# GLOBAL PERSPECTIVES

FEBRUARY 2024

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## IS THE US DOLLAR OVERVALUED?

HIGHLIGHTS

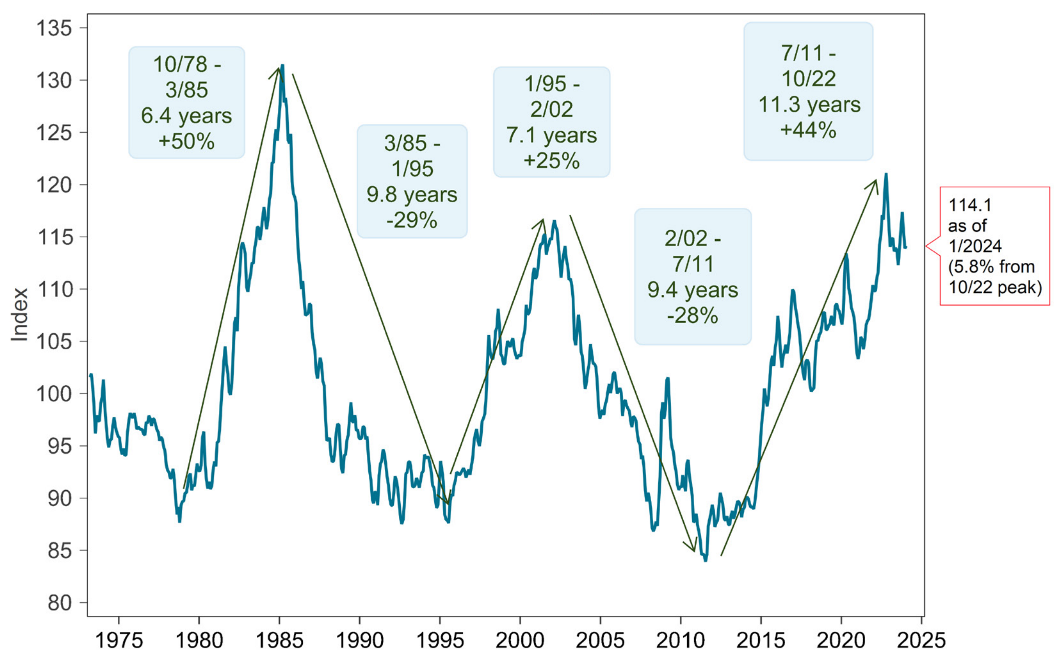
- After an 11-year climb from 2011 to 2022, the foreign exchange value of the US dollar remains very high by many measures.
- America's economic strength and the Fed's aggressive rate hikes support the dollar's value. America's tech boom is also attracting global capital.
- As growth slows and the Fed shifts to more dovish policies, some dollar weakness seems likely. History suggests a weaker dollar may persist for years.

## THE DOLLAR STAYS STRONG

The US dollar fluctuates continuously against other major currencies. One common metric is the Fed's inflation-adjusted, trade-weighted Real Broad Dollar Index, a weighted average of the US dollar against currencies from key US trade partners **(Figure 1)**.

### FIGURE 1

### The Dollar Has Ample Room to Decline Further: The US Real Trade-Weighted Dollar Index




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

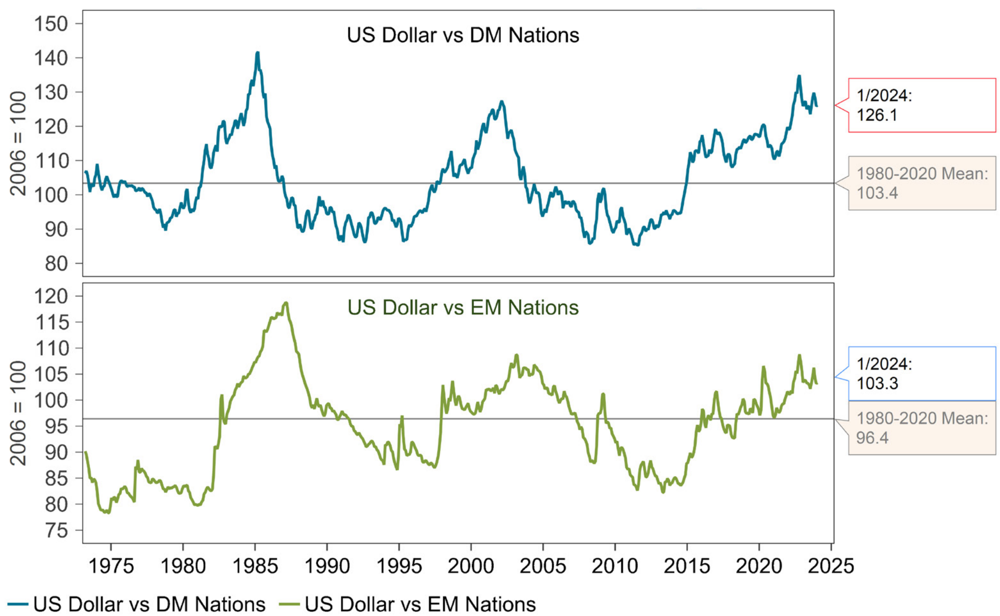
**The Fed's real trade-weighted dollar index is off its October 2022 peak but remains about 14% higher than its long-term average rate. Historically the dollar has tended to move in multi-year cycles.**

