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What a Weaker USD Means for Stocks

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Currencies are among the most difficult asset classes to forecast, but today the stars are lined up for a much weaker USD. The first reason to be a dollar bear is valuations, with the real effective exchange rate (REER) recently at its highest level since 1986 (**Figure 1**). On a Purchasing power parity basis, the greenback is overvalued by 31% vs the euro (EUR), 27% vs Japanese yen (JPY) and 19% vs British pound (GBP) (source: OECD). The Big Mac Index from *The Economist* produces similar results, with the dollar expensive by 34% against Chinese yuan (CNY) and 22% vs Mexican peso (MXN). While currencies can stay mispriced for a long time, today's extreme levels constitute a major headwind for the USD over the medium-term.

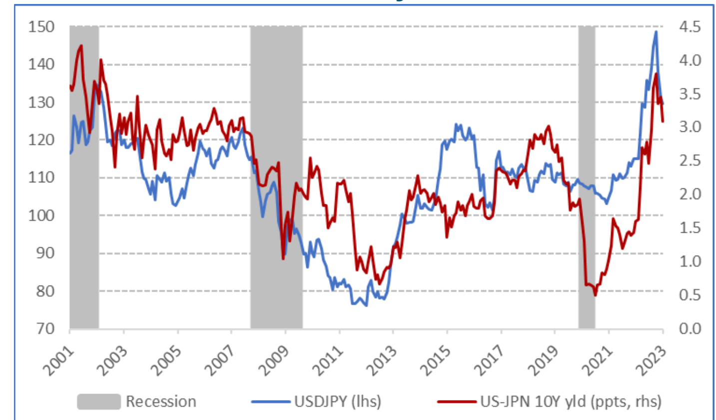
"A Big Mac is now more than 40% cheaper in Japan."
– The Economist, Jan 26

FIGURE 1 – Overvalued: The USD was turbo-charged by excessive COVID stimulus

Source: Bloomberg

A second reason to expect a weaker dollar is interest rate differentials, which peaked three months ago. The USD and 10Y yields are positively correlated, meaning lower bond yields (which we expect) typically result in a declining greenback. To provide a specific example, USD/JPY and the 10Y yield differential are highly correlated (63%), suggesting the pair could be headed below 120 over the next quarter or two (**Figure 2**).

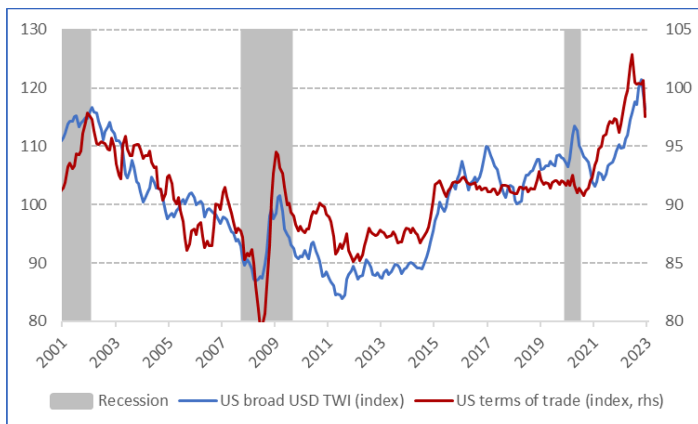
FIGURE 2 – USD/JPY appears to be headed lower as U.S. relative bond yields decline



Source: Bloomberg

A third driver of currencies is the terms of trade (ToT), defined as export prices/import prices. America's ToT peaked in June but has since declined during five of the last six months, largely on lower fuel prices (**Figure 3**). Remarkably, U.S. export prices are now 93% correlated with energy prices. With America becoming a net energy exporter, the greenback has apparently morphed into a commodity currency (similar to Australian dollar (AUD), Norwegian krona (NOK), South African rand (ZAR), Brazilian real (BRL), and Chilean peso (CLP)). With both the Bloomberg consensus and futures pricing indicating moderately lower WTI levels ahead, this suggests a weaker USD over the next year or so.

FIGURE 3 – Greenback as a commodity currency: The USD is highly correlated (63%) with the terms of trade

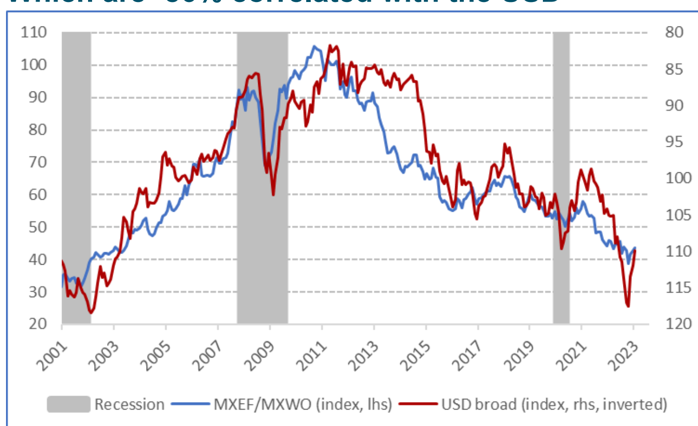


Source: Bloomberg

A Lower Dollar Implies Looser Financial Conditions

A weaker greenback is usually a positive for emerging market (EM) equities, as they benefit from easier financial conditions, including a reduced burden from their USD-denominated debt (**Figure 4**).

FIGURE 4 – Bullish for Emerging Markets: Which are -86% correlated with the USD



Source: Bloomberg

Emerging markets aren't the only beneficiaries though. European, British, and Canadian equities have also typically gained from a declining greenback. Further, at the S&P 500 sector level, the biggest beneficiaries have been materials and consumer staples, with financials profiting the least. This result makes intuitive sense as the materials sector derives 55% of its revenue from abroad vs only 21% for financials.

A Weaker USD: Implications for Investors

We expect the dollar to weaken during 2023, reflecting valuations, a declining ToT and narrowing interest rate differentials. The U.S. also faces cyclical headwinds as its relative growth prospects appear challenging. A weaker USD is generally positive for all equity markets, as it implies looser financial conditions. However, emerging markets, Europe, the UK, and Canada have been the biggest beneficiaries, along with sectors like materials and financials.

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