

Unwrapping the Mystery of Dollar Depreciation in 2017

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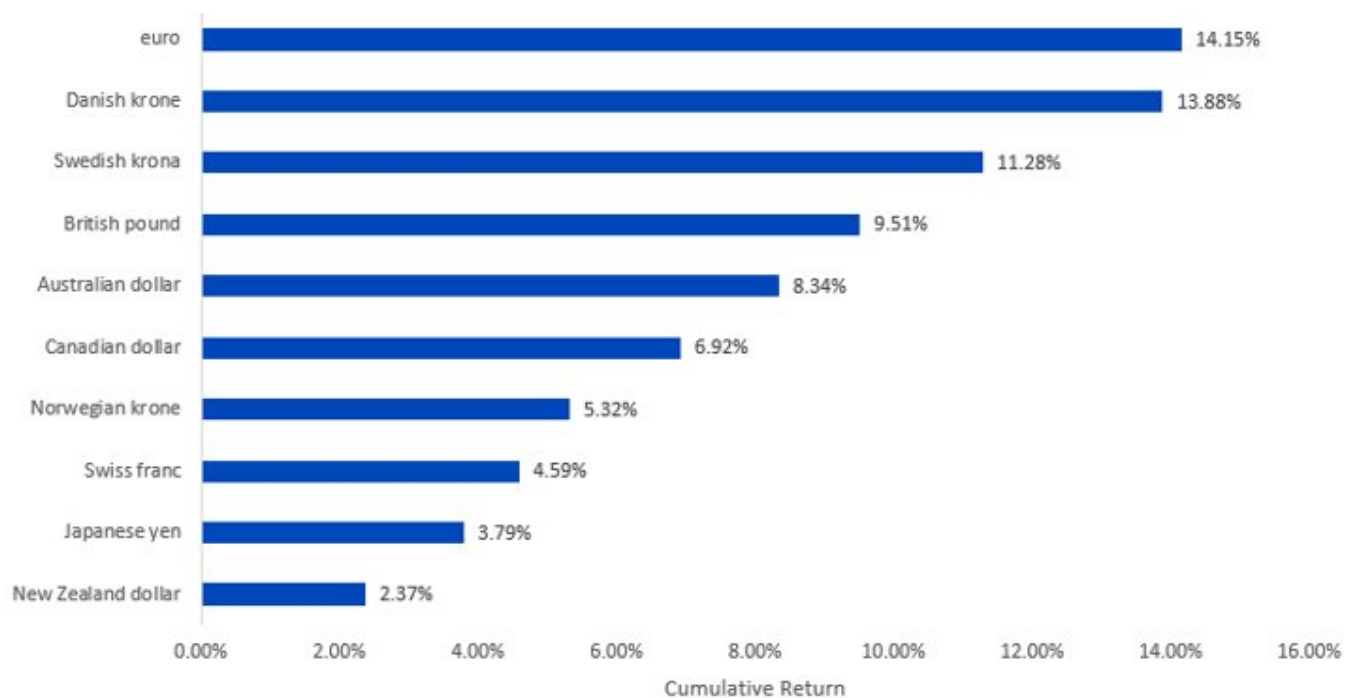
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One of the biggest surprises for us in 2017—given major macroeconomic factors like central bank policy divergence—was the depreciation of the US dollar. Many anticipated that the hiking of rates by the US Central Bank, combined with foreign central banks expanding balance, would be a catalyst for a stronger US dollar.

And yet the opposite happened.

Over the course of a few blogs, we aim to provide context for the behavior of the US dollar in 2017 and to enhance our understanding of what might happen in 2018 and beyond¹.

2017: Broad-based dollar depreciation



Source: Bloomberg. Period is from 31 Dec. 2016 to 31 Dec. 2017.

Past performance is not indicative of future results. You cannot invest directly in an Index.

