Audio Transcript: A Bull or Bear Outlook for the Dollar?
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Katie Klingensmith [00:00:01] Welcome, everybody to today's Around the Curve conversation at Brandywine Global. I'm Katie Klingensmith, and I am delighted to be joined by my colleague, Anujeet Sareen, who, among various important insights, will be talking about the US dollar. Anujeet is a member of our Global Fixed Income team and a portfolio manager on a number of the different strategies. His own career and expertise is very much aligned with today's conversation. He spent many years thinking about global currencies, and that's where we'll focus now. So, welcome Anujeet. We've spent a lot of time the last couple of years talking about rates, and certainly a lot of time recently focusing on the Fed. And the dollar has followed some of those conversations. But today I really just want to unpack what all is driving it, and if you think about some of the bull cases and the bear cases for the US dollar. But get us started. The dollar is mighty strong. Is this consistent with what you'd expect?

Anujeet Sareen [00:01:10] Sure. I mean, the dollar's, of course, been strengthening for quite some time, right? the dollar bull market started back in 2011. So, the dollar, at least the recent high that we've been able to observe, is back in 2022. So, for about 11 years the dollar's been advancing. And it's been advancing as all dollar bull markets, based on growth outperformance, right. Private sector growth outperformance is typically the driver of the dollar because that's what drives capital flows. If you see a strong growth case in a different country, that attracts capital from an equity perspective, from a foreign investment perspective. And I would say the majority of the dollar advance during that period was really about this story. Private sector growth outperformance in the United States. And we can talk about some of the sectors that drove that. But that's really fundamentally, I think, what's been the driver.

Katie Klingensmith [00:02:05] So, real growth. That makes a lot of sense. Given how much the dollar has gained over that more than the past decade, are there other factors that you would have us identify? Especially from a backward-looking perspective?

Anujeet Sareen [00:02:19] I do think relative growth is really central, and it is relative growth, mind you. Right? because the dollar, of course, is a relative price. And there are different ways that that manifests, right? I mean, when the US outperforms, it typically outperforms with a stronger equity market as well, right? It's reflecting that growth outperformance. It also tends to parallel higher interest rates in the United States. Right. The Fed is usually more hawkish than everywhere else when growth is stronger in the US. So, we've also seen that over that period. I'd say some of the more particulars of this dollar advance that we've had since 2011, certainly, technology leadership, right, has played has played a role, a different type of technology leadership than the 1990s. But nevertheless, technology leadership has played an important role. I think the energy story has been important as well. You know, the rise of shale gas and oil and the energy independence the US has been able to enjoy. That's certainly been an important aspect of it, as well. And meanwhile, there's been stories on the other side. For much of the 2010s, you had a European economy that was really languishing--with its sovereign crisis, its banking crisis--for a long time. China, of course, also rerated lower from its historical growth trajectory. And that had consequences then for commodity prices and other emerging market countries as well. So, you had a generally weaker growth profile in the rest of the world. And so, the contrast was quite strong. What I would note, by the way, is unlike the 1990s when US growth was exceptional, not just relative, but outright, growth was averaging near 4% for a good long period. This time around, US growth for much of that period was more like 2.5%, which is decent, but certainly nothing exceptional. It was the contrast, though, with the rest of the world that propelled the dollar higher.

Katie Klingensmith [00:04:24] And it's an interesting point. I mean, currency conversations are always going to be relative. I want to push a little bit on this concept of real. And you mentioned a number of different factors that have really been driving the real economy in the US, and potentially driving it more than those factors or other factors have been contributing to real growth elsewhere. Is the nominal also really important here? And how much of dollar strength, especially recently, has been more about a pure carry trade?

Anujeet Sareen [00:04:52] Okay, so when you say nominal growth I mean.

Katie Klingensmith [00:04:55] Or nominal rates.

