GW&K INVESTMENT MANAGEMENT

GLOBAL PERSPECTIVES

Will U.S. Fiscal Stimulus Reverse Dollar Weakness?

FEBRUARY 2021

William P. Sterling, Ph.D.

Global Strategist

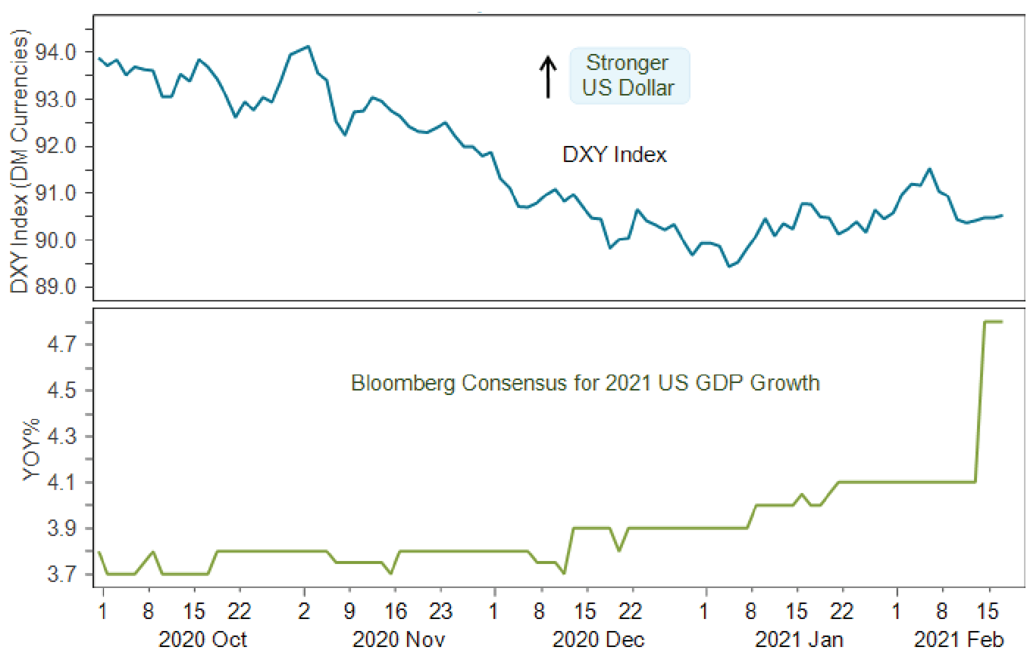
Highlights

- Despite widespread expectations for further weakness, the U.S. dollar has risen this year versus developed market (DM) currencies.
- A key question is whether U.S. fiscal stimulus is bullish for the dollar. That looks unlikely given the recent significant expansion of America's trade and current account deficits.
- Historically, given large U.S. external deficits, the dollar has tended to weaken even when U.S. bond yields rose. Such periods typically have generated positive tailwinds for non-U.S. equities.

The Dollar Has Firmed in 2021 As U.S. Growth Expectations Have Risen

According to Bank of America/Merrill Lynch's January Global Investor survey, investors ranked expectations for a weaker U.S. dollar as the third most "crowded trade" for 2021, following "Long Bitcoin" and "Long Tech." At least in the short run, contrarians have been rewarded as the dollar has strengthened so far this year along with rising U.S. growth expectations (**Chart 1**).

Chart 1: U.S. Dollar Index and Bloomberg Survey of Economic Forecasters



Source: GW&K Investment Management, Bloomberg, and Macrobond

The U.S. dollar has firmed modestly versus DM currencies in early 2021 against a backdrop of rising expectations for U.S. growth.

GW&K Investment Management

Boston, Massachusetts

Winter Park, Florida

New York, New York

617.236.8900

www.gwkinvest.com

So far the move has been modest, with the U.S. Dollar Index (DXY) against developed market (DM) currencies rising about 1% in the first six weeks of 2021 after having fallen by 7% over the course of 2020. In addition, the dollar has been slightly weaker against a basket of MSCI EM currencies so far this year, as a modest strengthening of China's yuan has offset dollar strength against a number of other EM currencies, most notably those of Latin America.

