In The Americas:
1200, McGill College Av.
Suite 1000
Montreal, Quebec
Canada H3B 4G7
T + 1 514.878.2377

Contact details:
Christopher Cook
VP, Macro Solutions
ccook@numeraanalytics.com

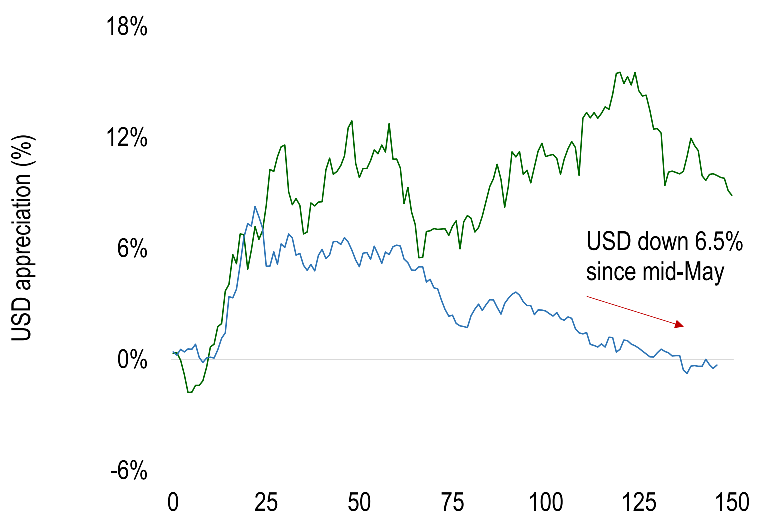
Kingdom under siege

After rising sharply early in the pandemic, the US dollar has depreciated considerably versus most major currencies. In this special report, we explore the causes for the ongoing slide, and evaluate the likelihood of a dollar 'bear' market. Although some factors are transitory, we believe there is a strong case for a persistent decline in the broad US dollar.

One major macro development since early summer has been the considerable weakening of the US dollar. The dollar has fallen 6.5% in trade-weighted terms since May (F1), posting similar declines against developed and emerging currencies. With the USD back to pre-COVID levels, a key question among economists and investors is whether the greenback will stabilize, or enter a period of structural weakness that would reverse its impressive gains over the past decade.

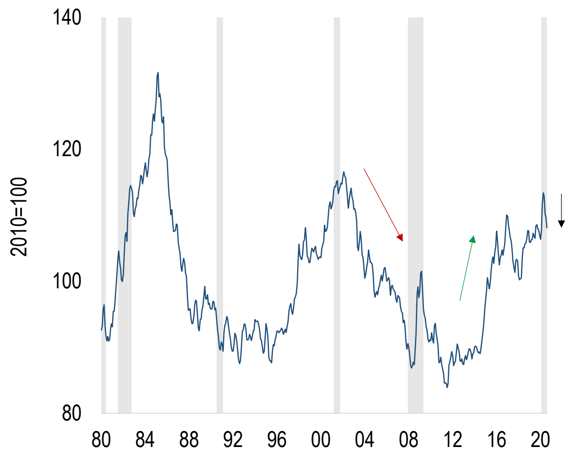
Although the dollar is (and will likely remain) the world's pre-eminent reserve and transactional currency, periods of prolonged dollar weakness are not unprecedented. The most recent 'bear' market (a 20%+ drop in the value of an asset) dates back to China's entry to the WTO in 2001 and ended during the Great Recession, during which time the USD fell 25% in real terms (F2).

F1: The dollar continues to weaken
USD during deep recessions



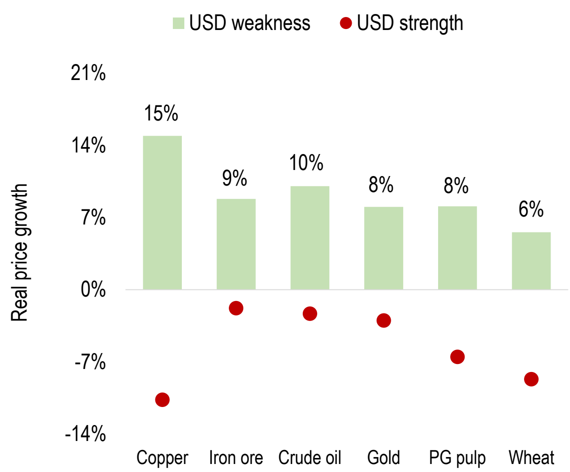
Note: Change in US dollar against currencies of major trading partners. Blue line shows change since mid-February. Green line shows evolution following the Lehman bankruptcy. Source: JP Morgan; Numera calculations.