Anujeet Sareen [00:04:57] You're right. Nominal rates. But nominal rates and real rates are connected here, too. I think, you know, if the markets really felt that trend inflation in the US was substantially higher than it is in other parts of the world, I don't think that necessarily would support dollar strength. That would be an erosion of the purchasing power. And so, I think the dollar would struggle with that. But I think instead, the market's taking the view that while US inflation might be modestly higher than other places, let's say Europe, for example, that US rates are still quite a bit higher, even given inflation differences. If you look at the, for example, the breakeven inflation rate that the bond market is discounting, it's 2.3%. I mean that's not particularly high. But the fed funds rate of course is north of 5%, which is quite a bit higher than some other places. So, you're right. I think nominal rates are playing a role here. But I think it's also true in real terms.

Katie Klingensmith [00:06:01] This has been mostly backward-looking. A lot of these factors seem to be exactly the ones that might drive the dollar up or down going forward. Just help us make the transition. What do you think is pivotal right now in terms of the dollar going forward?

Anujeet Sareen [00:06:14] Right. So, I do want to set the stage here a little bit in terms of, you know, we've talked about what's driven the dollar higher for most of that advance. But I think there is a distinction worth making here. And that is that the dollar advance in 2011 and 2019, in particular, corresponds to much of what we've just been discussing. That is to say, that was the period that was driven by true private sector dynamism in the United States. You know, it was paralleled by tremendous equity performance, by tremendous expansion of net household net worth in the United States. There are a number of factors that were very consistent with the strength that we saw in the dollar. What is different about the dollar's advance post-COVID is that it actually has a very different quality to it than what we saw previously. And that is to say, it's still the case the US economy outperform, but this time the US economy outperformed mostly because of tremendous fiscal policy support. It has sort of elements of what we saw a bit for the dollar in the early 1980s, when you had this easy fiscal/tight money dynamic. You had the Reagan tax cuts, and Paul Volcker had to tighten policy that much further, and that dual combination propelled the dollar higher. We've had a bit of that in the last three years. The US fiscal policy response to COVID was remarkable, arguably outsized, more than it was needed. And certainly bigger than most other parts of the world. And because it was so much bigger than the rest of the world, the Fed then had to respond more aggressively as well. Right? And I think that's played a bigger role. And one of the most striking data points to me about this is that when you look at the dollar's advance, let's say from '13 to '19, household net worth in the United States expanded by about 64 percentage points of

GDP. So pretty sizable expansion of wealth. But during a period where government debt levels drifted higher, and they drifterd higher by, I think, about five percentage points of GDP. So, a lot of just pure private sector wealth creation. Over the last three years, net worth as a share of GDP in the United States has expanded by about 15 percentage points. And that's exactly what we've seen in terms of the expansion of the fiscal balance as well. In other words, all the net worth expansion has equaled the expansion of government debt. So, you've had a big transfer of wealth from the government to the private sector. Well, that's not true growth, right? That's not sustainable growth. So, I think that's a very different aspect of this dollar advance.

Katie Klingensmith [00:09:09] So, that speaks against this case for US exceoptionalism, or at least at this point. Do you not believe that the technological advances that, at least around me in San Francisco, are all the focus, AI and that around it, might not drive another period of real increases in productivity and investment in the US relative to other places.

Anujeet Sareen [00:09:32] Look, I think that's totally fair. I mean, and you know, my view here on the dollar ultimately is not to make the case that somehow the US is, you know, significantly less exceptional than it has been. It's simply to argue that, you know, the dollar, I think, has scope to return to levels we saw back in 2019, which is consistent with a strong US. I mean, it's consistent with US exceptionalism and growth outperformandce in the United States by, you know, supported by some of the factors you just mentioned. It's just this additional advance that we saw beyond that, I would attribute more to this fiscal story than I would to true private sector, tech-led, AI stories.

Katie Klingensmith [00:10:16] If we were to see a fiscal cliff or somehow a real reduction in fiscal spending, do you think that some of the dollar's gains that it's already experienced could be reversed?

