Manulife Investment Management

Market Note

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Sue Trinh
Head of Macro Strategy, Asia

Movements in the U.S. dollar are closely monitored by investors and policymakers—it is, after all, the world's dominant reserve currency. Crucially, big swings in the currency's value can have important implications on growth.

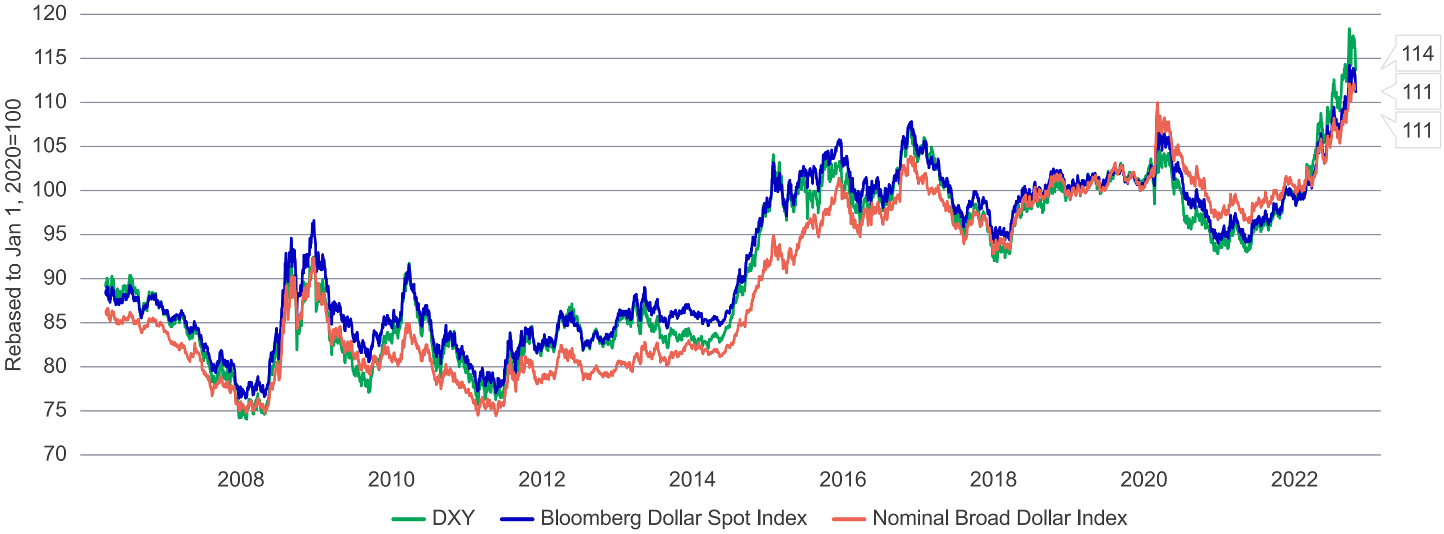
What does a strong U.S. dollar mean for global growth?

Within the financial community, the U.S. dollar (USD) can mean different things to different people. When traders refer to USD performance, they could be referencing one of the following:

- The ICE[1] U.S. Dollar Index, which tracks the performance of the greenback relative to a basket of six developed-market currencies and dominated by the euro.
- The Bloomberg Dollar Spot Index, a conceptually similar index with a slightly larger basket in which emerging-market (EM) currencies are represented.
- The U.S. Federal Reserve's (Fed's) Broad U.S. Dollar Index, a trade-weighted index that takes into account the currencies of the country's key trading partners.

Whichever benchmark you choose, the USD has appreciated 45% to 60% since 2008, with a large portion of those gains occurring in the past 18 months.

USD strength gathered pace in the past 18 months



Source: U.S. Federal Reserve, Macrobond, Manulife Investment Management, as of 27 October, 2022. DXY refers to the U.S. Dollar Index.

[1] ICE refers to the Intercontinental Exchange.

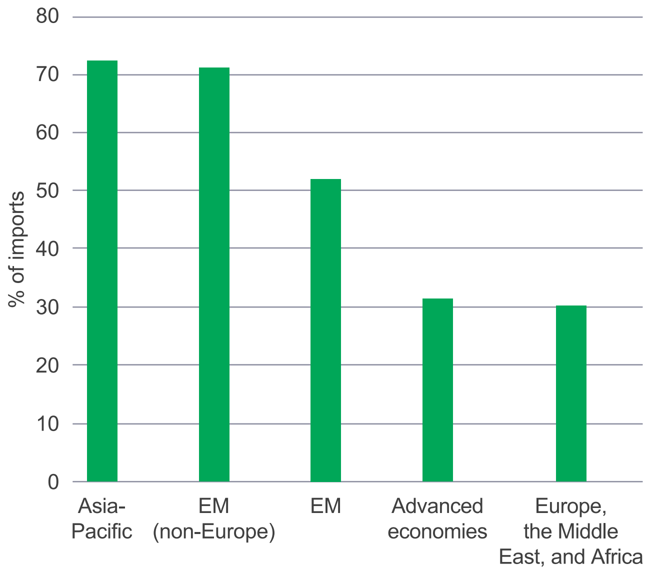
Is a strong dollar good for the economy?

There are three channels through which USD strength could affect the global economic outlook at the current juncture:

1. **Restraining economic growth in the rest of the world through weaker global trade**

   The stronger the USD is, the more expensive imports become for just about every economy apart from the United States. This will no doubt weigh on demand for global trade and hence global growth: Roughly 40% of world trade is invoiced in USD and this figure is much higher in many EMs.

