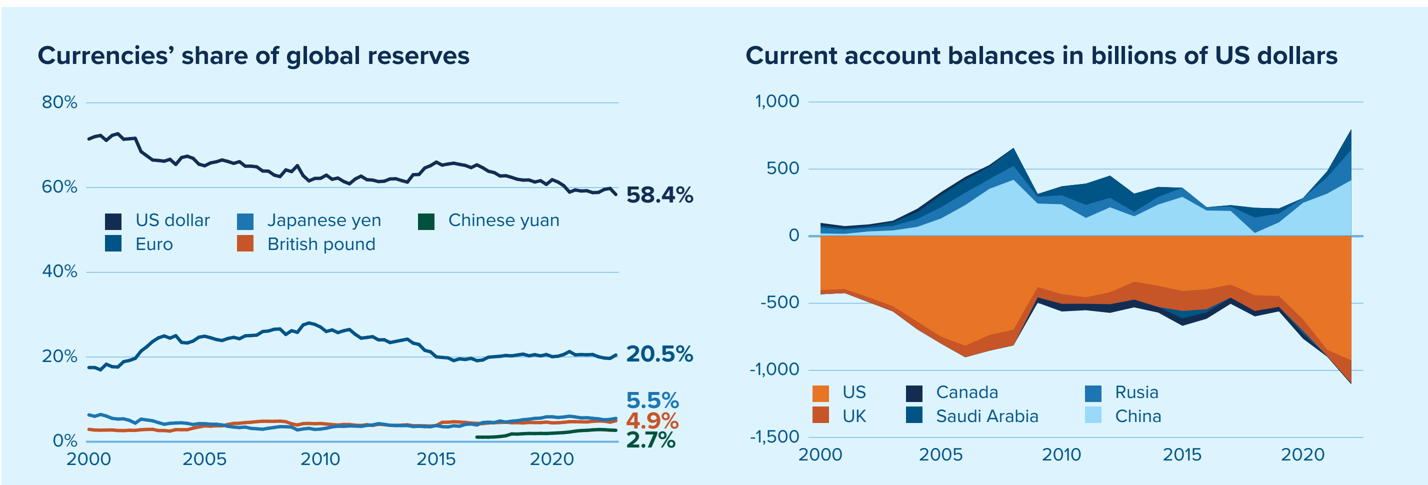
Challengers to US monetary hegemony, China chief among them, won't pay the steep economic and political costs required for their currencies to supplant the US dollar.

The US dollar should progressively decline in value over the next few years, even while it remains the dominant reserve currency.

Could the Chinese yuan replace the US dollar's role in the global economy? The yuan's share of global reserves has been rising quickly over the past few years, although it remains below 3% (see Figure 1). For the Chinese yuan to truly have a shot at supplanting the dollar, China would have to tick three boxes:

1. **Deep and liquid financial markets:** This is the sole criterion where China is close to the mark; it has the world's second largest bond market. Plus, the People's Bank of China setting up swap lines with other central banks should allow foreign investors to quickly raise liquidity from yuan bonds when needed.
2. **No capital controls:** The Chinese government still has a firm grip on the country's capital account. It's hard to imagine foreign investors holding yuan as long as they are implicitly frozen.
3. **Current account deficit:** If foreigners are going to hold yuan assets instead of dollar assets, China needs to sell them those assets. It must become a net provider of financial assets to the world, flipping its current global economic model on its head. Its export-driven economic model causes China to accumulate trade revenues, which it then uses to snap up financial assets in the rest of the world, most notably the US.

