A STRONG CASE FOR THE DOLLAR AGAINST ITS DEVELOPED WORLD PEERS

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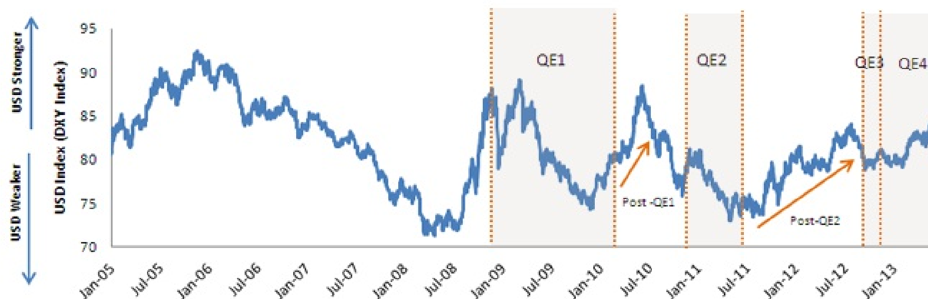
A bullish case for the U.S. dollar has been greatly strengthened by Fed chairman Ben Bernanke signaling that the Federal Reserve is ready to taper quantitative easing (QE) following the latest Federal Open Market Committee (FOMC) meeting. UBS AG's[1] chief currency strategist, Mansoor Mohi-Uddin, believes that slowing down the pace of Fed easing is now the base case for the U.S. central bank. In fact, UBS expects the FOMC to announce at its September 17–18 meeting that it will begin lowering its pace of bond buying at the start of Q4/13. Below, I discuss some of the most impactful lessons from the UBS research note. **What Does It Mean for the Dollar?** Given these expectations, the Federal Reserve may be the first major central bank to exit unconventional monetary policy. The implications for the U.S. dollar could be quite significant and supportive for dollar strength as the Fed starts to reduce and eventually end its asset purchases. Mohi-Uddin made these target exchange rate predictions for the major developed world currencies by year-end 2013: U.S. dollar to strengthen to 1.20 (vs. EUR), 110 (vs. yen), 1.41 (vs. GBP). Before reviewing some of Mohi-Uddin's rationales for each of these currency calls, I thought it would be fitting to discuss the dollar's performance through episodes of quantitative easing conducted by the Federal Reserve. **Chart 1: USD Strengthens Post Episodes of Quantitative Easing (01/01/2005–06/25/2013)**



Sources: WisdomTree, Bloomberg Past performance is not indicative of future results.

• **Post-QE1**: In anticipation of the end of QE1, which lasted from December 2008 to March 2010, the USD index began its upward trend and peaked in the summer of 2010. Between November of 2009 and June of 2010 the U.S. dollar, measured by the DXY Index, appreciated by approximately 18%. • **Post-QE2**: In November 2010, the Fed announced a second round of quantitative easing, buying $600 billion of Treasury securities by June 2011. The DXY Index broke its cycle of depreciation at the end of QE2 and experienced an appreciation of approximately 13% between July of 2011 and July of 2012. • **QE3/QE4**: Since the Fed announced QE3 in September of 2012 and QE4 in December of 2012, the dollar has appreciated approximately 1%. This is due to a combination of factors, namely global central bank activism and currency wars among the major central banks. Mohi-Uddin warns that dollar strength and foreign currency weakness could accelerate if foreign central bank reserve managers and sovereign wealth funds start to shift assets back to the U.S. These three investor types are the largest holders of dollar-denominated capital in the world: • UBS estimates that U.S. fund managers hold $45 trillion of liquid assets, while central banks have $11 trillion of reserves and sovereign wealth funds are $3–$4 trillion in size. • U.S. fund managers: Since the financial crisis of 2008–09 and the eurozone crisis of 2010–13, U.S. fund managers have stopped increasing the share of their portfolios held in foreign markets, which currently stands at 20%. UBS warns that if American investors start repatriating funds as they did in the second half of the 1990s, when the U.S. economy was also seen to be outperforming its peers, the impact on the dollar will be considerable. For example, a 1% reduction in the proportion of U.S. fund manager portfolios held in overseas markets would generate an inflow of $450 billion into the U.S. economy. • Sovereign wealth funds

appear more favorable to the greenback too, having also been strong dollar diversifiers in the past 10 years. **What Does It Mean for the Euro?** The upside for the euro remains capped by the risk of further monetary easing from the European Central Bank (ECB). ECB president Mario Draghi said that monetary policy had “regained steering capacity” and that was an “important positive development.”[2] By this he meant that changes in the ECB benchmark refinance rate, currently at 0.50%, were having an impact on broader credit growth. This suggests that further rate cuts would have benefits. Draghi also said again he had an “open mind” about non-standard policies, including cutting the ECB deposit rate below zero. **What Does It Mean for the Yen?** UBS alludes to a weaker yen over the next few months, heading into year-end, and one key rationale are the widening interest rate differentials in the U.S. and Japanese local bond markets. While the Japanese Government Bond (JGB) market has remained relatively stable, the sell-off in U.S. Treasuries following the FOMC meeting has been pronounced. On June 25, 10-year JGB yields were 0.87%, while 10-year U.S. yields had reached 2.58%.[3] The wider interest rate difference may encourage Japanese investors to start buying U.S. Treasuries, causing more pressure on the yen. **What Does It Mean for the British pound?** Bank of England (BOE) and Fed policy are likely to diverge once quantitative easing in the U.S. ends next year. Former Governor of the BOE, Mervyn King, argued that rapid interest rate rises would do “great damage”[4] to the UK economy. The divergence in UK vs U.S. monetary policy is likely to result in a weakening pound and strengthening dollar. Secondly, the departure of the BOE’s deputy governor Paul Tucker in the autumn will allow the UK Treasury to appoint a more dovish replacement. Thirdly, Mark Carney, whose term as BOE governor will begin on July 1, could call for swift implementation of unconventional monetary policy. **Implications for Foreign Equities** Given expectations for broad-based U.S. dollar strength and further currency weakness in the United Kingdom, the European Union and Japan, investors might want to consider strategies that hedge the currencies for these markets. Many of these markets export to the United States, and an improving U.S. economy is supportive of their business prospects. But the dollar strength and foreign currency weakness could inhibit the returns to U.S. investors unless a currency hedge is in place. [1]UBS: Formerly known as the Union Bank of Switzerland [2]Source: Reuters [3]Source: Bloomberg [4]Source: Speech by Mr. Mervyn King, Former Governor of the Bank of England, at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London, London, 19 June 2013

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Asset purchases : The Fed purchases longer-term securities issued by the U.S. government and longer-term securities issued or guaranteed by government-sponsored agencies such as Fannie Mae or Freddie Mac.

DXY Index : Weighted geometric mean of the dollar's value compared only with basket of 6 other major currencies, Euro, Japanese Yen, Pound Sterling, Canadian Dollar, Swedish Krona, and Swiss Franc.

Sovereign Wealth Fund : Pools of money derived from a country's reserves, which are set aside for investment purposes.