Periods of extreme dollar overvaluations don’t last

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Highlights

- The U.S. dollar exchange rate has gained against all advanced-economy currencies this year and is now well above its long-term fair value, as determined by economic fundamentals.
- A strong U.S. dollar tends to tighten global financial conditions, amplify macroeconomic vulnerabilities and weigh on global growth.
- Given the extreme overvaluation of the U.S. dollar, odds are that it will depreciate against peers over the next few quarters, which would provide breathing room to emerging markets and help boost global growth. In the short term, however, potential tailwinds may continue to bolster the U.S. dollar.

On July 14, the euro briefly hit parity with the U.S. dollar, dipping below US$1.00 per euro for the first time since 2002. The past year has certainly been challenging for the euro. An economic slowdown in China – a prime destination for high-value manufactured goods coming out of European factories – likely weighed on demand for eurozone exports starting in the second half of 2021. Then, Russia’s invasion of Ukraine shocked the eurozone economy, which has an acute dependence on Russian gas. As a result, the eurozone’s trade balance with the rest of the world is more negative than it’s ever been in the common currency era. But the euro’s drop to parity with the U.S. dollar is not solely a symptom of weakness in the euro. It’s also a result of U.S. dollar strength.

Year-to-date, the U.S. dollar has appreciated relative to all currencies in the G10 universe of major foreign exchange (FX) markets, as Figure 1 shows. The Japanese yen and British pound, which play a large role in international finance, have been notable underperformers. Interest rate differentials are one part of the story. The U.S. Federal Reserve Board (Fed) has been raising interest rates more aggressively than many peers, drawing yield-seeking capital to the U.S. However, even countries keeping pace with Fed rate increases have seen their currencies weaken versus the U.S. dollar, notably Canada. As we explored in our May commentary, the CAD/USD exchange rate is much lower than would be suggested by interest rates and commodity prices, which have both been tailwinds for the Canadian dollar in 2022. But those tailwinds were outweighed by a “flight to safety” trade: macro volatility, market drawdowns and geopolitical crises, all of which we’ve experienced this year, tend to drive capital flows to U.S.-dollar-denominated assets, strengthening the dollar against every other currency.

A strong U.S. dollar tends to tighten global financial conditions and amplify macro vulnerabilities, through a few different channels:

1. Many international goods, especially commodities, are typically priced in U.S. dollars. When the dollar is overvalued, those goods increase in price, choking off international trade. Commodity-importing emerging markets are especially vulnerable to a rise in the price of their imports, even if these imports have a non-U.S. origin.
2. Outside the U.S., many governments and corporations borrow in U.S. dollars – for example, by issuing “hard-currency” bonds. The principal and coupons of those bonds must be paid in U.S. dollars. When the dollar appreciates relative to the country’s domestic currency, paying back those loans becomes more costly. Partially as a result of strength in the U.S. dollar, the yield spread of emerging markets hard-currency bonds to U.S. Treasuries has risen in 2022, squeezing borrowers in emerging markets.

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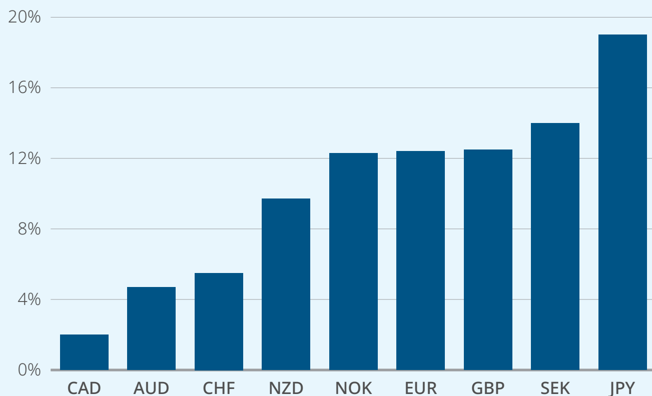
3. A surging U.S. dollar effectively exports inflation from the U.S. to other countries, many of which are already facing inflationary pressures. For the first time since 2008, the world's 60 largest economies all have an inflation rate above 2%. On net, this "inflation transfer" amplifies global macro vulnerabilities, since a portion of these countries have weaker inflation-control tools than the U.S. (i.e., lack of central bank independence, populist government, etc.)