F2: Is a dollar bear market likely?
Real trade-weighted US dollar



Note: Chart shows the evolution of the real trade-weighted US dollar. Dahsed grey lines denote official NBER recession dates. Source: Federal Reserve.

F3: Weak USD benefits commodities
Real price growth across USD cycles



Note: Average growth in real spot price for selected commodities during periods of US dollar strength and weakness since 1975. Source: Numera Analytics.

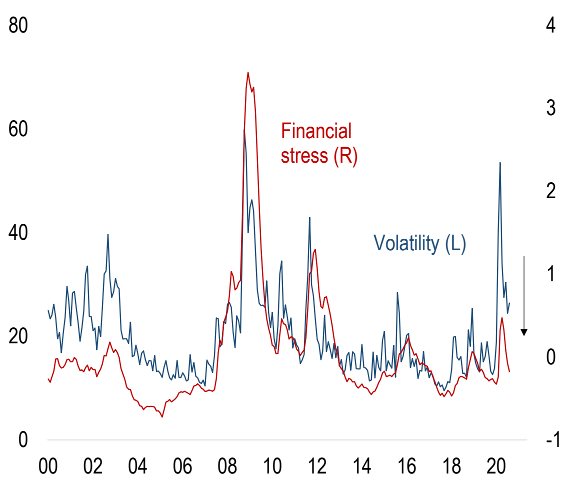
While a strong USD signals the relative strength of the US economy, a weak dollar boosts global economic growth. The positive link stems from the fact that many countries and firms borrow in USD, so a weak dollar lessens debt repayment and encourages capital investment. In addition, the dollar is the currency of choice for 50%+ of all international trade invoices, 4X higher than the US share of world trade. As a result, USD depreciation lifts trade volumes by lowering import costs. A **2017 paper** by current IMF Chief Economist Gita Gopinath and others finds that a 1% drop in the USD boosts global trade by 0.6-0.8%.

In part because of this positive demand effect, dollar bear markets are generally inflationary – especially for goods traded in USD. F3 compares average growth in real spot prices for selected raw materials during periods of USD strength and weakness. Notice that while dollar depreciation is associated to positive price growth, USD appreciation is usually detrimental to commodity prices.

What explains the USD slide?

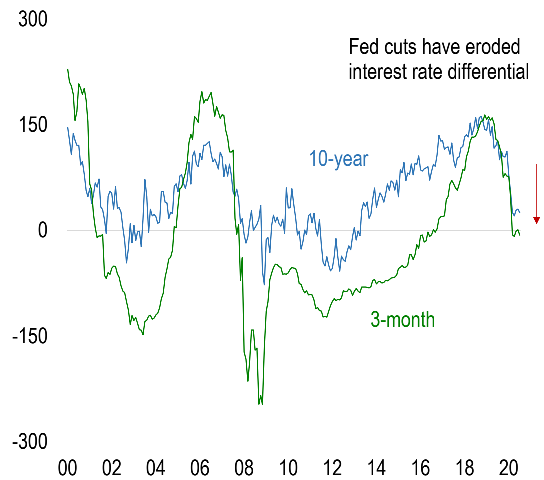
In order to assess the likelihood of the USD weakening markedly in coming years, we find it instructive to first analyze the factors behind the current slide. In our view, three key forces explain the ongoing decline. Firstly, greater risk appetite and expectations of stronger global growth have caused safe-haven plays to unwind. While gold demand by investors has soared, the gold market is simply too small to compensate

F4: Flight-to-safety effects have eased
Equity volatility and DM financial stress



Note: Chart compares US equity market volatility against the Numera DM financial stress index. The latter captures liquidity and credit default risk, leverage and access to financing. Higher values indicate tighter financial conditions. Source: CBOE; Numera Analytics

F5: US no longer offers yield premium
US - DM interest rate spreads (bps)



Note: Spread compares interest rate differentials between the US and other DMs. A positive spread indicates yields on 3M and 10Y US Treasuries exceed those of ex-US DM bonds of equivalent maturity. Source: US Treasury, Dallas Fed; Numera calculations.

sentiment shocks in the much larger FX market. Similarly, large-scale bond buying programs by major central banks has helped contain liquidity risk, causing global financial stress to diminish (F4).

