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What new developments mean for the dollar's decline

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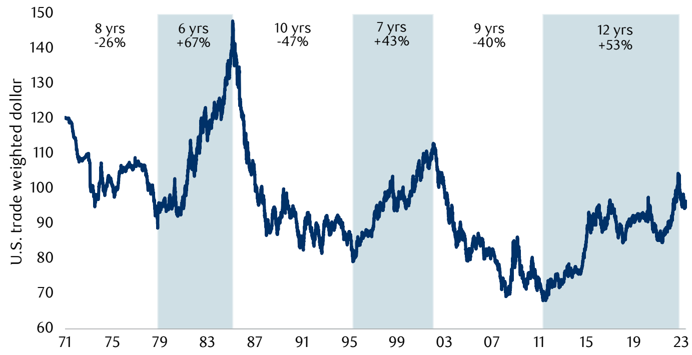
The U.S. dollar kept to a narrow 4% range in the first five months of 2023 in what we believe will turn out to be a pause in the currency's longer-term sell-off. Recent U.S. regional bank failures and monetary and fiscal trends support our view that the dollar will weaken, but this outlook has been challenged as the U.S. economy remained more resilient than its global peers. We retain our forecast that the greenback will fall over the next year and expect the declines to be greater than what we had been forecasting last quarter.

It is no secret that the U.S. dollar is expensive. The currency strengthened by 53% on a trade-weighted basis between 2011 and 2022 – the longest stretch of U.S.-dollar gains since currencies were unpegged from the price of gold in the early 1970s (Exhibit 1). This U.S.-dollar bull market was extended first by the pandemic and then by the U.S. Federal Reserve's (Fed) campaign to quell inflation through interest-rate increases. Since both the pandemic and Fed hikes now seem to have largely ended, investors appear in our view to be getting more comfortable with the idea that the dollar may finally crumble under its own weight. Even after a 7% decline since October, the greenback remains more than 20% rich based on purchasing power parity (Exhibit 2), an extreme level of overvaluation that is mirrored by most other models.

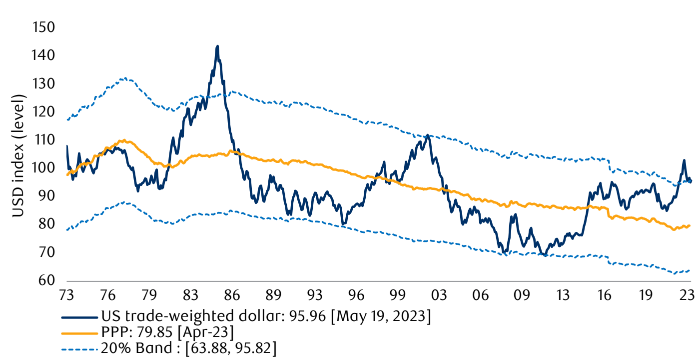
Exhibit 1: U.S. trade-weighted dollar



Note: As at May 19, 2023. Source: Bloomberg, U.S. Federal Reserve, RBC GAM

Exhibit 2: U.S. trade-weighted dollar

PPP Valuation



Note: Uses new Fed USD index from Dec 31, 2019 onward (USTWAFE Index).
As at: May 19, 2023. Source: U.S. Federal Reserve, Bloomberg, RBC GAM

History shows that the currency tends to travel from one valuation extreme to the other without much pause along the way. A comparison of the current decline relative to those that started in 1985 and 2002 offers some perspective on the considerable amount of dollar weakness that might materialize over the next several years (Exhibit 3).

Valuation is not the only factor suggesting a weaker dollar, and neither is the negative outlook simply about skyrocketing fiscal and current-account deficits. Other factors have been weighing on the greenback, including:

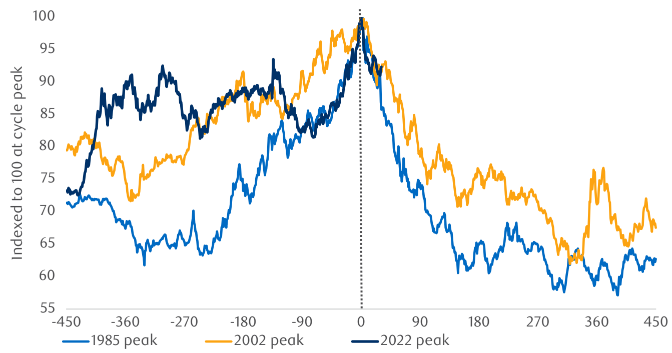
- Economic data in Europe improved for much of the spring, and there is no doubt that falling energy prices due to warmer weather and larger natural gas stockpiles have helped tremendously.
- The U.S. interest-rate advantage versus the eurozone has narrowed since the European Central Bank (ECB) began hiking rates aggressively, and the ECB is expected to outpace the Fed over the next six months. The Bank of England has also remained relatively hawkish.
- Issues involving U.S. regional banks, which may slow U.S. economic activity as lending to households and businesses is constrained. This seems to be mainly a U.S. problem, as banks elsewhere in the world are generally in better shape.
- Debt-ceiling concerns, which highlight U.S. fiscal imbalances and a fractured political landscape that inhibits sound policymaking.

These developments caused a noticeable shift in sentiment against the dollar beginning late last year, with an increasing volume of negative commentary from the press and global investment banks. Investors, voting with their wallets, recently pushed the euro above US$1.10, Bitcoin to US$30,000 and gold beyond US$2,000 per ounce. This dollar-bearishness was tested by a small rebound in May, but we don't expect this to alter the longer-term trajectory of the dollar. We note that capital continues to flow out of the U.S. and into Europe, as evidenced by eurozone balance-of-payments statistics and by purchases of European equity ETFs by U.S. investors (Exhibits 4 and 5).

De-dollarization

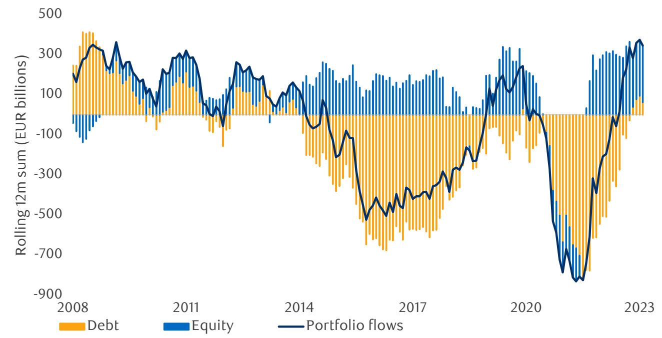
The shift in attitudes against the U.S. dollar has been widespread, and the term "de-dollarization" is becoming pervasive. The term refers to a gradual move away from the greenback as the main currency for global trade and

Exhibit 3: U.S. dollar has much further to fall



Note: As at May 21, 2023. Uses USTWAFE index. Source: Bloomberg, RBC GAM

Exhibit 4: Capital continues to flow into Europe



Note: As at March 31, 2023. Source: ECB, RBC GAM

Exhibit 5: Euro benefiting from strong ETF inflows

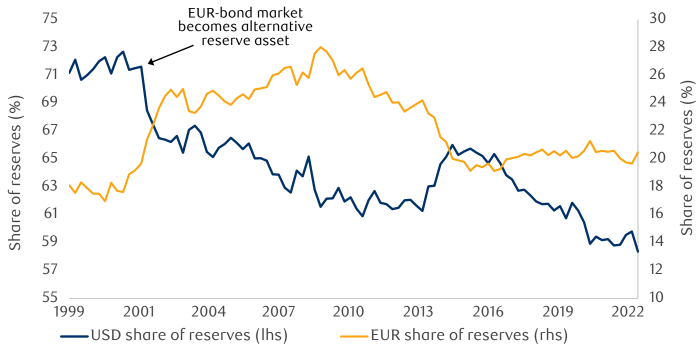
Note: As at May 26, 2023. Data from 5 ETFs VGK, EZU, FEZ, EWG, IEV. Source: Bloomberg, RBC GAM investment. China, which trails only the U.S. as the world's largest economy, is positioning the renminbi as an alternative by developing its financial system, loosening currency controls and making bond and stock markets accessible to foreigners. Progress toward this aim has been slow – it usually takes decades for a new reserve currency to emerge – but news that some oil trading is being done in renminbi suggests that the ball has started rolling.