   A substantial amount of global trade is invoiced in the USD

   Source: South East Asian Central Banks, Manulife Investment Management, as of July 2022.

   There are already signs that global trade is weakening: South Korea's nominal export growth in the first 20 days of October fell sharply by about 9%, on average, on a year-over-year basis after adjusting for working days—a 2-year low—and the new export orders index in global manufacturing Purchasing Managers' Index slipped further into contractionary territory in September.

2. **Implications on global inflation**

   Given the share of global trade that is invoiced in the greenback, it's clear that a strengthening USD will translate into higher import costs for nearly all countries as local currencies weaken. This will inevitably feed into the global inflation picture and could force central banks to respond with more aggressive tightening.

   In Asia, we've already seen central banks in Indonesia, South Korea, and the Philippines making explicit references to local currency depreciation/stability as a driver behind their respective decisions to raise interest rates. While net-exporting economies may typically find greater export competitiveness from weaker local currencies, the current context of weak global demand may offset those gains.

3. **USD strength weighs disproportionately on EM economies**

   A strong greenback can also hurt EM economies with large external vulnerabilities, particularly those with a substantial amount of USD-denominated debt, large current account deficits, and low foreign exchange reserves. This dynamic can potentially force central banks—specifically those in economies with weak external positions—to respond with more aggressive tightening than otherwise would be the case to stem capital outflows.

   Overall, we believe that a strong USD is one of several key factors that are contributing to a weaker global economic outlook. We expect the currency's appreciation will weigh further on global trade, add to global inflationary pressures, and push some central banks to hike policy rates further.

When might the momentum behind USD strength ease?

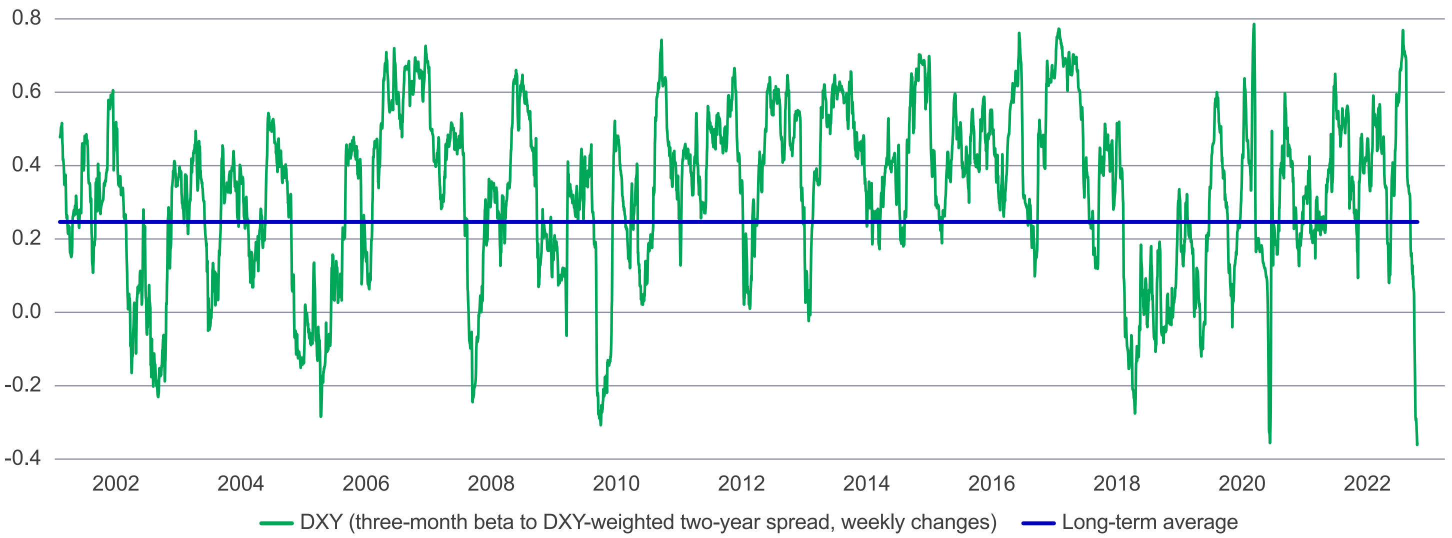
In our view, respite from the strong USD may arrive once we've witnessed a peak in inflation, U.S. Treasury yields, and Fed expectations (in other words, a dovish pivot by the Fed). We believe January's U.S inflation data will be important: It'll inform whether we should revisit our base case expectation that the Fed will pause its tightening efforts and reassess its path forward at the 21-22 March, 2023, FOMC meeting.

As always, there are risks to our views:

- **The Fed's dovish pivot could take longer to manifest than expected**—Trying to call the peak in the Fed's tightening cycle this year has been extremely challenging as terminal rates have constantly repriced higher. If this trend continues, it's likely that the strong USD trend could run on well into 2023.

- **Interest-rate differentials haven't been a major driver of USD strength**—Unusually, the greenback's beta to interest-rate differentials has not only fallen below average levels but is at record negative. Other factors have been more dominant in supporting the USD, including a global USD funding shortage, sustained U.S. economic outperformance in terms of growth, and the flight to safety. If this trend persists, even a dovish pivot from the Fed may not be sufficient to dent USD strength.

Interest-rate differentials may not be a major driver of USD strength



Source: U.S. Department of Treasury, Macrobond, ICE, Manulife Investment Management as of 27 October, 2022. DXY refers to the U.S. Dollar Index.

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