**Audio Transcript: The U.S. Dollar Defies Gravity**
**August 25, 2022**

**Katie Klingensmith** [00:00:02] Welcome Anujeet Sareen. It's a pleasure to have you here as part of this edition of Around the Curve at Brandywine Global. I'm Katie Klingensmith with Brandywine Global, and it's really a pleasure to be here today with Anujeet who has a long history of being focused on global macro research and currency research. He's currently a portfolio manager in the fixed income group here at Brandywine Global. So Anujeet, there's been really a lot of discussion over the last couple of years, certainly over the last year, about how extraordinarily high the value of the U.S. dollar has become. We can look at that value in a lot of different ways. I know looking at the broad trade-weighted measure that the Fed tracks, we're really seeing the dollar at close to some historic highs. Just to get us started, what has been driving the dollar so high? Why are we finding it at the values where it is right now?

**Anujeet Sareen** [00:00:56] Thanks, Kate. The dollar story, which you rightly point out has been underway for quite some time. I think the dollar rally began back in 2010, I believe. So, we're in the 12th year of a bull market in the dollar, which is the longest bull market we've seen in the last 50 years. The driver of that story really boils down to relative growth. It's been about U.S. exceptionalism, the technology leadership that the United States offers. And related to that, a certain manufacturing renaissance as well. The prior decade when the dollar was weak was largely about the U.S. adjusting to the entry of China into the WTO, and there was a significant loss of manufacturing share in the United States. That has reversed in part over the last decade. But again, I would really boil it down to growth leadership coming from the technology sector. At the same time, if you think about what's happening in the rest of the world, the two major areas of the world have had to deal with their own challenges. So, Europe had its sovereign and banking crisis during that period, and China and emerging markets had to deal with the slowdown in Chinese housing and the loss of competitiveness among EM countries.

**Katie Klingensmith** [00:02:16] Yes, of course, currencies are always relative, so U.S. productivity relative to other countries. Well, we started this conversation, Anujeet, at the beginning of the year, and there was clearly a major shift in the geopolitical power balance in the world. Russia invaded Ukraine and that had some pretty clear consequences for the dollar. How much of the events in Europe have really been driving the value of the dollar?

**Anujeet Sareen** [00:02:41] Yeah, I mean, it's certainly been an important factor, but I wouldn't say it's been an exclusive factor. So, I think it's worth noting that the U.S. two-year yield - Treasury yield in the United States - has risen nearly 300 basis points. Fed hawkishness, the Fed's willingness to raise rates quite aggressively, has certainly played an important role in the dollar's performance this year. I'd also add that the slowing of global growth right after some very strong growth rates, I think there's more of a concern that growth is slowing, and central banks are still tightening in the context of that slowdown. That's been cause for concern among risk assets and hence a flight to safety. And then also, certainly again, it's the relative shock story again. Europe dealing with Russia and Ukraine. China dealing with its property markets and COVID. I think those relative stories, and the U.S. not really having anything specific within the continent to deal with.

**Katie Klingensmith** [00:03:40] So tell me a little bit more about the implications of that kind of relative shock approach. How much is the dollar gained because there was a real flight from risk across financial markets?

**Anujeet Sareen** [00:03:54] I think it's been meaningful. I mean, it's still today, right? It's not entirely clear how the Russia-Ukraine story ultimately resolves. Germany and the rest of Europe are having to still figure out how they're going to get through next winter with the energy needs that they have. So, there's still uncertainty about it. It's not like the war happened, and we've moved on. There are underlying uncertainties and that tends to support the dollar. I think in China there's a similar dynamic at play. The property markets have been struggling for quite some time, and it's not entirely clear when China, or if China, will move in a manner to help support growth in that sector, along with their COVID policies. Their zero-COVID policies are also quite dramatic or draconian, if you will, compared to the rest of the world. And it's unclear when that might change as well.

**Katie Klingensmith** [00:04:48] I want to come back to that kind of question about the dollar's role as the reserve currency. But I think first back to the more basic question. You mentioned the Fed and markets' expectations around rates. I think typically we think about those relative rates across different countries as being a big driver for short-term FX. Is that at the end of the day what we're talking about mostly here in terms of the dollar's strength relative to the euro and the other majors?

**Anujeet Sareen** [00:05:12] I'd say it's been a significant factor, no doubt. I think going forward, that might change. I mean, the markets have been concerned, and what has supported the dollar has been both the Fed raising interest rates but also a concern that the Fed might drive the U.S. into a hard landing. That they might overstay their welcome or overtighten if you will. And that certainly would be a concern and the flight to quality that would support the dollar. To the extent that the Federal Reserve does back off soon, and the world experiences more of a soft landing, then I think the market's attention – investors' attention - will shift more to other factors, not just interest rate differentials. Growth opportunities, current account and balance of payments positions, other factors that I think will play a more prominent role.

**Katie Klingensmith** [00:06:06] But you do think that if there's that bumpier landing or a true hard landing, if it's the Fed's fault or otherwise, that could be dollar positive?

**Anujeet Sareen** [00:06:13] Yes. Yes.

**Katie Klingensmith** [00:06:16] Interesting. Absolutely. So, we certainly have a world where real and nominal rates are more different than they were, and there's been high inflation in the U.S. and elsewhere. And the dollar has clearly been gaining in this environment. How much does inflation really drive currency right now?