The belief that de-dollarization has accelerated is supported by these recent developments:

- Last year's G7 sanctions barring most Russian institutions from using U.S.-dollar-based financial payments systems and the freezing of large portions of Russia's global foreign-exchange reserves. The moves followed similar steps to isolate Iran a few years ago, when the country took steps to further develop nuclear weapons. Measures that weaponize the dollar are concerning to the world's largest holders of foreign-exchange reserves, and are part of the reason that China has developed a parallel payments system of its own.
- News that Brazil and Argentina are looking to abandon the dollar in their own bilateral trade. It's unclear how this type of arrangement might work, given that no Latin American currency appears to be a viable candidate for settling trade. However, it is conceivable that the Chinese renminbi could be used in this way within Asia. Strengthening trade ties among Asian countries and the region's huge foreign-exchange reserves mean that progress on this front would have an impact on currency markets.
- Eroding faith in the U.S. dollar as a store of value. Some investors are questioning whether the greenback deserves to be the primary currency on which the global financial system is built given the country's large fiscal deficits, funded in part by Fed bond purchases, and a growing reliance on international creditors.
- The mounting pile of evidence that the U.S. dollar is gradually losing its appeal, as evidenced by the IMF's quarterly report showing that the dollar has lost share in global foreign-exchange reserve portfolios (Exhibit 6). The drop in reserves coincides with the development of the single-currency bond market in Europe, which provided a viable alternative.

There is no doubt that this fall in the U.S. dollar's share represents a long-term headwind to the greenback, but the simple truth is that the dollar is likely to remain the world's

Exhibit 6: U.S. dollar share of global reserves continues to fall



Note: As at December 31, 2022. Source: IMF, RBC GAM

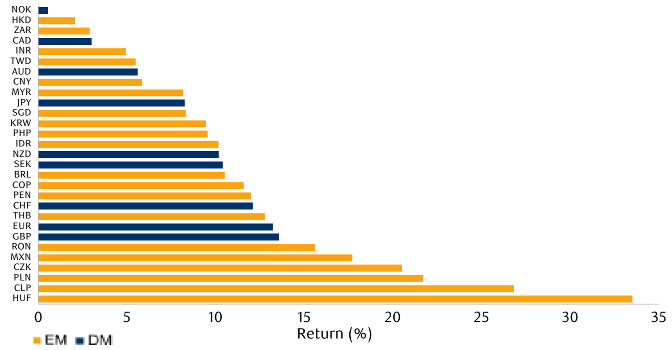
primary reserve currency for many years to come. No other country offers the combined advantages of free capital flows, established rule-of-law, deep financial markets and structural current-account deficits. The greenback's position is so well entrenched that exporters and importers must still use the U.S. dollar as a go-between when invoicing trade and making payments in one another's currencies. The Bank for International Settlements reports that 88% of all currency transactions involve the greenback. In any case, it appears that the de-dollarization theme has contributed to some short-term weakness, but we view the issue as a longer-term one for the greenback and one that will be persistent throughout U.S. dollar bull and bear markets.

Emerging Markets

We think that most emerging-market currencies will continue to appreciate versus the dollar, but perhaps less so than in recent quarters. Since the dollar's peak in October, all currencies have benefited from U.S.-dollar weakness, but emerging markets have generally outperformed (Exhibit 7). Some emerging-market currencies have posted returns in excess of 20% over the past year, led by high-yielding cyclical ones such as the Mexican peso and the Hungarian forint. The same cannot be said for G10 currencies, where the cyclical Norwegian, Canadian and Australian currencies have been among the weakest in the world.

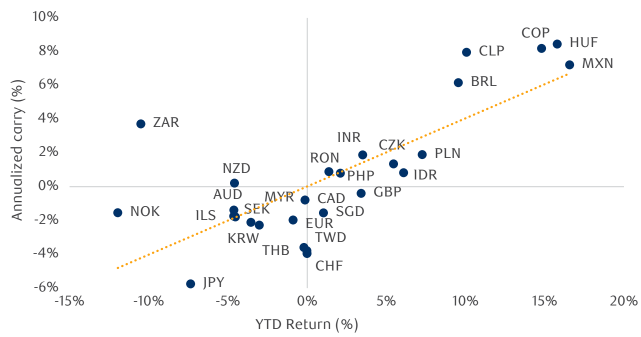
One reason why emerging-market currencies have fared so well is that their central banks were quicker to raise interest rates than the Fed when inflation began to flare, and were more aggressive in doing so. A clear relationship

