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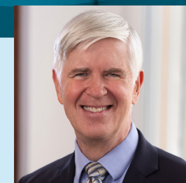

GLOBAL PERSPECTIVES

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WHY THE STRENGTH OF THE US DOLLAR MATTERS

HIGHLIGHTS

- The surge in the value of the US dollar creates headwinds for the US and global economy but should help the Fed bring inflation back under control.
- While the strong dollar may initially bring slower growth and lower corporate profits, both stocks and bonds have tended to perform well following periods of dollar strength.
- A strong dollar also provides US investors an opportunity to buy overseas assets at a discount.

WHY THE STRENGTH OF THE US DOLLAR MATTERS

A SURGING US DOLLAR, DESPITE HIGH INFLATION

In the past two years, the dollar has lost 15% of its purchasing power — the worst erosion in purchasing power since 1982. However, the dollar is strong in terms of its value against key foreign currencies. The US Dollar Index has reached its highest level in 20 years and has gained 16% since the end of last year.

The dollar has also risen against the Japanese yen and the euro, by 29% and 15% respectively. The dollar's strength against foreign currencies has been broad-based, with nearly all major currencies falling against the dollar, with the notable exception of the currencies of oil exporters.

The foreign exchange value of the US dollar has soared this year because of an aggressive US rate-hiking cycle, commodity price shocks favoring the energy-independent US, and geopolitical uncertainty triggered by Russia's invasion of Ukraine.

Why should the strong US dollar matter to investors? Here we'll focus on three key reasons:

1. For investors who are worried about inflation, there are several reasons to believe that the strong US dollar will help bring inflation back under control.
2. While slower growth and lower corporate profits may occur in the near term, both stocks and bonds have tended to perform well following periods of dollar strength.
3. When the dollar is strong, it provides an opportunity to buy overseas assets at a discount.

HOW THE STRONG DOLLAR HELPS CURB INFLATION

A strong dollar is helpful for curbing inflation in the United States for several reasons. First, it means some imports are less expensive, which helps to reduce inflationary pressures. It also has the indirect effect of crimping US export growth and reducing the demand for labor, which also helps to reduce inflationary pressures. Finally, a strong dollar also has the effect of reducing global growth, which has the knock-on effect of reducing commodity prices and inflationary pressures.

In practice, the direct effect of dollar strength on import prices is quite modest since about 95% of US imports are priced in US dollars. Moreover, imports amount to just 15% of US gross domestic product, less than one half of the average for other developed nations. As a result, swings in the dollar's foreign exchange value have little direct impact on the prices of US imports. According to one estimate, when the dollar rises by one percent, inflation in the US falls by just 0.03%.[1]

US exporters do face strong headwinds to their growth prospects when the dollar strengthens because nearly 100% of US exports are invoiced in US dollars. That means that foreign customers of US export firms are faced with sharp increases in the price of US goods when their currencies slump against the dollar, which typically forces them to curb their purchases.

Research by the New York Fed found that a 10% surge in the value of the US dollar would tend to reduce real exports by 2.6% over one year and 3.5% over two years, creating a drag on overall economic growth of 0.5% – 0.7%.[2]

Another key impact of a surge in the US dollar is that it directly curbs the profits of US multinational corporations. That's because when the dollar is strong, American companies that sell their products overseas see their profits shrink when they convert their foreign earnings back into dollars.

This dynamic is already starting to play out, with several major corporations reporting disappointing earnings in recent months. If dollar strength continues, it could put a significant dent in corporate profits. For example, Morgan Stanley recently estimated that every 1% gain in the US Dollar Index would have a negative 0.5% impact on corporate profits.[3]

If this relationship holds, weaker profits could lead to job cuts and other cost-cutting measures in export-oriented sectors. Thus, the strong dollar helps curb inflation pressures through the indirect channel of slowing US growth and reducing the demand for labor. Those effects appear much more important than the direct effects of a strong dollar on reducing US import costs.

