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Market Update (April 2023) - Outlook for the U.S. Dollar

There has been elevated speculation in the global news cycle of late regarding the outlook for the US Dollar. Most connotations are from a negative point of view contemplating the likelihood of depreciation of the US Dollar against other major currencies, ranging to the more significant theory that the global economy is about to enter a period of major de-dollarization.

How would these 2 scenarios be defined characteristically?

Depreciating Dollar – The general way to measure the value of the dollar is to measure against a basket of global currencies (weighted according to the value of their trade with the US). By this measure the dollar was in a decade long bull market increasing 140% in value from 2011 through 2022. As of late, the dollar has fallen by 8% to 10% in real and nominal terms.

It is normal for the Dollar (and other global currencies) to go through valuation cycles (similar to the economy and markets). The cyclical nature is impacted by things like economic growth, interest rates, international trade, relative economic strength to other global economies, etc.

In general, cyclical appreciation and depreciation of the Dollar against other currencies is normal and expected within economic cycles.

De-Dollarization – A more extreme condition would be entering a season of de-dollarization. The characteristics that would embody a season of de-dollarization are more complex and uncertain. The simple explanation of de-dollarization would be movement away from using the US Dollar as the primary currency of exchange in global trade and investment. Ultimately, a meaningful de-dollarization process may end in the Dollar losing its status as the world's major reserve currency.

The primary headlines suggesting a de-dollarization movement were sparked by a recent summit among BRICS nations that include prominent emerging economies Brazil, Russia, India, China, and South Africa – in which they discussed the exploration of a unified currency for trade amongst these nations. Elevated speculation around de-dollarization efforts have been common periodically for decades, without a major interruption to the status quo.

Of particular interest, what would a meaningful de-dollarization mean for the Dollar itself as well as the United States as a whole?

Current Standing of the US Dollar in the global landscape: The US Dollar today represents about 60% of global currency reserves (a modest decline from 67% 20 years ago). On a transaction basis, the US Dollar represents nearly 90% of global financial transactions (based on a 200% scale – representing 2 sides to a transaction). The Dollar is regarded as the global reserve currency and is a pillar to the global economic ecosystem.

Consensus outlook from respected economists and research firms: Big picture, there is a consensus we are seeing from respected research firms that a material de-dollarization is

unlikely despite recent concerns. A key pillar to this outlook is that there is no identifiable alternative to the role the US Dollar plays in the global economy. Specifically, a reserve currency needs to be freely convertible and have deep and liquid markets to be considered safe for foreign central banks to hold – nothing compares to the US Dollar from this perspective. The quality, size, and openness of the US market is unmatched on a global scale – the combinations of resources (human and natural) and freedoms in the US make it very difficult to identify any viable alternatives. As the research team at Schwab recently noted, “A long-term trend toward diversification of currencies in global financial transactions and trade may develop, but it’s a big leap from dollar dominance to de-dollarization.”

While the consensus is that the US Dollar will remain the primary reserve currency in the global economy for the foreseeable future, Brian Wesbury, Chief Economist at First Trust, wisely cautions, “What made America strong is not its natural resources (which it definitely has), but its human resources and freedom. China, Saudi Arabia, and Russia may have resources, but they are not free. It will not be any of these countries that replaces the dollar and it is highly unlikely to happen in our lifetimes. However, that’s not to say it won’t happen in our children’s lifetimes. Bad policies beget bad outcomes. King Dollar will only stay that way if the US keeps its fiscal and monetary house in order.”

Looking below the surface: While we are comfortable with the outlook for the US Dollar and the trajectory for the future, it is important to consider both the bull (positive) case and bear (negative) case of potential developments.

Bull (positive) Case for the future outlook of the Dollar:

- The Dollar still represents 60% of global currency reserves and 90% of all global transactions (based on 200%).
- Value of the Dollar remains close to a 10-year high versus currencies of other countries – and remains the primary currency used for trade and financial transactions in the global economy.
- International investment flows indicate demand for Dollars beyond the Treasury market. The positive impact of foreign direct investment in business, property and risk markets (stocks) in the US, further enforce Dollar strength. Access to the US consumer alone drives substantial Dollar demand.
- There are few signs that major foreign holders are poised to suddenly shift away from the Dollar and few (if any) currencies that would be a viable alternative.
- There is no hard evidence that gradual diversification away from the Dollar will have a material impact to the strength of the currency or US economy.

Bear (negative) Case for the future outlook of the Dollar:

- Headlines suggest there is new momentum building amongst other nations to explore a reduction in dependence on the US Dollar in international trade and transactions: China is beginning to use the Yuan in some commodity trades; Brazil and Argentina are exploring a common currency; China is experimenting with a Central Bank Digital Currency (CBDC); Prominent emerging economies (Brazil, Russia, India, China, etc.) have explored reducing Dollar dependence for cross-country exchange; etc.
- The “weaponization” of the US Dollar is also a reason to believe there could be movement away from Dollar dependence. Last year as Russia invaded Ukraine, Russia was effectively cut off from entering into US Dollar transactions. This was a recent example of the power of the US Dollar in the imposition of Western sanctions – other countries will look to diversify this risk and impact in the future.
- Long-term movement to a multi-currency global economy is possible and could have benefits for other countries. However, it would require major structural changes in many regions – such as reducing barriers to trade and investment, along with strengthening protections for investors. These changes take time and political will.

Our point of view: Our team is confident in the case laid out by research teams that we respect regarding the outlook for the US Dollar and its continued prominence in the global ecosystem. It is unlikely that the US Dollar will be replaced any time in the foreseeable future as the global reserve currency – although further diversification appears likely over time. While the Dollar may lose its dominance over time it is unlikely that a gradual reduction in Dollar dependence would cause major turmoil to the US economic ecosystem or the viability of the Dollar as a prominent global currency. The United States continues to be viewed as the

“safe-haven” of choice for other sovereign nations and that is unlikely to change in the near future – providing further reassurance that the Dollar and Dollar-denominated investments will continue to function as an important part of the global economy.

Practically speaking, our firm is very comfortable with portfolio positioning to navigate any cyclical changes in the currency markets. We use a globally-diversified approach to portfolio construction that is designed to respond well across changes in economic cycles and leadership. In the case of the US Dollar, when the Dollar is outperforming a basket of global currencies it tends to act as a tailwind for US Stocks, while the Dollar is underperforming it tends to act as a tailwind to International Stocks. Our philosophy to diversify across countries in a balanced way will mitigate the impact to our investors in regards to cyclical currency movements. Dollar strength has been a stimulant to US Stocks outperforming International Stocks in the previous decade, and we would not be surprised to see a period of time in which some currency reversion supports outperformance of International Stocks. We are confident that a globally-diversified approach will continue to serve clients well and help provide stability amidst the cyclical nature of markets and market components.

As always, we are here for you. Thanks for the trust and partnership in your journey to continued financial success.

Additional Resources RE: Outlook for the U.S. Dollar

Will the U.S.
Dollar be
Dethroned? -
Schwab

How to Lose
Reserve
Currency Status -
First Trust

Dollars Reserve
Currency Status
is No Sure
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