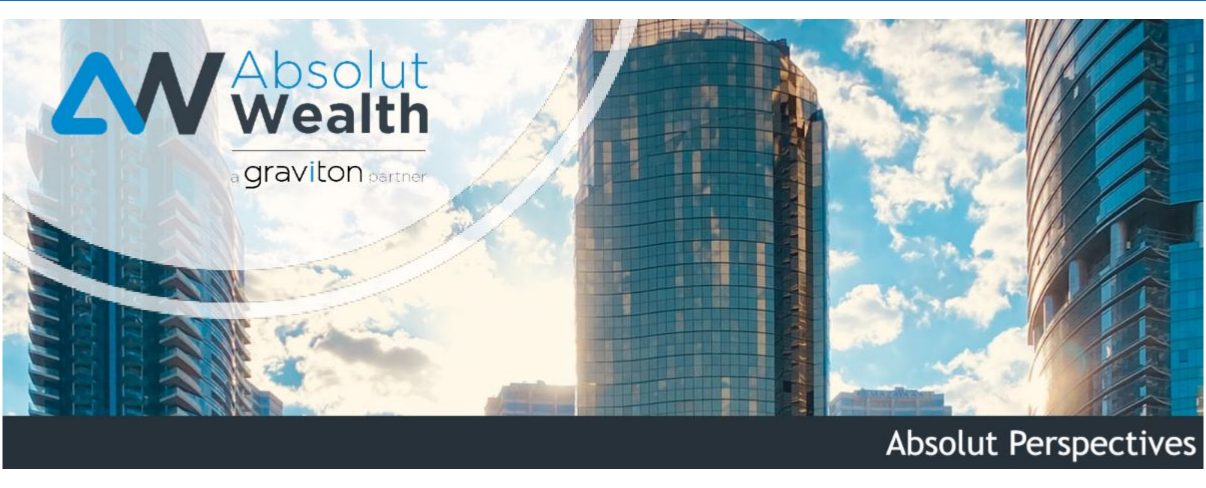

King Dollar - The Effects of a Strong US Dollar on Global Economies

Richard Harris | September 2022

There have been very few places to hide this year with almost every asset class, globally, selling off.

For the first time in decades, investors have seen both equities and bonds sell off together, soaring inflation, and to top it off, a rapid depreciation of their local currencies relative to the US Dollar.

For those that have held Dollars, it has been one of the only asset classes providing a safe haven during this turbulent year. The Dollar Index (DXY), which measures the Dollar against a basket of global currencies, is up almost 20% year-to-date and many economists predict a move even higher.

We will discuss a few of the contributing forces to this strong demand for US Dollars and also highlight the effects of a strong Dollar on global economies and multinational companies.

What has led to this surge in the US Dollar?

Multiple forces have led the Dollar higher this year. Something to note is that the US Dollar has been considered the global "base" currency for decades as most assets are priced in Dollars, creating a natural demand. The US has also been considered the safest economy to invest in for many years due to their pro-growth policy and a relatively stable political structure.

During periods of extreme uncertainty, also known as "risk-off environments", empirical evidence points to investors selling out of risk assets in favour of Dollar cash holdings, most recently witnessed during the Dot-com Bubble in 2000, the 2008 Global Financial Crisis, and the 2020 COVID-19 sell-off, where the Dollar saw exaggerated moves higher.

The major contributing factor to the Dollar strength this year, however, is the intensity with which the US Federal Reserve (the Fed) have increased interest rates in an attempt to slow inflation; a call they got horribly wrong last year, despite having more than 200 PHD economists on their advisory team.

Together with this, the Fed have also highlighted their intention to reduce balance sheet debt. This is done by selling Treasuries on the open market in exchange for US Dollars, essentially removing Dollars from the system and reducing Dollar supply.

Lastly, as Global Emerging Markets have come under further scrutiny this year, funds have flowed from their local currencies in search of Developed Market currency exposure. Due to the fact that the Eurozone and UK have experienced their own economic turmoil, there has been no other option than to seek salvage in Dollar investments, creating greater demand for the Dollar and further appreciation as a result.

The Knock-On Effects of the Stronger Dollar Globally

A stronger Dollar is generally bad for global economies as other currencies depreciate and countries become "poorer" on a relative basis. This "strong Dollar effect" is felt across the globe however and I will highlight several other areas that are impacted below:

(1) Global Trade - A strong Dollar often depresses growth in global trade as it is essentially the "invoicing" currency of the world. When it appreciates, in general, other currencies depreciate on a relative basis, making the world relatively poorer and less able to engage in trade.