We estimate that the U.S. dollar is currently at its most overvalued in more than 35 years. In other words, based on our in-house valuation models, the current U.S. dollar exchange rate with currencies of other advanced economies has rarely been higher compared to its long-term "fair value," as determined by economic fundamentals (inflation, productivity, current account, etc.) Figure 1 plots a simple real effective exchange rate (REER) for the U.S. dollar, which shows the U.S. dollar REER is in the top decile of deviation from its historical average. In general, the more stretched its valuation gets, the faster a currency will revert to its fair value exchange rate.

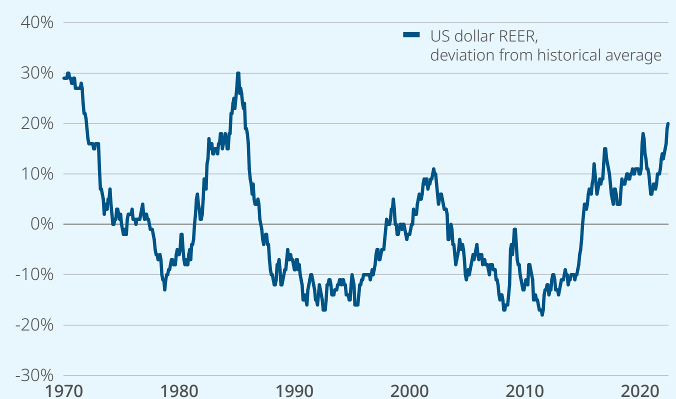
To find a time when the U.S. dollar was at a larger premium to long-term fair value than today, we have to go back to the mid-1980s. Fed Chair Paul Volcker was raising rates aggressively to control inflation, which widened interest rate differentials with the rest of the world. U.S. President Reagan was running large fiscal deficits and the U.S. current account deficit was surging (sound familiar?). After peaking in 1985, the dollar index reverted quickly towards its fair value, dropping more than 40% over the following two years. The initial trigger for the devaluation was the 1985 Plaza Accord, when government officials from rich countries met to act on the U.S. dollar's overvaluation. But the extent of the dollar's slide over the next few years was a symptom of the dollar's disconnect from long-term fundamentals.

Figure 1. U.S. dollar strength has been one of the main macro themes of 2022

The USD gained vs. all G10 currencies in 2022



The U.S. real exchange rate is well above its historical average



Notes: All data via Bloomberg as at July 31. The chart on the right uses the Bank of International Settlement's version of the real effective exchange rate (REER) for the U.S. dollar against its "narrow" set of peers, minus its average from 1970 to today.

The macro volatility and market tremors that have driven U.S. dollar strength in 2022 could persist, but we also see potential triggers for a reversal in the appreciation trend. The most obvious trigger is a peak in U.S. inflation. This would have the dual effect of (1) a break in the widening of the U.S.-world interest rate differential, and (2) a softening of market and macro volatility. Another trigger could be the unfolding of a "reverse" currency war, in which countries around the world attempt to prop up their own currencies to tame domestic inflation. We have already seen shades of this in recent months, as central bankers around the world have talked up the importance of strong currencies for inflation control. Even Tiff Macklem, Governor of the Bank of Canada (BoC), emphasized the impact of a weak Canadian dollar on inflation.

U.S. dollar overvaluation is a headwind for global trade and a headache for countries with macro vulnerabilities. Thankfully, periods of extreme U.S. dollar overvaluation don't last forever, especially when so many inflation-ridden countries have an incentive to push back against U.S. dollar appreciation. Timing the dollar's reversion to fair value is tricky, especially amid the current macro volatility, but eventually gravity should take hold.

