Audio Transcript: U.S. Dollar Growth Drivers Set to Reverse
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Katie Klingensmith [00:00:00] Welcome, everybody, to today's conversation with Anujeet Sareen as part of our ongoing Around the Curve Brandywine Global content. I'm Katie Klingensmith with Brandywine Global. Anujeet is a portfolio manager here on our global fixed income team and has a tremendous experience in currency markets, which is good because today we will focus along with a lot of other people on the current situation with the U.S. dollar and what we think might happen with the greenback going forward. So Anujeet, just to get us started, we all love to hate the U.S. dollar. We have massive fiscal deficits, a big accumulated debt, a trade imbalance. And yet the dollar has had a really strong period over really the last ten years. Just set some context here. What's going on with the U.S. dollar?

Anujeet Sareen [00:00:50] Sure. Sure, Katie. I think those issues around the fiscal deficit and trade deficit I think are often a distraction from what are the more important underlying drivers of the currency. The dollar long term is primarily a function of relative growth trends. And we've had an experience over the last ten years that's been particularly constructive for the U.S. versus the rest of the world. On the U.S. side, there have been two drivers that contribute toward this sense of U.S. exceptionalism. The first and the most prominent one is its leadership in technology. Alright, the demand for technology has been robust for the last decade. If you think about what are the major global companies that provide those technology products, well they're predominantly denominated in the United States. So, I think that's been a very strong underpinning of the U.S. growth outperformance story. The second piece has been the renaissance on the energy side. The rise of shale gas and oil has led to a remarkable turnaround in the U.S. energy balance. A decade ago, or maybe it's as early as sort of 2008, the U.S. was running an energy deficit on the order of 1% of GDP. Today, it's in slight surplus. That's a pretty big change. So, that's true on the U.S. side. And it's worth keeping in mind, again, despite the trade and fiscal deficits on the other side, you've had all kinds of headwinds. Europe has struggled with the sovereign, its sovereign crisis, right, for much of the last decade. If you think about what was trend growth in Europe in the late 2000s, it was well north of 2% over the ten years since. Right. It's been less than 1%. I mean, that's a 50% reduction from the trend growth rate. And China, by the way, has seen something similar, right. Growth rates have gone from the high single digits or low double digits to something quite a bit lower. So that shift in relative growth has been the primary driver of dollar strength.

Katie Klingensmith [00:02:58] Anujeet you mentioned relative growth is a big driver for currencies. How synchronized are the big economies right now?

Anujeet Sareen [00:03:07] I think the perspective on this is that the COVID shock created a lot of synchronization. Everything collapsed together. Big policy responses. Everything surged together. So the cycles have been pretty synchronized. And then, of course, following the synchronization of the cycle was a synchronization of policies, right. Policies really have tightened across the board this past year and a half. So it's been more of a synchronized story than desynchronized. But that started to change last year, right. Again, that started with the Russia-Ukraine war having this particular shock to Europe, the COVID property issues in China having a particular impact there. We started to see, I think, a shift there. And I think that's going to continue this year. Right? It's going to continue the other, where the energy stories get better in Europe, and in China the growth story will get better with the COVID restrictions easing. And meanwhile, the U.S., the U.S. has tightened policy the most. They started earlier than most. And I think that the lagged consequences of that will be felt for the better part of 2023. Europe's going to have a different pattern this year.

Most of its slowing last year was because of a real income shock related to energy prices. That's going to be better certainly in the first half of this year. So I think the cycles have become a little bit more desynchronized. I think that's going to lead to some desynchronization in monetary policies as well. Which is why you've already started to see some interest rate convergence. The difference in yield between the United States and European bond markets is much narrower today than it was six months ago. If you look at the difference in the two-year yield spread, it was north of 200 basis points back in the fall. That spread has narrowed closer to 100 basis points at this stage, and I think quite possibly is going to zero at some point later this year. So, I think we are entering a more desynchronized period. And I think that's where these relative stories do take center stage.

Katie Klingensmith [00:05:07] There's a lot in there Anujeet that I look forward to unpacking. But just a little historical context first. Relative growth, and maybe different drivers during different periods of time, but how does this period of dollar strength stack up to what's happened over the last several decades?

