Around the Curve

Plot Thickens for U.S. Dollar

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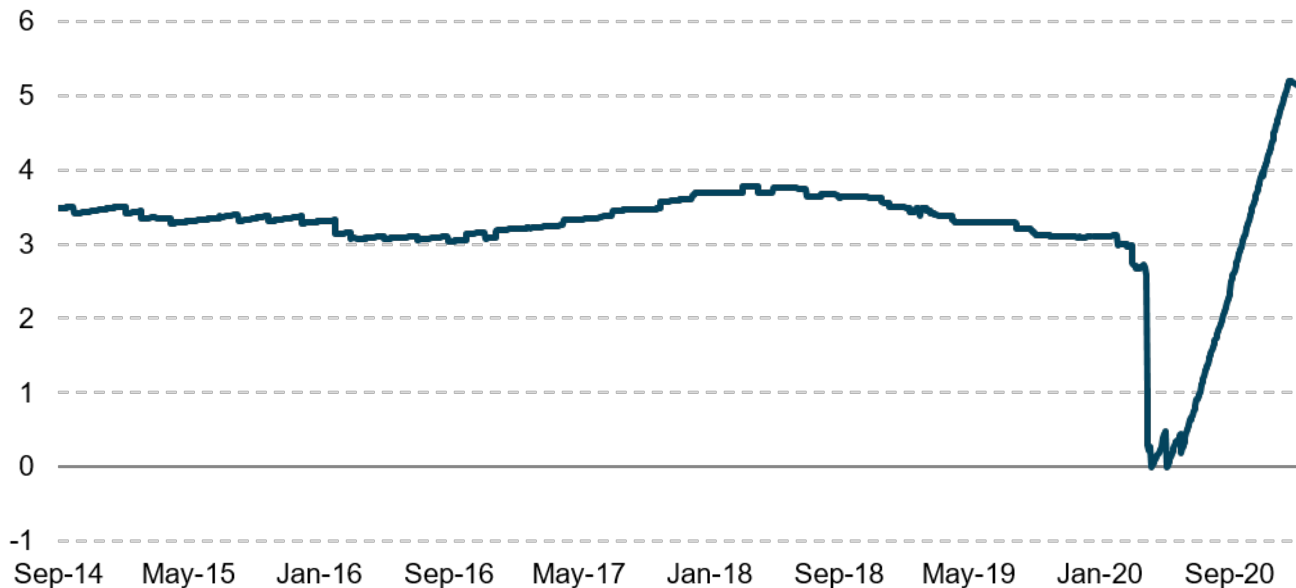
Since late March of 2020, the U.S. dollar has declined in an unrelenting, direct manner for four reasons.

1. Improved Global Recovery

The combination of effective COVID-19 responses, including supplies, treatment, social distancing, etc., and substantial monetary and fiscal policies has led to an improved outlook for the global economy. Meanwhile, the U.S. dollar, as the world's reserve currency, strengthened into the teeth of the crisis in March and weakened ever since as global growth prospects improved.

1 Global Growth Consensus Expectations
%, As of 1/15/2021



Source: Bloomberg Finance L.P.

