

The US dollar's rise could go further

UBS House View - Daily Europe

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Thought of the day

The DXY dollar index has hit a 16-month high and is now up 5.8% so far this year. The latest rise in the US currency follows data showing the fastest inflation in three decades in October, accentuating concerns that the Federal Reserve may be more aggressive in tightening monetary policy. By our calculations the US dollar was already overvalued on a purchasing power parity basis, and now looks even more so. For example, we estimate the fair value of the euro as USD 1.34 compared to just 1.14 at present.

But despite this long-term misalignment, we believe the dollar could continue to rise over the coming year for several main reasons:

- 1. The Federal Reserve is out ahead of other major central banks in terms of tightening.** We expect the Federal Reserve to look through the recent elevated level of inflation, resisting pressure to raise rates prematurely. Despite this, the US central bank is still in the global vanguard of monetary tightening, behind only the likes of Norges Bank and the Bank of England. The Fed is set to move well ahead of the European Central Bank. As a result, we expect the yield premium offered by 10-year US Treasuries over German Bunds to rise to 200 basis points from 175 basis points currently, supporting the US dollar. Bank of Japan policy will also remain more accommodative than the Fed's. Added to this, the US economy is less harmed than most other major nations from the recent strength of energy prices, since it recently became a net fuel exporter for the first time since the 1950s.
- 2. Slowing global growth favors the US dollar over the currencies of more export-oriented economies, such as the Eurozone and Japan.** The peak in global growth rates has likely passed. We see global GDP expanding by around 6% this year and 4.7% next. That's still solid. However, the greater reliance of the Eurozone and Japan on foreign sales could hurt their currencies relative to the dollar in the coming year. Exports as a share of GDP are 29% for the Eurozone, 18% for Japan, and 12% for the US, based on World Bank data.
- 3. The dollar should benefit from rising real rates.** The yield on the 10-year US Treasury after expected inflation fell this week to a record low of minus 1.2%. However, we see this rising as the Fed gradually tightens

Market update

KOSPI +1.1%, South Korea outperforming on chipmaker, biopharma gains.

EURUSD +0.1%, the euro up near 1.145 in Asia trade.

Brent -0.8%, oil futures declining to USD 81.5/bbl.

policy. Based on quarterly data since 1996, the US dollar performs well in periods of rising real rates in which growth is positive.

So, we see further US dollar strength ahead against the euro, Swiss franc, and Japanese yen. By the end of 2022 we forecast the euro falling to 1.10 versus the US currency. The US dollar should rise versus the Swiss franc from 0.92 at present to around 0.98. We see the dollar rising from 114 against the yen to 116. We advise clients to position for a stronger dollar, with currency trades being one means of adding yield to portfolios. For more on seeking unconventional sources of yield, [click here](#).