Anujeet Sareen [00:05:21] Sure. It's a good question. You know, we've had three dollar bull markets since the U.S. went off the gold standard in 1974. There was the bull market in the early 1980s. We had another bull market in the late 1990s. And this most recent bull market, which started in 2011. The other two bull markets were shorter in nature. They lasted about six to seven years. This one's been longer. It's been, you know, 11 years in its making. So, in time it's been a much longer bull market, but in magnitude it's actually quite comparable. The 1980s bull market, the U.S. dollar in broad real effective terms, so its average performance against its trading partners, was up around 45%. The nineties bull market was less than that. It was closer to 33%. This bull market's been around about 43% trough to peak. So, duration-wise, somewhat longer, but magnitude-wise, quite comparable.

Katie Klingensmith [00:06:25] The dollar the last couple of years until recently just saw a tremendous surge already from overvalued levels. What's been happening more recently in the U.S.?

Anujeet Sareen [00:06:35] Yeah. So, there's issues on both sides, right? On the U.S. side, you had a much larger fiscal and monetary response to the COVID shock, right? I'd say even more so than monetary. The fiscal response was just massive. And so, it's led to this bust/boom cycle in the U.S. Where core inflation surged, and that led to a very aggressive Federal Reserve response. So, you've had this amplified cycle because of the fiscal policies of two years ago that are somewhat unique to the U.S. Right. We didn't see a similar response or at least to the magnitude in most other parts of the world. So that's one contributor. The other is COVID accelerated the technology story, right? I mean, as we were all working from home or remotely or in all contexts of our society, not just business, that led to an increased or an acceleration in demand for technology products. Both of these really served, again, the U.S. well and hence supported the dollar. On the other side, you've had two specific shocks, notably in the past year, that have undermined growth elsewhere. The energy shock in Europe related to the Russia-Ukraine war. That's been a significant adjustment for the European economies. And in China's case it's been mostly self-inflicted through overly conservative COVID policies and very restrictive property sector policies. I think those, again, those in combination have led to this surge in the dollar until the fall of last year.

Katie Klingensmith [00:08:09] And what shifted in the fall of last year?

Anujeet Sareen [00:08:13] I think a couple of things have shifted. I think one on the U.S. side, I'd say it's been more that the inflation surge in the U.S. has been peaking, right. Has been decelerating. Sequential inflation in the U.S. is slowing quite markedly. And I think there's a sense that the Fed is close to peak rates in the U.S., whereas there was a lot of angst last year that the Fed could be hiking quite a bit more. So, I think that's been one source of a relief, rather, and this I think led to some dollar weakness in the U.S. side. Accompanied with that has been the tentative signs of weakness in the technology sector. And if you think about where have the profit warnings come from, where are the layoff signals coming from, it's specifically from that sector. I'm not saying it's large enough yet to be alarming, but it is worth noting. Meanwhile, in Europe, the energy story is quite a bit better. Some of that's been luck. You've had a warmer winter, and that's reduced the need for, you know, energy supplies. But it matters because it allows Europe, it buys them time to develop longer-term solutions or alternatives to Russian sources. And China, of course, has done a full 180 on COVID policies. Right. So now you're seeing quite a bit of an acceleration in Chinese growth as well.

Katie Klingensmith [00:09:36] And just any additional comments forward looking about Europe and China? Clearly there's many currencies we could talk about relative to the US dollar, but those seem like the big areas of interest.

Anujeet Sareen [00:09:46] Yeah, I think Europe's really the most significant change here, and I don't think there's a consensus view on this at the moment. But I would really underline that the primary headwind to Europe, which was this sovereign crisis--and it lasted a long time, I mean, it took really just about a decade for Europe to make the necessary adjustments--it's done. It's happened. Yes, you can always point to certain things that are not quite there yet. I mean, the main objection would be that Europe never had a full fiscal union while it did have a monetary union. And that's a disconnect that's been a negative for the region. But they've taken all kinds of steps to address that. Some of that's through the central bank, which is facilitating a certain type of fiscal union. You've seen a series of policies, you know, from the euro area really thinking about the region as a whole now, not just at the individual country level. And if you look at some of the adjustments at intra-country, they're quite significant. I mean, in the 2000s, you had seen a very significant acceleration in wages in Spain, France, Italy vis-a-vis Germany. So, they'd become far less competitive. That has largely reversed at this stage. Italy. Italy was a big borrower from the rest of the world a decade ago. They ran a very large net investment deficit. They're now running a net investment surplus. So, you've seen it over the course of time, some significant adjustments that puts Europe in a much better place. And perhaps one of the most, I think, notable ways one can see this in the data today is the strength of their labor market. The unemployment rate is at record lows. Now, admittedly, it's low in the U.S. as well. But in Europe, the labor force participation rate is at record highs. Which you can't say in the U.S. So, you have a very broad-based, you know, strong labor market in Europe, I think, supporting the economy.