Anujeet Sareen [00:10:26] I do. You know, it's a very different macro picture than we're accustomed to seeing. I mean most of the significant fiscal policies the US has employed over the last several decades are countercyclical, which is to say, we increase government spending, we cut taxes when the economy is weak, which is appropriate. That's the time when the government needs to step in and help out the private sector. But what has shifted is since the Trump tax cuts in 2018, we've actually started to use fiscal policy even when the economy's strong. And I think that's made the Fed's job harder. And we really went over the top, I would argue, the last couple of years and really last year in particular. So, you saw growth in almost every part of the world slow below trend in 2023, with the exception of the US. And the main difference, the main difference between the US and the rest of the world is that the US government deficit got a lot worse. So, we did a lot more government spending and tax cuts last year than the economy needed. And that's why the economy, you know, outperformed expectations. So, I think looking forward, it's not that there needs to be a fiscal cliff, necessarily. It's just that the rate of change is, you know, is going to slow. We're not going to continue to expand fiscal policy the way we have it. So, I think the IMF shows that last year the, what we would call the primary fiscal balance, which is excluding interest costs rates, so actual government spending and taxes, that changed by about two percentage points of GDP. That's actually a really big change. I mean, that's comparable to what we did in 2008, for example. Right. So, it was an enormous boost to the economy last year. That number the IMF expects will be now -1% in 2024. Now, let's just assume it's zero, right? Let's assume it's not quite as negative as the IMF is thinking, but it just is not going to be offering the same sort of support. Well, that means that the growth rate should slow, right? Because it doesn't have that support this year. And the Fed of course hasn't cut interest rates yet. So, you don't have that source of support. So, I think there's reasons to think the US economy will slow relative to last year as that fiscal support diminishes. And I think more medium term, even given the election, you know, what might be the prospects of fiscal policy, you know, given how, where debt levels are now at 120% GDP. Even if, I think, Donald Trump were to get reelected, or actually regardless of who gets elected next year, the Trump tax cuts in 2018 expire next year, and Congress is going to have to focus at a minimum just to reextend those, let alone the prospect of trying to do even more fiscal easing. So, it does seem like fiscal policy has reached some kind of inflection point here where we're not likely to get much more stimulus. And I think that has, you know, implications for US growth.

Katie Klingensmith [00:13:33] I think often the currency conversations are much more focused on rates, and especially central bank policies. We can spend a whole podcast talking about what we expect from the Fed. What's your baseline there? And as you emphasized before, this is all relative. So, what's your baseline for Fed policy and how much rates in the US may diverge or not from other regions and how that then influences the dollar?

Anujeet Sareen [00:14:01] I mean, one of the things that I spend a lot of time on when I'm thinking about currencies, particularly in the developed world, is that the interest from monetary cycle and F/X cycles, therefore, really track the relative outperformance of labor markets, right? Because in the long term, if you really pressed the Fed and the ECB, what they'll tell you is if the labor market's strong, they get more worried about wage growth and therefore inflation. Right. So, the tightness of the labor market really matters. And what is so distinctive, you know, about the last three years, unlike the prior seven when the dollar was going up, the US labor market was clearly outperforming. The unemployment rate was going down in the US. It was going up in Europe. That's not true anymore. Europe's unemployment rate is at record lows. And so, the labor market differential, if you will, between the US and the rest of the world is not nearly as extreme as it used to be. All that says is that it's consistent with a much narrower interest rate gap between the US and the rest of the world. Now, how much that means that the Fed will cut versus the, I mean You know, there's a lot of factors to consider, where inflation will settle and so on. But I would say that the yield spread, right? The excess yield one gets at the moment in US short-term interest rates, that I think will narrow versus the rest of the world over the coming, over the coming year. Again, as this fiscal boost diminishes distinctly for the US, not anywhere else. And the Fed doesn't need to have rates quite as high as it does today.

Katie Klingensmith [00:15:39] And that would be a headwind for the dollar?

Anujeet Sareen [00:15:41] Yes.

Katie Klingensmith [00:15:42] Let's transition towards some different risk factors. You already mentioned one component of election outcomes in the US. Are there other elements of the US election that you think will be particularly important to understanding the dollar trend?

