Dollars and Sense:
I Feel the Need, the Need for Speed

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Highlights

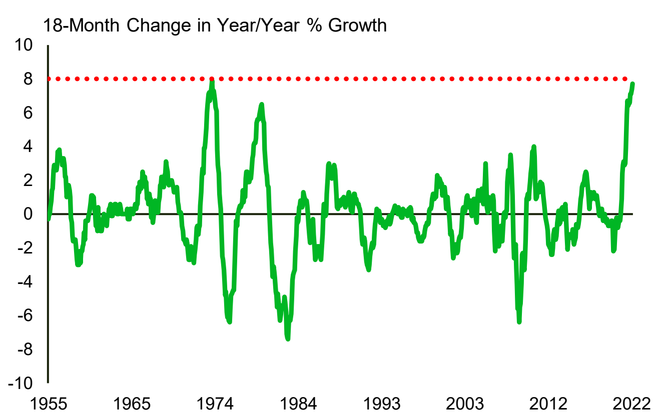
- Investors are buckling up for a bumpy ride, evidenced by a deep inversion in the Treasury yield curve and ongoing USD strength.
- The current economic shock is disproportionately impacting the U.S.'s global peers, with energy dependent economy currencies taking the biggest hit. This is causing a massive adjustment to the euro, yen, and pound sterling.
- The next few months will be key for the U.S. dollar. Threat of recession, the path of commodity prices, and the central bank race to hike rates will be driving factors to determine how much more runway is left for the greenback.

The engine may have sputtered before takeoff, but the Federal Reserve is unambiguously feeling the need for speed. The shock of four-decade high in inflation (9.1% year-on-year) is exceeded only by its swiftest 18-month acceleration since 1974 (Chart 1). The Federal Reserve is now matching speed for speed, with a policy rate that is likely to crest above 3% in less than a year. This speed of tightening hasn't happened since former Fed Chair Paul Volcker aimed to break the back of inflation in the late 1970s. Although that economic cycle ended with a crash landing, it was successful in pulling down inflation. Today's volatile and plummeting global equities have all the markings of risk-off investor jitters. And a deeply inverted Treasury yield curve (10Y-2Y) is a manifestation of recession fears. With few places to hide, the U.S. dollar has offered refuge.

Greenback: In good times and in bad

Over the last year, the broad trade-weighted U.S. dollar has appreciated by an impressive 12%. The initial rise reflected U.S. economic outperformance relative to peer countries. However, this dynamic shifted over the last six months, from capitalizing on a position of strength to capitalizing on a position of weakness. Over that time, financial conditions tightened to a level on par with the 2011 European Sovereign Debt Crisis and the 2015 Oil Shock (Chart 2). Investors have sold risky assets and sought shelter in the safety of the greenback. Already, the USD's advance is close to the 14.6% average appreciation over the last three U.S. recessions, even though the degree of financial stress is still at lower levels.

Chart 1: Inflation Acceleration at 1970's Level



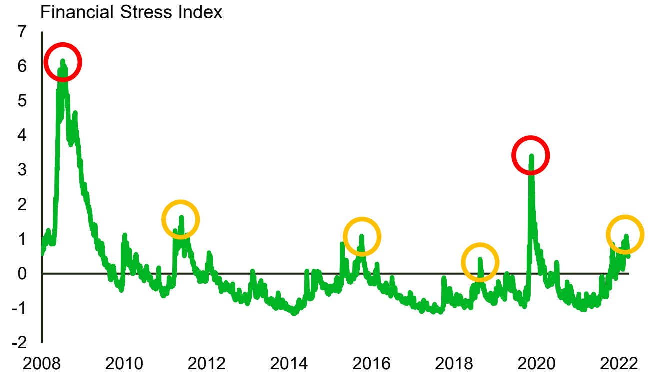
Source: BLS, TD Economics.

So what is the greenback telling us? Its track record in signaling economic recession is spotty. Sure, it has appreciated before four the last five recessions. The pandemic experience is excluded from the analysis since that recession was deliberately manufactured to mitigate a health crisis. However, the USD has also sent many false signals. There have been five cases since 1990 where the USD has advanced by a similar amount in the absence of a recession (Chart 3). These false positives occurred alongside desynchronized global growth trends, where U.S. economic outperformance was the primary driver of USD appreciation. Recent instances include the 2018 U.S./China Trade War, the 2015 Oil Price Shock, and the 2011 European Debt Crisis. None of these shocks led to a U.S. recession. Like today, the greenback is capturing an economic and financial decoupling.

