

Dollars and Sense: Greenback Exceptionalism

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Highlights

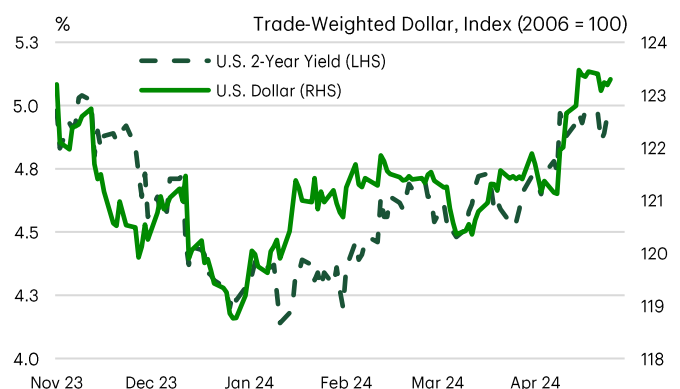
- We have shifted our Federal Reserve call to only one rate-cut this year due to the recent back-up of inflation that does not meet the Fed’s “confidence” threshold to return inflation to 2% in a timely manner.
- With markets punting out Fed cuts but not doing the same for other countries, the U.S. dollar’s strength has no challenger until a pivot occurs in economic dynamics between countries or a geopolitical shift takes hold.
- An escalation of geopolitical risks is likely to add to the greenback’s strength, and even the outcome of the U.S. election could give it another leg up.
- The Canadian dollar is caught in the crosshairs. The Bank of Canada does not manage monetary policy with an eye on the loonie, but spreading interest rates too wide to its U.S. counterpart could cause a break below the resistance level of 72 U.S. cents.

The U.S. dollar is flying high. Since last July, the broad trade-weighted dollar has appreciated nearly 5%, with much of that occurring over the first four months of 2024. Expectations for Fed rate cuts this year have nearly disappeared from the futures market, lifting U.S. Treasury yields and the greenback’s attractiveness (Chart 1). At the same time, a further intensification in geopolitical risks could result in another leg higher in the U.S. dollar.

U.S. exceptionalism and the dollar

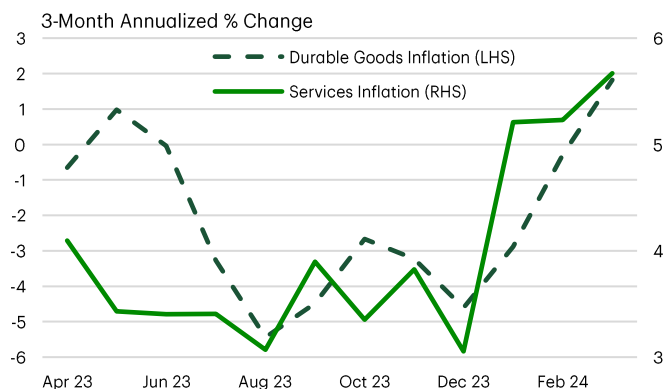
In February, [we wrote](#) about U.S. exceptionalism with economic growth and productivity unparalleled by peer countries. However, the ability for high productivity to continue to counter the forces of strong domestic demand on inflation was an open question that is now revealing an answer. Since the start of 2024, core inflation has turned higher in

Chart 1: USD Rising on Higher U.S. Yields



Source: Federal Reserve Board, TD Economics. Last Observation: April 30th, 2024.

Chart 2: U.S. Inflation Ticking Higher



Source: Bureau of Economic Analysis, TD Economics. Last Observation: March 2024.

part due to strong spending on health care, recreation activities, and travel. Services inflation is back above 5% on a three-month basis (from 3% in December). To make matters worse, the deflationary impulse from durable goods evaporated in March – with prices now up 1.8% on a three-month basis compared to -4.6% in December (Chart 2).

In terms of the Fed's preferred core PCE inflation measure, it is holding at a reasonable 2.8% year-on-year (y/y). But developments within the CPI metric foreshadow what's to come. We expect core PCE to edge back towards 3% y/y in the coming months. This speaks to the staying power of inflation in the absence of a "growth sacrifice" within an economy holding in excess demand territory. From our perspective, consumer spending must ease for inflation to return, and be sustained, on a 2% path. There is only limited evidence of this, and certainly not enough to cause a sudden capitulation in underlying inflation dynamics. It's not surprising, then, that markets moved quickly to reprice from 150 basis points in cuts at the start of the year, all the way to a total of 38 bps by year-end. Although we never sided with the magnitude of the market's initial pricing over the January to March period, we agree with right-sizing the rate cuts to recent data developments. We have penciled in just one cut in December, aligning to when we forecast the 3- and 6-month trends in core PCE inflation will provide the central bank sufficient comfort of reaching its 2% target by mid-to-late 2025.