**Anujeet Sareen** [00:06:32] So I think this is a really interesting question because at face value, you could certainly argue that while the Fed has been more aggressive in raising interest rates than, say, perhaps Europe or other developed markets, the U.S. also has higher inflation than other countries. So, from a real interest rate perspective, it's not entirely obvious that the state of the policy is dollar bullish. Right? And as you know, the dollar has still performed in that environment. I think the reason for that is that real interest rates are at the moment very backward-looking. It has certainly been the case that inflation has been much higher in the United States, and so real interest rates on a trailing basis look quite low. But I would suggest that the state of monetary policy is much more restrictive than that would suggest. You can certainly see this in the very significant slowdown in growth rates of money supply, whether you use narrow money measures or broader money measures, or just look at the overall level of bank deposit growth, it's collapsed this year. And the Federal Reserve, of course, has also started quantitative tightening and is going to accelerate that process. So, from a pure dollar liquidity perspective, I think policy has been tighter than what inflation and real interest rates would have suggested.

**Katie Klingensmith** [00:07:54] So you mentioned before that the dollar has gained and could continue to gain on the back of geopolitical uncertainty or more of an economic shock for, you know, a hard landing. But I've also heard you and the fixed income team talk about the danger to the dollar of weaponizing it. Of really withholding access to reserves by countries that don't behave in the way that we're comfortable with. How much is this weaponization of the U.S. dollar threatening the dollar's long-term reserve currency status?

**Anujeet Sareen** [00:08:26] That's a great question. And I would start by saying I think that narrative has merit. I mean, there's no doubt, I think, that other countries are paying attention to how Russia was treated in this context. And this is not to pass judgment on who's right or who's wrong. It's simply to observe that Russia's access to the financial system was completely cut off, led by the United States. And to the extent that the global financial system, the global payment system, is still based on the dollar, I think it's been a warning shot for other countries to think about. That if in the future - I'm really thinking about China here - there is a more serious decline in the bilateral relationship to the U.S., countries have to think about and anticipate that this could happen to them as well. So, what do you do? You have to think about how to pay for goods and services with other currencies. You have to think about keeping your assets, perhaps, in other currencies that you can still access, as opposed to Russia who has lost access to some of its reserves. So, I think it is a longer-term challenge for the dollar. I don't think it's been a particularly big driver of the dollar this year because of the other factors we've talked about have been so much more significant in driving capital flows. But longer term, yes, I think it's an issue.

**Katie Klingensmith** [00:09:53] Is it an issue for all developed market currencies or is it particularly about the dollar?

**Anujeet Sareen** [00:09:57] That's a fair question. I mean, the U.S. was able to galvanize quite a bit of the world in support of this effort. So, is the euro really a different currency than the dollar when it comes to this? I think that's a fair point. I would say it's particularly a dollar issue because that's where the payments are and that's what the reserves are, so you would diversify away. Even diversifying away to other developed currencies, I think is still in the interest of other countries to protect themselves in the event of something more serious.

**Katie Klingensmith** [00:10:29] Sure, that premium that the dollar has rather uniquely held. Well, you did mention at the beginning, we've mostly talked about the dollar relative to other developed markets, but emerging markets have their own story. How are you broadly understanding the dollar's strength against EM FX?

**Anujeet Sareen** [00:10:47] Part of it has just been, you know, as you say, a broad dollar trend that has impacted both developed and emerging markets. I think the interesting thing about emerging markets, though, notably in the last, call it, 6 to 9 months, is that there has been some differentiation. And that's because a number of emerging markets have been far more orthodox and much more preemptive in tightening monetary policy than the Fed has. So, you look at interest rates today in Brazil, Mexico, Chile, and a number of countries, they are high both in nominal and real terms versus the United States. So, I think that's altered the forward return potential for these currencies. I think also, if you look over the past 6 to 9 months, there's been a particularly strong source of support for currencies that are tied to commodities. And to the extent that we do have a more longer-term bull market in commodity prices because of a lack of supply and the shift to alternative energy, I think those currencies are also likely to benefit. So, I am constructive on emerging markets on a medium-term basis. I think what has to, however, still be selective of where to make that allocation.

**Katie Klingensmith** [00:12:07] Sure. Well, let's bring this all together. Anujeet, you mentioned at the beginning that a lot of the story driving dollar strength is really the relative productivity, the U.S. exceptionalism that has been demonstrated over the last decade. But there are a lot of different factors in play. If I were a dollar investor now and saw how strong the dollar was and thinking about diversifying. Should I do it now? Should I do it later? Should I think about select EM? Should I just think about diversification? What advice would you give me going forward?

**Anujeet Sareen** [00:12:39] Yeah, I think where you started this conversation, Katie, is a good place for investors to think about. Which at the level of the dollar today is at an extreme. We are near the highs of the dollar of the 2000 - 2002 period. Not quite at the highs of the 1980s cycle. But these are very elevated levels. And so, if one thinks out medium- to long-term, returns in markets outside the U.S., I think, will benefit from a currency tailwind. So, what would I do today? I would start to invest in some of these higher-yielding emerging market currencies that have pursued, as I said before, more orthodox policies in conjunction with better trade and balance of payments fundamentals. I would start there, but I would be thoughtful and careful about how much to allocate because we are still in the context of a slowing global economy and the Fed's still moving aggressively. And I think one needs to become a little bit more certain about the path of global growth, I think, to make a more aggressive allocation.

**Katie Klingensmith** [00:13:51] Fair. Thank you so much, Anujeet, and everybody who's listening to this edition of Around the Curve with Brandywine Global.