Anujeet Sareen [00:15:58] Sure. I mean, I think I mentioned at least a couple that come to mind. I mean, certainly, a Donald Trump presidency would bring with it risks around further protectionism. And all things being equal, you know, if the US raises tariffs, that would tend to depress other currencies as they adjust, right, for the relative expensiveness of their exports to the US. So, I think that is a risk that sits out there. What is curious though about that risk is Trump has also complained about the strength of the dollar, right? I mean, he wants a policy that is supportive of US competitiveness. And to simply raise tariffs along with a strong dollar doesn't really achieve that. Now, how does he get a weaker dollar is a different question. That might mean he wants to politicize the Federal Reserve and who he replaces Jay Powell with in 2026. There are other other components to this. So, it's a little bit more, I think, mixed. But at face value, you know, just raising tariffs across the board, you know, would be probably somewhat dollar supported in the short term. So, I think that is a risk post the election. I think some of the other risks out there would really revolve around, you know, might the authorities find yet more money to spend somehow and prolong this easy fiscal/tight money dynamic that's been supportive of the dollar. I mean, that's a risk. It is sobering and disturbing that there really hasn't been a significant call from either side of the aisle to really take our federal debt issue more seriously, you know, on a structural basis. I think Joe Biden has made reference to it but not in any meaningful way. And it's certainly missing from the dialog on the other side of the aisle. So I think that's a concern. As I said earlier, I'm a little less concerned because I don't think there'll be much more incremental fiscal. I mean, if we were really to address or our debt levels, which would mean cutting fiscal expenditures or raising taxes and really bringing our debt levels down, that would be very dollar negative. But that's more than I'm expecting. So, I'm not assuming that we do a significant amount on that front.

Katie Klingensmith [00:18:19] Before we move on to thinking about a bunch of other currencies. Dollar smile. Lots of big risks out there. Are you worried or optimistic for the dollar in context of a lot of the geopolitical worries that a lot of us are seeing?

Anujeet Sareen [00:18:40] Yeah. I mean, look, the dollar smile concept. Right? That whole concept is the idea that, you know, at the extremes the dollar does really well. If the economy is too hot, too strong, and that means you've got a Fed that had to be more heavy handed on monetary policy, well that tends to be dollar bullish either in, you know, typically in a more risk-off environment. Alternatively, on the other hand if we get a hard landing, and risk assets struggle for that reason, that also tends to lead to safe-haven flows into the dollar, and the dollar does a bit better. The dollar tends to struggle in the middle, which is the period in which global growth is fine. It's pretty benign, and there's less of a reason to hold on to dollars from a safe-haven perspective. And it's a bit of what we've been in you could argue for the last 18 months. The dollar is down over that period, despite the fact that US growth has outperformed, particularly last year. Why is that? Well, because there is some other places that have decent growth or decent interest rates, and so the dollar at a minimum has become well, it's overall down, but even its performance among currencies has become more mixed in the middle of that dollar smile.

Katie Klingensmith [00:19:56] So, Anujeet, we could go deep into any number of currencies. But when you look in the G3 or the developed market space, are there particular currencies that you think might fare especially well or poorly against the dollar in the near term?

Anujeet Sareen [00:20:12] Yeah. I mean, I think it's worth just observing that, and this may not hold in the future, so we can talk through that, but over the last, you know, year in particular, the US has outperformed much of the developed world. But currencies have not responded as one might expect in that context. And I think the most notable example of this is the euro. The euro has rallied over the last 18 months, even as US growth has outperformed European growth. And I think one, that might speak to valuations. The dollar is more expensive at this stage. But two, I think it speaks to the fact that there isn't the same structural overhang that Europe struggled with for a long time. Right? The banking crisis is over. The sovereign crisis is over. Some of the best performing countries now in