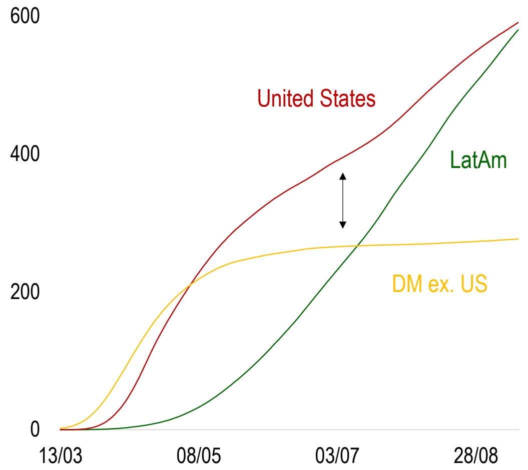
A second – related – factor have been the interest rate cuts by the Federal Reserve, narrowing the interest rate differential between the US and its trading partners. F5 plots the interest spread between US and other developed markets (DMs). US bonds no longer offer a yield premium, encouraging diversification towards non-US assets. Zero US rates also benefit emerging market (EM) currencies by reducing the opportunity cost of holding riskier assets (thus incentivizing risk-seeking behaviour).

Beyond financial market developments, the dollar has suffered from the US government's struggles in containing the virus spread. The difference is particularly striking when comparing critical COVID cases between the US and other DMs. Notice from F6 that the gap between new COVID deaths with other DMs has widened consistently since May, in turn affecting relative growth expectations. Conversely, elevated infection rates in Latin America (green line in F6) is a key reason why major LatAm currencies – including the BRL and MXN – continue to trade at a steep discount.

Could the dollar weaken sharply?

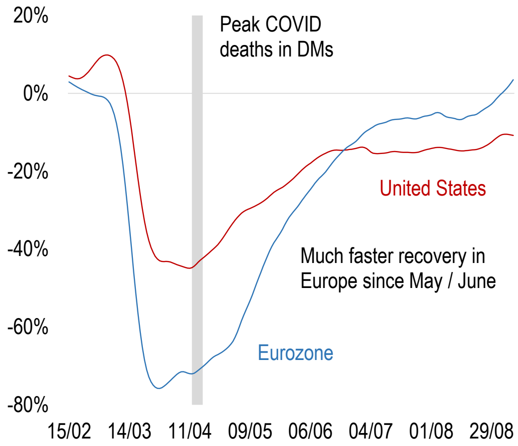
While some industry pundits have been warning of the possibility of a dollar bear market, others dismiss the claim on the USD's royal status. The argument relies on what Yale economist Stephen Roach coins the

F6: High relative death rate a further drag
Cumulative COVID deaths per million



Note: Chart compares cumulative COVID-19 deaths per million inhabitants. Source: ECDC, United Nations; Numera calculations.

F7: Europe has recovered faster
Away-from-home traffic (%)



Note: Chart shows changes in retail and recreation traffic in the United States and the Euro area versus 01/20. Shaded grey band denotes period of peak COVID-19 deaths in DMs. Source: Google Community Mobility Reports.

'TINA (there is no alternative) defense'. Simply put, if the USD remains the world's pre-eminent medium of exchange, as well as the preferred store of value by central banks across the globe, then it is unlikely for its value to decline sharply moving forward.

