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WEAPONS OF MASS DEPRECIATION AND THE US DOLLAR'S NEW DOWNTREND

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Key Takeaways

- After a long period of chronic strength, the US dollar index is now over-valued at comparable levels with past secular peaks (1985 and 2002).
- Most of the financial excess and leverage occurred in America over the last decade. Doubt is now growing whether the US is really the world's safest house.
- Expect a multi-year period of US dollar weakness and a corresponding outperformance of international assets.
- Forstrong portfolios are strategically positioned to benefit from the unfolding dollar downtrend.

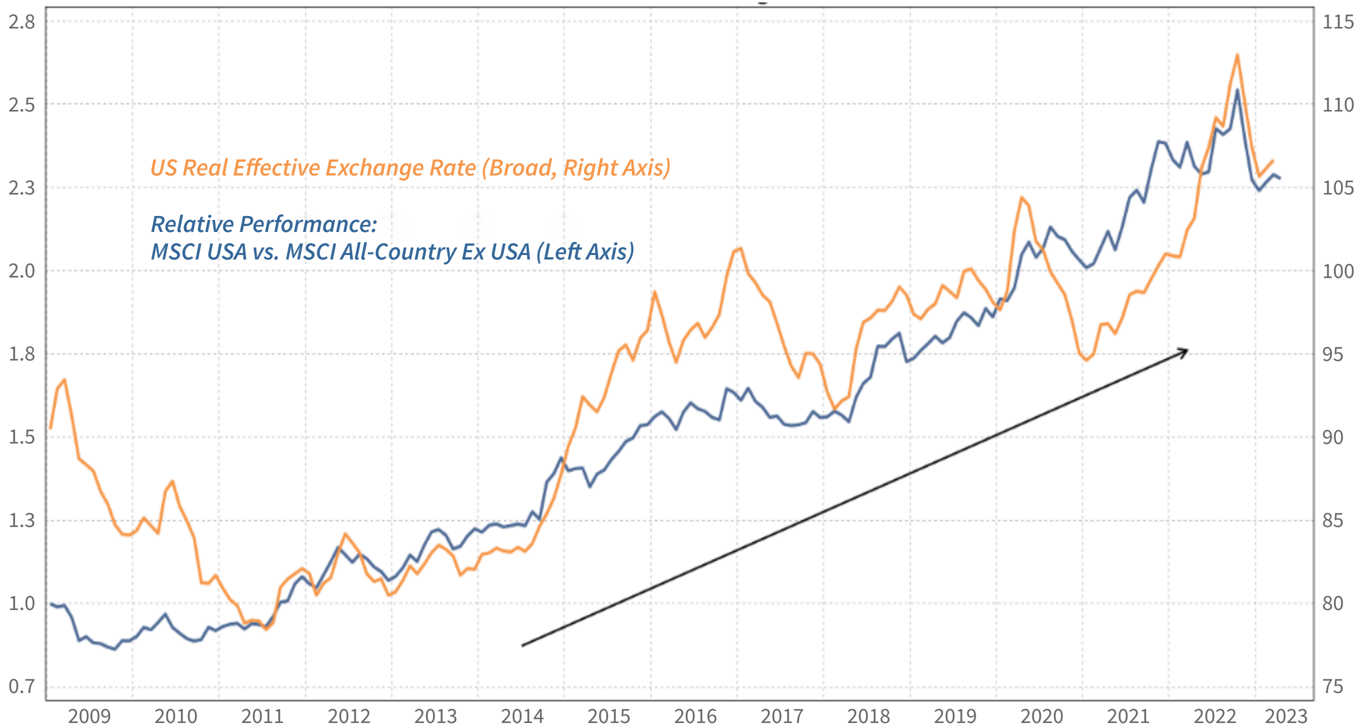
Ask Forstrong: The US dollar has been trending down since October 2022. Do you anticipate this weakness to last?

Behold the outperformance of America. A stock market that has tripled the performance of its global peers since 2010. A bond market that refuses to break, with investors still hoovering up negative real rates far out on the yield curve. And, an unemployment rate that is lower today than when the Fed's 500 basis points of tightening began.

And, yet, what's this? A looming debt ceiling cliff-edge less than one month away. A string of bank failures showing that deposits can now flee with a stroke on the smartphone in this new normal of digital finance and social media rumour mills. And, more broadly, a steady withdrawal from the architectural pillars of globalization, with countries continuing to slip out of Washington's orbit.

This remarkable and contradictory collection of facts, at a minimum, should give investors pause. The key question is this: where next for the seemingly indomitable US dollar? Starting points matter. After a long period of chronic strength since 2008, it's broad trade-weighted index is now over-valued at comparable levels with past secular peaks (1985 and 2002) and is 23% more expensive than a decade ago. The French Minister of Finance during the 1970s, Valéry Giscard d'Estaing, who reserved a special kind of contempt for the US dollar's seniority and the monetary perks that went along with it ("exorbitant privilege" were his exact words), is no doubt rolling over in his grave.