FIGURE 1. SURPLUS COUNTRIES HAVE NO CHOICE BUT TO RECYCLE THEIR EXPORT EARNINGS IN THE US

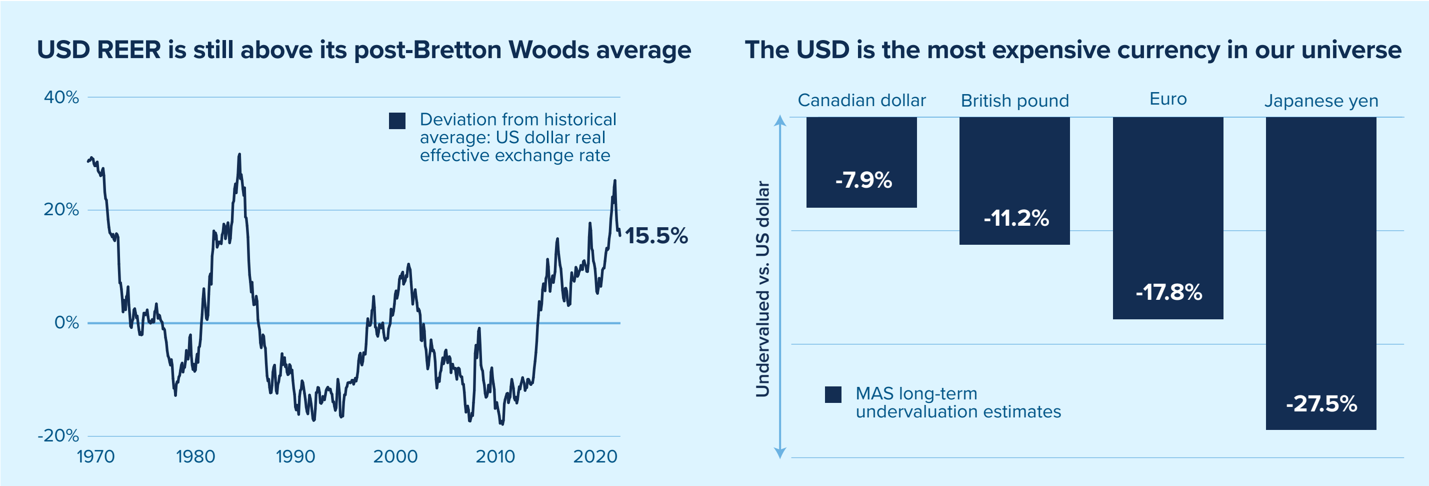


Source: Bloomberg as of April 30, 2023.

The idea of a group of countries ganging up to displace the US dollar makes for great financial fiction. But it won't happen. China, Russia and Saudi Arabia are all "surplus" countries. Figure 1 shows that they collectively amassed $800 billion in foreign assets in exchange for their excess exports. They can't trade together without one of them violently rebalancing their economy and running trade deficits to absorb the others' mercantilist proceeds. Perhaps China will be ready to do so in a few decades. But not today.

Make no mistake, we are far from dollar bulls: the US dollar can lose value, all while remaining the dominant global currency. The US dollar is too strong against emerging market currencies and other developed market currencies, over and above the premium it warrants for being the global reserve currency. Last year, the US Federal Reserve hiked rates faster than most other central banks. Plus, the US had the strongest economy in the world, with China in lockdown and Europe facing an energy crisis. As those dynamics began reversing in Q4 of last year — China reopened, Europe's energy crisis abated, and the Fed slowed its pace of hiking — the US dollar tumbled. We remain significantly short US dollars in our Global Macro Fund to benefit from a continuation in this depreciating trend. The US dollar's financial dominance is here to stay, but its overvaluation is not.

FIGURE 2. THE US DOLLAR IS OVERVALUED, OVER AND ABOVE ITS "RESERVE CURRENCY PREMIUM"



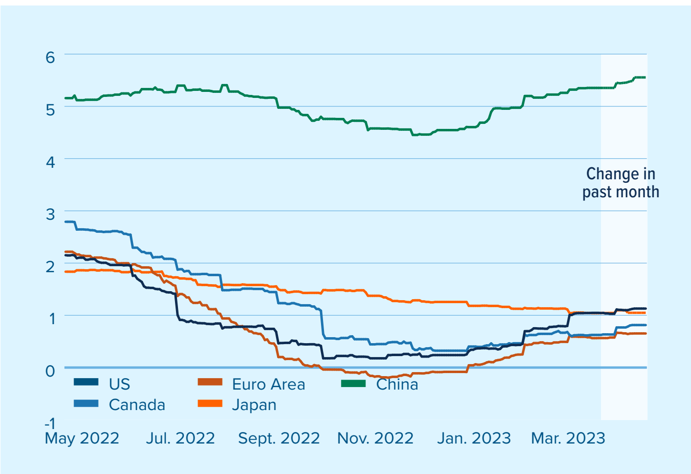
Source: Bloomberg as of April 24, 2023. The chart on the right shows the Multi-Asset Strategies Team's estimates of the undervaluations of the Canadian dollar, British pound, euro and yen relative to the US dollar.

