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MARKET INSIGHT

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PEAK DOLLAR, MAYBE; WEAK DOLLAR, NO

The narrative in favour of a new bear cycle for the US dollar is strong and based on solid arguments: a massive expansion of the Fed's balance sheet, the loss of the competitive advantage of the most attractive rates among G10 currencies, and the highest fiscal deficit in the post-war era. Moreover, in light of past cycles, the length (nine years) and magnitude (a rise of more than 30%) of the current cycle point to an upcoming downturn. In the current context, a more nuanced analysis is nevertheless appropriate.

The Fed has expanded its balance sheet by almost 70% since the start of March, which according to many experts will inevitably lead the dollar to depreciate. However, empirical research shows that the correlation between the change in the Fed's balance sheet and the dollar is weak and unstable. Although the Fed has been more reactive than the ECB in implementing a new quantitative easing (QE) programme, since the beginning of March the Fed and the ECB have increased their balance sheet relative to GDP to the same extent (around 13%). Economists are also expecting a further rise in the ECB's balance sheet before the end of the year, greater than the eventual increase the Fed may make.

CENTRAL BANKS CONTINUE TO BE IMPORTANT IN A WORLD OF ZIRP AND NIRP

The Covid-19 crisis has led the Fed to introduce a zero interest rate policy (ZIRP), eliminating the appeal of the US rates that had prevailed until now. However, we note that the rate differential had been losing its influence for several years, most likely because there is a level of differential below which this factor loses its influence. Central banks are nevertheless continuing to play a key role via expectations of unconventional monetary policies (negative rates, yield curve control, intervention on the foreign exchange market). Given the low probability of seeing the Fed apply a negative interest rate policy (NIRP), expectations of relative monetary policies could provide support for the dollar.

THE DOLLAR BENEFITING FROM "EXORBITANT PRIVILEGE"

With the erosion of the rate differential as a differentiating factor, the currency market now appears to attach more importance to structural aspects.
We note that the currencies with the largest QE programmes and large external and fiscal deficits are also the most overvalued. From this perspective, the dollar appears to be structurally very vulnerable. However, the greenback remains the dominating reserve currency and enjoys what some specialists call "exorbitant privilege": among G10 currencies that saw a year-to-date decline in yields, and a deterioration in the country's external current account, the US dollar is the only currency that appreciated this year. In the event of a global crisis and systemic risk, the US dollar remains a safe haven currency with no real alternative.

THE COUNTER-CYCLICAL BEHAVIOUR OF THE DOLLAR REMAINS THE KEYSTONE

Since the crisis, movements in the dollar have been based more on expectations of the speed, extent and quality of the global economic recovery than on growth expectations relative to other economies or on idiosyncratic US factors. Studies show that the economic bar is high and that a full V-shaped global economic recovery would be needed for the dollar to depreciate substantially. But the "economic scars" that certain sectors and parts of the global economy will be left with are likely to limit the recovery to below pre-crisis levels.

THE POLITICAL FACTOR COULD BE A WILD CARD

In the United States, a victory by Joe Biden in the November elections would lead to at least a partial reversal of the 2017 tax cuts (TCJA) and, most probably, a relaxation of the trade tariffs on Chinese imports. A Democrat administration could thus on the one hand put an end to the "American exceptionalism" that has buoyed the dollar over the past few years, and on the other reduce the defensive appeal of the dollar. In the eurozone, greater solidarity and cohesion within the EU, notably by sharing the fiscal burden of the rescue fund, could further compress the political risk premium still weighing on the EUR. However, this optimism appears to be already factored into exchange rates, as reflected in the speculative net long EUR positioning, at its highest since 2018. It is therefore unlikely that a positive surprise on this front could trigger a substantial upward movement in the EUR/USD in the near term.

The dollar may have reached its cyclical peak in March, but the conditions for a new dollar bear cycle and the loss of its "exorbitant privilege" are not yet there. Relative quantitative easing, monetary policy expectations, the global economic cycle and the privileges stemming from a dominant position should all help to support the dollar. The political factor could nonetheless reshuffle the cards more quickly than expected.

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