- Broad dollar weakness in 2017: The chart above shows the performance of the US dollar against the G10 currencies during 2017. Critically, this phenomenon was not confined to one or two of the major currencies, but rather all of them.
- It's also notable to consider the performance of the US dollar in terms of major indexes. DXY is one of the longest standing and it is heavily tilted towards the euro and the yen in its exposure. DXY was down 9.9% in 2017. The Bloomberg Dollar Index, which WisdomTree worked with Bloomberg to create in 2013, is more balanced in its exposures and was down 8.5%².
- The MSCI Emerging Markets Index had a great year in 2017. For US Dollar-based investors, this was helped a cumulative 5.2% by emerging market currency appreciation against the dollar³.

Examining the apparent disconnect between policy and performance

Especially after the global financial crisis of 2008-09, policies of central banks—particularly the actions of the Fed, the European Central Bank (ECB) and the Bank of Japan (BOJ)—are discussed and publicized almost daily. Recapping the last few years⁴:

- As of the end of November 2015, the Fed's effective policy rate was 0.08%, and there had not been hikes from the global financial crisis onwards. As of 4th May 2018, the effective policy rate is now 1.69%, signifying six hikes, 25 basis points each.
- As of the same starting point, the ECB's main refinancing rate was 0.05%. Currently, this rate is at 0.00% and has been for some time.
- The BOJ initially had its policy rate at 0.10%. Currently this rate is at -0.10%, and it has been for an extended period.

Bottom Line: The Fed embarked on a multi-year path of policy normalization, whereas the BOJ and the ECB have not. Many have looked at this—and it was widely telegraphed to markets by all three of these institutions—and have assumed that a stronger US dollar was basically a foregone conclusion.

The Connection between expected policy & enacted policy

Yield Curve Slopes and Spot Rates (31 Dec. 2016 to 1 May 2018)



Sources: Macrobond, Record. Yield curve slope is measured using interbank rates. Spot rates are indexed to 100 in December of 2016

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A critical part of the story outlined above is just how much information and communication central bankers are publicizing about their policy expectations. The actual difference in policy rates does not do a great job at capturing market expectations of future policy—rather, they confirm that what market participants have been told ahead of time is happening.

- The dotted lines are measuring the difference between the one-year and one-month interbank rates for the US minus that of either the Eurozone or Japan. A falling value, therefore, is telling us that the gap between the one-year and one-month rate in the specified market OUTSIDE the US is widening faster than INSIDE the US. An interpretation of this is markets “pricing-in” expected short-term rate hikes in these respective markets and that expectations for the Bank of Japan and European Central Bank to raise rates were being factored into these interest rates during 2017.

Putting a story to the data

We cannot overstate the importance of the shifting yield curve data because it conveys an evolving narrative for the US dollar—and one that will continue to contribute to future movements.

1. The Fed basically did what it had communicated and what was expected. This DID NOT impact future expectations, as we saw the yield curves moving in a direction implying less of a gap between the US and the other markets.

2. They also reflect that, due to strong data out of the Euro area particularly in 2017, markets were starting to expect future rate hikes out of the ECB and then even Japan. These factors DID impact the yield curve slopes, as well as how the market was pricing future currency behavior.
3. Unfortunately, there is more to the story, as there was also a shift in relative slope directions toward the end of 2017, signaling falling euro area and Japan short-term rate expectations against the US. This move did not translate into any significant dollar strength versus the euro or yen, telling us that other factors were more dominant at that time.

Monitor the inflection points

Euro area data in 2018 has been nothing like observed in 2017. In 2017, the narrative placed strong credence on an ECB exit path starting at the end of September 2018. Now that might be less certain, and we have seen the euro pull back from its gains.

From an investor flow perspective, much of European equity exposure in 2017 went into unhedged strategies that are fully exposed to the euro's movements. We would question the long-run rationale for that euro bet and suggest employing an intentional currency program to have exposure when one has a positive view on the euro. The data is increasing questions around that long euro bet in the short-run.

You may also be interested in reading

+ [A Return to King Dollar Policy - Implications](#)

1 We'd like to thank Record Currency Management, a global thought leader on currencies for analytical support in this blog series.

2 Bloomberg, with data from 31-Dec.-2016 to 31-Dec. 2017.

3 Bloomberg, with data from 31-Dec.-2016 to 31-Dec.-2017.

4 Bloomberg, with data measured from 30-Nov.-2015 to 4-May-2018.

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