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U.S. Dollar: What Goes Up, Must Come Down?

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After years of strength, is the U.S. dollar poised for a fall?

The U.S. dollar has been in a sustained uptrend over the past decade, contributing to persistent underperformance across numerous asset classes but most acutely affecting both foreign equities and natural resources.¹ Given the U.S. dollar's position as the global reserve currency, there are numerous drivers of its relative strength or weakness. Understanding the factors behind the current strengthening trend, and when they may turn, is critical to evaluating how multi-asset class portfolios may perform going forward.



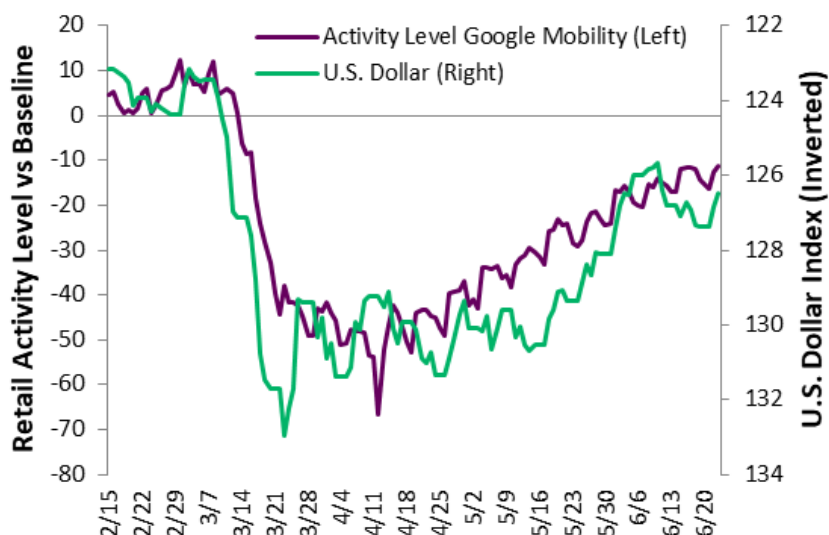
Sources: FactSet, JP Morgan

In this article, we will look at three important factors, including relative GDP growth expectations, interest rate differentials, and the impact of the “flight to safety” effect. While no single factor, nor a group of factors, will completely explain or predict U.S. dollar movements, the three we discuss below are informative in understanding U.S. dollar demand dynamics and in what direction the U.S. dollar may head next.

The position of U.S. treasuries as the safest of “safe” assets creates an inverse relationship between economic growth and the U.S. dollar in times of crisis. During panics, global investors tend to sell risky assets and rush into U.S. treasuries, resulting in a strengthening U.S. dollar as investors purchase dollars to buy treasuries. Once the crisis passes, the U.S. dollar generally reverts to pre-crisis levels.

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An informative way to illustrate this “flight to safety” effect is by examining trends in global retail activity as the COVID crisis unfolded. Using cell phone location data from Google covering several thousand regions across 136 countries, we can chart the decline in visits to retail establishments around the world (a proxy for general economic activity) against the strengthening U.S. dollar. As shown in the chart, the U.S. dollar (inverted) moved in lock-step with economic activity, strengthening as economic activity declined (increasing panic and uncertainty) and subsequently weakening as activity bottomed and began recovering (panic and uncertainty easing). We expect the U.S. dollar could face headwinds as the global economy continues to recover from the coronavirus shock.



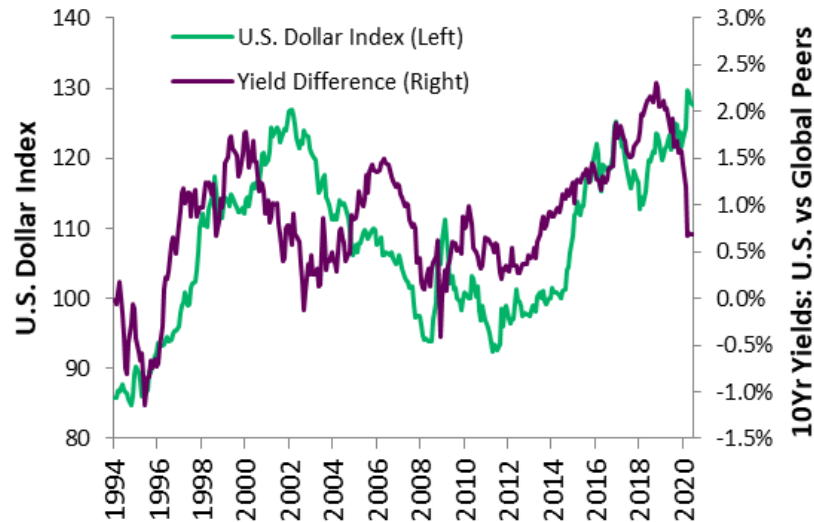
Sources: FactSet, JP Morgan, OPCM, Google

Relatively high interest rates in the U.S. have been another contributor to persistent U.S. dollar strength over the past decade. Since the end of the global financial crisis, interest rates in the U.S. have significantly exceeded those found in other developed markets. In early-2019, U.S. 10-year treasuries offered yields that were more than 2% higher than the average of global peers - the highest spread in at least 20 years.

