Confluence INVESTMENT MANAGEMENT

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Geopolitical Report
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Prospects for the Dollar in a Fracturing World

As investment managers and strategists, we are often asked by clients about our outlook for the United States dollar. Very often, our clients have heard some worrisome news about a rival currency becoming more attractive than the greenback or global investors selling off the dollar because of economic or political problems in the US. Their concern is often about the US's growing debt or political polarization. As the world continues to fracture into relatively separate geopolitical and economic blocs, another concern is that China, Russia, Iran, and some of their authoritarian allies want to stop using the dollar for trade and investment. If those countries cut their demand for the greenback, the fear seems to be that the currency will lose value, its purchasing power will decline, and consumer price inflation will rise.

In this report, we provide some guideposts for thinking about exchange rates. We then examine the main global forces that could theoretically reduce demand for the dollar and cut its value. We conclude with a discussion of the prospects for the dollar and the implications for investment strategy.

How to Think About Exchange Rates

When people ask about our expectations for the dollar, they usually put it in terms of the dollar's value in exchange for a foreign currency, i.e., the dollar's exchange rate. We suspect those people are actually more concerned about the purchasing power of the dollar and inflation. Nevertheless, in this section of the report, we focus on dollar exchange rates.

Currency Pairs. To start with, it's important to remember that no currency has one universal value or exchange rate. In its monetary role as a store of value and a medium of exchange, a currency has value in terms of what it can buy,[1] which in the international arena is usually expressed as how many units of another currency it can purchase. A currency will typically have a different rate of exchange for every other currency. The exchange rate is different for every "currency pair." Confusingly, some US dollar (USD) exchange rates are traditionally expressed as the number of foreign currency units that $1 can buy, such as the rate of about 145 Japanese yen per dollar (as of this writing). Other USD exchange rates are quoted as the number of dollars needed to buy the foreign currency, such as the rate of about $1.30 to buy one British pound (as of this writing).

- For a summary measure of a currency's strength, some governments, media firms, and financial institutions have devised indexes tracking the currency's

[1] Economists usually recognize "money" as having three roles. It is: 1) a unit of account, 2) a store of value, and 3) a medium of exchange. Some goods are conventionally priced in a specific currency, making the currency a unit of account for that commodity. Crude oil, for example, is widely valued in US dollars. Other goods and services use many different currencies as their unit of account. Here, we focus on the dollar's role as a store of value and medium of exchange in international transactions.

value across a basket of currency pairs. The various exchange rates in the basket are typically weighted by the relative level of international trade between the underlying countries.

- For example, the Federal Reserve has a broad index of the USD's value that consists of more than two dozen currency pairs, ranging from the USD/euro to the USD/Brazilian real. The exchange rates in the basket are weighted by the underlying country's total trade with the US (see Figure 1). The Fed also maintains subindexes covering only the currency pairs with advanced and emerging countries.
- Like other USD indexes, the Fed's index provides a summary measure of the dollar's value, akin to a weighted average. However, different exchange rates within the index can move in different directions. Even if the USD index is historically high and/or rising, the USD could be historically low and/or falling against a particular currency in the index. For example, even though the USD has been in a bull market against most currencies for more than a decade, it has been depreciating against the Swiss franc (see Figure 2).

Exchange Rate Drivers. Unless a government intervenes, the exchange rate between a currency pair will be determined by the relative supply of, and demand for, one currency versus another in the foreign exchange market. The supply of a currency can be affected by factors such as the underlying country's trade balance (bigger trade deficits lead to more supply), monetary policy, or capital flight. The demand for a currency can come from factors such as the relative level of the country's interest rates, the overall attractiveness of its assets to foreign investors, or its reputation as a safe haven or a good place to park savings. Arbitrage between currency pairs can also affect an exchange rate, as shown in the simple model in Figure 3.