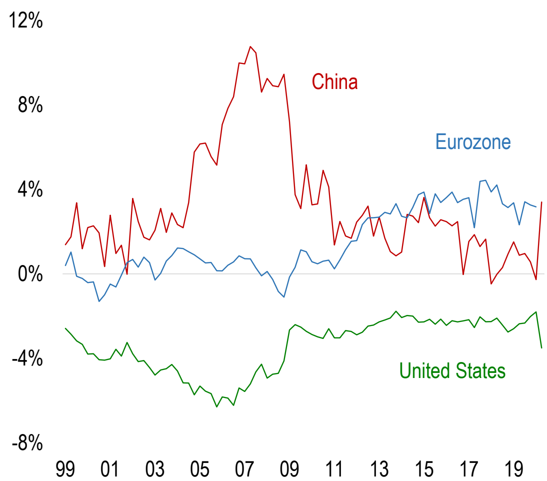
Like any foreign exchange rate, the dollar is a relative price. As such, its evolution depends on multiple factors, both foreign and US-specific, which could easily offset the high demand for the 'king' dollar. Given existing merchandise trade patterns, what is clear is that a broad US dollar depreciation is unlikely unless

				12M probabilities (%)		
T1: Current outlook	Baseline outlook			-5%	Appreciation[1]	+5%
	08/20	3M	12M			
USD vs. BRL	5.49	5.45	5.41	39%	44%	29%
USD vs. CAD	1.30	1.29	1.25	45%	29%	11%
USD vs. CNY	6.85	6.83	6.81	11%	44%	7%
USD vs. EUR	0.84	0.81	0.81	43%	35%	18%

1. Probability of the US dollar appreciating against a given DM currency over a 12M horizon.

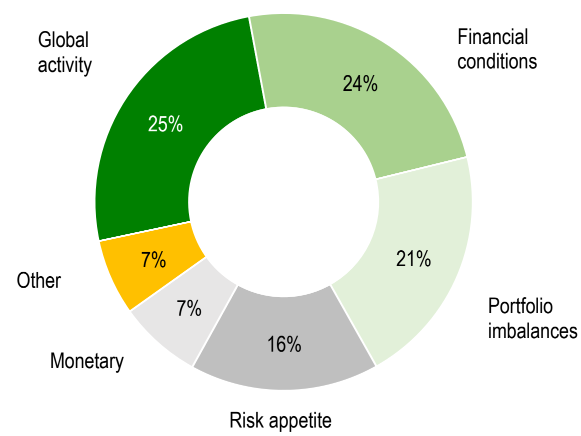
Source: History: Federal Reserve; Forecast: Numera Analytics

F8: Trade differentials have widened
Current account balance (% GDP, SA)



Note: Chart compares the current account balance for CN, EZ and US as a % of GDP.
Source: OECD, State Administration of Foreign Exchange (SAFE).

F9: EM FX depends on global factors
12M variance decomposition - EM FX



Note: Chart isolates the contribution of selected drivers to the 12M variability in EM currencies (debt-weighted; see F3) since 1994. Risk appetite proxied by the VIX. Monetary factors include interest rate

accompanied by a strengthening of the EUR and CNY (both regions represent nearly 40% of US cross-border trade). As we anticipated earlier this year, the euro has gained considerable ground over the summer fueled by a much stronger recovery in consumption. Similarly, the CNY is up 5% versus the USD since June fueled by favourable growth and productivity differentials.

We expect the USD to continue weakening against both currencies over the coming year. At 35%, the probability of the dollar rising against the euro stands at a 40M low (T1). Considering the USD is down 10% since May, there is a one-in-four chance of an actual bear market within the next year. The bullish euro outlook reflects greater confidence on Europe's full economic recovery, owing to a stronger fiscal response to COVID-19. The pandemic also widened the vast trade differential between both regions (F7), exerting further downward pressure on the USD.

The China call is less clear given ongoing political tensions, but there is still at 44% chance that the USD will weaken against the CNY 12M out. Like the euro outlook, the high probability of a CNY appreciation reflects favourable growth and current account differentials (F8). This should more than offset the impact of existing trade barriers on the CNY.

We also expect the USD to weaken against the currencies of mining countries like Canada or Australia. This reflects a projected recovery in **raw material prices**, owing to further improvements in transportation and robust CN industrial activity. A favourable oil price outlook vastly improves the upside for the CAD, with less than a 30% chance of the US dollar appreciating against the loonie 12M out.

The EM currency outlook is more uncertain, but falling financial stress, rising commodity prices and stronger global activity are all beneficial and materially important for EM FX prospects (F9). Although LatAm currencies like the BRL should strengthen, tail risk remains elevated owing to the possibility of a disruptive ‘second wave’, as this would likely result in capital flight. As we can see from T1 above, the likelihood of the USD strengthening 5% or more against the BRL (although not the most likely outcome) is much higher than for other currency pairs.