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Has the crescendo of fear brought the US Dollar to a peak?

The last year has seen considerable negativity across many asset classes. Bond markets have fallen into their first bear market in a generation, and equity markets are still in negative territory as the reality of a slowing global economy and rising interest rates takes its toll.

However, there is one asset that has stood tall amidst all the gloom and that is the US dollar (USD). Over the last 12 months, USD has appreciated 18.4%.

Most commentators anticipate that USD strength will continue in the short term, but it may be close to a peak, based on overcrowded positioning and fundamentals. This is a clear risk for investors overweighted USD assets.

USD's recent strength can largely be attributed to two factors:

Firstly, USD is perceived as a haven in a volatile world. Investors have a plethora of concerns to manage from both a geopolitical and macroeconomic perspective. Despondent foreign exchange investors are assessing the impact of developments in the Russia/Ukraine conflict, the Italian General Election, tensions between China and Taiwan, and concerns that the new Truss administration may soon be in conflict with the European Union over the Northern Ireland protocol.

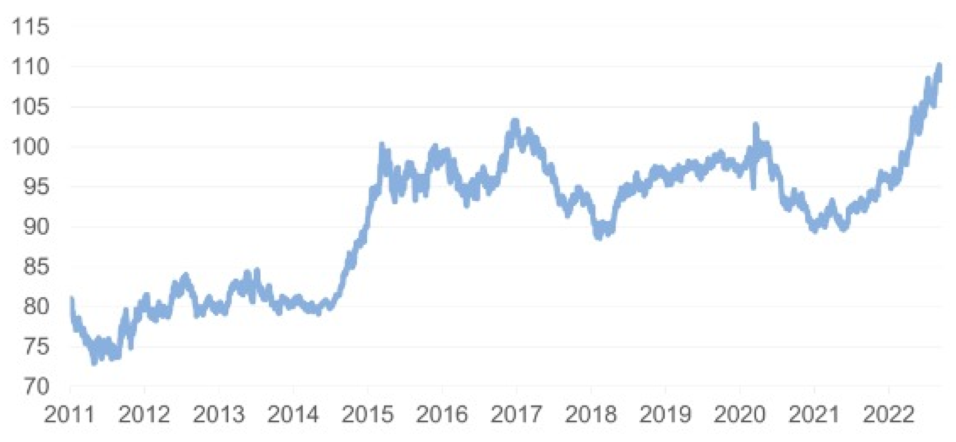
Secondly, there are macroeconomic issues that partly explain the strength of USD. Elevated inflation is at the forefront of concerns for policymakers globally. This inflation is largely attributable to the excess monetary and fiscal stimulus provided during the Covid period, supply chain disruption, and pent-up demand for goods and services as developed economies exited lockdowns.

Global Central Banks (with the notable exception of the People's Bank of China) have increased interest rates aggressively to combat this inflation - and the US Fed has been at the forefront of this. The high yield offered by US cash assets has proved extremely attractive to investors and has caused subsequent capital flows and USD strength.

Over a longer period, as reflected in the chart below, USD strength is also evident.

In the past decade, low global interest rates and innovation have proved beneficial for the USD, as investors piled into growth securities and as exemplified by the FAANG (Facebook, Amazon, Apple, Netflix and Google) stocks. In addition, the Bank of Japan and the Bank of China were for large parts of the graphed period, significant buyers of US Treasuries.

DXY Index (USD vs major developed economy currencies)



Source: Bloomberg, September 2022

What will be required for a reversal of USD strength?

To a certain extent, the turnaround of some of the factors mentioned previously, would entail:

In the short term...

- A global economic recovery that it is not reliant on the United States as its primary driver
- An overly aggressive Federal Reserve that causes an economic "hard landing" in the US, with a subsequent fall of yields on offer
- A successful application of fiscal policy in Europe, lessening the growth headwinds from the energy crisis and allowing interest rates to rise in Europe
- A relaxation of the zero-Covid policy employed by Chinese authorities
- The easing of geopolitical tensions

Over the medium to long term...

- Higher inflation than that experienced in the decade post the Great Financial Crisis, which had, via interest rate levels, made growth (typically USD denominated) stocks so attractive
- Continued de-globalisation with China reducing the amount of USD held in its currency reserves
- The reduction or elimination of capital controls in China
- The development of capital markets that bear favourable comparison to their US peers
- The Japanese exit from their extended hibernation in a deflationary environment
- A greater focus by investors on the balance of payments metric as an evaluation tool for currencies

We have held a cautious view on USD this year.

We did not want material exposure to an expensive currency that we believe isn't going to be a winner through the forthcoming economic cycle (one we believe will be more inflationary and see higher levels of growth in the world excluding the US).

While this view has not been correct to date, we haven't changed our opinion and - whilst we don't know the catalyst for USD to weaken - we think the reality is that USD may just run out of buyers as the bad news for the economy/good news for USD appears to be priced in and the risk of over-exposure to USD remains high.

Please visit our website for further information. The latest views and insights from the team can be found here.

Investment team


Niall Dineen
Chief Investment Officer


John Mattimoe
Senior Fund Manager


Derek Heffernan
Senior Fund Manager


Pat Kilduff
Senior Fund Manager

Get in touch with our Client Relationship team

Patrick Lawless
Managing Director
E: p.lawless@greshamhouse.ie
D: +00 353 662 4050

Kathryn Hannon
Head of Private Clients
E: k.hannon@greshamhouse.ie
M: +00 353 87741 6057

Ian Naughton
Senior Relationship Manager
E: i.naughton@greshamhouse.ie
D: +00 353 662 3986

Sean Breheny
Business Development Executive
E: s.breheny@greshamhouse.ie
D: +00 353 969 3277