Why Dollar Weakness Is Likely to Persist for Now

Some investors are interpreting recent dollar stability as a sign its bout of weakness is nearing an end. We think those expecting a reversal are in for a disappointment.

Insight from sub-adviser Schroders Investment Management

James Barrineau
Head of Global EMD Strategy

AFTER A RAPID FALL, THE DOLLAR HAS RETRACED SOME GROUND. Some are suggesting this means the dollar's fall is over, but we believe more caution is still advisable.

The US twin deficit[1] deterioration remains very firmly in place and central banks are similarly inclined to let loose monetary policy continue in an uneven recovery. Therefore, fundamental drivers for a meaningful reversal seem scant.

We view any potential "taper" move by the Federal Reserve (Fed) as a significant cause to re-think. But while there has been some discussion of this, we believe it's premature and unlikely to drive markets for most of this year at least.

The last sustained dollar bear market was in 2002. In that period, the first move down before a correction was just over 13% in seven months, as **FIGURE 1** below shows. The recent drop has been almost identical, but over a slightly longer period.

Current positioning surveys suggest the short dollar trade is likely over-extended, so a retracement should not be mistaken for a fundamental shift. In 2002, retracement was about 4%; to date, it has been around 2%.

FIGURE 1
US Dollar Index
DXY Index

Source: Bloomberg. The US dollar Index is a measure of the value of the US dollar relative to the value of a basket of currencies of the majority of the US's most significant trading partners.

Key Points

- Though the dollar has retraced some ground, caution is likely still necessary.
- The combination of these fundamental factors and similar price movements suggests any retracement is more likely to be short-lived rather than an indication that dollar weakness has run its course.

[1] Twin deficits refer to economies that have both a fiscal deficit and a current account deficit.

FIGURE 2 shows the deterioration in the US trade balance—a level last reached around the dollar lows of the mid-2000s. With the level of fiscal deterioration set to accelerate as well, ingredients that are very similar to the previous multi-year period are well intact.

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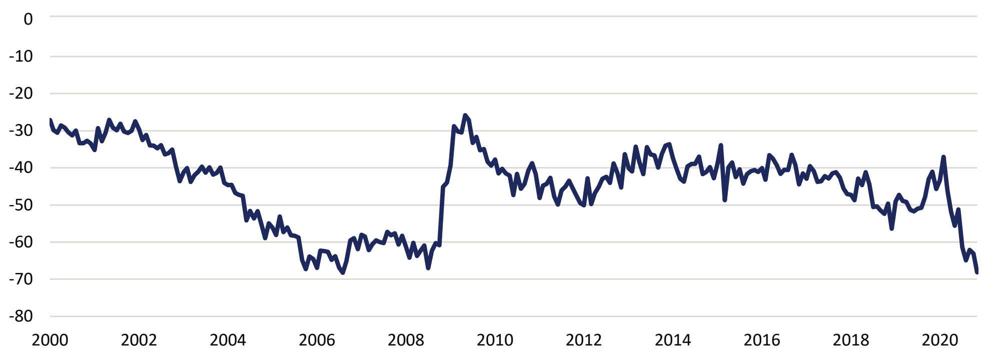
FIGURE 2

US Goods and Services Trade Balance

Seasonally adjusted $, bn



Source: Haver

Recent Fed-speak has sparked a notion that the Fed might taper its balance sheet growth while keeping rates at zero. Given the 2013 experience of a rise in the dollar, such a move would cause a re-think. However, given continued weakness in employment and a sluggish rollout of vaccines, we are likely months away from contemplating such a change.

Talk to your financial professional about how best to position your portfolio.

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