USD: Chronic Strength



Sources: Macrobond, MSCI, BIS, Forstrong Global Asset Management
*Relative performance rebased to 100 as or Jan 1st, 2009

But much must go right for this strength to continue. What is now clear is that we are living through, if not the end of the US dollar as the world's reserve currency (a very long-term topic), then a brutal exposure of its cyclical limits. The stakes are high. Strong currencies are some of the best tailwinds to total returns. For international assets to outperform — a key Super Trend of our investment team — a corresponding weak US dollar trend needs to be in place, as capital abandons America in search of better prospects.

Currency markets are also long-trending markets. Once momentum is established in one direction, it tends to stay in motion for years. The US dollar was strong for most of the 1990s, weak in the early 2000s, and then strong from 2008 to October of last year. But these long cycles begin, and end, unceremoniously. Timing can be tricky. And, in theory, currencies should encapsulate a broad constellation of a nation's value proposition — economic, financial, social, and political — as viewed against comparable qualities of other nations. But they rarely do. Currency movements, in practice, aren't always driven by the same factors. Aggressive Fed tightening was an important driver of USD strength for the first three months of 2022. But other global central banks have joined the tightening party, reducing the potency of this driver.

Shifting Narratives

Ultimately, currencies are driven by stories. Good stories attract capital and drive up the national currency. After 2008, a lingering risk aversion from the global financial crisis and the perception that economies were fragile, caused capital to stay close to shore. That meant America, with its senior economy and deep and liquid capital markets, was the prime beneficiary (name your applicable metaphor: cleanest shirt in the dirty pile, safest house in a bad neighbourhood, etc.). The technology sector was also the crown jewel of global asset markets during the 2010s and Silicon Valley was its epicenter. Then, throw in some favours from providence — the shale gas revolution, Europe's austerity drive, China's long lockdown — and capital practically ran into the US dollar's embrace. Everyone swiped right on America for years.

But those are all yesterday's stories. Turbulence and transition now mark the times. Old realities are crumbling. Our collective stories — which, in financial markets, are told over and over — are unravelling. The facts are readily supporting this new order. Silicon Valley has stumbled. Doubt is growing whether the US is really the world's safest house. It was America, not emerging markets and certainly not the Eurozone, where animal spirits were unleashed most ferally and where excess and leverage were the most extreme. Forget the US government's record pandemic stimulus and soaring budget deficits, most of the scandals and business failures are now appearing in the US. First it was trouble in crypto-land with the collapse of FTX. Then it was regional bank failures.

Next is trouble in private markets, especially in venture capital and growth equity. Trillions of dollars rushed into private capital in the US since 2008, as regulatory reform pushed banks away from speculative lending. New lenders stepped in to fill the void. In a higher-rate world, and with the growing realization that the artificial smoothness of mark-to-make-believe accounting cannot last forever, the flood of money is now drying up. For those awaiting that next proverbial shoe to drop, look no further than US private markets.

Coming To America: Currency Warfare

Another headwind for the USD is geopolitics. One does not have to venture into the dark web and a deep conspiratorial rabbit hole to see what is happening: capital is no longer flowing to the US the way it once was. The Ukraine war buoyed energy prices, meaning commodity exporters are swimming in money. During previous booms, the proceeds were always recycled into

America's capital markets. That is not occurring this time. Why? Primarily because the US has increasingly turned to financial sanctions as a weapon. Instead, money is heading back into domestic currencies and even into gold (with foreign central banks buying more tons now than at any time since data begins in 1950).

Currency markets, like all markets, are arenas of action and reaction. Weaponizing your currency with sanctions and using dollars as an alternative to military force when policing international order — rightly or wrongly — has consequence. In fact, sanctions have now turned against US dollar strength, becoming weapons of the currency's own mass depreciation. Looking ahead, the dollar-centric financial system that has been in place since the 1950s is now clearly moving toward a more multi-polar currency system. A mere glance of the facts shows evidence of the shift: the de-dollarization of assets, new bank-to-bank payment mechanisms and, of course, settlement of bilateral trade in national currencies other than the USD. Countries that formerly grumbled about America's financial might (and did nothing) are finally pushing back.

Investment Implications

It was natural that America and its currency held the world rapt when that world was unipolar. The 2008 crisis, which originated in the United States, paradoxically strengthened its status as a safe haven. When global trade, saving, borrowing and reserves are largely in one currency, these strengths are mutually reinforcing.

But the world is moving on from US dollar dominance. Over the next few years, new stories, new meanings, and new identities will offer themselves as replacements for the old monetary order. While these trends will take years to play out, the implications for global asset allocators in the period directly ahead are enormous. A strong US dollar has been a huge headwind for international markets with weak currencies. Yet, if weakness turns to strength, then a self-reinforcing cycle will unfold, as stronger currencies attract more capital and further drive up local markets. This is already happening: 70 percent of non-US stock markets outperformed the United States in 2022.

Investors should remain overweight international stocks, overweight resources (which are priced in US dollars and benefit from weakness) and hedge US dollar currency exposures. This investment positioning, far out of favour during a decade of US dollar strength, is now proving resilient. Forstrong portfolios, with much higher international exposure than average, are strategically positioned to benefit from the unfolding dollar downtrend.

Tyler Mordy, May 2023