Figure 1

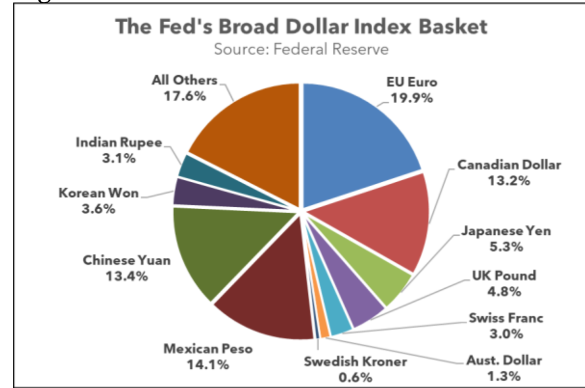


Figure 2

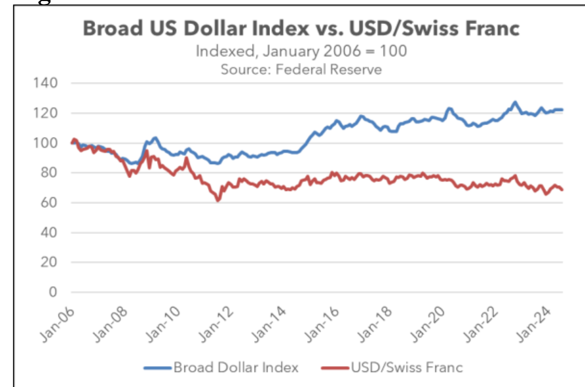
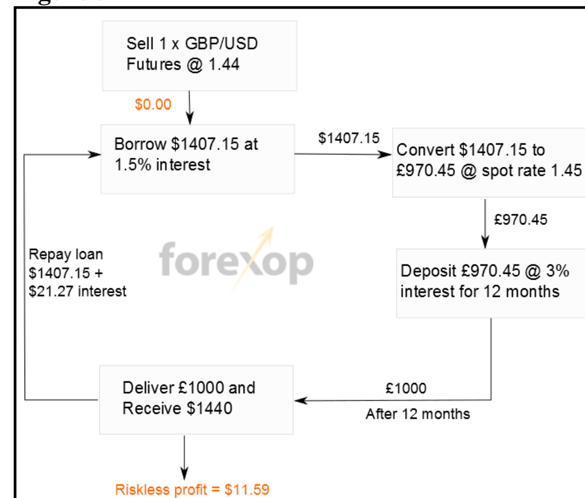


Figure 3



Interest rate arbitrage as one source of currency demand and supply (Source: Forexop.com)

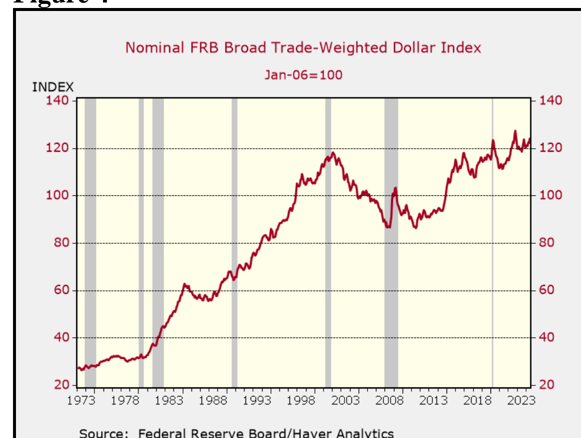
To summarize our argument so far, the prospects for the USD going forward will depend on whether it appreciates or depreciates versus other specific currencies. And that, in turn, will depend on the supply and demand of the USD versus the other currency based on various trade and investment flows.

Emerging Threats to the Dollar

As mentioned above, the greenback has been appreciating against most other major currencies for more than a decade (i.e., the other currencies have been weakening against the USD). As measured by the Fed's broad USD index, the greenback has been in an extended bull market despite the US's yawning trade deficit, rising public debt, and slowing population growth. Those factors have been offset by strong investment flows into the US, likely reflecting the attraction of the big, liquid, well-regulated capital markets in the US compared to the relatively less attractive returns that are available overseas. For now, those factors will likely keep drawing investment into the US, putting upward pressure on the dollar versus most other currencies. However, there are several reasons why the USD could eventually reverse course. Below, we discuss some developments that could push the USD into a new bear market.

