International Commentary — June 17, 2021

U.S. Dollar: Spike Likely Transitory, Softness Should Resume

Summary

While the FOMC made no substantive changes to monetary policy yesterday, the updated "dot plot" has turned market discussion toward whether the Fed may look to tighten monetary policy earlier than previously expected. As a result, the U.S. dollar has spiked against G10 and emerging market currencies; however, in our view, the recent strength in the dollar will likely be temporary and could make for attractive entry points to gain exposure to foreign currencies.

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Our View Hasn't Changed

Yesterday's FOMC meeting has created some renewed volatility across financial markets, particularly within currency markets. While actual policy changes were limited as the FOMC opted to keep its asset purchase program unchanged and the target for the fed fund rate near 0%, the updated "dot plot" has shifted market discussion towards whether the Fed may look to tighten monetary policy earlier than initially expected. For an in-depth recap of yesterday's FOMC meeting please read the update from the U.S. economics team, but the key takeaway from the "dot plot" is that expectations of future Fed policy tightening has been brought forward. Fed members now expect 50 basis points of tightening by the end of 2023, a notable change from March. As a result, the U.S. dollar has rallied, with the U.S. dollar index (DXY) posting a near 1% gain yesterday and up another 80 basis points this morning. In addition, DXY has broken out of its recent holding pattern and is heading toward 92.00, a level not seen since April. A hawkish "dot plot" has also created a backdrop where the U.S. dollar is outperforming against emerging market currencies, in particular the higher beta currencies in Latin America and emerging Asia.

The spike in the dollar has been noteworthy, but in our view, is likely to be temporary and we maintain our view for a softer U.S. dollar over the medium-to-long-term. Yesterday's FOMC meeting was clearly more hawkish than expected, but is not enough to spark a sea change in our outlook on the U.S. dollar. Part of the reason for maintaining our view is that actual monetary policy settings in the United States remain unchanged, while foreign central banks across the G10 have already taken, and will likely continue to take, more concrete steps to tighten monetary policy. For example, the Bank of England and Bank of Canada have slowed asset purchases recently, and in our view, will continue to scale back purchases over the course of this year. In addition, Norway's Norges Bank brought forward expectations for rate hikes and will likely look to tighten policy in September, with multiple rate hikes also possible in the following quarters. Even the Reserve Bank of New Zealand may be turning less accommodative as strong Q1 GDP data have markets now anticipating New Zealand's central bank could hike rates by May 2022, earlier than previously expected. With foreign central banks tightening policy and explicitly signaling future policy changes, and the Fed remaining patient, we expect foreign currencies to attract capital flows.

We also maintain our view for a weaker U.S. dollar as growth prospects for foreign economies continue to improve. In our view, a backdrop of synchronized growth should result in a weaker U.S. dollar over time. Within the G10, we believe economic prospects for the Eurozone are improving amid a strong vaccination campaign and imminent fiscal stimulus, while we are not concerned that a delayed full re-opening will disrupt the U.K.'s economic recovery significantly. COVID cases are also not a concern in Australia and New Zealand, with COVID containment allowing Q1 GDP data to outperform relative to expectations. We also remain optimistic on growth prospects in Canada and Norway as higher oil prices can support local economic recoveries. As foreign economies demonstrate resilience, or in some cases outperformance, and with the U.S. economy still strong, a backdrop of synchronized growth within the G10 should fuel positive sentiment toward foreign currencies and push the dollar lower. We saw similar dynamics play out after the Global Financial Crisis, while synchronized growth also resulted in a weaker greenback over the course of 2017 as well. As the post-COVID recovery becomes more engrained, we believe those dynamics will repeat themselves and the U.S. dollar will gradually depreciate against G10 and emerging market currencies over time.

Given the recent spike in the U.S. dollar and depreciation of many G10 and emerging market currencies, now could make for attractive entry points to gain exposure to certain foreign currencies. In particular, currencies closely linked to commodity prices and more hawkish central banks could be trading at attractive levels. On the G10 side, we are most optimistic on the Canadian dollar as well as the Australian and New Zealand dollars, while within the emerging markets the Russian ruble and Mexican peso appear attractive at current levels as well.

What Could Change Our View?

While our view on the U.S. dollar has not changed, risks around our view have risen. But in order for us to reverse course and forecast longer-lasting U.S. dollar strength, the Fed would need to follow-up yesterday's meeting with additional hawkish commentary or near-term action to demonstrate a move to less accommodative monetary policy is imminent. As far as hawkish commentary, we will be particularly focused on the minutes from yesterday's meeting, which could reveal FOMC members discussing timing around a tapering of asset purchases. June FOMC minutes will be released in early July, and should the minutes reveal a more in-depth conversation around Fed tapering, the U.S. dollar's recent rally could continue. In addition, multiple Fed members will speak at conferences between now and the FOMC's next meeting on July 28. Hawkish commentary from Fed members could also prolong the dollar's run and force us to re-think our outlook on the U.S. dollar.

Over the next few months, the Fed will have multiple opportunities to follow through on members expectations for earlier-than-expected tightening. In particular, we will be focused on the July FOMC meeting as well as the Jackson Hole Economic Symposium toward the end of August. As of now, our U.S. economics colleagues do not expect any policy change in July, while we also note there will not be an updated "dot plot" released at that meeting. However, Fed Chair Powell will give a post-meeting press conference where he could choose to be more hawkish and signal U.S. inflation is not as transitory as the Fed initially expected. Should Powell signal inflation risks are more tilted to the upside than previously forecast, the dollar would likely spike again and we could re-visit our U.S. dollar forecast. Also, the Jackson Hole Economic Symposium has been highlighted as a possible event where the Fed could telegraph a tapering of asset purchases to financial markets. Again, our U.S. economics team does not currently anticipate a taper signal from Jackson Hole, but a change in policy messaging in August could also result in adjustments to our views on the dollar.

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