Market Insight:
When I Find Myself In Times of Trouble

Beata Caranci, SVP & Chief Economist | 416-982-8067
James Orlando, CFA, Director & Senior Economist | 416-413-3180

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Highlights

- Investors have flooded into the U.S. dollar, reflecting a prototypical safe haven flow that has occurred during every economic shock over the last four decades.
- The USD has seen its greatest strength against the currencies of other Advanced Economies due to a mix of energy import dependence, political uncertainty, and an overall inability for central banks to keep pace with the Fed.
- Though the USD's heightened valuation leaves it vulnerable to a pullback, for so long as recession fears are elevated, the greenback will be the asset of choice for investors during times of trouble.

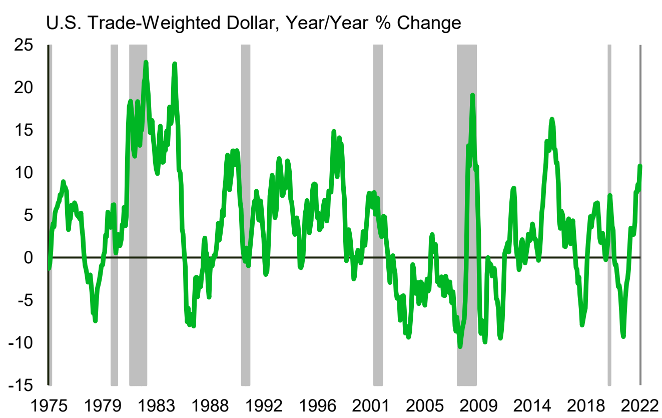
With the world economy sitting on a knife's edge, volatility continues to cut into financial markets. Equities are in a bear market, bond yields are rising at a pace on par with the 1970/80s, and U.S. mortgage spreads are surging to levels last seen during the housing market crash of 2008. The current environment has left investors with few places to hide. But, there is one safe haven investors can count on: the U.S. dollar (Chart 1).

Over the last four decades, times of trouble have led to an impressive performance by the greenback – whether it be the 23% gain during the depths of the 2008 financial crisis or the 10% jump during the global pandemic. Once again, it's speaking words of wisdom by gaining 16% since the summer of 2021.

The light that shines

Economic shocks can quickly shift the investor mindset into protection mode. Risks are re-assessed, vulnerable assets are avoided, and safe ones come into favor. From the 1970s through the 1990s, Emerging Markets (EMs) were at the epicenter of various crises. The Latin American Debt Crisis of the 1980's, the Mexican Crisis in 1994/95, and the Asian Financial Crisis in 1997 being the most notable during the period. In all instances, investors sold vulnerable EM assets and bought U.S. Treasuries. This capital flight caused U.S. dollar (USD) appreciation, which had a compounding effect where the entire EM basket of currencies was depressed. (Chart 2).

Chart 1: USD as a Safe Haven Once Again



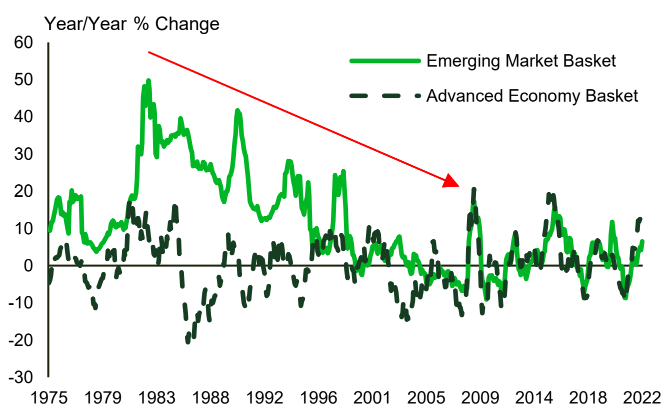
Source: FRB, NBER Recessions, TD Economics.

But there was a change over the last two decades. China's economic rise entrenched globalization and raised the stading of EMs, which now account for more than half of global GDP. Many EMs have amassed sizeable foreign exchange reserves, implemented flexible exchange rates, and reduced their foreign debt exposure. This has mitigated the threat of capital flight and has provided more foreign exchange stability. The impact of this change has been apparent over the last year. The USD has appreciated only 7% against the EM basket, compared to a 16% annual average gain over the last six U.S. recessions.

This relative currency outperformance of EMs also speaks to the current risks facing the global economy. Economies most exposed to Russia and/or energy imports are seeing significant currency depreciation, most of which are Advanced Economies (AE). And these are mostly Advance Economies (AE). The euro has dropped over 16% in the last year under a darkened economic outlook with the onset of Russia's aggression on Ukraine. The fast-approaching winter months coupled with a quadrupling in Europe's natural gas benchmark has heightened angst regarding whether the region will have to further scale back production and its basic need for heating.

In the same vein, the British pound is down around 19% over the last year. The UK's dependence on purchasing energy in the spot market has left it vulnerable to global forces as a price taker. The nation is also dealing with homegrown problems. The impact of Brexit on investment and labor supply is a long-term negative that continues to lower the ceiling for the pound. And more recently, the shock of the government's proposed mini-budget speaks to a level of political uncertainty that has further tested investor commitment to the region. Even though the government "walked back" that budget, the pound still carries the weight of political uncertainty.

Chart 2: EMs Seeing Less Capital Flight



Source: FRB, TD Economics.

The Japanese yen also makes the list of star underperformers, which is down close to 23% on the year. Japan too is an energy importer and rides the wave of oil prices. But this has not been the main influence on its currency. The Bank of Japan has been unwilling to adjust course on monetary policy, creating stark divergence with global peers. When nearly every central bank in the world is hiking interest rates, the BoJ is still implementing extraordinary monetary easing measures to prevent yields from rising. Japan has been through decades of deflation and doesn't want to initiate another ill-fated policy error. However, yield hungry investors have little choice but to contrast a central bank that is keeping rates at the floor relative to the Federal Reserve that is marching rates towards 5%.

We can go on and on about the currencies that have depreciated against the USD, but there is a clear pattern. Relative to the U.S., global peers are more exposed to the various sources of economic shocks that are causing investors to pull out capital.

Bottom Line

The U.S. economy historically displays resilience to global peers when turmoil comes into scope. The environment should maintain the attractiveness of the dollar into early 2023, as markets assess the transmission of global risks on various countries.

However, as risks recede, become better understood, and positions in the USD become too weighty, repricing will again swing back toward peer currencies. We anticipate this timing is most likely around the middle of 2023. This is when we forecast the downturn in economic momentum will trough, as inflation moves decisively lower in the back half of the year. However, until there's convincing evidence of this, investors will likely opt for the safety of the greenback.

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