US Politics. Not only do trade and investment flows affect the value of a currency, but, in return, the value of a country's currency can impact its trade and investment. When the USD is dear against other currencies, US exports can lose global market share. After all, US exporters ultimately want a currency they can use at home. Foreign purchasers may need to pay in USD, which they'll purchase in the foreign exchange markets. Likewise, when the USD is strong, US firms producing and selling abroad end up with fewer dollars when they sell the weak foreign currency they've earned. Measured by the Fed's broad USD index, the greenback is now near a record high (see Figure 4), so these problems are acute. Former President Trump and his advisers have therefore hinted that if he is elected again, he'll try to weaken the USD (perhaps by pressuring the Fed to cut interest rates). Such an effort could push the USD lower over time, especially if it's coordinated with other countries, as we saw in the Plaza Accords of the mid-1980s. At this point, it remains difficult to handicap whether or when this government-driven USD depreciation could happen.

Figure 4



Global Economic Fundamentals. The USD is not just at a record high these days, but it also looks unmoored from the economic and financial market fundamentals that appeared to drive its value in the past. For example, over the long term, the exchange value of one currency against another has often reflected the relative rate of price inflation in the two underlying countries. We often estimate fair-value exchange rates based on "purchasing power parity" (PPP) models derived from consumer price indexes (CPI). Most of those models currently show that the USD is extraordinarily over-valued. For example, as shown in Figure 5 (next page), the current USD/yen rate is about two standard deviations from its PPP-derived

fair-value rate of 57.24. With the greenback trading so richly against its estimated fair value, investors could well begin to sell the USD and weaken it again at some point.

- As noted above, capital flows also affect the value of the greenback, so we can also calculate the USD's fair value based on the US capital investment cycle.
- In our capital-cycle models, the USD is somewhat less over-valued than in our PPP models, but it still looks rich (see Figure 6 for one example). Again, the implication is that investors could therefore force the greenback down again at some point in the future.

Figure 5

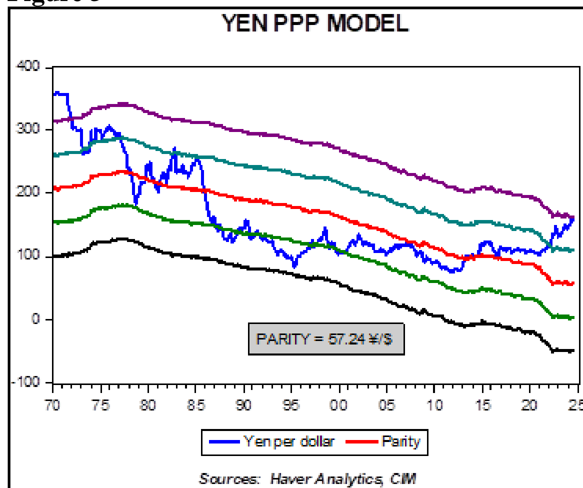
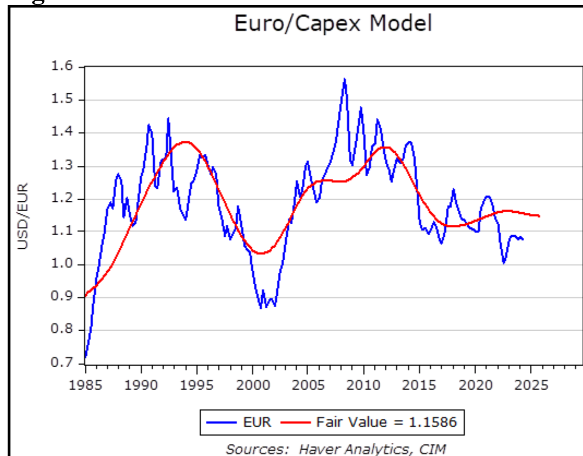