Not surprisingly, rising U.S. bond yields have accompanied rising U.S. growth expectations. Despite weak year-end data on jobs growth in December and January, the yield on U.S. 10-year Treasury bonds rose by nearly 30 basis points to 1.21% in the first six weeks of 2021. That rise, which was accompanied by rising inflation expectations and higher commodity prices, reflects optimism that U.S. growth will accelerate in coming quarters as the vaccination campaign restores normal patterns of consumer behavior while sizable fiscal stimulus also boosts growth.

In a world with nearly $16 trillion of negative yielding debt, even a modest increase in U.S. bond yields apparently has been attracting capital flows to the U.S. dollar. As a point of reference, the yields on 10-year German bunds and Japanese government bonds were minus 0.43% and plus 0.06%, respectively as of February 12. Moreover, Europe and Japan have experienced much less upward pressure on bond yields than the U.S. due to tepid near-term growth expectations based on prolonged coronavirus lockdowns, lagging vaccine rollouts, and more restrained fiscal stimulus.

Both Interest Rates and External Imbalances Matter for the U.S. Dollar

Against this backdrop, a key question for the U.S. dollar is whether prospects for further U.S. fiscal stimulus will continue to widen economic growth differentials in favor of further dollar strength. With the Biden administration proposing an additional $1.9 trillion in fiscal aid following the $900 billion package approved late last year, the potential for further sizable upward revisions to U.S. growth is clear – even if the latest Biden proposal gets watered down to $1 to $1.5 trillion in the legislative process as many economists expect.

Moreover, the new stimulus would come on top of apparently unspent stimulus payments from last year, which leave an estimated $1.6 trillion in "excess savings" – or 7.6% of GDP of pent-up demand – that could be unleashed when the pandemic subsides. Against that savings backdrop, and with as much as 13% of GDP of new stimulus on the table (last year's $900 billion plus the proposed $1.9 trillion), the current consensus forecast for 4.8% U.S. GDP growth in 2021 looks conservative.

We will leave it to others to debate the degree to which U.S. fiscal stimulus will boost growth. However, we will note that trends in the U.S. dollar tend to be driven not only by growth and interest rate dynamics, but also by the size of U.S. trade and current account deficits. By definition, such deficits imply a reliance on foreign capital flows that often require a combination of higher yields and a weaker dollar to attract the necessary funds from overseas investors. To show this, we will look at quarterly data from after 1973, which was the year that the Bretton Woods fixed exchange rate system was replaced with floating exchange rates.

As shown in **Table 1**, since 1973 the Fed's real broad-trade weighted dollar index on average changed very little on a one-year basis in periods when U.S. 10-year Treasury yields rose in the range of 0% to 3%. There was a wide range of outcomes in periods of rising yields, although the dollar declined about 60% of the time during periods when U.S. yields rose by 1% to 3%. There were, however, three one-year periods when U.S. yields rose by more than 3% and when the dollar index rose by an average of nearly 10%. Those exceptional episodes all occurred in the early 1980s when Fed chair Paul Volcker was focused on crushing runaway inflation with extremely high short- and long-term interest rates.

Table 1: 1-Year Change in Fed Real Trade-Weighted Broad Dollar Sorted by Change in 10-Year U.S. Treasury Yields, 1974:Q2 - 2020:Q4

1-Year Change in 10yr UST Yield (%)	1-Year Change in USD (%)	High (%)	Low (%)	No. Periods	% Negative
[-5, -4)	-14.1	-14.1	-14.1	1	100%
[-4, -3)	6.2	10.3	3.3	4	0%
[-3, -2)	-4.2	11.4	-13.8	7	57%
[-2, -1)	1.1	9.1	-10.5	28	36%
[-1, 0)	1.2	16.4	-9.7	63	48%
[0, 1)	-0.2	11.9	-10.1	57	47%
[1, 2)	-1.9	6.0	-11.9	19	58%
[2, 3)	0.6	4.6	-1.2	5	60%
[3, 4)	9.7	13.1	5.8	3	0%
All	0.4	16.4	-14.1	187	46%

Source: GW&K Investment Management, U.S. Federal Reserve, Bloomberg, and Macrobond

Periods of rising U.S. bond yields have frequently been accompanied by a weaker U.S. dollar, with the average change being close to zero for yield increases in the range of 0% to 3%.