2. Shifting Growth Expectations

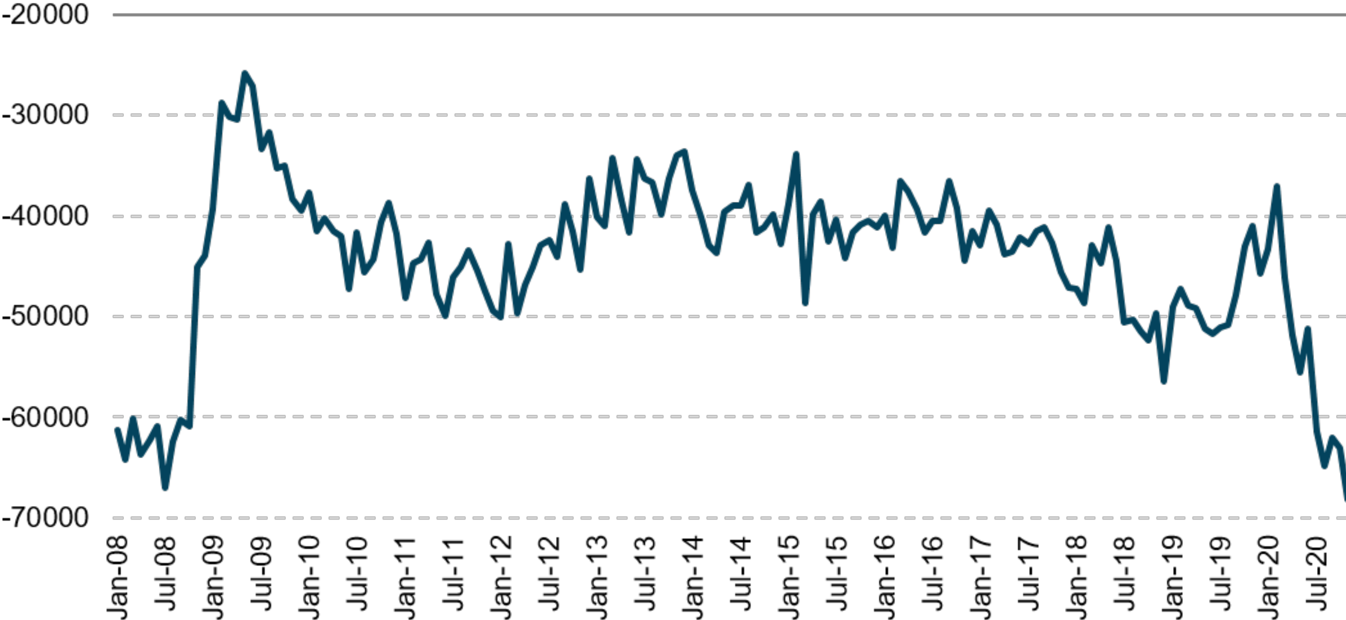
Relative growth expectations have shifted in favor of non-U.S. growth over U.S. growth, particularly following news of the promising efficacy of COVID vaccines. The U.S. economy has experienced a strong recovery, which is expected to continue. However, the rest of the world, excluding China, contracted more severely in the first half of 2020. These countries are likely to experience a larger recovery as well. When U.S. growth underperforms, particularly in an improving global growth environment, the dollar weakens.

3. Delayed Normalization

In addition to its participation in the easing of global monetary conditions, the Federal Reserve (Fed) took an additional step toward formalizing average inflation targeting. Unlike previous cycles, the Fed will not withdraw stimulus as the domestic economy improves. Instead, it will wait until inflation dynamics are more entrenched around the target before acting. Consequently, real yields can fall pro-cyclically, which is exactly what has happened over the past several months, placing added downward pressure on the dollar.

4. Growing Trade Deficit

Finally, the U.S. goods and services trade balance has deteriorated sharply over the past six months; the November deficit was the largest in well over a decade. This decline partly reflects the lack of U.S. dollar competitiveness, the relatively higher fiscal support to U.S. household incomes, and the idiosyncratic nature of this recovery that boosts goods consumption over services consumption.



What's Next for the Greenback?

Of these themes, the global growth theme remains most clearly intact. Leading indicators appear uniformly constructive for growth in 2021, and as COVID case growth and vaccination efforts bring countries to herd immunity, we will see strong service sector demand accelerate this year as well. In our view, 2021 is poised to be one of the strongest years on record. This theme, therefore, remains a negative for the greenback.

The U.S. trade balance for the first half of 2021 also will remain a headwind as further increases in buying power for U.S. households, boosted by phases four and five of fiscal stimulus, are constrained by the limited ability to spend on services. These forces will lead to further erosion in the trade balance, which is also negative for the dollar.