Global macro update

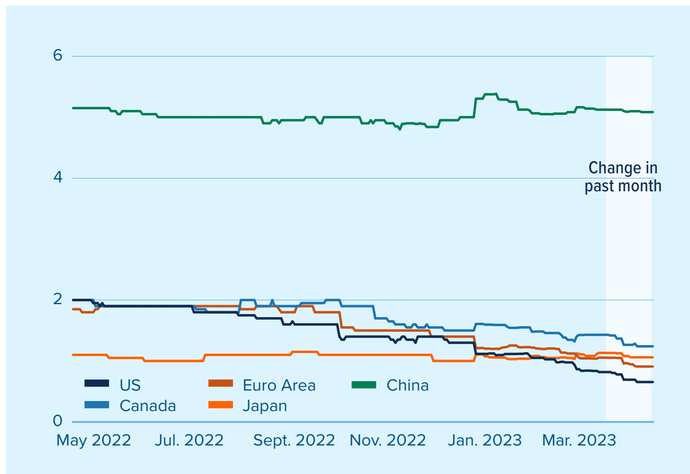
Consensus inflation forecasts for Japan kept creeping up in April. Headline inflation moderated over the past two months, but the slowdown mainly reflects new government subsidies for gas and electricity bills. But these measures, which amount to fiscal stimulus, should be seen as inflationary, rather than deflationary. In fact, core consumer prices, which strip out energy costs, are still climbing steeply. We are short Japanese bonds in our Global Macro Fund to benefit from an eventual phasing out of the Bank of Japan's cap on long-term interest rates.

A key determinant of **central bank decisions** in the US and Canada is the fate of both countries' housing sectors over the next few months. Tiff Macklem, Bank of Canada Governor, clearly stated that his decision to pause rate hikes was informed primarily by fears of a crisis in residential real estate. Since the Bank's pause in January, Canadian housing has clearly stabilized. House prices are bouncing and mortgage activity is picking up. If inflation sticks above 3% over the summer, the Bank could go for a final "insurance" hike to finish the job, now that the housing risk has been dulled.

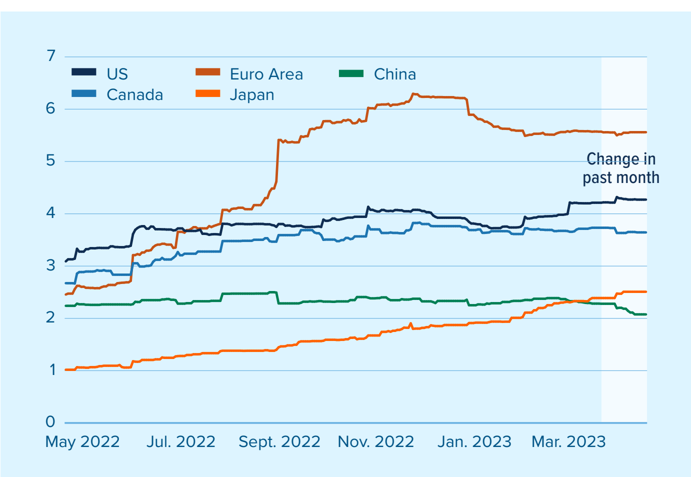
2023 REAL GDP GROWTH FORECAST (%, CONSENSUS)



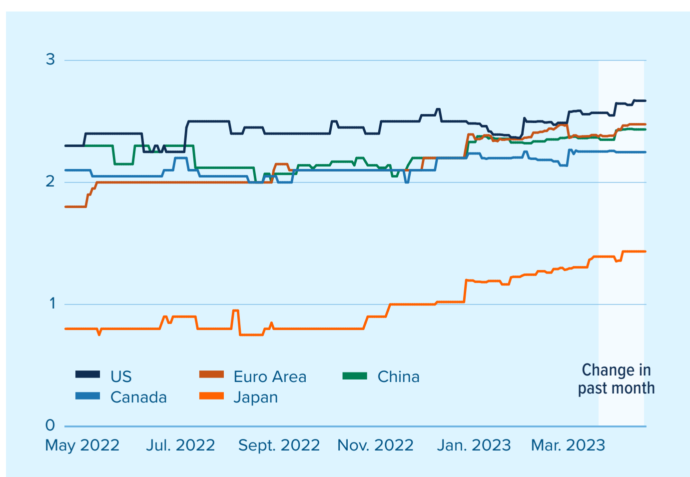
2024 REAL GDP GROWTH FORECAST (%, CONSENSUS)



2023 INFLATION FORECAST (%, CONSENSUS)



2024 INFLATION FORECAST (%, CONSENSUS)



Source: Consensus Economics as of April 30, 2023.