However, the three periods in the early 1980s that saw U.S. bond yields rise by more than 3% in a year, which also saw short-term rates rise by even more, were accompanied by notable dollar strength.

If periods of rising yields have typically been neutral for the dollar since 1973, the picture is different during periods which started with a large U.S. external imbalance. In **Table 2**, we focus on periods since 1973 when the U.S. current account deficit was initially larger than 3% of GDP. That corresponds to the late 1980s and most periods from 1999 to 2011 (**Chart 2**). It also corresponds to the current situation, which saw a notable expansion of the U.S. external deficit from 1.9% of GDP at the end of 2019 to 3.4% of GDP by the third quarter of 2020. As shown in **Table 2**, during periods when the current account deficit was large, the dollar declined about 80% of the time on a year-on-year basis when U.S. bond yields were rising. In fact, the average year-on-year decline was 6% when yields rose between 1% and 2% over the course of a year.

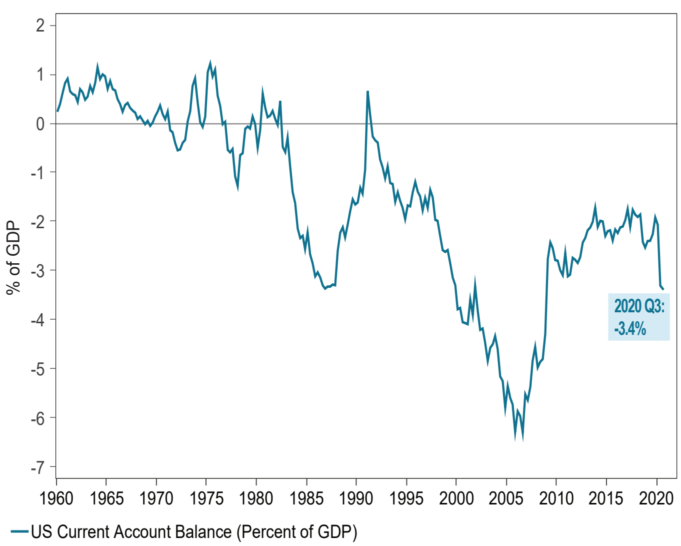
Table 2: 1-Year % Change in Fed Real Trade-Weighted Broad Dollar Sorted by Change in 10-Year U.S. Treasury Yields, Limited to Periods Since 1973 When Initial U.S. Current Account Deficit > 3% of GDP

1-Year Change in 10yr UST Yield (%)	1-Year Change in USD (%)	High (%)	Low (%)	No. Periods	% Negative
[-2, -1)	0.2	7.9	-10.5	11	45%
[-1, 0)	-0.6	16.4	-7.7	18	67%
[0, 1)	-3.6	3.7	-10.1	15	73%
[1, 2)	-6.0	-0.8	-11.9	6	100%
All	-2.0	16.4	-11.9	50	68%

Source: GW&K Investment Management, U.S. Federal Reserve, Bloomberg, and Macrobond

During times since 1973 when the U.S. ran a large current account deficit, periods of rising U.S. bond yields have usually been accompanied by a weaker U.S. dollar.

Chart 2: The U.S. Current Account Deficit has Widened During the Pandemic



Source: GW&K Investment Management, BEA, and Macrobond

The U.S. current account deficit, a measure of America's dependence on foreign capital, has widened significantly during the pandemic and could widen further as fiscal stimulus boosts consumption.

Thus, rising yields are no guarantee of a stronger dollar when the U.S. is dependent on foreign capital to finance external deficits. Under current circumstances, if large U.S. deficit spending supports a surge in U.S. consumption as the pandemic fades, we would expect U.S. trade and current account deficits to widen further. That is because global supply chains, especially Asian ones, will tend to work overtime to satisfy the needs of U.S. consumers. This dynamic has already worked to boost the currencies of China and other Asian exporters during the pandemic and seems likely to continue even as the pandemic recedes.