Katie Klingensmith [00:11:43] Interesting. And China, obviously a very different story. Doesn't feel like very long ago that there were a lot of conversations about when the Chinese economy would overtake the U.S. economy, how to measure that, would the Chinese renminbi become the reserve currency of choice? How do you think about that conversation having shifted over the last couple of years?

Anujeet Sareen [00:12:03] Yeah, So China is a little bit more of a complicated story. I think it's more at the moment a cyclical story than a structural story. Xi Jinping for the last several years has been focused on consolidating his power, has been focused on issues that are not about maximizing growth, right. It's been about reducing financial risks, dealing with geopolitical issues, becoming more self-sufficient, addressing excesses in the property sector, distributional issues within the populace, those sorts of things. And I don't think those concerns have gone away. I think they're still, you know, still something he's focused on. But at least cyclically, it looks like their emphasis on growth has changed. I think that's going to offer some support to the Chinese activity. I think the more structural change is in Europe, and I think quite possibly in one of China's, I think, growing competitors, its neighboring country India.

Katie Klingensmith [00:13:03] One comment you made about U.S. oil exports being transformative has me thinking about commodities and currency markets in general. We've spent a lot of time with the Ukraine conflict talking about supply. How does supply and demand of commodities impact currencies right now?

Anujeet Sareen [00:13:21] I think this is a really critical question to consider. Most of the commentary, as you suggest, has around commodities is driven by supply concerns. Right. That there's been disinvestment or lack of investment in the commodity sectors for quite a few years at this point. And because of that lack of supply, there's upward price pressure. Some of that has been amplified by concerns about climate change, right, that's discouraging investments in fossil fuels at a time when we still don't have quite enough of alternative energy sources to fill the gap. So, it's been mostly a supply-side concern, again, amplified by the Russia-Ukraine situation. I think the interesting story going forward might be, though, that there is another demand source. And this is still early days yet, but I think there are finally some signs that India has taken some very significant steps in improving its infrastructure, increasing public investment spending to allow for India to become more of a manufacturing hub, not just a service hub for the global economy. Again, I say this is early. I don't think there's a definitive answer here, but for the first time we have a viable option other than China in what might drive commodity demand.

Katie Klingensmith [00:14:50] It seems like we've talked about a lot of headwinds for the U.S. dollar. Are there acute risks or triggers in the near term that could really cause some further depreciation of the greenback?

Anujeet Sareen [00:15:05] Well, Katie, before I go there, I do want to address one additional point about the forward-looking view on the dollar. And that is that of the different growth drivers of the dollar, I think we've touched on most of them, but one in particular on the technology side, I do want to underline, I think that one is likely reversing. I think we're at a stage here where technology investment has overshot longer-term trends. I think there's some overinvestment and overconsumption of technology that's occurred. And I think that we're on the cusp of that reversing here. And there's some evidence that this is beginning to show up in the data. So, if you look at business surveys in the United States and compare them to business surveys elsewhere, you've seen a reversal the likes of which we have not experienced really since the 2000s, and during that dollar bear market phase. To your point, though, are there nearer-term factors that could sustain dollar strength? I think there are. I mean, I think this view that I'm expressing is a multi-year view on the dollar, that it will decline over the next few years. But over 2023, there are some crosscurrents worth noting. The Federal Reserve has rates closing in on 5%. That's very high in absolute and relative terms. You still get a lot more yield to park your money in the United States than you do in most other developed countries. And the Fed has not indicated its intention to reverse that policy anytime soon. So, I think that could still support the dollar. And by the way, that's concurrent with the Fed's quantitative tightening policies, right. They are withdrawing dollar supply from the market. So, I think that is still somewhat of a tailwind for the dollar cyclically. We also haven't fully resolved the debate whether this is going to be a soft or hard landing. To the extent that the Fed overstayed its welcome at these high rates, and we head into a hard landing, one can imagine a world in the second half, in particular, where there is a flight to safety that again, supports some further dollar strength. So, I think it's possible that we spend the better part of this year with the dollar in some type of a topping pattern before a more sustained decline unfolds over the next over the next several years. But I don't want this to distract, though, really from the more, I think, fundamental and enduring point here, which is that the factors that drove the dollar up over the last decade are reversing, and we're much more likely to see a multi-year dollar decline from here.

Katie Klingensmith [00:17:42] Thank you very much, Anujeet Sareen, for sharing your views on the U.S. dollar and its path forward as part of today's Brandywine Global conversation Around the Curve.

Anujeet Sareen [00:17:51] Thanks, Katie.