[1] Ruchir Sharma, "Biden should act now on the wrecking-ball dollar," Financial Times, October 10, 2022

[2] Mary Amiti and Tyler Bodine-Smith, "The Effect of the Strong Dollar on US Growth," Liberty Street Economics, New York Federal Reserve, July 17, 2015.

[3] Michael Wilson, "Weekly Warm-up: Can You Hear Me Now? The Fed Leaves No Doubt; Focus on Growth Now," Morgan Stanley, September 26, 2022.

GLOBAL IMPACTS OF A STRONG US DOLLAR

If a strong US dollar tends to curb inflation pressures by slowing US growth, it can also exert strong contractionary forces on the world economy for several reasons.[4]

Tighter Monetary Policies Globally

One reason for the global contractionary impact of a strong dollar is that most countries care about their exchange rates, particularly when inflation is a worry. Thus, they tend to tighten monetary policy as a group when the dollar is strong and their currencies are weak. This can lead to synchronized global tightening with combined effects that are larger than the sum of its parts.[5]

The US Dollar Has an Outsized Role in Global Markets

Another reason the strong dollar tends to reduce global growth is related to the fact that US capital markets and the role of the dollar are far bigger than the relative size of the US economy suggest **(Figure 1)**. That means that whenever financial flows change direction from or to the US, everybody is affected. The risk of capital flight is highest for nations who are most dependent on external financing. That includes many emerging market (EM) nations like Chile, Hungary, and Turkey.[6]

FIGURE 1

The US Dollar's Disproportionate Share in Global Assets and Transactions

Source: Maurice Obstfeld and Haonan Zhou, "The Global Dollar Cycle," Brookings Papers on Economic Activity, September 8, 2022.

The US share of world trade is only about 10%, but US dollar accounts have a disproportionate share in global assets, transactions, and official foreign exchange reserves.

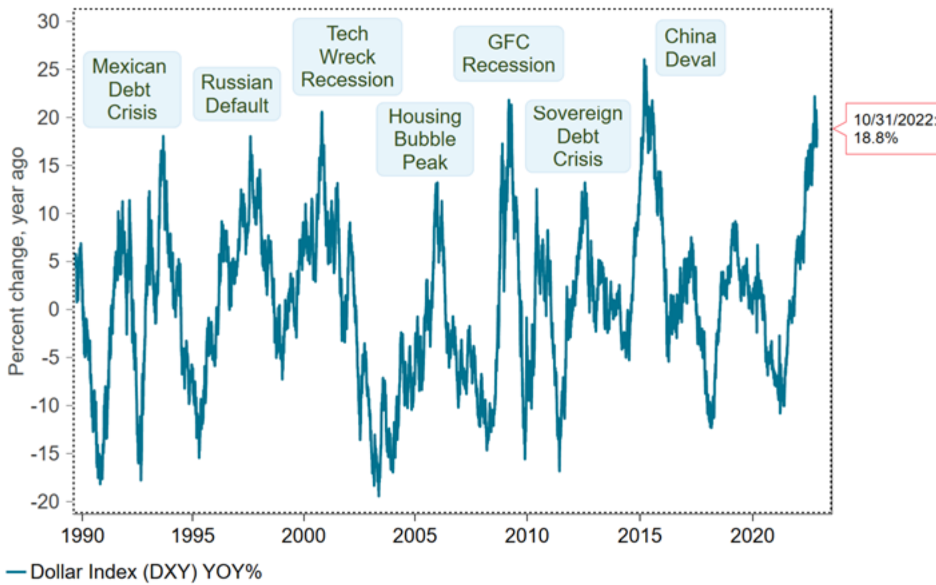
[4] The negative impacts of a strong dollar on global growth have been documented extensively in recent research byMaurice Obstfeld, former chief economist of the International Monetary Fund, and Haonan Zhou in their paper, "The Global Dollar Cycle," Brookings Papers on Economic Activity, September 8, 2022.
[5] Lael Brainard, "Restoring Price Stability in an Uncertain World," Federal Reserve, October 10, 2022.
[6] Those three nations were rated by J.P. Morgan research as having the most vulnerable currencies within EM. See Global Emerging Markets Research, "Emerging Markets Outlook and Strategy," J.P. Morgan, October 6, 2022.