Figure 6



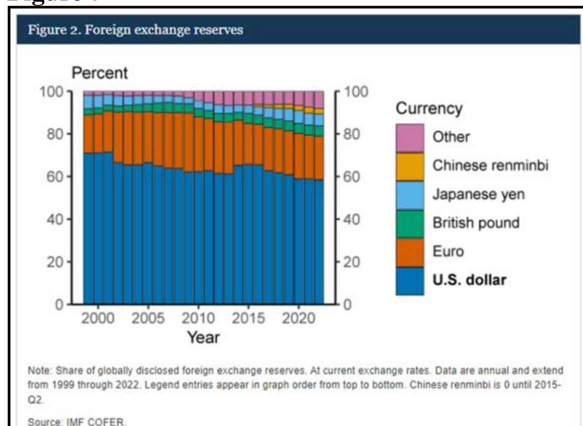
Geopolitics. Finally, the USD could be undermined by the actions of foreign adversaries as the world fractures into various geopolitical and economic blocs. We have written much about this fracturing, and we've developed an objective, quantitative method for predicting which camp each country will end up in, i.e., the US bloc, a US-leaning bloc, a neutral bloc, a China-leaning bloc, and a China bloc. Leading countries in the China bloc — such as China itself, Russia, and Iran — are adversarial to the US and its allies. They have therefore been trying to cut their use of the USD for trade and investment, especially after the US seized Russian and Iranian foreign exchange reserves in recent years over foreign policy disputes. China has also actively encouraged the development of a common, non-dollar currency for the broader "BRICS" group of developing countries.

- In theory, if these countries stop using the USD for trade and investment, the reduced demand for the greenback or for US assets would make the USD less valuable. China has already been selling off its holdings of US Treasury securities in favor of gold, driving up USD-denominated gold prices (and cutting the greenback's purchasing power versus the yellow metal).
- Nevertheless, it isn't clear how much USD usage would have to fall for the currency to weaken. While it's hard to find reliable data on how much the USD is used for all the different trade and investment flows around the world, one proxy is the share of the currency in global central banks' foreign reserves. As shown in Figure 7 (next page), the USD share of reserves has been gradually sliding for the entire century to date, mostly because of a modest rise in the share of reserves invested in the Chinese yuan and other developing

country currencies. And yet, despite its falling share of foreign reserves, the greenback remains in its long bull market.

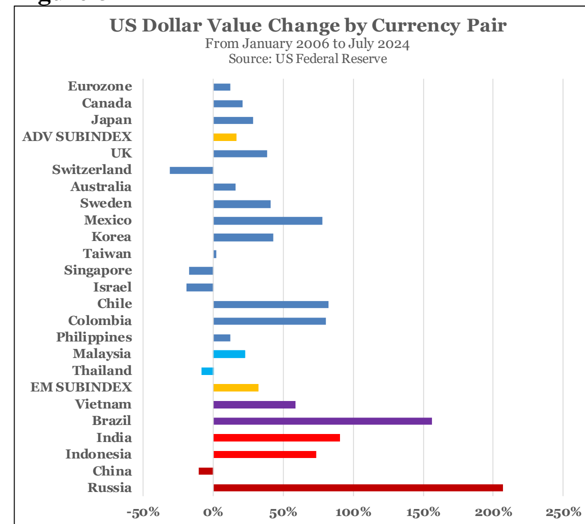
- Another thing that could prop up the USD going forward is simply the remaining economic and financial flows within the US bloc. The evolving US bloc is basically composed of today's rich, highly industrialized, technologically advanced, liberal democracies, such as Germany and Japan, and a few closely related emerging markets, such as South Korea and Mexico. As those countries continue to decouple from China and its bloc, they may channel even more trade and investment into the US, putting upward pressure on the USD versus their own currencies. The US may use free currency flows, including dollar swaps between the Fed and other central banks in the bloc, to cement those countries into the group. In any case, the USD is likely to retain its preeminent place in the US bloc, just as it does on a worldwide basis today.