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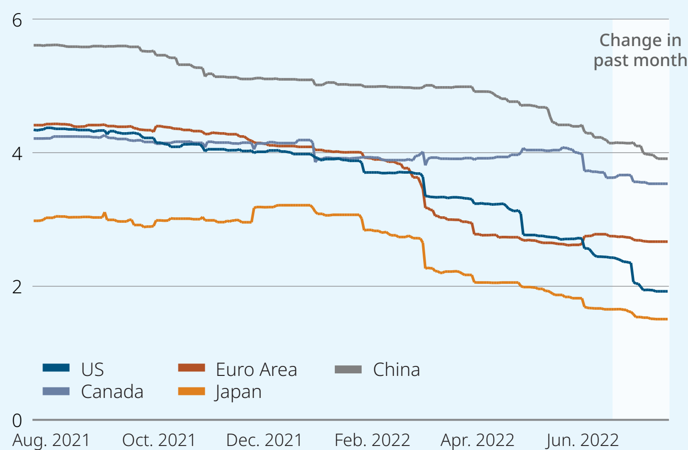
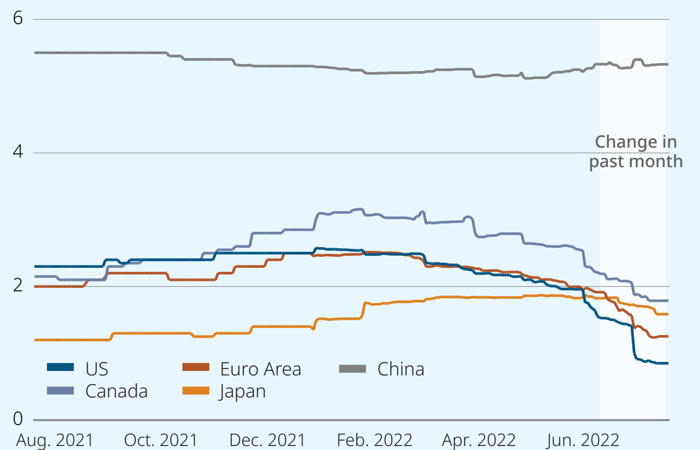
Global macro update

- In the second quarter of 2022, the **U.S.** experienced **negative growth** in gross domestic product (GDP) of -0.9% annualized. This will likely not meet the National Bureau of Economic Research (NBER) criteria for a recession. During the first half of 2022, higher frequency economic indicators did not mirror the weakness in GDP numbers: employment grew at an exceptional pace, industrial production was solid and housing starts remained well above pre-pandemic levels. This month's Emerging theme explores one of the reasons why NBER does not rely solely on GDP data to date recessions.
- In the past two months, we saw an interesting dichotomy between **U.S. inflation** expectations, as implied by market prices, and economist forecasts. While market expectations of near-term inflation softened in June and July, economists still expect sticky inflation over the next two years. Economist forecasts are consistent with the current macro landscape: the U.S. economy is overheating, wage growth is high, employment has not shown any signs of weakness and inflationary pressures have been broadening throughout economic sectors.

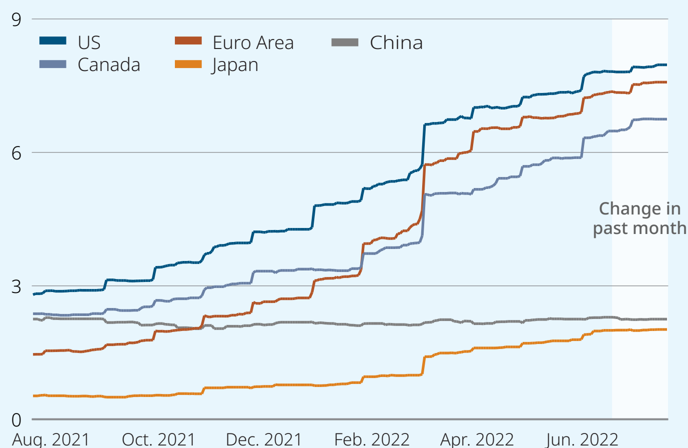
2022 real GDP growth forecast (%, consensus)



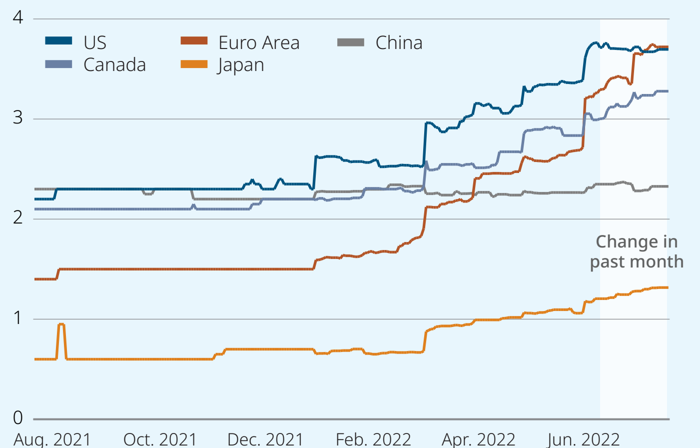
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)



Notes: Average growth and inflation forecasts from Consensus Economics as at July 31, 2022.