Europe are those very, you know, southern European economies that struggled for so long. So, Spain and Italy in particular. And I think of the Italian equity market this year as an example of one of the strongest performing equity markets in the world. So, I think there is more of an acknowledgment by investors that there are, that there's a better sort of structural underpinning, certainly in Europe. The place where currencies would have really struggled the most in the developed world, but even to some extent the EM world, are currencies closer to China. Right. That's where we've had the biggest, I would say, growth disappointment. And so, whether it's renminbi, even, you know, something like the Australian dollar, and then most certainly the Japanese yen, those are the currencies that have struggled. So, you need to see some either improvement on the commodity cycle for the likes of an Aussie dollar, or just better, you know, growth prospects out of the region to help those currencies. The yen in particular would be the one, I think, to focus on, more from the perspective that it is certainly been the worst performing currency in the world the last several years. We're at 150 yen to the dollar here today. These are not levels we've seen very often in history. And it's here because as the world raised interest rates, the Bank of Japan, of course, did not. And so the stark contrast in monetary policy has sat heavily on that currency. What is curious and important, I think, for Japan is that it's just in a different stage of its cycle. And we're talking about slowing inflation, slowing wage growth in most parts of the world, including the US. And we're talking about the opposite in Japan on on the wage side. We have wage negotiations going on right now in Japan. And we're seeing numbers that would be higher than what we're seeing in the US. We have not seen higher wage growth in Japan than the US in over three decades. I'm not saying that's about to happen, but it's in the conversation for the first time in a long time, and policy would need to change quite significantly on a relative basis if that were the case. So I think the yen has the most potential to appreciate. It's been the timing of, you know, a policy shift from the Bank of Japan that's been more difficult to pinpoint, but it's certainly a very cheap currency. And you can see it most visibly in the performance of the equity market. The equity market has been tremendous the last few years. In this year alone, despite the yen weakness, it is outperforming in dollar terms, despite the Nvidia story, despite all the AI, you know, excitement in the US, Japanese stocks have been a better place to invest.

Katie Klingensmith [00:23:46] Brandywine Global has always had an orientation towards, you know, understanding emerging markets. EM currencies haven't fared particularly well lately, with some exceptions. How do you see the landscape there?

Anujeet Sareen [00:23:59] So, I'd say, I'm actually a little bit more encouraged by the trends in emerging markets. I mean the resilience of some of these EM currencies in 2022, like the Mexican peso, the Brazilian real, in the face of a tremendous Fed tightening cycle was remarkable. And that had a lot to do, I think, with the fact that many of these countries pursued more orthodox policies than the Fed did. Like they were outhawked the Fed during that period. So, that really has helped currencies like the Mexican peso, the Brazilian real, certainly in the last year, the Colombian peso. And I think that it hasn't been uniform for all emerging markets. Right? There have been other EM currencies that have struggled over that. Again, either ones in Asia, South Africa has struggled. But I think this is partly what's indicative of a dollar top, is that the dollar rally starts to narrow. That there are currencies that do start to outperform at a certain stage. And I think we've started to see that sequencing unfold. It started with the higher-yielding emerging market currencies. Not uniform across all of EM as you note. But I think we'll see more of that over the coming couple of years.

Katie Klingensmith [00:25:23] Lots of information. Currencies always involve a lot of different factors. Bring it all together. What do you expect for the US dollar in the near term and over the next couple of years.

Anujeet Sareen [00:25:34] Yeah, look, I'm broadly thinking that the dollar is going to return to levels we saw back in 2019. That's about 10% weaker from where we are today. I think that's in the context of a US economy that doesn't have this fiscal juice, if you will, supporting the economy. And as that settled in, and the Fed had reasons to pare back some of its hikes, I think you'll see some more dollar normalization. So, 10% lower in the dollar, I think, on average across the board is what I'm looking for. But what I worry about is that there is more just resilience in the economy, more inflation persistence in the economy. It's exactly the things that the Fed has been thinking about that might delay that. Maybe it takes longer for that to unfold. I think so. I think what we see in the growth numbers in the first half of this year, particularly in the US labor market side, will be pretty important to watch for this story to unfold. So, I'm looking for a weaker dollar, not calling, you know, some major dollar, you know, deathloop or something like, you know, bear market that we saw, we've seen in previous eras. Because I don't think the underpinnings of the US economy are in terrible shape. But I do think this, again, this government fiscal piece, that's the piece that's going to come out and I think drive the dollar somewhat weaker.

Katie Klingensmith [00:26:53] Thank you so much. It was a pleasure to speak with you, Anujeet Sareen. Thank you, everybody, for joining us for this Around the Curve conversation at Brandywine Global.