The story of America's growth surge and inflation strength is, uniquely, American. Peer economies have weakened under the weight of their past interest rate hikes. The Euro Area and the UK produced negative GDP prints to close out 2023, while a country that typically benefits from U.S. exceptionalism – Canada – has posted a streak of negative GDP per capita over the last year. Poor economic performances have lent more confidence to these central banks that inflation can be tamed back to the 2% target in a timelier manner. Expectations for rate cuts have subsequently remained anchored around the summer time period, with an ongoing easing path priced thereafter ranging from 50 to 75 basis points by year-end. This would follow the Swiss National Bank and a handful of other central banks in the developing markets that have already cut interest rates.

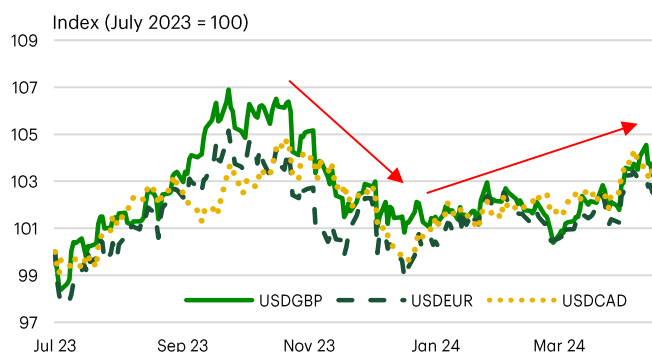
Expectations favoring widening monetary policy divergence has caused international government yields to diverge from U.S. Treasuries. While the U.S. 2-year is flirting with a cycle high at 5%, peer-equivalent yields have failed to keep up. Likewise, this has pressured currencies. The pound, euro and loonie are down between 4% to 5% in the last nine months (Chart 3). But given the 50 to 100 basis point central bank policy divergence expected by markets relative to the Federal Reserve, we think the next significant move in the U.S. dollar would require a new or larger catalyst.

Global risks picking up

It makes sense that the greenback typically appreciates when the U.S. economy is doing well. But the greenback also appreciates when geopolitical risks threaten the economy. This historical pattern is known as the 'USD smile'. The latter is due to the USD's safe haven appeal. When risks abound, investors seek the shelter of U.S. dollar assets. At this juncture, the global economy has plenty of risks to worry about. Russia has made more advances into Ukraine and tensions have deepened between Israel and Iran. Commodity markets are capturing this with the price of oil up nearly 10% in four months.

As our readers know too well, disruptions to energy supply can lead to economic instability. Just look at Europe's energy insecurity since Russia invaded Ukraine.

Chart 3: USD Moving Higher Against Major Trading Partner Currencies



Source: Wall Street Journal, TD Economics. Last Observation: April 26th, 2024.

It is also more common for countries outside of North America to experience the negative economic impacts from higher oil prices due to less energy independence. A good comparison is the 1994 to 2000 period. During that time, the U.S. economy was leading the globe on the back of the technology revolution. And even though oil prices were rising throughout that period, the USD kept appreciating. It was an island unto its own.

What matters most in causing a depreciation of the U.S. dollar are homegrown risks, like the failure of LTCM, the bursting of the tech bubble, and the global financial crisis where the U.S. mortgage market marked the epicenter. None of these conditions are present today. The U.S. economy is on stronger footing than its peers when it comes to economic and financial risks, as well as being a net energy exporter.

That means it's still possible for the U.S. dollar to have another leg up relative to peer currencies, it would likely require a "next-level" escalation in geopolitical events. This is entirely possible but difficult to predict, but some currencies are already showing significant vulnerability. The Turkish lira has depreciated about 9% to start the year, and some central banks are now intervening to defend their currencies. The Bank of Indonesia imposed a rate hike (rupiah down ~5%), and the Bank of Japan buying yen assets to backstop the currency (yen down ~10%).

And what about the upcoming U.S. election? Will this help or hinder the valuation of the greenback? Hard to say. Should a new administration enact harsh and broad tariffs on other countries, it could boost the USD.

During the Trump administration, an escalation in U.S./China trade tensions saw an 11% appreciation in the greenback between 2018 and 2019. At the same time, policies that cause a rapid escalation in sovereign debt dynamics could move the currency in the other direction due to a market confidence shock. As yet, markets have not taken a side on either of these risks. Major currencies like the euro and loonie haven't broken below their current resistance levels, even though yield differentials have been growing increasingly unfavorable. This supports the notion that the USD would require a fairly significant event to trigger risk-off sentiment to push against recent thresholds.

How far can the CAD fall?