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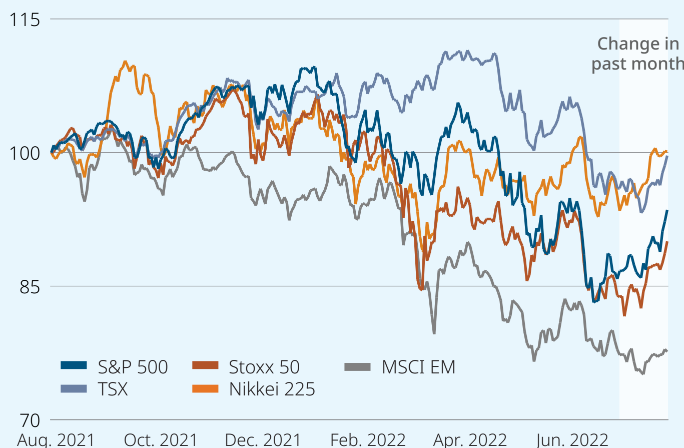
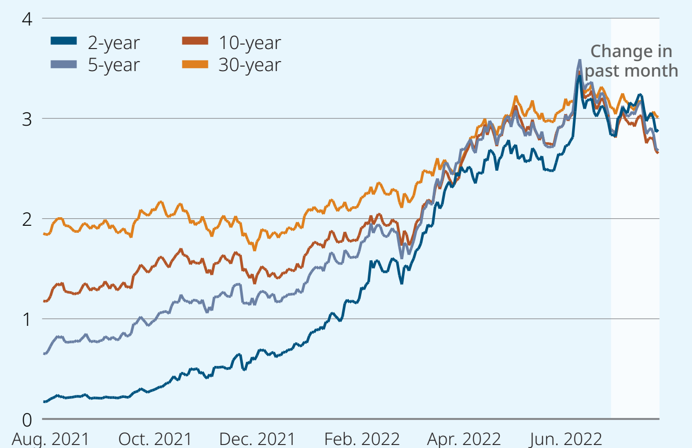
Capital markets update

- **Global equity prices** rebounded in July as market expectations for Fed rate increases softened and realized equity volatility decreased. The risk-on mood spread to all major stock markets: notably, European stocks rose 7.2% in a month where the European Central Bank raised rates more than expected and the continent's energy crunch worsened.
- **U.S. Treasury yields** dropped in July and the 2s-10s yield curve inverted further as fears of a global recession rose. While the late-June bond rally was driven mainly by a softening of "breakeven" inflation – inflation expectations embedded in bond prices – July's move can instead be explained by expectations of lower Fed interest rates. Markets are betting that the ongoing moderation in economic indicators will spread to the job market, forcing the Fed to reverse its cycle of rate increases as soon as the start of 2023.
- The **Japanese yen** broke its depreciation streak in July, as the global rally in bonds pulled Japanese 10-year yields below the Bank of Japan's 0.25% yield cap, relieving pressure on the yen. The yen now sits 25% below its fair value with the U.S. dollar, providing it with some room to recover if the Japanese macro situation stabilizes, which will hinge on oil prices not re-testing their recent highs.

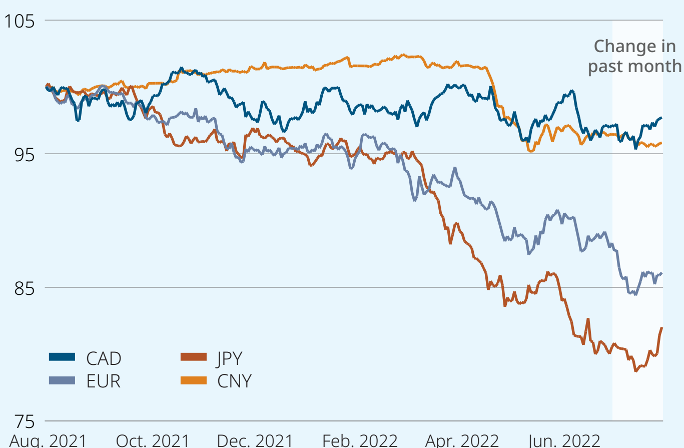
Equity indices (one year ago=100)



