Matthews Asia

Matthews Asia Perspective

Dollar Strength

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The U.S. dollar has been rallying ever since mid-2014 and has had a further rise since President-elect Donald Trump won the election. What is driving this rally? Should we expect it to go further?

Well, the answer to the second question is yes. Yes, but … The answer is only yes because prices tend to go in trends and your best SHORT-TERM guess as to the direction of the dollar is that it will continue to move higher. But beware! Once we look at what is driving the dollar higher, we may feel that the rally is on shakier ground than most investors seem to think. Let's look at three important reasons behind recent dollar strength.

The first factor driving the dollar higher is tighter monetary policy. The Federal Reserve has been contracting the money supply since the beginning of 2015 and started to raise interest rates in December. This tightening has probably helped the dollar strengthen. But the recent history of central banks tightening has been that they have been too early, too aggressive. If we look at the Federal Reserve's own projections of where rates will be in a year's time, they have consistently overestimated the pace of rate rises. So, it is likely that rates will not go up as quickly as the Federal Reserve, or investors, expect.

The second factor is real bond yields. This is due to the new Trump administration's stated policies. Tax cuts and infrastructure spending will raise the budget deficit, increase the supply of bonds to pay for it, and raise long-term interest rates. Real rates for U.S. 10-year Treasuries rose from 0.15% (for the 10-year inflation-protected security) to 0.74%. But how likely is it that the budget will go through as envisaged? The Republican Senate leader has already downplayed the idea of massive infrastructure spending and President–elect Trump's pick for Treasury secretary has said he expects tax cuts to be partially offset by limiting deductions. Could they get rid of mortgage interest tax relief? Perhaps the effects on the budget deficit will not be as large as the market first thought?

Finally, the third factor—trade. Yes, if President-elect Trump follows through with his protectionist tendencies and starts to raise tariffs on imports, one would expect a short-term impact to strengthen the dollar. But that is just the short-term impact. Over the long term, as the U.S. seeks to push its trade balance from a deficit to a surplus, that is likely to weaken the dollar. You cannot convince other people to buy more of your goods without lowering the price and that must ultimately come from either lower wages for U.S. workers, which is highly unlikely and against the President-elect's policies and personal interest, or by lowering the price internationally through a weaker dollar.

So, whereas the dollar might be strengthening right now, things could easily change over the course of the next few weeks and months. For the factors driving the dollar higher are neither as robust nor as persistent as the market seems to think. So, by all means take strong dollar momentum as your best first guess as to the short-term direction of the currency—just beware that it could change direction rapidly!

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