This index shows multi-year swings in the dollar's real value. The latest 11-year upswing boosted the dollar's value 44% from 2011 to 2022. Following a 6% drop from its October 2022 peak, the index remained very high by historical standards in early 2024 (90th percentile since 1973).

At its January level of 114, the index was 14% above its long-run average of 100. This suggests the dollar may be "overvalued" by about 14%. Breaking this down, the dollar looks more overvalued against developed market (DM) currencies than emerging market (EM) currencies **(Figure 2)**.

## FIGURE 2

### The Dollar Remains Strong vs DM and EM Currencies Based on the Fed's Real Trade-Weighted Indexes



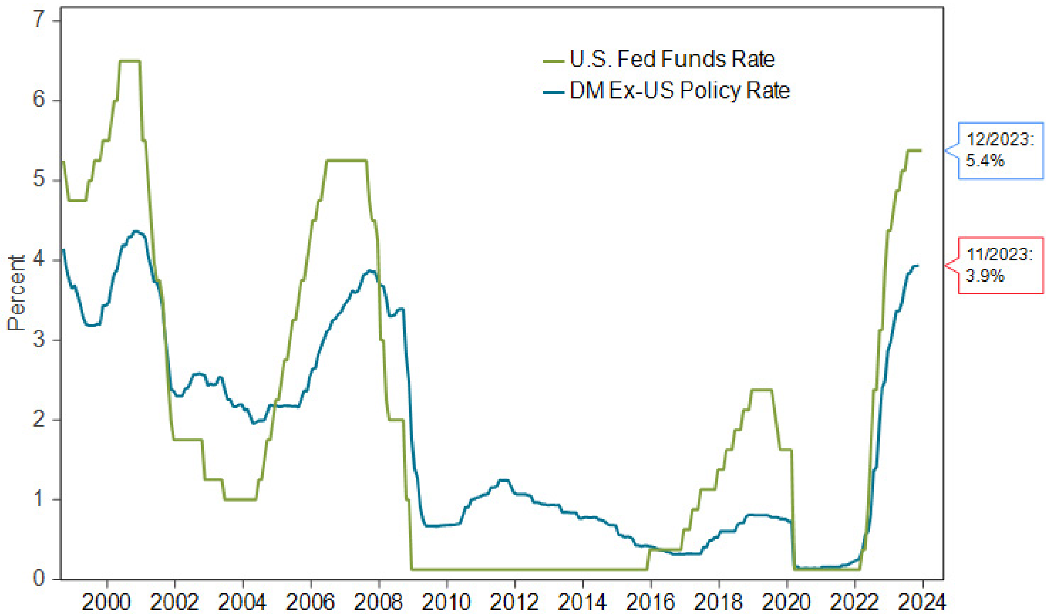

Sources:GW&K Investment Management and Macrobond

The dollar is 22% higher than its long-term average against developed market (DM) currencies but is only 7% higher than its long-term average against emerging market (EM) currencies.

We'll examine other ways to assess the dollar's valuation. The takeaway: the dollar looks overpriced by almost any measure, signaling downward pressure ahead. That bias could strengthen if the Fed cuts rates as sharply as it hiked them **(Figure 3)**.

FIGURE 3

The Fed Went Bigger, Faster with Rate Hikes:
Will It Do the Same with Rate Cuts?