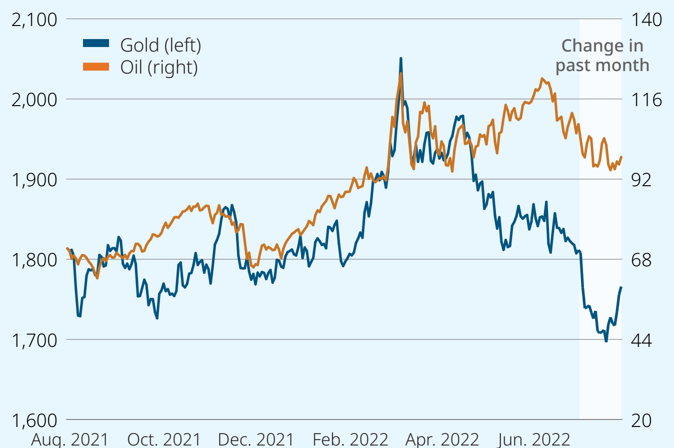
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as at July 31, 2022. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

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What we'll be watching in August

August 12: University of Michigan August inflation expectations survey

- In speeches, Fed officials have stressed the importance of consumer inflation expectations for the future path of interest rates. In July, the average U.S. consumer's 5-10 year inflation forecast dipped from 3.1% to 2.9%. Given that consumer inflation expectations tend to track gasoline prices, we could see another decline in the August survey.

August 16: Canada's July consumer price index (CPI)

- With retail gasoline prices easing by more than 10% in July, we expect to see a decline in year-over-year Canadian CPI inflation from the 8.1% recorded in June. This would be the first drop in headline inflation over the past 13 months.
- All three of the BoC's preferred measures of core inflation, which attempt to tease out the "true" underlying rate of inflation, are above 4.5%. It's hard to see the BoC pausing rate increases before these three indicators begin to moderate.

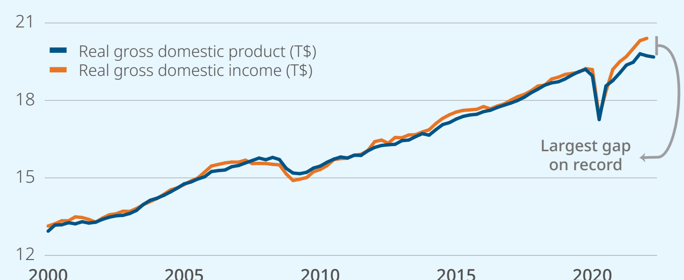
August 31: Canada's second-quarter GDP

- The average economist expects Canada's GDP growth for the second quarter to come in at 4% annualized, following a 3.1% print for the first quarter. A second-quarter print of 4% would bring cumulative GDP growth since end-2019 to 1.8%, still below the 2.5% cumulative growth for U.S. GDP, even after two quarters of negative U.S. growth.
- Special attention will be paid to the residential investment line item in Canadian GDP. While house sales have slowed significantly, housing starts have remained solid since the BoC began raising rates. Residential investment represents 10% of Canadian GDP, versus 5% for the U.S.

Emerging theme

- With the July 28 release of the preliminary GDP number for the second quarter, the U.S. has now registered two straight quarters of negative growth. But one of the reasons why the dating committee at NBER doesn't rely solely on GDP to designate recessions is that quarterly growth numbers are subject to significant revisions. In fact, a simple model based on historical revisions suggests there's approximately a 40% probability that growth in either the first or second quarter will get revised upward enough to turn positive.
- In addition, while gross domestic product has been contracting, gross domestic income (GDI) has not. In theory, these two measures should be equal: one's spending (GDP) is always someone else's income (GDI). In fact, some countries don't report these two measures separately. For example, Statistics Canada reports one measure for both, simply taking an average of GDP and GDI. While the U.S. Bureau of Economic Analysis reports a different number for each concept, both measures typically track each other pretty closely; after all, they measure the same thing. However, GDP and GDI have diverged markedly since 2020, opening the door to the possibility that GDP is being undercounted. Adding in GDP-GDI convergence to the simple statistical model described above, the probability of growth in either the first or second quarter getting revised to a positive number rises to around 70%.
- No wonder the NBER doesn't use the "two negative quarters" rule to date recessions, when the criterion underlying the decision could end up failing to hold once the data are finalized. Fortunately, the committee has the latitude to consider other indicators (employment, industrial production, etc.) to make their ruling. If these other series begin turning, expect a swift recession call.