Take Europe, where the euro has plummeted approximately 17% from its 2021 peak against the greenback to near parity. Most of that has occurred since Russia invaded Ukraine. Europe's energy dependence on Russia has left it shouldering more economic and financial risks relative to Americans. The rise in European natural gas prices over the last year is approximately four times that of the U.S. equivalent. Furthermore, the United States has been a net-energy exporter since 2019. The cash inflow from the rise in energy prices is boosting corporate earnings and acting as an economic hedge to rising prices.

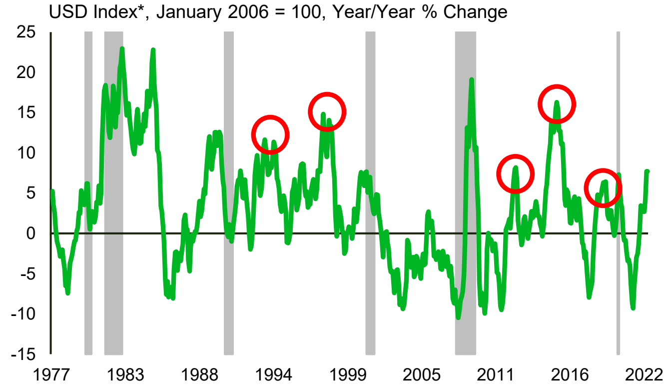
In the UK, the story is similar. Gas prices and another bout of political instability have put the British pound on its back foot, depreciating by 13% y/y. However, the Japanese yen is the worst performing major currency with a 20% fall from grace in the past year. Commodity import dependence has been an ongoing concern for Japan, but the negative yen sentiment also captures a central bank that is determined to stay on the sidelines while the Federal Reserve moves rates higher with conviction.

Chart 2: Financial Stress Showing Slowdown, Not Recession Yet



Source: TD Economics.

Chart 3: USD Rising on Growth Shock



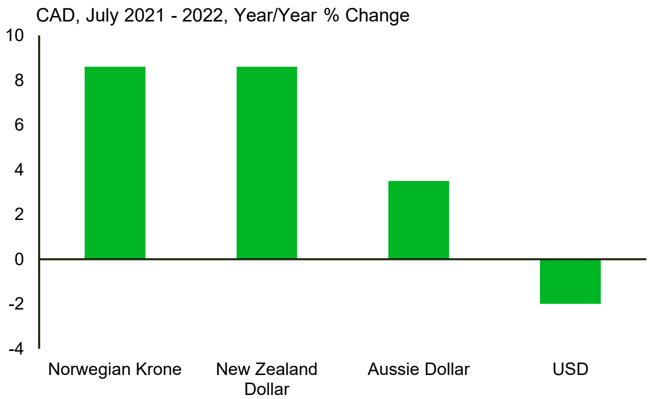
*Nominal FRB Broad Trade-Weighted Dollar Index. Note: Shaded areas denote NBER recessions. Source: FRB, TD Economics.

Shining a new light on the loonie

With WTI oil oscillating around $100 a barrel for several months and with the Canadian dollar's reputation as a commodity currency, many clients have questioned why CAD consistently trades within a 76-79 U.S. cent range. Historically, such a commodity shock would have sent the currency cross towards parity. Not anymore. The U.S.'s emergence as an energy powerhouse combined with limitations on Canadian energy investment has muted the link between the currency and oil prices. However, the link is not completely gone. Against other currencies, the CAD has been a standout – up over 4% in the last year and 17% over the last six years. Narrowing the field to compare valuations against other "commodity currencies", the CAD has outperformed this year (Chart 4). Of course, an aggressive interest rate cycle on pace with the U.S. is also maintaining a valuation preference to peer countries.