When the financial tide is going out, as signaled by a rising US dollar, the risks are highest for nations with large dollar-denominated debts. Those debts must be serviced with payments in US dollars, even as the domestic value of their currencies shrink in US dollar terms. This can result in cutbacks in capital spending and forced deleveraging among foreign borrowers, while also raising the risk of defaults or other financial accidents.

These facts help explain why a soaring US dollar has historically been associated with financial or economic stress **(Figure 2)**. A potential accelerator for financial accidents overseas is growth in offshore dollar-denominated debt, which lies outside the regulatory scope of the Federal Reserve. According to data from the Bank of International Settlements (BIS), offshore dollar lending has grown nearly six-fold since the beginning of the century to a current level of $13.4 trillion.

FIGURE 2

Sharp Year-on-Year Rises in the Dollar Index Have Been Associated with Financial/Economic Stress



Sources: GW&K Investment Management and Macrobond

Sharp rises in the US dollar's value have been associated with many episodes of global financial and economic stress that have tended to curb global growth and inflation.

Commodity Prices

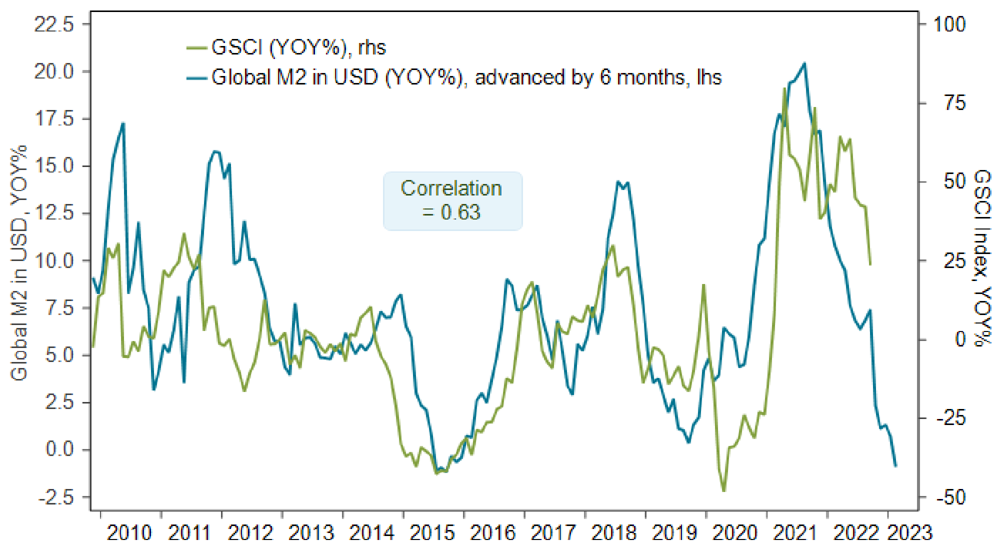
A final way a strong dollar can help curb global inflation is through the impact of contracting dollar liquidity on commodity prices. The intuition is simple: most commodities are priced in US dollars. When the foreign exchange value of the dollar rises, those outside the US have less money in dollar terms available to purchase commodities.

Putting that intuition to work, a measure of global money supply (M2) in US dollar terms has provided a good leading indicator of commodity price trends as measured by the GSCI Commodity Index. The global M2 measure is based on money supply data from the four largest economies: the US, China, the euro area, and Japan. Year-on-year growth in that measure tends to lead year-on-year growth in the GSCI Commodity Index by about six months.

With global M2 as of September having declined about 1% from a year earlier, it is about as weak as it has been any time since 2010 and consistent with an estimated year-on-year decline in the GSCI Index of more than 25% by early next year **(Figure 3)**. Perhaps this will not occur due to supply shortages associated with the Ukraine war and chronically weak investment in new sources of supply. That said, weak global M2 growth in US dollar terms seems likely to create a demand headwind for commodity prices.