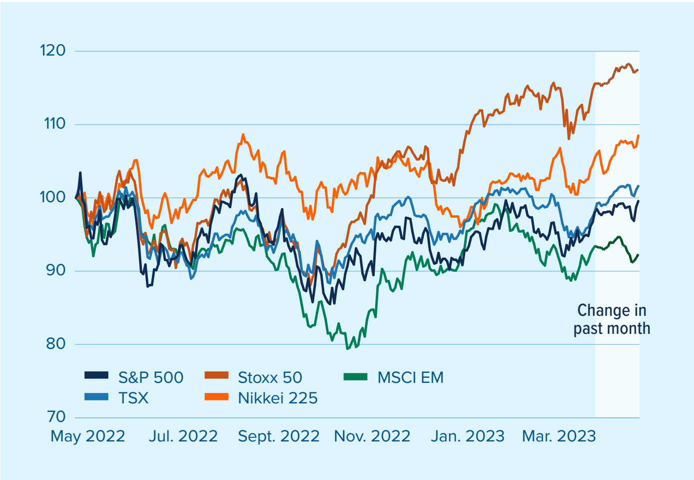
Capital markets update

Equities continued their post-banking crisis rebound in early April, as stock markets progressively priced in lower peak interest rates for 2023. Canadian equities outperformed peers as commodity prices firmed and the local real estate market showed signs of stabilization. Even after significantly outperforming US stocks over the past 18 months, Canadian stocks remain more attractively valued by most measures.

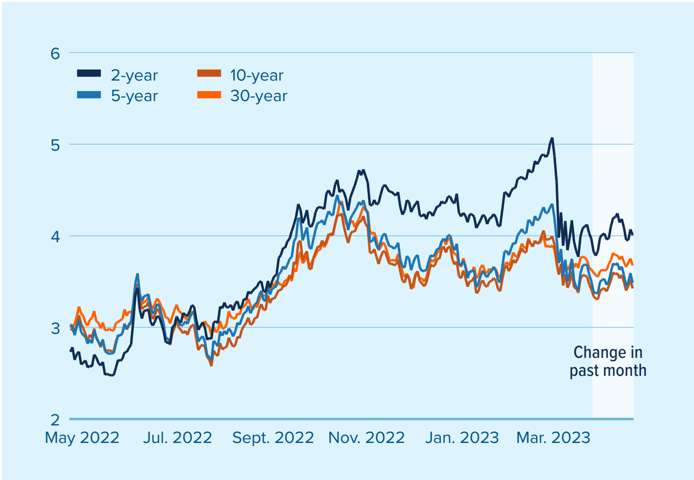
April saw the **US dollar** depreciate against most currencies. In fact, the DXY US Dollar Index has dropped in six of the past seven months. Even so, it remains overvalued against every G10 currency and most emerging market currencies in our investing universe.

Bond yields inched up across the curve in April, but they remain well below their levels from early March, before Silicon Valley Bank's failure rocked markets. We don't expect yields to rebound to their pre-crisis levels, but we do think government bonds are expensive across the curve. We expect global growth to hold up and inflation to stick above target, a downside scenario for bonds.

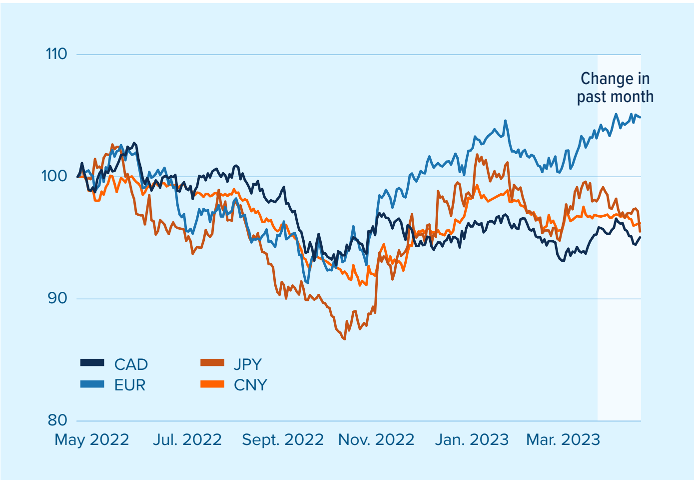
EQUITY INDICES (ONE YEAR AGO=100)