Figure 7



- The USD has also shown that it can keep appreciating on a currency-by-currency basis even as the world fractures into blocs. In Figure 8, we show how much the USD has appreciated or depreciated against each country in the Fed's broad index since 2006. We color-code each currency pair to show which bloc the underlying country is in — dark blue for the US bloc, light blue for the US-leaning bloc, purple for the neutral bloc, red for the China-leaning bloc, and dark red for the China bloc. The chart shows that despite the dollar-dumping by adversarial countries in the China and China-leaning blocs, the dollar has appreciated the most against them.

Figure 8



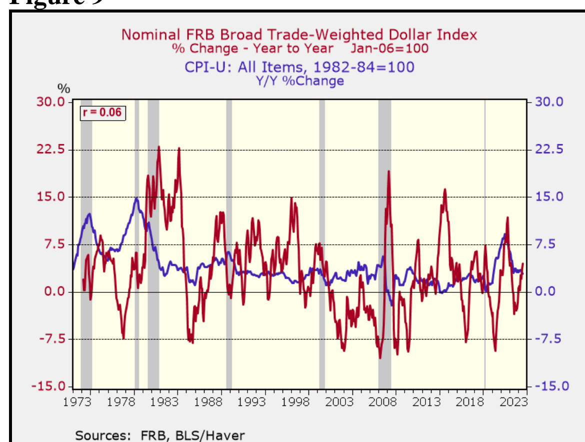
Prospects for the Dollar and Inflation

The analysis above suggests that US politics, a reversion to economic fundamentals, and geopolitical tensions could all fail to drive the USD lower and end its current bull market. Nevertheless, in case we're wrong and the greenback does start to drop, it might be useful to examine the likely economic impact in the US, especially in terms of consumer price inflation. To reiterate: When we're asked about the prospects for the greenback, we suspect it's usually out of concern for the purchasing power of the dollar. Sometimes, the question may stem from someone's upcoming trip overseas or an interest in buying a foreign property, but more

generally, we think the question is really about inflation.

If the dollar begins a long, broad depreciation, what impact would it have on US inflation? Would it drive up inflation by making foreign goods and services more expensive? Our analysis shows that, over long periods, domestic US inflation as measured by CPI is virtually uncorrelated with the strength of the dollar. In terms of changes on a year-over-year basis, the USD index is much more volatile than the CPI, as shown in Figure 9.

Figure 9



The apparent lack of any impact on US inflation probably reflects the fact that international trade makes up a relatively small part of the overall US economy. For many other countries that are smaller or more exposed to trade, currency changes can have a much more dramatic and immediate impact on inflation. Going forward, we still think US inflation and interest rates will be higher (and more volatile) than they were before the coronavirus pandemic, but we think that will be primarily due to the structural economic implications of global fracturing rather than a weakening greenback.

Investment Implications

In sum, the USD remains in a long, strong bull market as of this writing, at least in terms of the broad currency indexes. One USD today can purchase a historically large amount of most other currencies, although it remains unusually weak against the Swiss franc. Several developments could potentially start to put downward pressure on the greenback in the coming years, including a possible government effort to deliberately push down the currency, a reversion to historical relationships with other economic indicators, and reduced use of the currency by countries in the China-led geopolitical bloc. Still, it isn't clear when or if those factors could start to undermine the US currency. For now, the US's economic outperformance and attractive investment opportunities versus other countries seem likely to keep buoying the USD.

When and if the USD does start to decline in a meaningful way, the most dramatic effect would likely be for ***foreign equities***. For US investors, the return on foreign stocks has typically been best when the USD is weak and/or weakening. Throughout the current dollar bull market, foreign stocks have delivered much weaker returns than US stocks, but that could change in a new dollar bear market. Separately, a weakening greenback that reflects reduced foreign buying of US bonds could boost bond yields, leading to still more downward pressure on ***fixed income***. In contrast, a weaker dollar could boost prices for key ***commodities*** priced in USD. One key opportunity would likely be in gold and other precious metals, which, as noted above, are already benefiting from increased purchasing by the world's central banks.

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