Exhibit 7: All currencies gain vs. the weak U.S. dollar



Note: As at May 26, 2023. Data since October 21, 2022. Source: Bloomberg, RBC GAM

Exhibit 8: Strong relationship between yield and FX performance

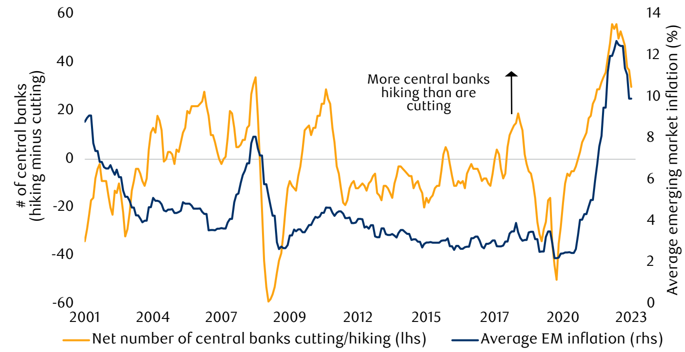


Note: Data as at May 26, 2023. Source: Goldman Sachs, Bloomberg, RBC GAM

exists between the level of yields and the performance of currencies, owing largely to the influx of capital attracted to higher rates (Exhibit 8). This link is particularly strong at a time of stable risk appetite and low volatility, where traders assign a low likelihood of currency depreciation that would offset the higher yields that they earn while invested in these currencies.

Having said this, we are particularly attentive to the reaction of central banks as inflation starts to fall (Exhibit 9). To date, monetary authorities have earned credibility by keeping policy tight, but a few have hinted that interest-rate cuts are on the horizon, including in countries where inflation remains at double-digit levels. The independence of most emerging-market central banks is not nearly as well established as it is in developed markets, and there is increasing pressure from politicians to ease policy in support of economic growth, even if it comes at the expense of higher inflation. For this reason, we have become more cautious on emerging-market currencies as valuations become less attractive (still cheap, but less so) and as hard-won policy credibility comes under threat.

Exhibit 9: Central-bank reaction function important as inflation begins to fall

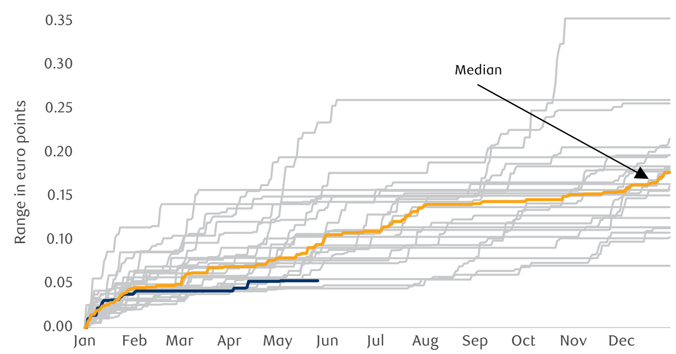


Note: As at April 30 2023. Source: Macrobond, RBC GAM

Euro

The euro has kept mostly to a range of US$1.05 to US$1.10 this year, one of the narrowest on record (Exhibit 10), and we believe the euro at some point will strengthen toward the upper end of the range. Our expectation that the euro will gain is about more than just overall weakness in the dollar. The view is also based on a convergence of short-term interest rates between regions as the ECB continues

Exhibit 10: Euro trading at one of the tightest ranges on record



Note: As at May 26, 2023. Source: Deutsche Bank, Bloomberg, RBC GAM to increase rates while the Fed remains on hold. European policymakers are likely to be especially ardent about tightening policy because the prevalence of unions in the region makes it tougher for them to slow wage growth, a key ingredient of inflation. With spreads on bonds of southern European countries well contained and European banks not faced with the deposit flight plaguing U.S. banks, the ECB can afford to be persistent in raising rates further.

To date, growth has held up surprisingly well in Europe, owing largely to falling energy prices and disbursements made from Europe's 723 billion-euro pandemic emergency fund, though economic data softened somewhat during May. Lower energy prices, a stable banking industry and higher interest rates have all helped generate foreign interest in European assets. Even after recent outperformance, European equities remain cheap, and the undervaluation is magnified by the fact that the euro trades well below its fair value. With this migration of global capital to Europe, we think the euro can rise to US$1.20 within the next 12 months.