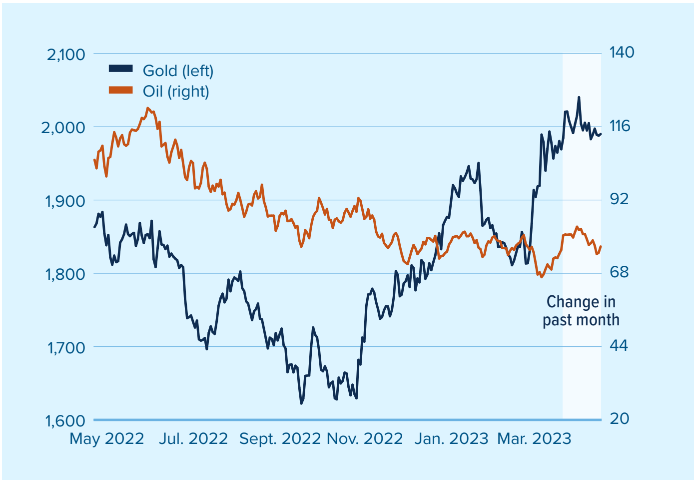
US TREASURY YIELDS (%)



CURRENCIES (RELATIVE TO USD, ONE YEAR AGO=100)



COMMODITY PRICES (USD)



Source: Bloomberg as of April 30, 2023. Total return equity indices are in local currencies, except MSCI EM, which is denominated in US dollars.

What we'll be watching in May

May 5: **Canada jobs for April**

- The headline employment number for March surprised to the upside (34,700 versus 7,500 expected) for the seventh month in a row, the longest beat streak since 2002.
- But beneath the strong March headline number hid some worrying signs of emerging economic weakness. Jobs were lost in construction and manufacturing, two economically sensitive sectors. Considering the meltdown in Canadian house prices last year, the strength of employment in the construction sector surprised analysts as construction jobs grew 8% in 2022. Last month's report could be the start of a reversal in the sector.

May 18: **The Bank of Canada releases its Financial System Review**

- The Bank of Canada's Financial System Review comes at an interesting time this year, in the aftermath of the collapse of Silicon Valley Bank (SVB). Canadian banks do not have the type of hidden balance sheet losses that brought down SVB, and their deposit bases are more diversified. But the stress test that will accompany the Financial System Review could conclude that high interest rates are a risk to the solvency of Canadian banks.

May 31: **Canada gross domestic product (GDP) for Q1**

- Canadian GDP stagnated in the fourth quarter of 2022. While household consumption grew solidly, business investment collapsed.
- Typically, shrinking investment spending is a harbinger of a recession, but growth and employment indicators were very solid to start 2023. Therefore, we probably won't see negative GDP growth in Q1, and a recession in Canada should be delayed to the second half of the year.

Emerging theme

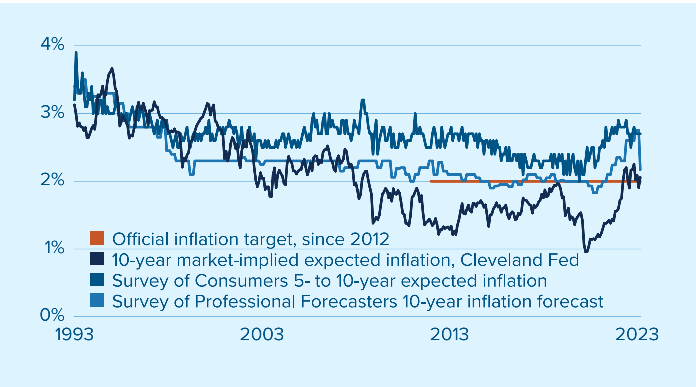
Could the Fed raise its inflation target to 3%? Not any time soon.

By raising the inflation target in the current context, the Fed would lose an incredible amount of credibility, and its monetary policy tools would lose effectiveness. Monetary policy effectiveness relies on inflation expectations being anchored in the long term. Raising the inflation target to 3% would not simply raise that anchor from 2% to 3%; it would destroy it.

The current Fed leadership has shown during the Trump years that it is mostly immune to political pressures. Powell is evidently obsessed with the idea of "legacy". Raising the inflation target in a context of high inflation would certainly ruin his legacy.