Note: Non-US policy rates based on 18 DM nations, aggregated at US trade weights
Sources: Federal Reserve Bank of Dallas and Macrobond

The dollar's recent strength can be largely attributed to the Fed's aggressive rate hikes relative to foreign central banks. But we could easily see a weaker dollar if the Fed is more aggressive with rate cuts.

Incidentally, the dollar's October 2022 peak aligned with the bottom in US stocks. That fits the dollar's reputation as a "risk off" indicator, with dollar weakness signaling "risk on."

## WHAT EXPLAINS THE HIGH DOLLAR?

Forecasting currency values is notoriously difficult. Factors like central bank policies, interest and inflation rate differences, trade balances, and investment flows can all have a major impact.

To simplify, Canadian economist and Nobel laureate Robert Mundell emphasized each nation's policy mix. Nations with loose fiscal policy and tight monetary policy tend to see rising real interest rates and currency strength. The opposite mix brings declining rates and currency weakness.

Viewed this way, the Reagan-era tax cuts and Paul Volcker's tight monetary policy drove the dollar's spike in the mid-1980s. In contrast, loose money after 2001 and especially post-2008 brought dollar declines.

More recently, huge pandemic relief spending, plus supply disruptions, fueled major inflation. The Fed aggressively tightened money in response — channeling Paul Volcker. This textbook recipe lifted the dollar since the Fed hiked rates more sharply than other key central banks.

We'd also note the dollar tends to reflect stock market performance. Markets offering better returns attract more capital inflows. Likely the dollar benefited from investor enthusiasm for AI advances and big tech stock gains. Should the tech rally wane, for whatever reason, the dollar could slip.

## ASSESSING THE DOLLAR THROUGH BURGERNOMICS

Purchasing power parity (PPP) suggests exchange rates should equalize the prices of similar goods across countries. This abstracts from realities like shipping costs and regulations. But it offers insight.

For years *The Economist* magazine has assessed PPP via The Big Mac Index, comparing burger prices internationally. This determines if currencies are under- or overvalued versus the dollar **(Figure 4)**.

### FIGURE 4

### US Dollar and Foreign Currency Over/Undervaluation Based on *The Economist* Magazine's "Big Mac Index"

| Foreign Currency | Under/Overvaluation of National Currency from a US Tourist Point of View (%) | Under/Overvaluation of US Dollar from a Foreign Tourist's Point of View (%) | Big Mac Price, USD |
|---|---|---|---|
| Swiss Franc | 38.8 | -27.9 | 7.74 |
| Norwegian Krone | 24.8 | -19.9 | 6.96 |
| Euro | 3.1 | -3.0 | 5.75 |
| Danish Krone | 1.0 | -1.0 | 5.63 |
| Swedish Krona | 0.9 | -0.9 | 5.63 |
| British Pound | -2.9 | 3.0 | 5.42 |
| Mexican Peso | -4.8 | 5.0 | 5.31 |
| Canadian Dollar | -4.8 | 5.0 | 5.31 |
| New Zealand Dollar | -11.3 | 12.7 | 4.95 |
| Australian Dollar | -11.6 | 13.2 | 4.93 |
| Polish Zloty | -12.0 | 13.6 | 4.91 |
| Colombian Peso | -12.2 | 13.9 | 4.90 |
| Singapore Dollar | -13.5 | 15.6 | 4.83 |
| Brazilian Real | -14.4 | 16.8 | 4.78 |
| Czech Koruna | -14.6 | 17.1 | 4.76 |
| Argentine Peso | -16.2 | 19.3 | 4.68 |
| Chilean Peso | -19.8 | 24.7 | 4.47 |
| South Korean Won | -28.6 | 40.0 | 3.99 |
| Hungarian Forint | -29.8 | 42.4 | 3.92 |
| Thai Baht | -34.4 | 52.5 | 3.66 |
| Chinese Renminbi | -37.4 | 59.8 | 3.49 |
| Turkish Lira | -39.2 | 64.4 | 3.39 |
| Japanese Yen | -44.7 | 80.7 | 3.09 |
| Hong Kong Dollar | -47.2 | 89.4 | 2.95 |
| Malaysian Ringgit | -48.5 | 94.2 | 2.87 |
| Philippine Peso | -50.0 | 100.2 | 2.79 |
| South African Rand | -50.4 | 101.8 | 2.77 |
| Indonesian Rupiah | -55.4 | 124.4 | 2.49 |
| Russian Ruble | -76.6 | 326.7 | 1.31 |
| United States | NA | NA | 5.58 |
| ***Median*** | **-14.6** | **17.1** | **4.76** |

Sources: GW&K Investment Management, Bloomberg, and *The Economist*

The data show most foreign currencies look undervalued. The median currency is undervalued by about 15%. That corresponds to dollar overvaluation of 17% — remarkably close to our 14% overvaluation estimate earlier.