In short, if foreign trade surpluses expand as U.S. consumption surges, foreign exporters will accumulate more dollars than they may wish to hold, especially if the Fed keeps short-term interest rates near zero for an extended period as is widely expected. As they convert those dollars back to their domestic currencies, downward pressure on the dollar is a natural result.

Dollar Weakness Tends to Create Positive Tailwinds for Non-U.S. Equities

Our bottom line is that prospects for more U.S. fiscal stimulus may well weaken the dollar in coming quarters by pushing more dollars into the global financial system than foreign investors wish to hold. If past is prologue, that is likely to be a positive tailwind for non-U.S. equities which have historically tended to outperform during such periods.

As shown in **Table 3**, in periods since 1973 when the U.S. current account deficit was large and U.S. bond yields were rising, U.S. equities delivered on average solid double-digit returns. That tended to reflect above-average profit growth during such periods, which typically more than offset any compression of PE ratios triggered by higher bond yields.

Table 3: Non-U.S. versus U.S. Equity Performance Gap Sorted by Change in 10-Year U.S. Treasury Yields, Limited to Periods Since 1973 When Initial U.S. Current Account Deficit > 3% of GDP

Panel A: S&P 500 Total Return (1-Year Performance, %)					
1-Year Change in 10yr UST Yield (%)	Average	High	Low	No. Periods	% Positive
[-2, -1)	-13.8	5.3	-37.0	11	27%
[-1, 0)	-1.6	30.0	-38.0	18	50%
[0, 1)	16.8	50.0	-7.0	15	93%
[1, 2)	15.7	43.3	-8.4	6	83%
All	3.3	50.0	-38.0	50	62%

Panel B: MSCI EAFE vs S&P 500 (1-Year Performance Gap, %)					
1-Year Change in 10yr UST Yield (%)	Average	High	Low	No. Periods	% Positive
[-2, -1)	-4.5	5.8	-19.8	11	36%
[-1, 0)	3.4	36.5	-17.3	18	67%
[0, 1)	9.5	35.1	-8.8	15	87%
[1, 2)	14.2	26.4	4.1	6	100%
All	4.8	36.5	-19.8	50	70%

Panel C: MSCI EM vs S&P 500 (1-Year Performance Gap, %)					
1-Year Change in 10yr UST Yield (%)	Average	High	Low	No. Periods	% Positive
[-2, -1)	-3.1	25.8	-21.7	11	45%
[-1, 0)	11.7	40.5	-13.4	16	69%
[0, 1)	23.1	44.3	9.0	12	100%
[1, 2)	29.8	51.0	12.8	3	100%
All	12.4	51.0	-21.7	42	74%

Source: GW&K Investment Management, U.S. Federal Reserve, Bloomberg, and Macrobond

During times since 1973 when the U.S. ran a large current account deficit, periods of rising U.S. bond yields have usually been accompanied by large outperformance of non-U.S. equities vs. the S&P 500 Index.

That said, the real action in such periods was in non-U.S. equities. As shown in **Table 2**, the MSCI EAFE Index of non-U.S. DM equities outperformed the S&P 500 Index more than 90% of the time in periods of large external deficits and rising bond yields – and by relatively wide margins. The results were even more striking for the MSCI EM Index, which outperformed the S&P 500 Index 100% of the time during such periods, and by margins of more than 20% per year.

In short, the U.S. economy tends to act as a driver of global growth when it runs large trade and current account deficits. At such times, the resultant rise of U.S. dollars in the global systems has tended to create downward pressure on the dollar and been accompanied by upward pressure on bond yields. In turn, dollar weakness has also encouraged foreign policymakers to stimulate their economies to avoid deflationary pressures from their own currencies' appreciation. More often than not, the end result has been notably strong performance from non-U.S. equity markets.

The normal caveat applies to this type of analysis: past performance is no guarantee of future results. That said, for U.S. investors who are wondering how U.S. fiscal stimulus may affect global markets, history suggests that exposure to non-U.S. equities may represent a useful complement to an otherwise diversified portfolio.

William P. Sterling, Ph.D.
Global Strategist