Many countries are also price-takers for global commodities and as a result, end up paying higher prices for goods as the Dollar appreciates. A good example of this is South Africa being an oil importer and the effect on petrol prices as the Dollar appreciates relative to the Rand.

(2) Dollar-Denominated Debt - Many countries, especially those poorest with volatile currencies, are unable to issue debt in their own currencies. Instead, these countries usually borrow in Dollars with the promise to repay their debt and interest in Dollars. As the Dollar appreciates relative to their native currencies, their debt appreciates too, and default risk rises dramatically.

Top 10 Foreign Countries Holding $ Debt			
Country	$ Debt (bn)	% Holdings of Global $ Debt	Currency Movement YTD vs $
Japan	$ 1,304.00	16.80%	21.0%
China	$ 1,069.00	13.80%	12.0%
United Kingdom	$ 647.00	8.40%	19.5%
Ireland €	$ 334.00	4.30%	15.0%
Luxembourg €	$ 326.00	4.20%	15.0%
Switzerland	$ 288.00	3.70%	6.6%
Belgium €	$ 271.00	3.50%	15.0%
Cayman Islands	$ 262.00	3.40%	0.0%
Taiwan	$ 251.00	3.20%	16.0%
Brazil	$ 245.00	3.20%	6.0%

Source - Congressional Research Service

(3) Emerging Markets - Emerging Market economies usually bear the largest brunt of Dollar appreciation as they are usually the most influenced by a stronger Dollar, especially when combined with rising US interest rates.

As the US Dollar rises, emerging countries must tighten their own monetary policies to heed off dramatic falls in their own currencies to keep inflation in line and not raise the cost of their Dollar-denominated debt.

(4) American Multinational Companies - US companies that operate in multiple geographies will be severely affected by Dollar strength based on their returns from foreign operations revenues. For example, approximately 70% of Apple's revenues come from offshore sales. If the Dollar has appreciated on average 20% year-to-date, Apple's total unhedged revenues are likely to experience a 14% decline, based solely on Dollar appreciation.

As US equities make up more than 50% of global investments, the effect on company multiples as earnings decline could have serious knock-on effects globally as long as the Dollar remains strong.

(5) Exporting Countries - Exporting countries and their currencies actually benefit to a degree as an appreciating Dollar should be offset by additions in prices received for goods, subject to the prices of their exports remaining the same in Dollar terms.

It is difficult to predict the path of the US Dollar going forward and it is likely that at some point we will see a pullback closer to its average multi-year trend (mean reversion).

However, in the short term, the Federal Reserve is maintaining it's stance of monetary tightening (Hawkishness) and we have pockets of concern globally; (i) a drawn out war between Russia, Ukraine, and likely NATO, (ii) a severe energy crisis playing out in Europe as a result, and (iii) economic and political instability in Asia, notably China.

All of these concerns tend to add further demand for the US Dollar and should at least keep it elevated for the time being.

Market Review

Global markets were on the back foot this month due to a higher than expected US inflation number and continued hawkish commentary from US Federal committee members, highlighting that they will do whatever it takes to get inflation back down to their targeted 2% level. This was backed up with another 0.75% interest rate increase.

The UK and the Eurozone markets were also dealt a blow as investors didn't take much liking to a worsening energy crisis in Europe and some interesting policy announcements from the UK as they attempt to tackle the current crises. The Euro is now trading below parity with the US Dollar (€0.97/$) and the Pound reached a low of £1.03/$ but later recovered to near £1.10/$ at month end.

Hong Kong's Hang Seng Index led indices lower this month, down a staggering 14%, followed by the NASDAQ100 Index (-10.5%) and the S&P500 Index (-9.7%).

SA's Top 40 Index dropped 9%, less than other indices, buoyed somewhat by a weaker Rand. The local Index was led lower by financials (-12.5%) and property (-12%). The depreciating Rand has, to a certain degree, been a saving grace to the performance of our local market this year as approximately 60% of our Index constituents derive earnings from abroad, providing a good Rand-hedge.

As discussed above, there are numerous forces at play and volatility is currently prevalent across all asset classes. We are interested to see how recent monetary tightening will reflect in Q3 earnings figures that start reporting early next month. Many companies have already signalled to slowing growth. It is likely that it will be a choppy end to the year; however, with market uncertainty, opportunity is borne and those who are patient will often be rewarded.

Our market outlook, both locally and offshore, remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We are defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios. Although we believe that this is more volatility to come, we have started deploying capital to certain opportunities and will look to deploy further into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Chart of the month:

The chart below illustrates the magnitude of Dollar appreciation against global currency counterparts year-to-date.

"In investing, what is comfortable is rarely profitable" - Robert Arnott