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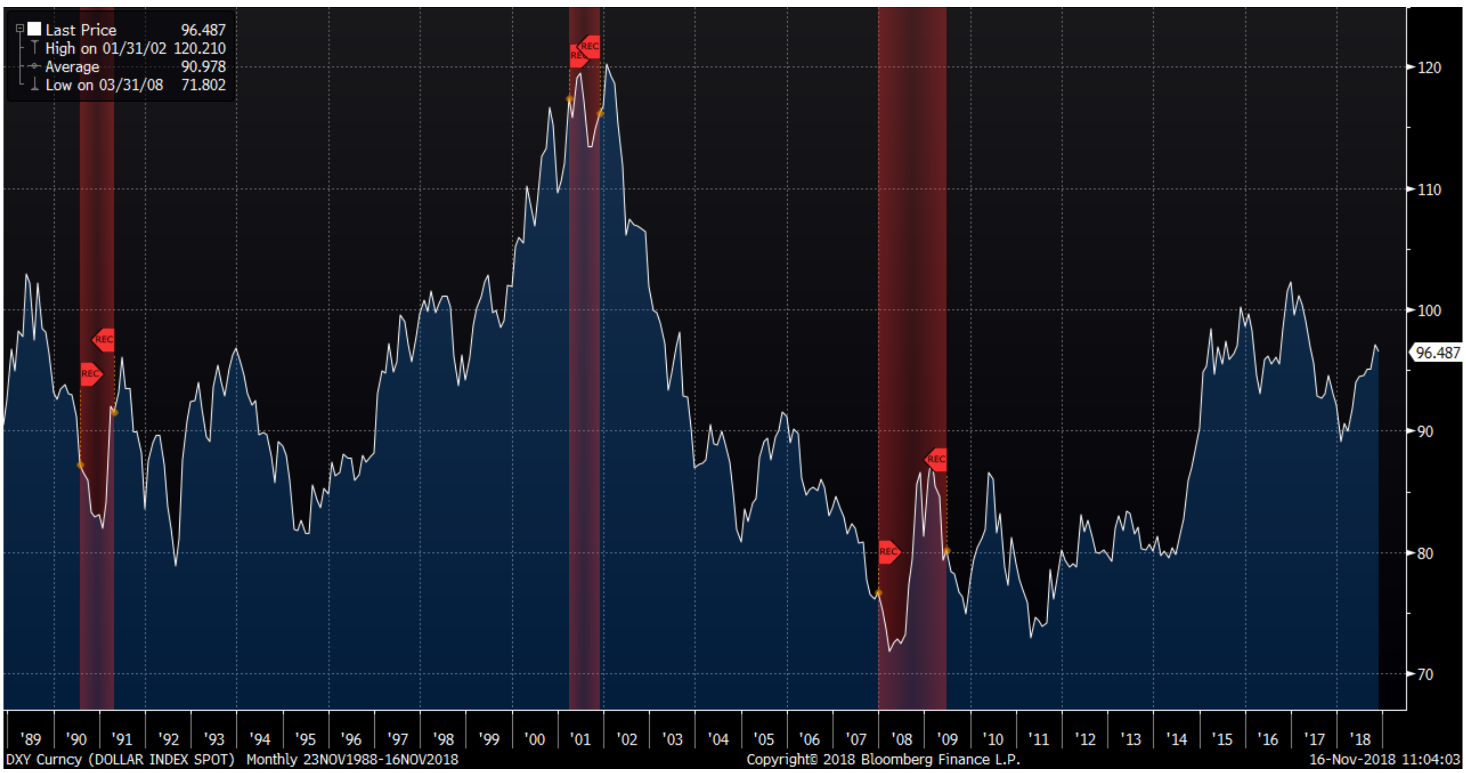
U.S. Dollar – When Will It Weaken?

