A moment in markets – The perks and perils of a weak US dollar

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If the US dollar remains weak or gets weaker still, the ramifications could extend across a host of asset classes. This could become an important theme for investors to consider when allocating their capital this year.

Our article on the benefits of currency hedging gold exposures illustrated how the greenback has historically moved in tandem with the US twin deficit, i.e. in periods when both the current account and budget deficits are widening, dollar weakness ensues. With Democrats at the helm, further policy accommodation can be expected this year causing the twin deficit to possibly widen even more. This, in turn, is likely to continue exerting pressure on the currency.

Dollar weakness can create tailwinds in certain asset classes and introduce pitfalls in others (see figure below).

Source: WisdomTree. For illustrative purposes only.

Time for EM equities to shine?

Emerging market (EM) equities automatically receive the spotlight when dollar weakness is under discussion. Low to negative real yields in the US encourage investors to seek risk premia elsewhere. EM equities become the frontrunners to receive this capital as dollar weakness makes it easier for emerging markets to service their dollar-denominated debt. This is even more important when economies around the world might be looking to employ fiscal tools to induce growth. According to the International Monetary Fund (IMF), emerging markets and developing economies are expected to outgrow advanced economies by 2% in 2021 – a forecast that has not gone unnoticed in markets.

China could be a frontrunner within the EM universe given it has entered the new year with its economy in a relatively stable state. This puts the country in a strong position to pursue its growth ambitions set out in its 2021-2025 plan.

A boost for commodities?

Following recent price moves, terms like ‘bull run’ and ‘supercycle’ for commodity markets have resurfaced. This is not altogether surprising. Commodities not only stand to benefit from a cyclical economic upswing

as the world emerges from the pandemic, but they could also see their demand rise from the fiscal spending governments expect to deploy. With most commodities priced in US dollars, weakness in the greenback appears to be catalysing the process by stimulating demand from holders of other currencies. China, in recent months has particularly ramped up its imports of cyclical commodities.

Therefore, holding a broad basket of commodities could help capture the effect of these tailwinds on the asset class. With inflation expectations on the rise, particularly in the US, a broad commodities basket becomes an even more pertinent tool to consider.

For European investors, however, there is an added layer to think about. While the fundamentals of commodities may benefit from a weaker dollar, the total return potential may be diminished when gains are translated back to the local currency. Therefore, currency-hedging commodity exposures can add that extra layer of protection to minimise the risk of further dollar depreciation. The encouraging thing is that interest rate differentials between Europe and the US have narrowed. This implies that the cost of hedging currency exposures has also come down.

Where is the underweight?

The sector facing headwinds from all the things putting pressure on the dollar is nominal US Treasuries. With the US Federal Reserve (Fed) keeping its monetary policy on autopilot at a highly accommodative altitude and inflation expectations on the rise, the upside in Treasuries may be relatively limited. Investors looking for fixed income may want to consider inflation-linked Treasuries or higher-yielding alternatives instead.

The Fed unexpectedly turning hawkish would be the key risk to the dollar weakness story. The probability of this happening is not zero but is still relatively low. The central bank, which is now targeting an average level of inflation, is likely to allow inflation to shoot above 2%. Policy tightening is likely to be preceded by a meaningful and sustained improvement in the global economy. It is probably unlikely that the economy reaches that level of strength this year.

Thus, whether dollar stays rangebound around its current levels or weakens further, the impact on asset markets is likely to be profound and widespread – an important consideration for investors in the year ahead.

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