We can view PPP two ways. First, the table shows current exchange rates make Big Macs cheaper abroad for US tourists. Second, it shows how over- or undervalued the dollar is for foreign tourists in the US. **Figure 5** explains the math for the Japanese yen.

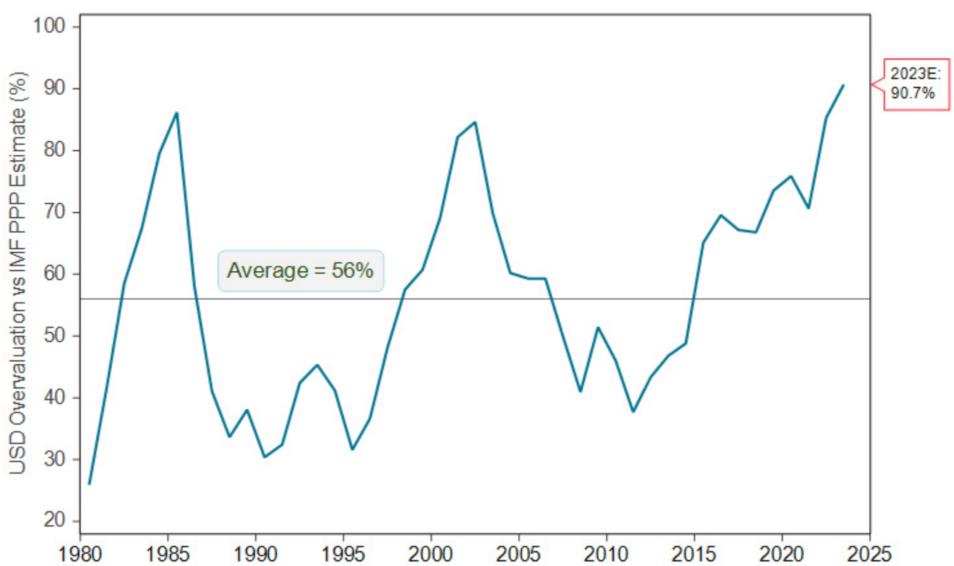
## THE IMF'S MORE COMPREHENSIVE DATA

Like the Big Mac index, the International Monetary Fund (IMF) uses extensive price baskets to calculate PPP exchange rates across countries. However, the IMF approach is far more detailed and complex than comparing burger prices.

The IMF data indicate the US dollar was 91% overvalued in 2023 — a new record high **(Figure 6)**.

### FIGURE 6

### US Dollar Overvaluation vs Foreign Currencies Based on Purchasing Power Parity (%)




Note: Based on the ratio of IMF estimates of world ex US GDP in PPP-based vs. nominal terms.
Sources: GW&K Investment Management, IMF October 2023 World Economic Outlook, and Macrobond

Based on the IMF's PPP estimates, the US dollar posted a record overvaluation in 2023 of 91% against non-US currencies, eclipsing previous peaks reached in 1985 and 2002.

### FIGURE 5

Example: Applying Burgernomics to the Japanese Yen

In Japan, a Big Mac is priced at ¥455, whereas in the United States, it costs $5.58. This price differential implies a PPP exchange rate of 81.54 yen to the dollar, based on the equalized purchasing power of the two currencies. However, the market exchange rate stands at approximately 147.5 yen to the dollar, signaling a notable deviation from the theoretical law of one price.

From the point of US tourists in Japan, the yen is undervalued by about 44.7%, reflecting the degree to which Big Macs in Japan are a bargain to US tourists. That's because at the market exchange rate of 147.5 yen to the dollar, a Big Mac in Japan costs only $3.09 to the US tourist compared to $5.58 back in the US.

Conversely, from the point of view of Japanese tourists to the US, the dollar is 81% overvalued relative to the yen. That's because at the current exchange rate, Japanese tourists are used to paying the equivalent of $3.09 for a Big Mac back in Japan. But the $5.58 price for Big Mac in the US is 81% higher. Put differently, for the law of one price to hold, the yen would have to appreciate by 81% against the dollar.