We don't think the CAD is done yet. The loonie is being dragged down by risk-off sentiment that favors the USD. This leaves about 5% to the upside for CAD, although the next few months will be key in determining how much of that gap can be closed. In Canada, rising rates have already sharply impacted the residential real estate sector,

Chart 4: CAD Outperforming Other Commodity Currencies



Source: WSJ, TD Economics.

evidenced by an ongoing slide in sales and prices. The risk this imparts to the consumer profile is enhanced by higher household indebtedness relative to its American counterparts. However, Canada also holds several advantages, such as a more robust job market, a mortgage qualification rule that required an interest rate stress test and a consumer with higher savings. The economy has sustained outperformance to the U.S. in the first half of this year, and the jury is out if it will continue to do so. This outcome would be supportive of the CAD closing the gap towards an 80 U.S. cent target.

Yield curve signal flashing yellow

Flight to safety trades always occur when recession risks are elevated, so a strong USD makes sense. But of all the indicators to watch, we place emphasis on the slope of the U.S. Treasury yield curve. The Federal Reserve has been communicating a high tolerance for "growth sacrifice" to re-anchor inflation expectations towards its 2% target. As a result, money markets are priced for the policy rate to get to 3.5% by year-end. That's a full percent above the Federal Reserve's median estimate of the neutral rate. This aggressive pricing has caused the spread between 10-year and 2-year yields to invert decisively into negative territory. In other words, investors think the Fed will go too far with the policy rate and have to eventually reverse course. An inverted yield curve is an effective recession warning signal, preceding every recession since 1980. It's also less prone to false signals, unlike currency swings. From our point of view, the warning bell has been rung.

Historically, once the yield curve inverts, the lead time before recession ranges from one to two years. At the risk of using the words, "this time could be different", if a recession does unfold, this cycle might produce a compressed timeline relative to history due to the speed of rate hikes and the impact of high inflation on household confidence and purchasing power. In such an event, we would expect further near-term upside for the USD as investors continue to sell risky assets. And don't forget, currencies should be judged on relative value. If the U.S. tips into recession, we believe it would still fare better than its European counterparts where the challenges continue to mount.

Interest Rates & Foreign Exchange Rates

Interest & Exchange Rates		Spot Rate	2021				2022				2023			
		Jul-27	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		2.50	0.25	0.25	0.25	0.25	0.50	1.75	3.00	3.25	3.25	3.25	3.25	3.25
3-mth T-Bill Rate		2.37	0.03	0.05	0.04	0.06	0.51	1.66	3.00	3.15	3.15	3.15	3.15	3.15
2-yr Govt. Bond Yield		3.00	0.16	0.25	0.28	0.73	2.28	2.92	3.05	3.10	3.00	2.85	2.70	2.55
5-yr Govt. Bond Yield		2.85	0.92	0.87	0.98	1.26	2.42	3.01	2.75	2.80	2.75	2.70	2.60	2.55
10-yr Govt. Bond Yield		2.80	1.74	1.45	1.52	1.52	2.32	2.98	2.90	2.95	2.90	2.90	2.85	2.80
30-yr Govt. Bond Yield		3.08	2.41	2.06	2.08	1.90	2.44	3.14	3.10	3.20	3.25	3.20	3.15	3.10
10-yr-2-yr Govt Spread		-0.20	1.58	1.20	1.24	0.79	0.04	0.06	-0.15	-0.15	-0.10	0.05	0.15	0.25
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.76	6.55	6.46	6.44	6.36	6.34	6.70	6.75	6.80	6.80	6.80	6.80	6.80
Japanese yen	JPY per USD	137	111	111	112	115	121	136	135	125	120	115	110	105
Euro	USD per EUR	1.02	1.17	1.19	1.16	1.13	1.11	1.05	1.03	1.04	1.06	1.08	1.10	1.13
U.K. pound	USD per GBP	1.22	1.38	1.38	1.35	1.35	1.32	1.22	1.20	1.30	1.33	1.35	1.38	1.39
Swiss franc	CHF per USD	0.96	0.94	0.93	0.93	0.92	0.92	0.96	1.00	1.00	1.00	1.00	1.00	1.00
Canadian dollar	CAD per USD	1.28	1.26	1.24	1.27	1.28	1.25	1.29	1.27	1.24	1.26	1.28	1.30	1.29
Australian dollar	USD per AUD	0.70	0.76	0.75	0.72	0.72	0.75	0.69	0.72	0.72	0.73	0.73	0.74	0.74
NZ dollar	USD per NZD	0.63	0.70	0.70	0.69	0.68	0.70	0.63	0.65	0.65	0.66	0.66	0.67	0.67
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.02	1.17	1.19	1.16	1.13	1.11	1.05	1.03	1.04	1.06	1.08	1.10	1.13
Japanese yen	JPY per EUR	139	130	132	129	130	135	142	139	130	127	124	121	119
U.K. pound	GBP per EUR	0.84	0.85	0.86	0.86	0.84	0.84	0.86	0.86	0.80	0.80	0.80	0.80	0.81
Swiss franc	CHF per EUR	0.98	1.11	1.10	1.08	1.04	1.02	1.00	1.03	1.04	1.06	1.08	1.10	1.13
Canadian dollar	CAD per EUR	1.31	1.48	1.47	1.47	1.44	1.39	1.35	1.31	1.29	1.34	1.38	1.43	1.46
Australian dollar	AUD per EUR	1.46	1.54	1.58	1.60	1.56	1.48	1.52	1.43	1.44	1.46	1.48	1.50	1.53
NZ dollar	NZD per EUR	1.63	1.68	1.70	1.68	1.66	1.60	1.68	1.58	1.59	1.61	1.63	1.65	1.69
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	137	111	111	112	115	121	136	135	125	120	115	110	105
Euro	JPY per EUR	139	130	132	129	130	135	142	139	130	127	124	121	119
U.K. pound	JPY per GBP	166	153	153	150	155	160	165	162	163	160	155	152	146
Swiss franc	JPY per CHF	142.4	117.4	120.0	119.4	125.7	131.8	142.1	135.0	125.0	120.0	115.0	110.0	105.0
Canadian dollar	JPY per CAD	106.5	88.0	89.5	88.0	90.2	97.3	105.4	106.3	100.8	95.2	89.8	84.6	81.4
Australian dollar	JPY per AUD	95.5	84.2	83.2	80.6	83.3	91.1	93.7	97.1	90.4	87.2	84.1	80.9	77.6
NZ dollar	JPY per NZD	85.5	77.3	77.5	76.9	78.5	84.4	84.7	87.8	81.7	78.9	76.0	73.1	70.2