Japanese yen

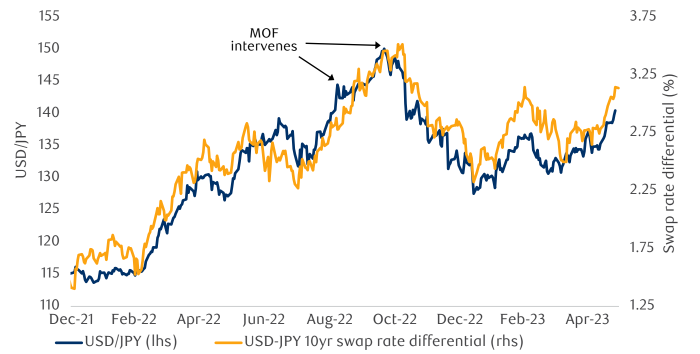
The yen has dropped 7% since the beginning of the year. The Japanese currency's link to differences in bond yields remains strong, and with U.S. interest rates staying elevated and the Bank of Japan (BOJ) capping yields, the yen underperformed peers. Expectations that the BOJ would allow longer-term interest rates to rise were dashed when new Governor Kazuo Ueda remained true to his predecessor's preference for holding down interest rates. Most traders expect that the BOJ will allow interest rates to rise later this year. The government announcement of fiscal stimulus could provide allowance for the BOJ to tighten even sooner.

Other yen-supportive themes that are likely to be in focus this year include:

- Japan's largest life insurers are shifting into domestic assets from foreign ones, and in the process of liquidating foreign assets convert at least some of the proceeds into yen. Not all of the foreign assets being liquidated are currency-hedged, so the impact of the shift results in actual demand for the Japanese yen.
- Demand for safe-haven currencies such as the yen would likely materialize if the global economy worsens more than expected.
- Currency intervention by the Ministry of Finance, which has become more relevant as the currency revisits levels where authorities last propped up the yen. (Exhibit 11)
- Japan's generally positive and high current-account surplus.
- Significant undervaluation.
- Short yen positions are higher than what one might expect given a negative outlook for the U.S. dollar.

We forecast a significant gain in the yen to 116 per U.S. dollar from the current level of 140. The degree to which we expect the yen to outperform over the next year relies heavily on our expectation of a pivot from the BOJ, but the currency should nonetheless benefit from the end of the Fed's rate-hiking cycle and the overall decline in the dollar.

Exhibit 11: Yen falls to level that attracted government intervention



Note: As at May 26, 2023. Source: Macrobond, RBC GAM

British pound

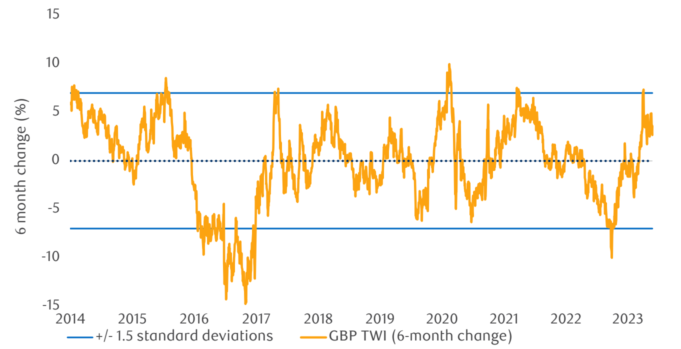
Against our expectations, the pound has been one of the better performing G10 currencies since the dollar peaked last fall, but we are skeptical that sterling can continue to outperform its peers even if it manages to rise against the U.S. dollar. On a shorter-term horizon, the pound's strength looks stretched (Exhibit 12), pushed higher perhaps by seasonality in April, historically the most positive month for the currency, and by higher-than-expected inflation that increased the number of times that investors now expect the Bank of England (BOE) to raise interest rates. In the longer term, the U.K.'s higher inflation is problematic because the economy (the only one in the G7 whose GDP hasn't reclaimed pre-COVID levels) will be challenged by the elevated level of interest rates needed to rein in prices. Higher yields may in fact be here to stay because the BOE has over the past few decades developed a reputation for tolerating an average level of inflation that has been higher than other major economies. We expect that the pound will underperform most of its G10 peers and see the currency rising only marginally versus the U.S. dollar to US$1.30.