Why does the IMF data show such a high degree of dollar overvaluation?

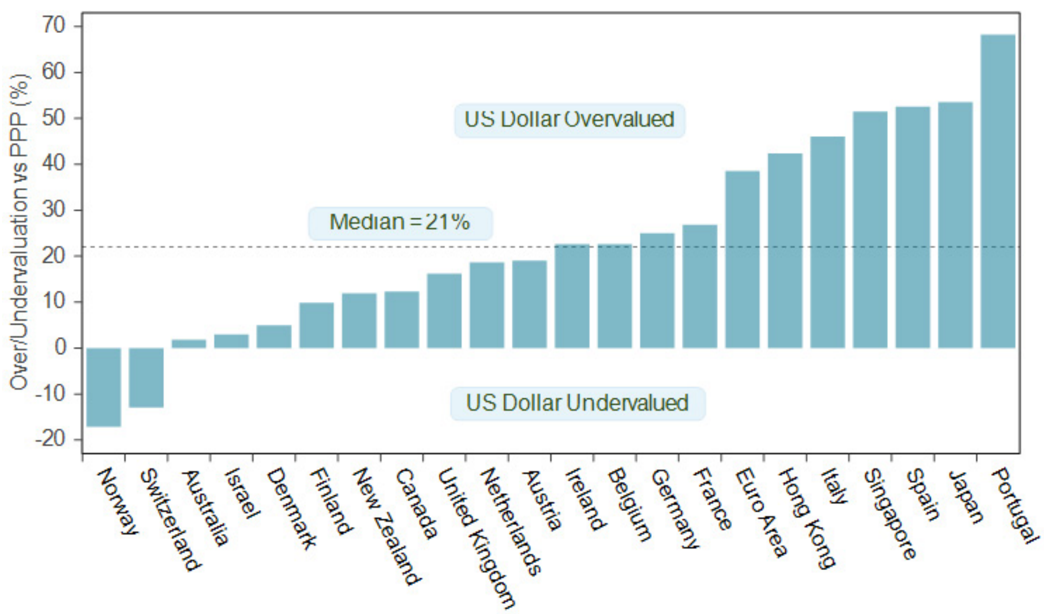
First, IMF data has always shown the dollar to be overvalued, even at past lows. This likely reflects ongoing demand for dollars as the global reserve currency. That stifles PPP and keeps the dollar high.

Second, surging emerging market (EM) economies have boosted US dollar overvaluation over time. EM nations often suppress currencies to spur surpluses and build dollar reserves. As a result, the US has run sustained trade deficits to meet dollar demand abroad.

Against key developed markets, the US dollar 2023 overvaluation was 21% **(Figure 7)**. But for leading EM nations it was 109%, driven by their need to maintain trade competitiveness **(Figure 8)**.

