CUSTOMER TREASURY SERVICES

Economist's Weekly Market View

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Soaring Dollar

The dollar made large gains in April, surging by nearly 6% in trade-weighted terms against a basket of major currencies. It has been a perfect storm in forex markets. The US Federal Reserve has turned increasingly hawkish on monetary policy, with some its members signalling that a series of 50bps hikes may be needed over the summer to contain inflationary pressures.

The dollar has proved very sensitive to interest rates in recent years. It climbed to very high levels ahead of the COVID pandemic as US rates rose well above elsewhere. The dollar then lost 12% against the other major currencies during 2020 as US rates were cut to virtually zero. It has been on a recovering trend since mid-2021, as expectations grew that the Fed would tighten policy and long term Treasury yields rose sharply to circa 3%. The dollar has now more than recovered all the ground lost in 2020.

Other factors have also aided the dollar, including its premier safe-haven status as the world's main reserve currency at a time of elevated geo-political risks following the Russian invasion of Ukraine. Market risk aversion has also increased due to fresh lockdowns in China to contain the latest wave of COVID-19. Surging commodity prices have boosted the demand for dollars further, as commodities are largely traded in the US currency.

However, it is the much more hawkish rhetoric of the Fed on monetary policy compared the ECB, Bank of Japan and Bank of England that would appear to be the primary driver of dollar gains. Markets expect the Fed funds rate to be raised from 0.375% at present to 2.75% by end year.

By contrast, other central banks are much more cautious about hiking rates aggressively on concerns it could tip their economies into recession. Indeed, the Bank of Japan is continuing with large scale QE bond purchases to cap 10 year Japanese government bond yields at 0.25%. Meanwhile, official Japanese rates are set to remain unchanged in negative territory.

The Bank of England is anticipating a very sharp slowdown in the UK economy, signalling that just some further modest monetary tightening may be appropriate in the coming months. Elsewhere, the ECB is still engaged in QE, with rate hikes to begin later in the summer. It is anticipated this will see the key deposit rate turn positive in the final quarter, finishing the year at circa 0.375% per futures contracts.

The dollar's rally has taken it to levels not seen in twenty years against the yen, soaring from ¥116 in March to above ¥130 recently, easily taking out the 2015 peak of ¥125. Meanwhile, the euro has crashed through the key support levels of $1.08 and $1.06. It is now likely to test its lowest point of the past twenty years too, of $1.04, hit at end 2015.

If this supports give way, it opens up a move towards parity for the dollar, which was last seen in 2002. The previous time that the euro fell below parity, it spent almost three years there, from 2000-2002. Meanwhile, sterling appears to be returning to the forty year lows of $1.20-1.25 seen during the period 2016-2020, in the aftermath of the UK referendum vote to leave the EU and all the uncertainty that followed.

Overall, given the considerable divergence in interest rates that seems likely to be seen over the next couple of years, and that it is now anticipated the War in Ukraine will be drawn out, the current period of dollar supremacy could last some time.

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