FIGURE 3

Weak Global M2 Growth Points to Weaker Commodity Prices Ahead



Note: Global M2 is the sum in current US dollar terms of M2 money supply measures from the four largest economies: the US, China, the euro area, and Japan.
Sources: GW&K Investment Management, Standard & Poors, and Macrobond

A strengthening US dollar shrinks the dollar purchasing power of foreign money, leading to weak global money supply (M2) growth and weaker commodity prices.

FINANCIAL MARKET RESILIENCE FOLLOWING US DOLLAR STRENGTH

As helpful as a strong dollar might be for curbing inflation, what are the implications for the performance of financial markets following strong dollar periods?

In view of the contractionary and disinflationary impulses for growth and corporate profits mentioned above, it is no wonder that a rising dollar is considered a “risk-off” sign by market participants. Indeed, the dollar’s rise this year has been associated with very weak financial markets as it has coincided with sharply rising interest rates and geopolitical shocks.

That said, it is instructive to look at how various markets have performed in the one-, three-, and five-year periods following periods of a sharply rising US dollar. The picture that emerges is generally one of financial market resilience as economies shook off the initially negative effects of US dollar strength.

Based on data since the beginning of 1980, we identified nine episodes when the year-on-year rise in the US dollar exceeded 17%. There is nothing magical about the 17% figure except that it roughly corresponds to the 95th percentile of extreme upward swings in the dollar's value over that period. Swings of that magnitude were also generally associated with the financial and economic stress periods shown in Figure 2.

We then assumed that investors bought various asset classes on the last day of the first month in each episode when the year-on-year rise in the dollar exceeded the 17% threshold — as occurred most recently in July this year. We kept it simple by sticking to the first month in what were often series of months of strong year-on-year surges in the dollar's value.

The US Dollar Index

First, consider buying the Dollar Index itself. On average, it declined in the one-, three-, and five-year periods following strong surges in its value, confirming its historical tendency to alternate between multi-year periods of strength and weakness **(Figure 4)**. We would call this weak evidence of "mean reversion" — i.e., not quite "what goes up must come down" but more like "what went up typically went down two-thirds of the time over the next three years."

FIGURE 4

Buy the Dollar Index When it is Up 17% YOY

Buy	One Year	Three Years	Five Years
May-1981	7.5	27.4	11.0
Jan-1982	10.9	41.9	-9.2
Jan-1984	13.1	-27.6	-29.1
Feb-1985	-28.7	-43.6	-41.8
Aug-1993	-4.8	-8.2	6.7
Aug-1997	1.1	13.3	7.8
Oct-2000	-2.0	-21.0	-22.8
Nov-2008	-13.3	-8.7	-6.9
Jan-2015	5.1	-6.0	3.2
Jul-2022	?	?	?
Average	-1.2	-3.6	-9.0
Median	1.1	-8.2	-6.9
% Negative	44%	67%	56%

Note: Assumes buying the US Dollar Index (DXY) on the last day of a month when the YOY% change first rises above 17% within a year.
Sources: GW&K Investment Management and Macrobond

Reflecting its cyclical nature, after surging 17% or more on a year-on-year basis, the US dollar has subsequently tended to decline over one-, three-, and five-year periods.

Bonds

To the extent that a strong dollar has acted as a disinflationary force in the global economy, we would expect bond markets to perform well in the wake of a strong dollar period. That has indeed been the case with the Bloomberg US Global Aggregate generating robust double-digit returns for investors in 80% of the one-year periods and 100% of the three- and five-year periods following surges in the dollar's value **(Figure 5)**. To be sure, that data is skewed by the secular decline in bond yields from double digits in the early 1980s. However, it is still in accord with basic intuition that dollar strength is a disinflationary force that should be a plus for bond returns.

