Elston

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Elston Insights

Past strong dollar's peak

- Strength of US dollar in 2022 has helped contain inflation
- Its run may be over for now, but a weaker dollar will stimulate growth
- Low merit in a tactical GBP hedge in absence of a catalyst for sterling

The strength of the dollar over the first 9 months of 2022 was remarkable. Faced with an array of risk factors – an energy crisis in Europe, Zero-Covid policy in China and soaring inflation worldwide, investors fled to the safe haven of the US currency sending it above Covid-era highs.

The Dollar became even more attractive with rapidly rising interest rates that meant that after over a decade of suppression, risk-free yield was back.

As inflation spiralled higher and interest rates ratcheted up, dollar strength proved a welcome counterbalance to depressed returns for bonds (buckling under inflation and interest rate risks) and equities (dragged down by the risk to growth and higher discount rates driving down valuations).

In our November 2021 and May 2022 Insights, we flagged the attraction of using dollar-denominated Floating Rate Notes as a neat way of 1) bringing in some low risk dollar exposure as a volatility buffer, 2) benefiting from a rising interest rate regime, and 3) protecting against GBP weakness.

So what brought the dollar run to an end?

Towards the end of 2022, we moved past "peak dollar" with other currencies staging a comeback.

Fig.1. Dollar Index suggests "peak dollar" was 14th October 2022

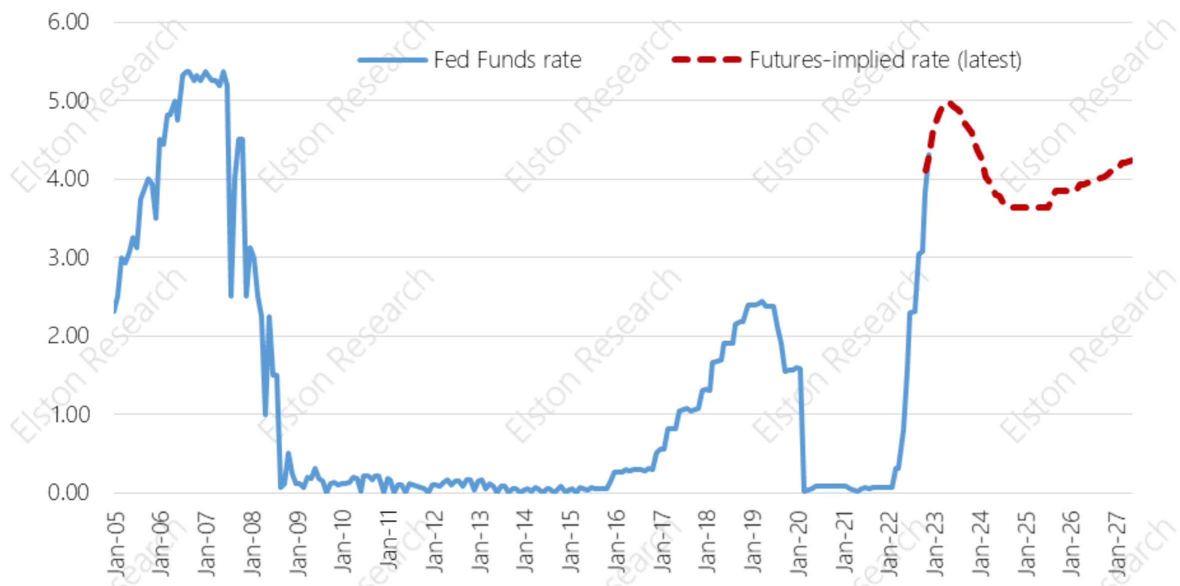
This was because there was moderation in the risk factors that had spiked earlier in the year. Inflation is moving past the peak, primarily owing to base effects and policy intervention. The question is (absent a severe recession), will it eventually settle at or above target rates. We think above, owing to its broadening base.

Furthermore, the hawkish pace of central bank tightening brought to light the growing risk of recession. A weaker US economy could necessarily translate to a weaker USD relative to its 2022 highs.

Where will the dollar go from here?

