IMPERIUM CAPITAL

momentum

Will the strong dollar continue to spook markets?

Global Matters Weekly

31 October 2022

– Robert White, *CFA — Portfolio Manager*

We are living in a dollar-dominated world, a fact most famously captured by John Connally, President Nixon's Treasury Secretary, who once told a group of global finance ministers "the dollar is our currency, but it's your problem". Students of economic history will be aware of the disruption that a strong US dollar can cause, however, at times such as this it is important to remember that the global economy is cyclical, and such periods eventually do pass.

To appreciate this fact, cast your mind back to the early 1980s. The Federal Reserve was sharply increasing interest rates to combat high inflation, which triggered a prolonged dollar rally. The dollar's rise came despite the US government running a large deficit, and the strength relative to its major trading partners caused prolonged pain for exporters. Furthermore, all this was going on at a time of geopolitical uncertainty as tensions between the US and Russia were escalating, culminating in Reagan's infamous "evil empire" speech. During this time, the US dollar index ultimately reached a peak of 164 in 1985, much higher than the current level of 110.

The parallels between the early 1980s and today should hopefully be obvious to readers, as Putin's war continues in Ukraine, and we are living through the most hawkish Fed Reserve policy since the Volker era. Given this similarity, many speculators believe that the dollar can still go much higher from here, and many hedge funds are heavily leveraged in long dollar contracts.

As the dollar is the global reserve currency, such periods of strength create a liquidity squeeze across the entire economy, which can then generate inflation in countries that import goods priced in dollars. An example of the supremacy of the US dollar can be seen from the fact that 60% of global reserves are held in dollars[1], with countries such as Japan and China being big buyers of US financial assets in recent years.

The other negative impact of a stronger dollar is on US exporters who find it more difficult to sell their products to international buyers. This has a restrictive impact on growth, but also creates political tensions as domestic industries come under pressure, and corporates are incentivised to offshore production to cheaper overseas markets. If we go back in time to the 1980s, these issues were of paramount importance. After political pressure and lobbying from large industrial companies in Congress, finance ministers met in the Plaza Hotel in New York to agree on the famous "Plaza Accord" whereby global central banks agreed to act in concert to weaken the dollar.

At times such as this it is important to remember that the global economy is cyclical

The effect on the US dollar index was dramatic; from a peak of 164, the index fell to 85 by the end of 1987. This sharp move was driven by a mix of fundamental weakness, an abrupt change in central bank policy, interest rates falling sharply from their highs, and the technical buying power of speculators who were betting on a weaker dollar.

Are there grounds for a "Plaza Accord" moment today? At first glance, the current political environment seems the biggest obstacle to this. The 1985 agreement was a triumph in international relations between some of the most powerful finance ministers in the world from the US, Japan, Germany, France, and the UK. That level of coordination seems more difficult to achieve today as world powers have become more inward-looking. There is also the complication of China's importance on the world stage today, and the backdrop of geopolitical tensions over Taiwan.

On the other hand, we have already seen Japan and China take action in recent weeks to strengthen their currencies; the Bank of Japan has been directly buying yen in the foreign exchange markets, while the People's Bank of China has been issuing statements warning of pain to come for speculators shorting renminbi. In a more recent example, in 2016 the US and China came to an informal agreement to keep the yuan from depreciating after the shock of the devaluation in 2015.

It is always difficult to predict currency movements over the short term, but many factors are aligning which suggests that the recent bout of dollar strength may eventually run out of steam. Much still depends on the level of inflation and the pace of interest rate rises in the US, however, we believe that we are near the peak, and we expect that the biggest portion of interest rate rises are behind us in the current cycle. If the dollar rally unwinds to the same extent as it did after 1985, it could well spark a sharp relief rally across global markets.

Sources: [1]International Monetary Fund

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The Marketplace

- Global equities returned 4% last week
- Developed markets saw positive returns whilst emerging markets were a mixed picture with China notably seeing a large decline
- Brent crude oil rose 2.4% last week to $95.7 a barrel
- Gold fell 0.8% last week to $1644.9 per ounce

Market Focus

US

- US equities returned 4% last week despite large declines in mega-cap tech stocks. Energy and industrials outperformed
- Q3 Gross Domestic Product in the US was 2.6%, above the 2.4% consensus estimate and a strong rebound from -0.6% in Q2. This was the first positive reading this year
- Manufacturing activity fell into contraction territory for the first time since June 2020

UK

- UK equities returned 1.1% last week
- The government is considering a raft of options including windfall taxes on banks and energy firms to plug a £35 billion budget shortfall
- UK car production fell 6.0% in September

Europe

- European equities retuned 3.6% last week
- The European Central Bank increased interest rates by 0.75%, but signalled a more dovish tone than expected for future increases which boosted investor sentiment
- Business activity in the eurozone contracted for a fourth consecutive month in October, indicating that the economy is likely entering a recession