FIGURE 5

Buy Bonds When the Dollar Index is Up 17% YOY

	Bloomberg US Agg. Total Return (%)			10-Year US Treasury Yield (%)			
Buy	**1 Year**	**3 Years**	**5 Years**	**Starting**	**+1 Year**	**+3 Years**	**+5 Years**
May-1981	14.9	52.4	131.7	13.50	13.71	13.89	7.99
Jan-1982	31.8	64.4	131.4	14.14	10.71	11.11	7.13
Jan-1984	12.8	58.8	78.7	11.67	11.11	7.13	9.00
Feb-1985	22.6	51.2	76.8	11.91	8.15	8.16	8.51
Aug-1993	-1.6	14.5	38.8	5.45	7.20	6.86	5.05
Aug-1997	10.8	19.4	45.5	6.34	5.09	5.81	4.16
Oct-2000	13.9	27.0	35.8	5.77	4.44	4.36	4.57
Nov-2008	11.6	25.1	29.6	2.93	3.21	1.97	2.71
Jan-2015	-0.2	3.4	15.8	1.68	1.93	2.73	1.57
Jul-2022	?	?	?	?	?	?	?
Average	12.9	35.1	64.9	8.2	7.3	6.9	5.6
Median	12.8	27.0	45.5	6.3	7.2	6.9	5.1
% Positive*	78%	100%	100%	NA	56%	67%	100%

Note: Assumes buying the Bloomberg US Aggregate Bond Index on the last day of a month when the YOY% change in the Dollar Index (DXY) first rises above 17% within a year.
*"% Positive" refers to the number of episodes when the Bond Index delivered positive returns or when the 10-Year UST yield fell from its starting level.
Sources: GW&K Investment Management, Bloomberg, and Macrobond

On average, the US bond market has produced solid returns in the one-, three-, and five-year periods following strong surges in the value of the US dollar.

Equities

Finally, consider equity performance as measured by the S&P 500 for US equities, the MSCI EAFE Index for non-US developed markets, and the MSCI Emerging Markets (EM) Index, which begins in 1987 **(Figure 6)**. In all cases, average returns were robust and positive over one-, three-, and five-year periods following surges in the value of the dollar. Also, on average, MSCI EAFE outperformed the S&P 500 in those periods, perhaps reflecting the positive tailwind of dollar weakness following the strong dollar surges. However, that did not hold for the MSCI EM Index, perhaps reflecting the crisis-prone nature of emerging markets.

FIGURE 6

Buy Equities When the Dollar Index is Up 17% YOY

	One Year			Three Years			Five Years		
Buy	S&P 500	MSCI EAFE	MSCI EM	S&P 500	MSCI EAFE	MSCI EM	S&P 500	MSCI EAFE	MSCI EM
May-1981	-10.7	-7.2	NA	32.3	25.7	NA	136.4	175.8	NA
Jan-1982	27.7	-1.0	NA	72.9	37.2	NA	184.5	295.3	NA
Jan-1984	15.2	5.6	NA	89.5	204.2	NA	120.0	349.5	NA
Feb-1985	30.5	75.6	NA	64.4	255.4	NA	118.8	317.6	NA
Aug-1993	5.5	11.1	47.1	52.1	21.2	27.7	131.2	32.7	-32.6
Aug-1997	8.1	0.1	-49.6	75.8	38.6	-7.6	9.0	-10.2	-31.7
Oct-2000	-24.9	-24.7	-23.5	-23.0	-16.3	23.5	-8.4	18.3	98.0
Nov-2008	25.4	38.4	85.7	48.6	35.4	90.6	124.9	92.1	121.5
Jan-2015	-0.7	-8.0	-20.6	50.7	32.7	41.4	79.2	31.5	26.9
Jul-2022	?	?	?	?	?	?	?	?	?
Average	8.5	10.0	7.8	51.5	70.4	35.1	99.5	144.7	36.4
Median	8.1	0.1	-20.6	52.1	35.4	27.7	120.0	92.1	26.9
% Positive	67%	56%	40%	89%	89	80%	89%	89%	60%

Note: Assumes buying the equity index on the last day of a month when the YOY% change in the Dollar Index (DXY) first rises above 17% within a year.
Sources: GW&K Investment Management, MSCI, Standard and Poors, and Macrobond

On average, equity markets have produced robust positive returns in the one-, three-, and five-year periods following strong surges in the value of the US dollar.