Historically, the dollar tends to peak at the same time as equity markets bottom out. Whilst some risk factors have abated, the market is torn between whether or not the US economy will achieve a soft landing. Separately, whilst the Fed's message that interest rates could stay elevated for as long as it takes to get inflation in check, markets are assuming the Fed wil have to cut rates as the outlook for the economy deteriorates.

Fig.2. Outlook for Fed Funds Rate



Source: Elston research, Bloomberg data

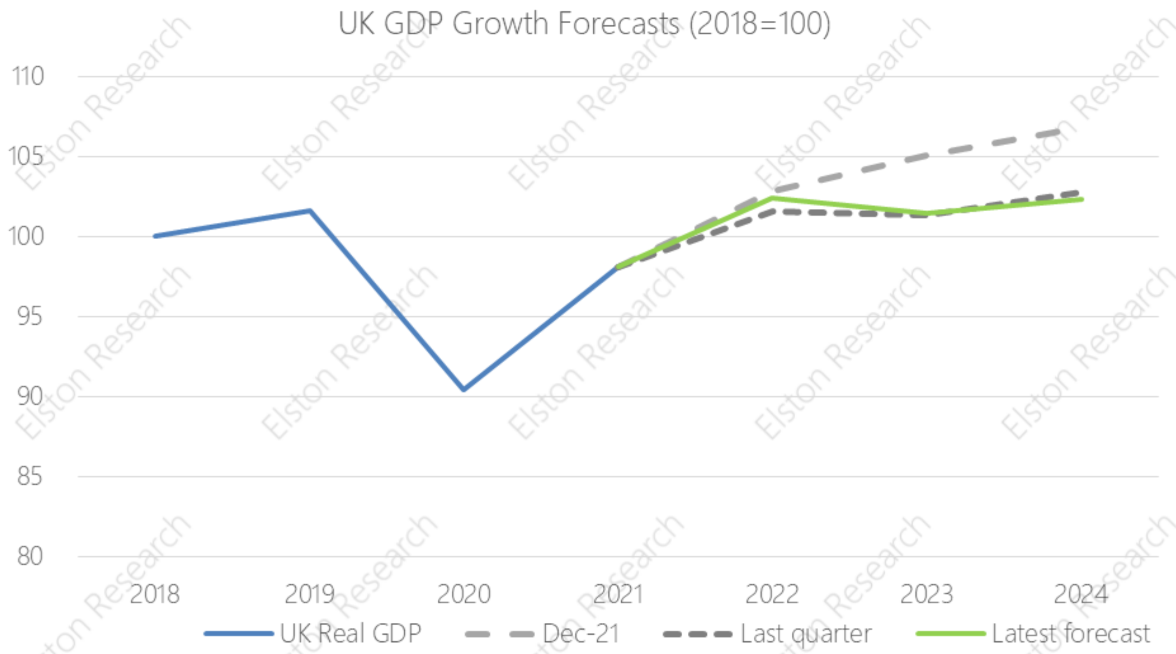
What about sterling?

In our view there is still good reason to maintain some exposure to the US dollar within the Bond & Cash allocation of a portfolio, not least because the outlook for the Sterling, is worse. Whilst the recovery from Trussonomics lows in September is welcome, there is no clear catalyst for Sterling to recover to June 2021 levels when the vaccine roll out kicked off.

Fig.3. Following technical recovery from 23rd September lows, no catalyst to return to 1.40 in near term

Since that time, the hope that growth would return to trends has been disappointed and UK economic growth has been downgraded.

Fig.4. Outlook for GDP growth has been downgraded since Dec-21



Source: Elston research, Bloomberg data, as at report date

We advocate for a predominantly sterling-based strategic asset allocation for Bonds, but tactical exposure to Dollar on the basis that 1) the US is likely to get growth back on track before the UK, 2) the US is more likely to contain inflation more quickly, and 3) US energy security is far more resilient than the UK hence we will continue to "import inflation" by buying dollar based LNG and Oil. Finally, the volatility of Sterling means that hedging to sterling introduces more risk into a portfolio from a purchasing power perspective, even if GBP-hedging reduces reported volatility.

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