F: Forecast by TD Economics, July 2022; Forecasts are end-of-period.
Source: Federal Reserve, Bloomberg.

Commodity Price Outlook

Commodity	Price	52-Week	52-Week	2021				2022				2023			
	Jul-27	High	Low	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	97	124	62	58	66	71	77	94	109	95	92	87	90	90	85
Natural Gas ($US/MMBtu)	9.44	9.45	3.34	3.56	2.94	4.36	4.77	4.66	7.48	8.30	8.50	7.50	5.00	4.50	4.00
Gold ($US/troy oz.)	1734	2051	1697	1796	1815	1790	1796	1876	1873	1735	1730	1700	1725	1734	1742
Silver (US$/troy oz.)	19.08	26.41	18.42	26.25	26.71	24.30	23.35	24.05	22.66	18.50	18.00	17.00	17.50	17.59	17.68
Copper (cents/lb)	341	513	325	385	439	425	440	453	433	340	340	342	338	340	341
Nickel (US$/lb)	9.79	21.81	8.13	7.97	7.86	8.67	8.99	12.73	13.20	10.00	9.50	9.30	9.30	9.35	9.39
Aluminum (Cents/lb)	110	175	106	95	109	120	125	148	131	110	113	115	117	118	118
Wheat ($US/bu)	11.09	15.64	9.73	7.41	8.53	10.27	11.44	11.55	13.69	8.00	7.80	7.50	7.50	7.54	7.58

F: Forecast by TD Economics, July 2022; Forecast are period averages; E: Estimate.
Source: Bloomberg, USDA (Haver).

Global Stock Markets

Major Market Indexes	Price Jul-27	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	4,024	2.9	-15.6	4,797	3,667
DAX	13,166	0.4	-17.1	16,272	12,401
FTSE 100	7,348	1.9	-0.5	7,672	6,904
Nikkei	27,716	4.6	-3.7	30,670	24,718
MSCI AC World Index*	612	-0.1	-18.9	759	585

*Weighted equity index including both developing and emerging markets.
Source: Bloomberg, TD Economics.