Week in Focus

9 April 2021

The dollar strength is finite

The US dollar has been gaining on account of the strong recovery of the economy, but for how long will this carry on? We demonstrate why the tide may turn in the second half of the year. **Page 2**

The dollar is recovering
EUR-USD and trade-weighted dollar versus currencies of advanced economies, January 2006 = 100

Source: Bloomberg, Federal Reserve, Commerzbank Research

Outlook on week of 12 April to 16 April 2021

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The dollar strength is finite

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In the coming weeks, the dollar is more likely to gain on account of the strong recovery of the US economy. However, it is likely to weaken again versus the euro in the second half of the year. This is because it should then become clear that, despite strong growth, inflation and thus also the key US interest rate will remain low for a considerable time. In the longer term, moreover, the ultra-expansionary fiscal policy of the Biden administration is more likely to weigh on the dollar.

Dollar strength: not a vaccination phenomenon,...

Since the beginning of the year, the US dollar has strengthened significantly, recouping almost a quarter of its losses since the start of the pandemic in March 2020. In the process, the 3.5% gain against the euro was equally reflected in the trade-weighted dollar gain against currencies of advanced economies (see front-page chart).

Some see the reason for this dollar recovery in the major progress made in corona vaccinations: While more than 50 vaccinations have already been administered per 100 inhabitants in the US, the figure in the euro area is less than 20 so far. And since the vaccination rate in the US (also in relation to the population) continues to significantly exceed that in the euro area, sufficient immunization of the population is also likely to have been achieved there much sooner, which will allow a noticeable easing of the corona restrictions and thus also a rapid recovery of the economy.

However, we do not find this explanation very convincing. After all, virtually no one doubts that immunization against the virus will also be achieved in the euro area in the further course of the year, meaning that there will also be a significant recovery of the economy there – albeit somewhat later. Thus, this interpretation contradicts the typically observed forward-looking behavior of the foreign exchange market. Recently, this explanation also seems to be losing more and more adherents. Last Monday, for example, the dollar even weakened slightly on balance, although the ISM purchasing managers' index for the service sector clearly exceeded analysts' expectations – which was a clear sign that the lockdown-related dampening of services activity in the US is already easing noticeably.

... but a consequence of higher US inflation expectations, ...

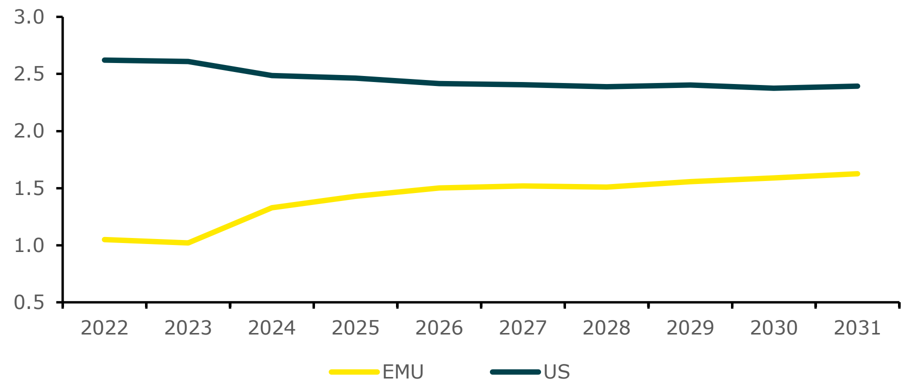
The much more convincing explanation for the recent dollar strength is the marked rise in inflation expectations for the US in recent weeks. For the next twelve months, the market expects US inflation to reach 2.6% (chart 1). More importantly, even for the years thereafter, the market expects inflation to decline only gradually toward the Fed's 2% target.

This contrasts sharply with expectations for the euro area. Here, inflation rates of around 1% (yoy) are expected for spring 2022 and spring 2023. For the years thereafter, the market expects gradual re-inflation; however, even in the long term (of 10 years), inflation is expected to remain well below the ECB's target of 2%.

With this inflation outlook for the euro area, no one can seriously expect the ECB to normalize its monetary policy in the foreseeable future. Therefore, from a market perspective, a continuation of the low interest rate environment is the only conceivable scenario for the euro area. Consequently, marginal changes in the macroeconomic picture for the euro area (which do not imply a fundamental revision of inflation expectations) are of little relevance for EUR exchange rates, and even statements by ECB representatives mostly have little effect.

By contrast, an interest rate hike could well be on the agenda in the US in the next two years if market expectations materialize. It is still not certain how the Fed will implement its new strategy, according to which it will tolerate a short-term, gradual overshooting of inflation above the target level. However, if inflation were to remain above 2% for a sustained period, the Fed would sooner or later raise its interest rates in order to push inflation at least in the direction of the target level. In doing so, it may wait longer than it would have in the Greenspan era, and rate hikes are also likely to be slower. But under any realistic interpretation of the new Fed strategy, it would be clear from these US inflation expectations that the Fed would have to start a pronounced rate hike cycle fairly soon (by early 2023 at the latest), overcompensating for inflation, i.e. raising the US real interest rate and making the dollar more attractive.