Note that the one-year average forward returns for the S&P 500 were only 8.5% compared to 13% annualized returns over the entire post-1980 period. So that may have reflected near-term growth challenges and risk events associated with dollar strength. But the three- and five-year average forward returns of 51.5% and 99.5% work out to above-average annualized returns of nearly 15%.

In short, despite near-term headwinds to global growth associated with periods of dollar strength, stock and bond market performance in the aftermath generally has been quite resilient.

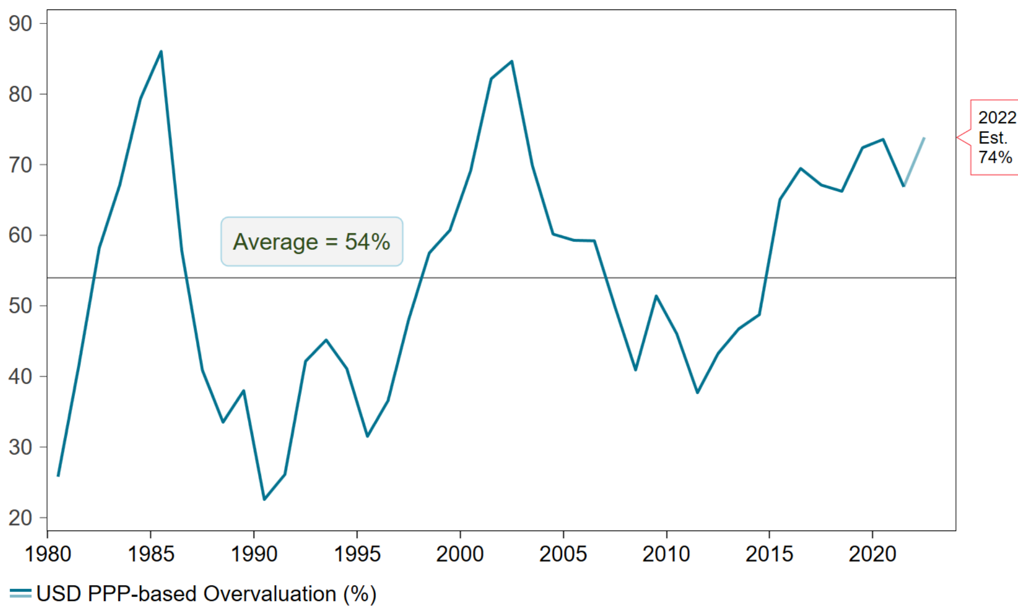
THE STRONG DOLLAR MAKES FOREIGN ASSETS CHEAP FOR US INVESTORS

We will conclude with a simple point that we have already touched on. A strong dollar should matter to US investors because it makes foreign assets cheap in dollar terms. That applies to foreign stocks, bonds, real estate, and even collectibles.

While there is no one single foolproof way to measure the dollar's strength, we would point to the International Monetary Fund's (IMF's) biannual estimates of the so-called "purchasing power parity" (PPP) values of foreign currencies as a useful yardstick. Based on this measure, the dollar is currently about 74% overvalued relative to its PPP level, or about 20% more than usual **(Figure 7)**.