As the following chart shows, the U.S. dollar has generally strengthened as the additional yield available from U.S. treasuries, relative to global peers, increased and weakened as this spread compressed.



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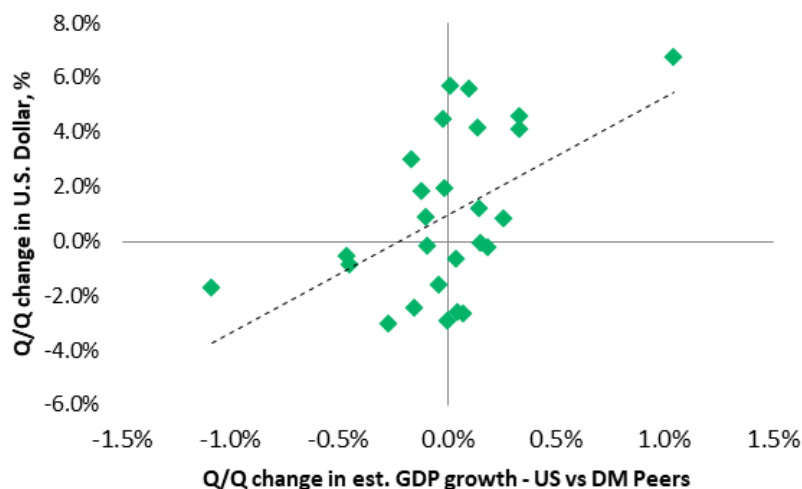
Sources: FactSet, OPCM, JPMorgan. Peers: Canada, Euro area, UK, Sweden, Switzerland, Japan

This dynamic is driven by global investors capturing the yield spread by selling their local currencies and purchasing U.S. dollars to facilitate the purchase of U.S. treasury bonds. The selling of local currencies results in lower demand and lower prices and vice versa when purchasing U.S. dollars. However, with the spread between U.S. 10-year treasuries and global peers at just 0.69%, we expect the dynamic could reverse.

Currencies generally strengthen or weaken based on a country's expected economic growth as measured by its GDP relative to other countries. When growth is expected to exceed peers, its currency generally strengthens and when growth is expected to lag, the currency generally weakens. For the past decade, stronger U.S. GDP growth relative to developed market (DM) peers has been a tailwind for the U.S. dollar. From 2009 to 2019, U.S. GDP expanded by 22% compared to an average of 16% for other developed market peers.

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The following chart shows how changes in the forecasted U.S. GDP growth for the next year relative to DM peers have correlated with changes in the value of the U.S. dollar. Positive numbers on the x-axis represent quarters where U.S. growth expectations for the coming year relative to peers improved (e.g. if U.S. was forecasted to outgrow DM GDP by 1% at the beginning of the quarter and by 1.5% at the end of the quarter that would represent a relative change of 0.5% on the chart). The U.S. dollar has tended to strengthen in quarters when the U.S. GDP outlook improved relative to DM peers and weaken in quarters when GDP expectations lagged DM peers.²



Source: FactSet, OPCM, Peers: Canada, Euro area, UK, Sweden, Switzerland, Japan

The period of sustained U.S. GDP outperformance may be coming to an end. The U.S. was reentering coronavirus induced lockdowns and restrictions at quarter-end, whereas, developed market peers continued to re-open their economies, likely leading to subpar U.S. GDP growth over at least the next several quarters.

We believe U.S. dollar strength is unlikely to continue as the three factors outlined here are all now positioned for weakening. First, the “flight to safety” effect is diminishing as the initial phase of the coronavirus crisis abates. Next, the interest rate differential between U.S. treasury bonds and global peers has narrowed significantly and is unlikely to return to prior levels in the near-term. Finally, U.S. GDP growth is unlikely to continue to outpace the rest of the world during the coronavirus recovery.



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Given these trends, we believe the recent high achieved by the U.S. dollar during the coronavirus “flight to safety” may mark a cycle high and presage a period of sustained dollar weakness, creating potential tailwinds for multi-asset class portfolios.

¹In this article, we use the U.S. dollar index calculated by JPMorgan. This index compares the U.S. dollar to 50 currencies and is much broader than the more commonly cited U.S. dollar index (DXY from Intercontinental Exchange) which only compares the U.S. dollar to six major currencies.

²GDP growth calculations: World Bank national accounts data, and OECD National Accounts data files, GDP (constant 2010 US\$) for Euro area, Sweden, Japan, United States, United Kingdom, Switzerland, Canada

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