Asia/Rest of The World

- Global emerging market equities fell 2.2% last week
- Japanese equities returned 0.9% last week
- Chinese equities fell 9% driven mainly by new Covid-19 related lockdowns
- The Bank of Japan stood by its ultra-low interest rates, pushing back against lingering market speculation that it will adjust policy as it continues to predict inflation will fall below 2% next year
- Russian President Vladimir Putin hit out at the US and Europe over his invasion of Ukraine. He praised Saudi Arabia and reiterated support for China's claim to Taiwan as he sought to cast Russia as a champion of conservative values against Western liberalism in a speech last week

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Asset Class/Region	Currency	Currency returns			
		Week ending 28 Oct. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	4.0%	8.9%	-17.4%	-14.2%
United Kingdom	GBP	1.1%	2.2%	0.8%	3.4%
Continental Europe	EUR	3.6%	6.3%	-15.7%	-13.3%
Japan	JPY	0.9%	3.4%	-2.3%	-2.5%
Asia Pacific (ex Japan)	USD	-1.6%	-4.4%	-29.7%	-32.0%
Australia	AUD	1.6%	4.8%	-5.2%	-4.5%
Global	USD	4.0%	7.7%	-19.7%	-18.2%
Emerging markets equities					
Emerging Europe	USD	3.4%	14.5%	-77.0%	-79.8%
Emerging Asia	USD	-2.5%	-6.0%	-33.1%	-35.1%
Emerging Latin America	USD	-3.4%	7.5%	10.7%	11.7%
BRICs	USD	-5.6%	-8.2%	-33.5%	-38.3%
China	USD	-9.0%	-15.6%	-42.0%	-47.6%
MENA countries	USD	-1.5%	1.9%	-0.5%	-2.2%
South Africa	USD	2.9%	4.3%	-15.3%	-16.6%
India	USD	1.6%	3.0%	-6.1%	-8.3%
Global emerging markets	USD	-2.2%	-3.4%	-29.6%	-31.8%
Bonds					
US Treasuries	USD	1.1%	-1.1%	-13.6%	-13.5%
US Treasuries (inflation protected)	USD	1.2%	1.4%	-13.2%	-12.2%
US Corporate (investment grade)	USD	2.0%	-0.8%	-19.3%	-19.3%
US High Yield	USD	2.4%	3.0%	-12.2%	-11.4%
UK Gilts	GBP	5.4%	4.1%	-22.8%	-23.0%
UK Corporate (investment grade)	GBP	4.5%	4.9%	-20.8%	-21.2%
Euro Government Bonds	EUR	3.0%	0.9%	-15.9%	-16.3%
Euro Corporate (investment grade)	EUR	1.6%	0.2%	-14.4%	-14.6%
Euro High Yield	EUR	1.9%	1.3%	-13.5%	-13.3%
Japanese Government	JPY	0.9%	-0.3%	-4.1%	-4.0%
Australian Government	AUD	2.9%	1.4%	-9.6%	-8.5%
Global Government Bonds	USD	2.7%	0.0%	-20.3%	-21.2%
Global Bonds	USD	2.7%	0.2%	-20.3%	-21.3%
Global Convertible Bonds	USD	2.1%	2.4%	-22.3%	-25.6%
Emerging Market Bonds	USD	4.2%	1.0%	-30.0%	-30.4%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 28 Oct. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	6.2%	5.1%	-25.2%	-20.3%
Australian Property Securities	AUD	6.8%	8.1%	-25.1%	-20.9%
Asia Property Securities	USD	-2.2%	-6.3%	-21.7%	-26.0%
Global Property Securities	USD	4.6%	2.4%	-27.0%	-25.2%
Currencies					
Euro	USD	1.0%	1.5%	-12.7%	-14.9%
UK Pound Sterling	USD	2.9%	4.1%	-14.4%	-16.0%
Japanese Yen	USD	-0.3%	-2.0%	-22.1%	-23.2%
Australian Dollar	USD	0.7%	-0.4%	-12.0%	-15.1%
South African Rand	USD	-0.2%	-0.5%	-12.3%	-16.8%
Swiss Franc	USD	0.3%	-1.3%	-8.6%	-8.5%
Chinese Yuan	USD	-0.3%	-1.9%	-12.4%	-11.9%
Commodities & Alternatives					
Commodities	USD	0.5%	2.6%	17.5%	15.0%
Agricultural Commodities	USD	-2.4%	-2.0%	4.6%	9.0%
Oil	USD	2.4%	8.9%	23.1%	13.6%
Gold	USD	-0.8%	-0.9%	-10.1%	-8.7%
Hedge funds	USD	-0.1%	-0.1%	-4.7%	-5.5%

Source: Bloomberg. Past performance is not indicative of future returns

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