The loonie is a good example of a currency that's been fairly rangebound between 72 and 76 U.S. cents since summer 2022. This marked the moment the Fed caught up to, and eventually surpassed, the BoC in terms of policy rate hikes. It also marked the time when the Canadian economy started to serially underperform the U.S. economy. Indeed, GDP per capita has been on the decline ever since. If it weren't for an inflating of domestic demand due to rapid and unsustainable population growth, Canada would have likely been in a recession by now.

As it stands, the bottom has not fallen out and the BoC has been afforded time to delay rate cuts. But as time wears on, the first rate cut is inching closer. While first quarter GDP is likely going to be strong due to a warmer winter, the stalwart of the Canadian economy – job growth – has started to crack. Growth in the number of unemployed workers is up 23% over the last year, a level consistent with past recessions. Assuming the current trend continues, and inflation maintains its downward trend, a summer rate cut appears likely.

As we mentioned above, the monetary policy divergence isn't likely to drift much more than what is expected by markets. The BoC won't want to get too far ahead of the Fed and risk undermining sentiment too much on the loonie. Rather, a further depreciation would likely be due to a risk off move, potentially driven by an oil spike. Even though Canada is still an energy-focused economy, the marginal benefit from higher oil prices relative to the U.S. no longer exists for

CAD. If geopolitical risks perk up in a way that presses oil prices higher, risk-off sentiment tends to dominate a depreciation in the currency relative to the nominal GDP benefits that flow through on the higher oil prices. The loonie could test at or below the 70 U.S. cent level.

Bottom Line

The story of the U.S. dollar's appreciation is one that intersects Fed policy and geopolitics. On the former, U.S. economic exceptionalism has pushed back the start of rate cuts towards December, widening the interest rate gap with other economies. This has been the driver of the first leg of the USD's appreciation. While Fed policy

might push the greenback a little higher over the coming months, a bigger leg-up would require a further intensification of geopolitical risks. And with the U.S. election quickly approaching, there are a significant number of events that could likewise cause the greenback to reach new highs, but also work against the currency if financial markets don't like what they see on the domestic debt dynamics. At this stage, financial markets have not taken a strong conviction on either side of the risk. Investors are in wait-and-see mode.

Interest Rate Outlook													
Interest Rates	Spot Rate May-01	2023				2024				2025			
		Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA													
Overnight Target Rate	5.00	4.50	4.75	5.00	5.00	5.00	5.00	4.75	4.25	3.75	3.25	3.00	2.75
3-mth T-Bill Rate	4.94	4.34	4.90	5.07	5.04	4.99	4.88	4.50	4.00	3.50	3.13	2.88	2.63
2-yr Govt. Bond Yield	4.29	3.74	4.58	4.87	3.88	4.17	4.35	4.05	3.75	3.45	3.15	2.85	2.55
5-yr Govt. Bond Yield	3.81	3.02	3.68	4.25	3.17	3.51	3.90	3.70	3.50	3.30	3.15	3.00	2.90
10-yr Govt. Bond Yield	3.76	2.90	3.26	4.03	3.10	3.45	3.85	3.70	3.55	3.40	3.25	3.15	3.00
30-yr Govt. Bond Yield	3.63	3.00	3.08	3.81	3.02	3.37	3.75	3.65	3.55	3.45	3.35	3.25	3.20
10-yr-2-yr Govt Spread	-0.54	-0.84	-1.32	-0.84	-0.78	-0.72	-0.50	-0.35	-0.20	-0.05	0.10	0.30	0.45
U.S.													
Fed Funds Target Rate	5.50	5.00	5.25	5.50	5.50	5.50	5.50	5.50	5.25	5.00	4.50	4.00	3.50
3-mth T-Bill Rate	5.25	4.68	5.17	5.32	5.20	5.23	5.25	5.25	5.05	4.65	4.15	3.65	3.15
2-yr Govt. Bond Yield	4.95	4.06	4.87	5.03	4.23	4.59	4.95	4.95	4.75	4.45	4.15	3.85	3.55
5-yr Govt. Bond Yield	4.64	3.60	4.13	4.60	3.84	4.21	4.70	4.65	4.40	4.15	3.90	3.70	3.50
10-yr Govt. Bond Yield	4.63	3.48	3.81	4.59	3.88	4.20	4.70	4.65	4.40	4.20	4.00	3.85	3.65
30-yr Govt. Bond Yield	4.75	3.67	3.85	4.73	4.03	4.34	4.80	4.75	4.70	4.50	4.30	4.15	3.95
10-yr-2-yr Govt Spread	-0.33	-0.58	-1.06	-0.44	-0.35	-0.39	-0.25	-0.30	-0.35	-0.25	-0.15	0.00	0.10
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	-0.31	-0.34	-0.27	-0.25	-0.16	-0.24	-0.37	-0.75	-1.05	-1.15	-1.02	-0.77	-0.52
Can - U.S. 10-Year Bond Spread	-0.87	-0.58	-0.55	-0.56	-0.78	-0.75	-0.85	-0.95	-0.85	-0.80	-0.75	-0.70	-0.65

F: Forecast by TD Economics, May 2024; Forecasts are end-of-period.