FIGURE 7

US Dollar Overvaluation vs Foreign Currencies Based on Purchasing Power Parity (%)



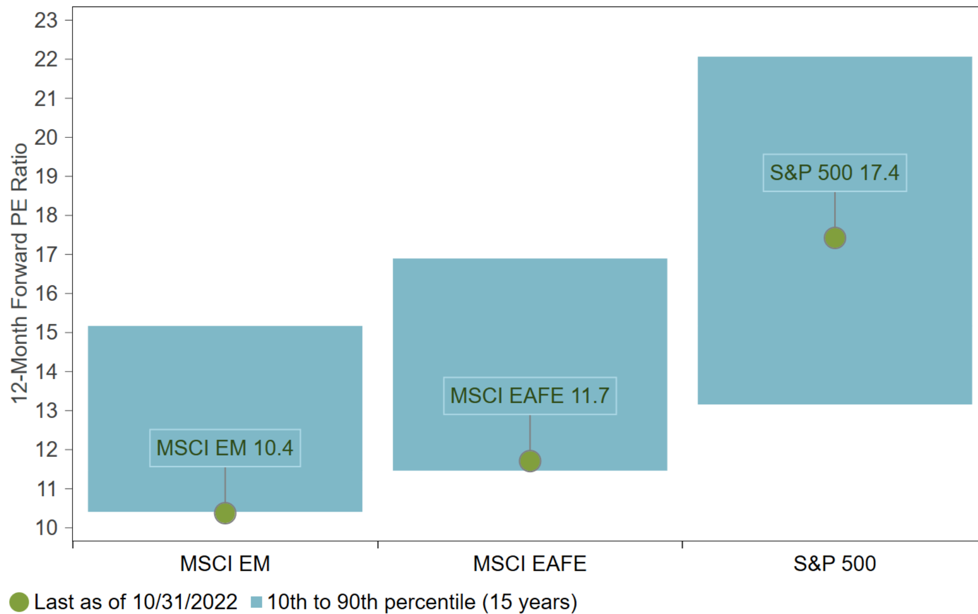
Sources: GW&K Investment Management, IMF October 2022 World Economic Outlook, and Macrobond
Note: Based on the ratio of IMF estimates of world ex US GDP in nominal vs PPP-based terms.

Based on IMF data, the US dollar is currently about 74% overvalued relative to its purchasing-power-parity (PPP) level, or about 20% more than usual.

This overvaluation of the dollar suggests that investors in foreign assets should potentially experience currency-enhanced returns if the dollar eventually weakens. In addition, foreign stocks are trading at price-to-earnings (P/E) valuations near the bottom of their historic range, with the MSCI EM and EAFE indexes respectively trading at 12-month forward P/E multiples of 10.4 and 11.7 times. That compares to 17.4 times for the S&P 500, which is near the middle of its historic range **(Figure 8)**.

FIGURE 8

MSCI EM, MSCI EAFE, & S&P 500: Forward PE Ratios vs 15-Year Historical Ranges



Sources: GW&K Investment Management, Bloomberg, and Macrobond

Not only is the US dollar richly valued against foreign currencies, but foreign EM and DM equity markets are trading at very low PE multiples relative to the US and to their own long-term history.

Of course, there is no guarantee that the dollar will eventually weaken or that foreign stock valuation multiples will move back up. However, we think the current setup of a very strong dollar and very low foreign stock multiples makes a compelling case for international diversification.

WHAT COULD EVENTUALLY WEAKEN THE DOLLAR?

Although the current set of forces boosting the dollar have considerable momentum, we can think of any number of developments that would slow or reverse its trend. These could include:

1. A greater-than-expected slowdown in the US economy, which could prompt the Fed to pause or reverse its rate-hiking cycle.
2. Monetary tightening overseas that begins to outpace Fed rate hikes and provides greater interest-rate support for foreign currencies.

3. An end to Japan's "yield curve control" (YCC) policy, which has capped long-term interest rates in Japan.

4. A lasting ceasefire in Ukraine, which would reduce the risk premium on European assets and curb safe-haven capital flows to the US.

To be sure, the strong dollar creates headwinds for the US and the global economy that are reflected in current market gloom. But if history is any guide, such periods create opportunities as well. And, in our opinion, the best way to take advantage of the opportunities created by a surge in the value of the dollar is to have a long-term investment horizon and a willingness to accept some short-term volatility.

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