UNITED STATES

Thoughts on the U.S. dollar’s strength

The U.S. dollar has strengthened since mid-October, as the likelihood of the Federal Reserve raising interest rates in December grew. This raise would occur in a context where most other central banks would need to stay on the sidelines for several quarters more, or even further ease their monetary policy. The divergence in monetary policies could promise other major gains by the greenback. However, there is reason to believe that this appreciation will be fairly limited.

First, it should be noted that the U.S. dollar’s current value already incorporates expectations of diverging monetary policies. Since July 2014, the U.S. dollar has appreciated over 20% according to various exchange rate indexes. For the currency to continue appreciating sharply, the divergence would have to be greater than the one already expected, or investors would need to expect a greater divergence for the coming quarters. This could be the case if, for example, economic data or inflation were to improve more than expected in the United States. The change in data in other countries and the behaviour of other central banks could also have an impact.

On another note, it is hard to believe that the greenback will keep appreciating without adversely impacting the U.S. economy. We have seen the trade balance, excluding oil products, deteriorate since 2014. This contributes to weakening the U.S. manufacturing sector, which must also grapple with falling oil investment.

This brings us to the relevance of increasing U.S. interest rates. A dollar that is too strong risks being followed by a more moderate increase in interest rates to avoid curbing the economy too much. This relationship can be illustrated with an index of monetary conditions calculated for the United States. This index weights the movements of interest rates and exchange rates. Assuming a weight of 10% for the exchange rate, the appreciation in the U.S. dollar recorded since July 2014 was equivalent to an interest rate increase of around 200 basis points.

Implications: To see further strong appreciation in the U.S. dollar, expectations on monetary policy divergence would have to again increase significantly. The stronger currency would also need to be without risk for the U.S. economy. Since these two assumptions seem difficult to defend, we expect limited appreciation, to around 5% in the coming quarters.

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