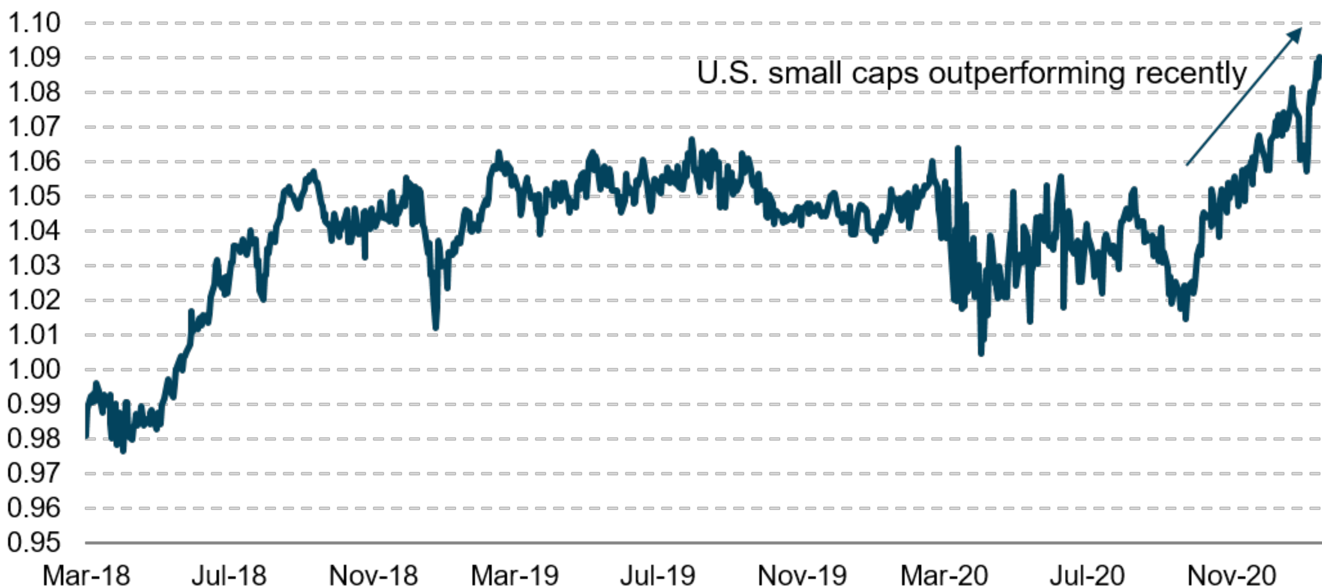
But Now the Plot Thickens

Unlike the technology and telecom bust in the early 2000s and the global financial crisis (GFC) in 2008, last year's recession was not primarily a U.S. problem. It was a global problem. One could argue there is no inherent reason to expect the U.S. economy to lag in its recovery, as it did from 2001 to 2007 and 2009 to 2011. In the early 2000s, the U.S. needed time to recover from the investment overhang of the tech/telecom bust. Similarly, in the 2009-2011 period, the U.S. financial and real estate sectors needed time to heal and allow displaced workers to find new jobs in new industries. Those were particularly distinct issues for the U.S. economy, leading to growth underperformance during those periods. At that time, the Fed ran policy with much greater accommodation than its peers.

Today, the Fed has eased monetary policy along with central banks globally. Except for the People's Bank of China, the Fed's current monetary policies are not materially different from other major central banks. The U.S. growth recovery has been far more robust this time around, in absolute and relative terms, because fiscal authorities have provided more financial support to the private sector. Additionally, the U.S. leads the world in providing the very technology services that proved essential in 2020. The additional fiscal stimulus from the December package and the forthcoming stimulus from the Biden administration will likely strengthen the domestic growth trajectory, even if some of that demand leaks out through the trade sector. Lastly, the U.S. is rolling out vaccines more aggressively than other major countries, with the exception of the U.K. Consequently, the U.S. economy may close its output gap more quickly than most other countries. So, perhaps relative growth favors the U.S. The recent outperformance of U.S. small-cap equities versus non-U.S. small caps may be pricing this outcome.

3 **Small Caps: U.S. vs. World**

Index, As of 1/19/2021



Source: Bloomberg Finance L.P.

This discussion brings us to the Fed. With its new average inflation targeting regime, the Fed has clearly indicated that stronger growth is not enough to induce policy changes. However, the Fed's policies today partly reflect emergency measures for the pandemic-induced recession and partly reflect the shift toward average inflation targeting. As the U.S. recovery gathers pace, arguably turbo-charged with considerable fiscal stimulus, the Fed will increasingly confront the task of balancing these two conflicting factors.

A Narrow Tightrope

What does all this mean for the dollar? It is still likely to fall further in the first half of 2021, particularly against the higher-beta emerging market and commodity-linked currencies. However, unlike the second half of 2020, the path down for the U.S. dollar will likely be more volatile as the Fed walks this narrowing tightrope between significant above-trend growth and the diminishing need for stimulus against the intent to more convincingly achieve its inflation objective.

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