Source: Bloomberg, Bank of Canada, Federal Reserve.

Foreign Exchange Outlook														
Currency	Exchange Rate	Spot Price May-01	2023				2024				2025			
			Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	7.24	6.87	7.25	7.30	7.10	7.22	7.20	7.25	7.30	7.25	7.20	7.15	7.10
Japanese yen	JPY per USD	157	133	144	149	141	151	150	149	148	147	146	144	143
Euro	USD per EUR	1.07	1.09	1.09	1.06	1.11	1.08	1.05	1.03	1.04	1.06	1.08	1.10	1.13
U.K. pound	USD per GBP	1.25	1.24	1.27	1.22	1.27	1.26	1.23	1.21	1.22	1.24	1.27	1.29	1.30
Canadian dollar	CAD per USD	1.37	1.35	1.32	1.35	1.32	1.35	1.39	1.41	1.42	1.39	1.36	1.34	1.31
Australian dollar	USD per AUD	0.65	0.67	0.67	0.65	0.68	0.65	0.64	0.63	0.63	0.65	0.66	0.67	0.69
NZ dollar	USD per NZD	0.59	0.63	0.61	0.60	0.63	0.60	0.59	0.58	0.58	0.59	0.61	0.62	0.63
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.07	1.09	1.09	1.06	1.11	1.08	1.05	1.03	1.04	1.06	1.08	1.10	1.13
Japanese yen	JPY per EUR	168	144	158	158	156	163	158	154	154	156	158	159	161
U.K. pound	GBP per EUR	0.86	0.88	0.86	0.87	0.87	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.87
Canadian dollar	CAD per EUR	1.47	1.47	1.45	1.43	1.46	1.46	1.46	1.45	1.48	1.48	1.48	1.48	1.47
Australian dollar	AUD per EUR	1.64	1.62	1.64	1.64	1.62	1.65	1.64	1.64	1.64	1.64	1.64	1.64	1.64
NZ dollar	NZD per EUR	1.81	1.73	1.78	1.76	1.75	1.80	1.79	1.79	1.79	1.79	1.79	1.79	1.79
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	157	133	144	149	141	151	150	149	148	147	146	144	143
Euro	JPY per EUR	168	144	158	158	156	163	158	154	154	156	158	159	161
U.K. pound	JPY per GBP	197	164	184	183	180	191	185	180	181	183	185	186	186
Canadian dollar	JPY per CAD	114.6	98.2	109.2	110.4	106.7	111.7	108.1	105.8	104.4	105.8	106.9	108.0	109.1
Australian dollar	JPY per AUD	102.5	89.0	96.3	96.4	96.2	98.7	96.1	93.7	94.0	95.2	96.1	97.1	98.0
NZ dollar	JPY per NZD	93.2	83.2	88.6	89.9	89.3	90.5	88.2	86.0	86.2	87.4	88.2	89.1	89.9
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.73	0.74	0.76	0.74	0.76	0.74	0.72	0.71	0.70	0.72	0.73	0.75	0.76
Japanese yen	JPY per CAD	114.6	98.2	109.2	110.4	106.7	111.7	108.1	105.8	104.4	105.8	106.9	108.0	109.1
Euro	CAD per EUR	1.47	1.47	1.45	1.43	1.46	1.46	1.46	1.45	1.48	1.48	1.48	1.48	1.47
U.K. pound	CAD per GBP	1.72	1.67	1.68	1.65	1.68	1.71	1.71	1.70	1.73	1.73	1.73	1.73	1.70
Australian dollar	AUD per CAD	1.12	1.10	1.13	1.15	1.11	1.13	1.12	1.13	1.11	1.11	1.11	1.11	1.11
NZ dollar	NZD per CAD	1.23	1.18	1.23	1.23	1.19	1.23	1.23	1.23	1.21	1.21	1.21	1.21	1.21

F: Forecast by TD Economics, May 2024; Forecasts are end-of-period.

Source: Federal Reserve, Bloomberg.

Global Stock Markets					
Major Market Indexes	Price May-01	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	5,057	-3.8	6.0	5,254	4,061
S&P/TSX Composite	21,793	-1.7	4.0	22,362	18,737
DAX	17,932	-3.0	7.0	18,492	14,687
FTSE 100	8,121	2.1	5.0	8,147	7,257
Nikkei	38,274	-5.2	14.4	40,888	28,950
MSCI AC World Index*	757	-3.4	4.1	784	629

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

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