Chart 1 - The market expects sustainable re-inflation in the US and EMU inflation persistently below ECB target
Market expectations implied in inflation swaps; percent



Source: Bloomberg, Commerzbank Research

... which will initially find support

In the coming months, market participants should initially feel that their expectations have been confirmed. Both the headline inflation rate and the core inflation rate are expected to pick up noticeably. Even if this is probably due exclusively to base effects: last year, many prices fell sharply at times in view of the Corona-related slump in demand. This, together with good economic data, should give the US dollar further tailwind. We therefore expect EUR-USD to remain strong in the coming months.

But: no re-inflation, ...

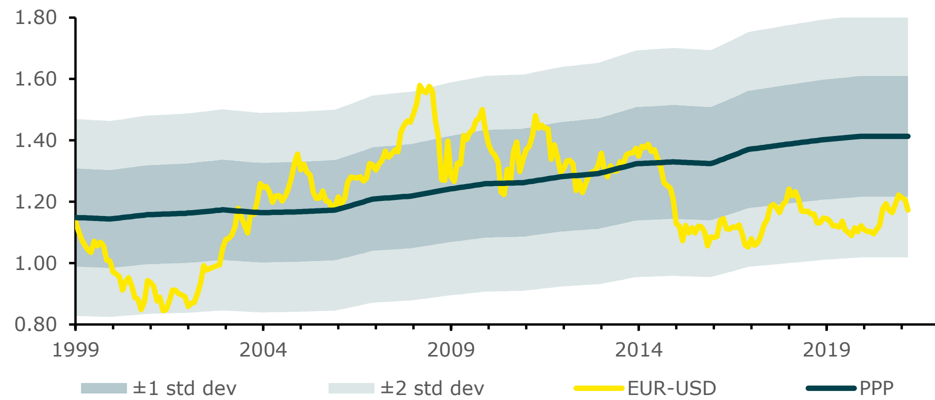
In the course of the summer, however, it should become increasingly apparent that inflation expectations are exaggerated, at least for the next two to three years. Then, the described base effect will run out and therefore the inflation rate will fall noticeably again. And until the strong growth of the US economy also noticeably boosts underlying inflation, capacity utilization in the economy will first have to increase significantly and thus the currently considerable underemployment will have to fall noticeably. Only then will wages pick up and thus noticeably increase the cost pressure on companies. The experience of recent years suggests that this process will take much longer than in the 1980s and 1990s due to structural factors such as digitalization and globalization. Therefore, we expect US inflation, as measured by the Fed's private consumption deflator PCE, to fall below the central bank's 2% target again in 2022 and to start rising slowly only in 2023.

If that happens, the Fed will not seriously consider rate hikes until 2024 at the earliest. And even then, it will be a different rate cycle than the market assumes now. In view of its strategy, which is now geared more to the goal of full employment than was the case previously, and its willingness to consciously accept an overheating of the economy, the speed and extent of such an interest rate cycle will probably be much lower than in the scenario assumed by the market. If one assumes our inflation view, it will be a long time before US monetary policy becomes active again, i.e. before short-term real interest rates rise noticeably.

... rather a gradual reduction of the dollar overvaluation

However, this means that the basis of the currently very high valuation of the US dollar is beginning to falter. After all, EUR-USD is currently trading well below the level that would be expected on the basis of purchasing power parity (chart 2). This high valuation was justified as long as the Fed was expected to pursue a qualitatively different monetary policy than the ECB. Not for nothing has it existed since 2015, i.e. since it became clear that the Fed would return to an active monetary policy, while the ECB would remain stuck in zero and negative interest rate policies in the long term. If the sustained re-inflation currently expected by the market were to occur, this would probably not change. If we are right and sustained higher inflation rates in the US are still some time off, the differences between the Fed and the ECB will become increasingly blurred so that the overvaluation of the dollar against the euro will have to be corrected. We therefore expect EUR-USD to rise to 1.23 by the end of the year and to continue its upward trend in 2022.

Chart 2 - EUR under-valuation vs. USD
EUR-USD and (absolute) purchasing power parity (PPP), with variation bands



Source: Bloomberg, OECD, Commerzbank Research

US fiscal policy: USD-positive or negative?

If things turn out as we have predicted, the ultra-expansionary fiscal policy of the Biden administration is more likely to prove a burden on the dollar in the long run. This is because it would not be the magic formula with which to boost the US economy as well as inflation and bring back attractive real interest rates for USD-long positions. Rather, it would only trigger a short- to medium-term artificial boom, which is too obviously finite for the FX market to be seduced by it in the long term.

What would remain would be a massive increase in government debt. Since private consumption and investment are picking up at the same time (as a result of the end of the lockdown), the US will again not be able to cover the resulting financing needs with domestic savings this year and next. Instead, high current account deficits are expected to continue in the coming quarters.

Now, high current account deficits are not per se an argument for a weak dollar. On the contrary, they can even strengthen it if capital flows into the US because high yields can be expected there. However, this USD-positive interpretation is unlikely to be sustainable in the medium term. For 2022, we expect the fiscally ignited boom to subside and US growth to trend back toward the 2% mark. At that point, the US capital demand is likely to be met only on the condition that the rest of the world is offered more attractive USD exchange rates (i.e.: a weaker dollar). There will then no longer be any room for massive USD overvaluation.

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