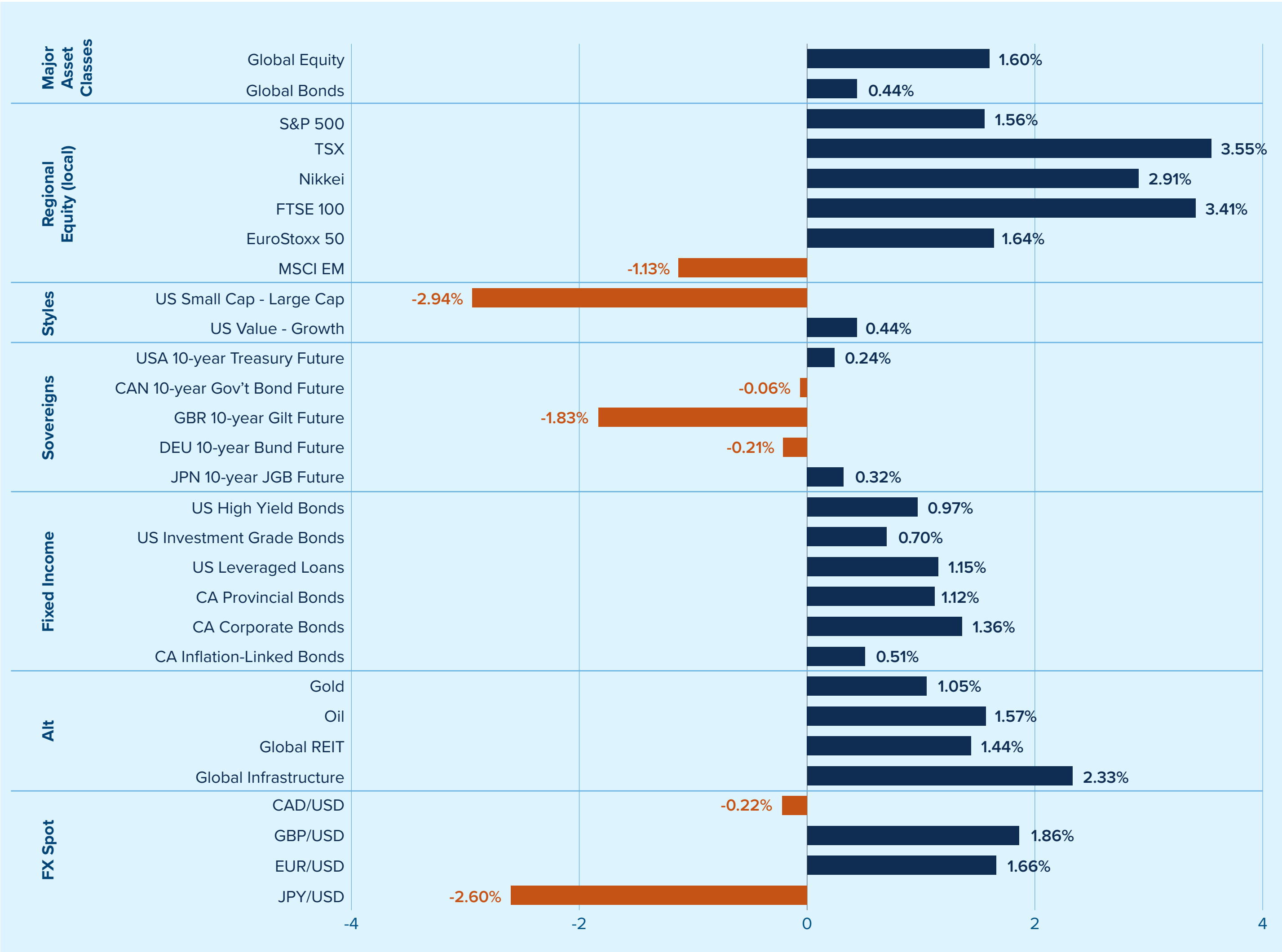
If the Fed won't independently decide to raise the inflation target, the impetus would have to come from Congress. Congress could fire the Fed Chair and unilaterally change the Fed's mandate. But Democrats don't have control of the House of Representatives, and their majority in the Senate is razor-thin.

INFLATION EXPECTATIONS: AN ANCHOR IN THE STORM



Notes: Data via Bloomberg as of April 24, 2023. All CPI-based data series adjusted to fit the PCE definition of the Fed's inflation target.

Capital market returns in April



Source: Market data from Bloomberg as of April 30, 2023. Index returns are for the period: 2023-04-01 to 2023-04-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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