The GDP-GDI gap foreshadows revisions to growth



Notes: Bloomberg as at July 29, 2022. Both GDP and GDI are measured in trillions of 2012 chained U.S. dollars.

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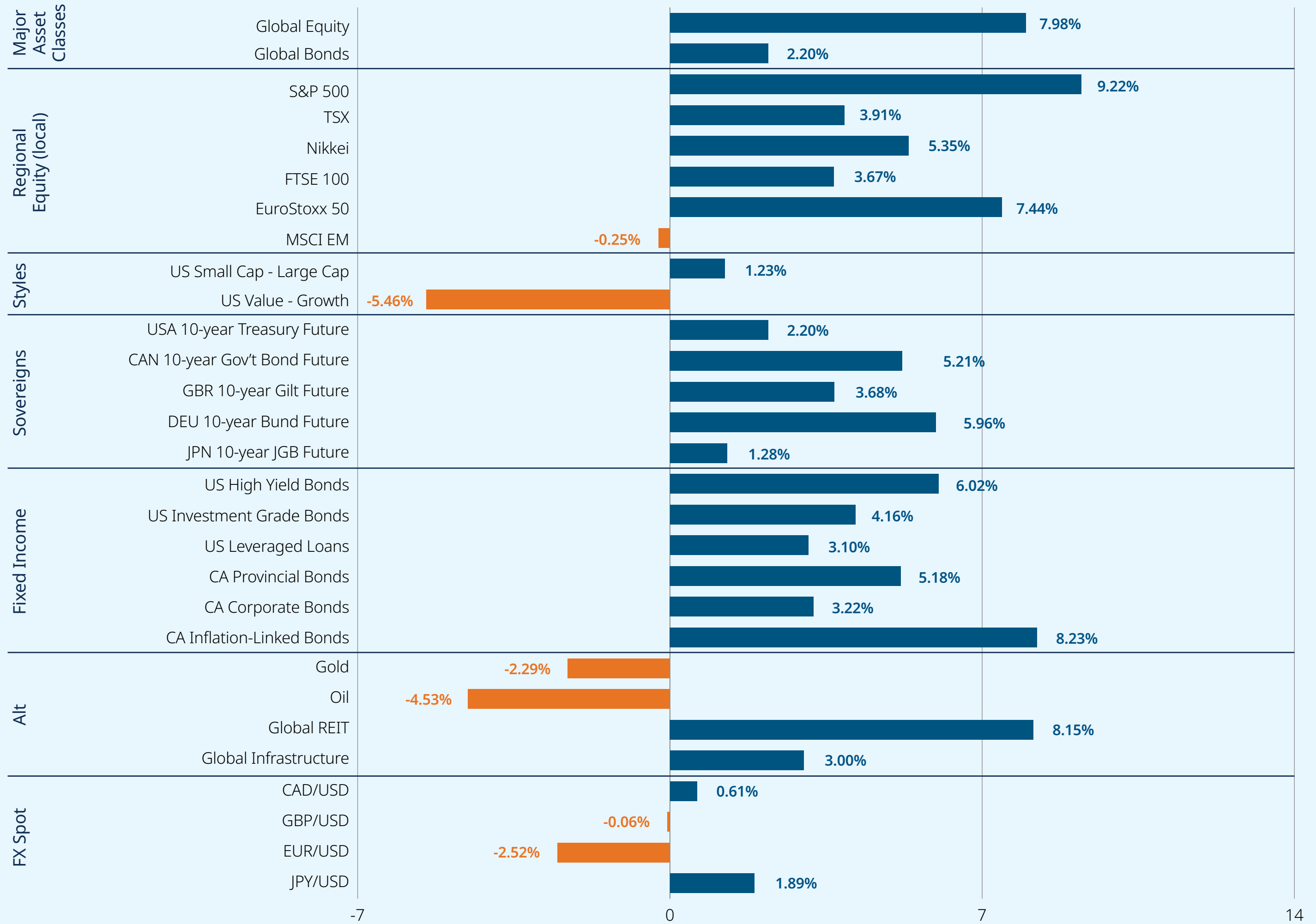
Capital market returns in July



Notes: Market data from Bloomberg as at July 31, 2022. Index returns are for the period: 2022-07-01 to 2022-07-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), S&P/TSX 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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