CIO Memo

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USD driven by risk sentiment

Key take aways

- The U.S. Dollar Index (DXY) has been on a sustained downwards path since late March 2020, with multiple factors important drivers in recent weeks and months.
- USD weakness has continued in recent days, with the DXY now down approximately 6% YTD.
- With fiscal policy stand-offs on both sides of the Atlantic, we could now see increased EUR/USD volatility, with USD gains possible in early 2021.

1. What happened?

After appreciating strongly for most of the first quarter of this year, the U.S. Dollar Index (DXY) has continued on a sustained downward trek, negating previous gains and leaving the DXY about 6% down on its level at the start of the year. USD weakness can be attributed to a host of factors that have now put the greenback out of favour.

The following factors have been particularly important in recent weeks and months:

Firstly, positive news on vaccine development has led to sharp gains in risk appetite across asset classes. In FX, we have seen investors ditch currencies seen as "defensive" (like the USD) for more cyclical alternatives that should stand to gain the most from the economic reopening trade.

Furthermore, this structural headwind for the USD has come at a time when forecasters and markets are anticipating that growth and interest rate differentials between the major economies are likely to narrow in the future. For example, the October outlook of the International Monetary Fund (IMF) forecast annual U.S. and Eurozone economic growth rates to slow to 1.8% and 1.4% over the next five years, respectively i.e. a differential of just 0.4%. This marks a significant convergence in growth rates from those previously expected. Just a few years back, it was common to forecast a 1% or more differential in growth rates.

Lastly, the collapse in the two-year U.S. Treasury yields has left USD carry traders looking for alternatives in the wake of a more tolerant Federal Reserve.

2. How did markets react?

After rising over 6% early in 2020, the USD Index (DXY) has fallen almost 12% since its March peak, marking its first correction since the second quarter of 2017. The index is down approximately 3% since the November 3 U.S. elections, and is currently down 6% year to date.

3. What does it mean for investors?

This year risk sentiment has been a significant driver of currency markets. The safe haven role of the USD along with the Japanese Yen (JPY) and the Swiss Franc (CHF) has been statistically significant in the last three months in particular. U.S. equity markets have recently hit new highs, with markets gaining confidence thanks to the vaccine news and ongoing expansionary path of global central banks, along with ongoing fiscal stimulus. With regards to monetary and fiscal policy, this week may see several important developments. The ECB meets on Thursday and may voice again its concerns about the EUR exchange rate, which they did (in a very rare move) in a statement earlier this year. The ECB is expected to demonstrate its "easing bias" and state a clear intention to guarantee supportive financial conditions, e.g. by increasing its pandemic emergency purchases programme (PEPP) by roughly EUR500bn to EUR1,850bn and extending it at least until the end of 2021. Furthermore a new round of targeted long-term refinancing operations (TLTROs) is expected with also very favourable conditions, even for operations in the longer term – but a cut in the deposit rate is unlikely. As regards fiscal policy, despite continuing negotiations there are standoffs on new stimulus packages on both sides of the Atlantic. There is no agreement on a fiscal package in the U.S. yet, although we may get firmed-up proposals this week, and uncertainty remains on the administration's ability to pass policy, at least until the Senate runoff elections in Georgia in early January. In Europe, the Recovery Fund is still blocked by Poland and Hungary and Brexit negotiations also add uncertainty. A European Council meeting on Thursday and Friday could be crucial here.

Investment implications: We could now see higher EUR/USD volatility until the end of the year, as markets evaluate fiscal stand-offs on both sides of the Atlantic. By early next year, a new U.S. president and Congress will offer more clarity and contrast with continued political uncertainty in Europe (with the Netherlands and Germany also facing elections in 2021) which could support USD. Our December 2021 EUR/USD target is 1.15.

Glossary

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

CHF is the currency code for the Swiss franc.

Congress is the bicameral federal legislature of the United States.

EUR is the currency code for the euro, the currency of the Eurozone.

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Council includes EU members' government leaders, the European Council President and the President of the European Commission. It defines the EU's overall political direction.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The International Monetary Fund (IMF) was founded in 1994, includes 189 countries and works to promote international monetary cooperation, exchange rate stability and economic development more broadly.

JPY is the currency code for the Japanese yen, the Japanese currency.

The ECB's pandemic emergency purchase programme (PEPP) is a temporary asset purchase programmeof private and public sector securities in order to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by COVID-19 outbreak.

Targeted long-term refinancing operations (TLTROs) are used by the ECB to provide financing to Eurozone banks.

Treasuries are bonds issued by the U.S. government.

The U.S. Dollar Index (DXY) is a weighted index based on the value of the U.S. dollar versus a basket of six other currencies.

USD is the currency code for the U.S. Dollar.

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