It seems everyone has a different opinion on the U.S. dollar. Should it weaken relative to international and emerging market currencies? It hasn't and may not for quite a while. What is happening?

Many investors have been frustrated by the persistent and seemingly illogical strength in the U.S. dollar. Numerous reasons exist to believe the U.S. dollar should weaken relative to other currencies: rising inflation, late stage U.S. equity bull market, tougher 2019 earnings comparisons for U.S. companies, slowing housing, slowing auto/retail sales. Yet, despite the reasons, the U.S. dollar as represented by the U.S. Dollar Index (DXY) has strengthened. Perhaps we can shed some light on the reasonings.

History

To provide some context, below is a 30-year chart of the U.S. Dollar Index. The highlighted red columns are recessions. As one can see, the range for the U.S. dollar is quite wide with the low being 71 in 2008 and the high of over 120 in 2002. Currently, it is trading at approximately its midpoint of the range.



The trading in the U.S. dollar (and other investments) is determined by the amount of orders to buy relative to the orders to sell. It seems simple…it is anything but simple. Let's look at some of the current demand/supply dynamics.

Demand versus Supply

First, the U.S. dollar is one of the world's primary reserve currencies. Bloomberg defines a reserve currency as, "a large quantity of currency maintained by central banks and other major financial institutions to prepare for investments, transactions and international debt obligations, or to influence their domestic exchange rate. A large percentage of commodities, such as gold and oil, are priced in the reserve currency, causing other countries to hold this currency to pay for these goods." To facilitate business transactions globally, economic participants must acquire the U.S. Dollar. In fact, it is estimated that 79.5% of global transactions (Swift, 2015) are conducted in the U.S. dollar. The demand for U.S. dollar is fairly consistent.

Second, the quantity of U.S. dollars is declining as the Federal Reserve reduces the assets on its balance sheet at an annualized rate of $600 billion. Effectively, this shrinkage eliminates $600 billion of U.S. dollars per year. Another possible constraint on the supply of U.S. dollars is the reduction in the trade balance. The negative U.S. trade balance is essentially the U.S. supplying $600 billion of U.S. dollars for foreign entities/individuals to conduct business. As the trade deficit shrinks, this will reduce the availability of U.S. dollars.

Third, potential geopolitical/economic risks are rising. The negotiations of U.K's exit from the EU have been contentious and are fraught with the potential for a "hard exit" which could be economically damaging to Britain and Europe. Additionally, Italy and their rancorous budget conversations with the EU threatens to escalate as Italy continues to become more indebted beyond their previous agreements. As perceived risks rise, investors and companies opt to hold low risk assets like the U.S. Dollar.

Fourth, international and emerging market economic growth is slowing while the U.S. growth is racing ahead. At latest print, the EU is growing at an annualized real rate of 1.9% down from 2.8% in 3rd quarter 2017 while the U.S. has accelerated from 2.3% in 3rd quarter 2017 to a 3.0% rate. Typically, higher economic growth will attract assets as long as it isn't accompanied by significant inflation. In October 2018, the U.S. reported a moderate 2.5% inflation rate over the past 12 months. Inflation could accelerate, but it currently seems well managed. The international and emerging market economies are typically more reliant on exports and, as such, the tariffs being introduced by the United States have made economic participants wary due to the increase in uncertainty.

What does this mean for me?

Changes in the U.S. dollar affect investment returns. Depending on the investments owned, changes in currencies can magnify or reduce the return provided by the underlying investments. As the U.S. dollar strengthens, domestic investments will be preferable to international investments. Conversely, if the U.S. dollar weakens, international investments would be preferable to domestic shares.

The U.S. dollar may continue to be stubbornly high as the quantity of U.S. dollars shrinks relative to demand. This will make international and emerging market investments less attractive, so investors should maintain a domestic tilt to their investments for now. Unfortunately, it may be awhile before we see U.S. equities pass the baton to their international and emerging market counterparts. That said, this trend can change and may change quickly.