Canadian dollar

We believe the Canadian dollar will appreciate against its U.S. counterpart over the next year but have tempered our outlook somewhat. The lower degree of optimism reflects concerns about the impact of higher interest rates and the high sensitivity of Canada to the slowing U.S. economy (Exhibit 13). To be fair, the Canadian economy has remained remarkably stable in recent months amid fears about a drop in Canadian house prices and a U.S. economic slowdown. Jobs in Canada remain plentiful and consumer confidence has rebounded from 2022 lows, but exports and industrial activity have started to show weakness.

Even with this weakness, we believe the Bank of Canada (BOC) will be vigilant on inflation and is thus likely to hold rates at levels that would tend to support the loonie later in the year. The BOC opted early in 2023 to hold rates steady for a time, a policy that differed from the Fed's continuous hikes. But past hiking cycles have shown that the U.S. central bank tends to hike interest rates to over-restrictive levels and is subsequently forced to cut quickly when the economy inevitably falters. In that sense, the BOC appears more prudent, especially in light of the Fed's willingness to keep hiking rates amid a banking crisis and debt-ceiling uncertainty.

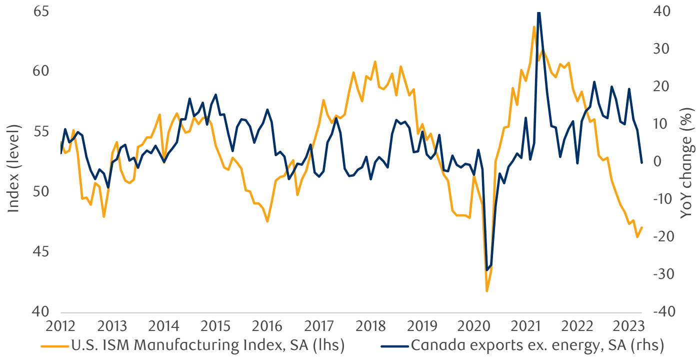
Exhibit 12: Pound appears streched



Note: As at May 26, 2023. Source: Bank of America, Macrbond, RBC GAM

> "We remain relatively downbeat on the pound, which should strengthen versus the dollar but is likely to underperform its peers."

Exhibit 13: Slower U.S. growth weighs on the Canadian economy



Note: As at April 30, 2023. Source: Credit Suisse, Macrobond, RBC GAM

Among the positives for the loonie are high levels of immigration (one million new Canadians in 2022), a healthy banking industry, strong commodity prices and what we believe will be the trend of a falling U.S. dollar. The Canadian dollar has kept to a range between $1.32 and $1.40 since last fall, trading sideways even as the U.S. dollar weakened against most other major currencies (Exhibit 14). Some of this Canadian-dollar underperformance stems from concerns about the housing market and high household debt, which have prompted investors, particularly those abroad, to bet on declines in the currency. We see the loonie appreciating to $1.26 per U.S. dollar over the next 12 months as investors continue driving down the greenback and fears about Canadian housing ebb.

Exhibit 14: Loonie trading in a tight range

Note: As at May 30, 2023. Source: Bloomberg, RBC GAM

Conclusion

The U.S. dollar has lost ground against all G10 and emerging-market currencies since its peak last October. Our view is that the dollar could fall significantly over the next few years, and several new considerations have emerged to buttress our negative view of the greenback. In addition to the dollar's overvaluation and a high dependence on foreign funding, the contentious debt-ceiling negotiations and recent bank failures highlight U.S.-specific issues that may continue to drag the greenback lower over the next few years. High-yielding emerging-market currencies have rallied the most in this period of U.S.-dollar weakness, but the outperformance could quickly reverse if emerging-market central banks cut rates pre-emptively.

Within developed markets, we think the yen likely has the most to gain, having recently cheapened to levels where the BOJ intervened last year. We have bumped up our euro forecast to US$1.20 from US$1.18 this quarter as European economic fundamentals improve and as the single currency remains the purest play on U.S.-dollar weakness. We have also tempered our optimism on the loonie by changing our forecast to $1.26 from $1.23 on the likely impact of slower U.S. economic growth. Finally, we remain relatively downbeat on the pound, which should strengthen versus the dollar but is likely to underperform its other peers.

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