## FIGURE 7

### Over/Under Valuation of USD vs MSCI World Currencies Based on IMF Purchasing Power Parity (2023E)

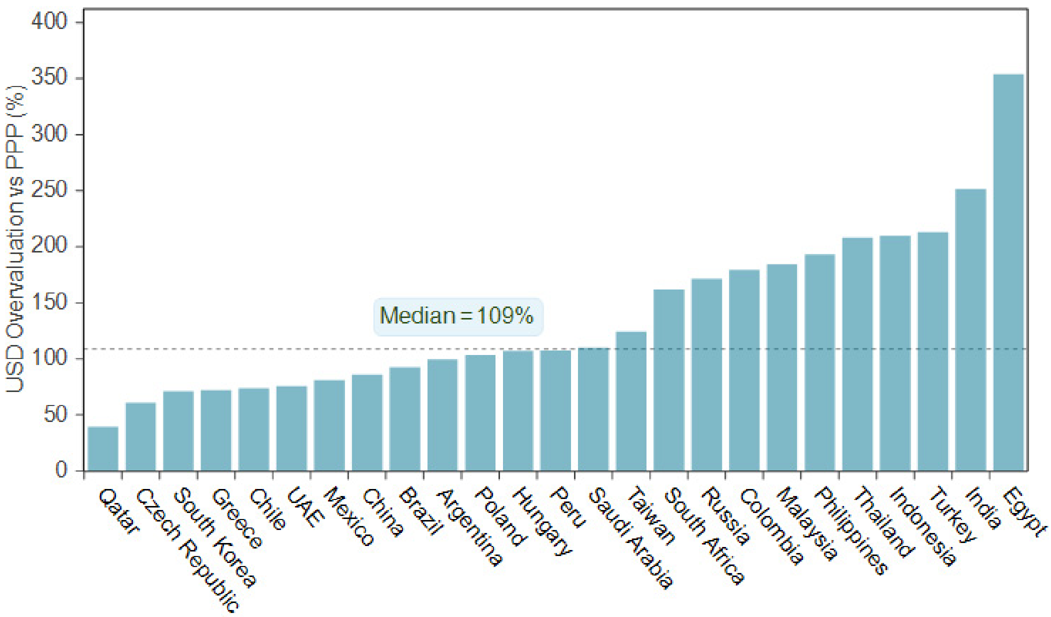



Note: Based on the ratio of IMF 2023 estimates of each nation's GDP in PPP versus current dollars
Sources: GW&K Investment Management, International Monetary Fund, and Macrobond

The median degree of US dollar overvaluation in 2023 against a group of key DM nations was 21%, but it was notably overvalued against important currencies like the euro (36%) and the yen (53%).

FIGURE 8

## Overvaluation of USD vs MSCI EM Currencies Based on IMF Purchasing Power Parity (2023E)



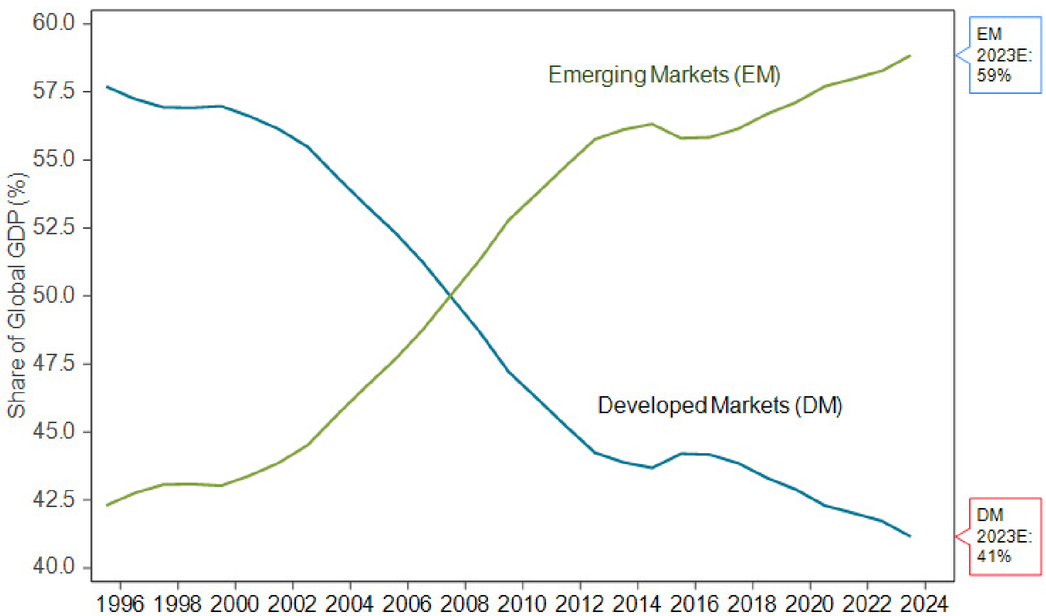

Note: Based on ratio of IMF 2023 estimates of each nation's GDP in PPP versus current dollars
Sources: GW&K Investment Management, International Monetary Fund, and Macrobond

The median degree of dollar overvaluation against a group of key EM nations was 109%, reflecting those nations' structural need to spur trade surpluses and build dollar reserves.

Since 1995, EM nations' share of global GDP on a PPP basis surged from 40% to 60% **(Figure 9)**. As this large, undervalued bloc grew, US dollar overvaluation followed.

FIGURE 9

Shifting Center of Gravity:
Regional Share of Global GDP, 1995 – 2023E




Note: The lines show each region's combined share of global GDP on a purchasing power parity basis.
Sources: GW&K Investment Management, International Monetary Fund, and Macrobond

The rapidly growing weight of EM nations in global GDP has meant that their policies of trade promotion and currency undervaluation helped push the US dollar's overvaluation to a record level in 2023.

## CONCLUSION: DOLLAR RISKS ARE DOWNSIDE

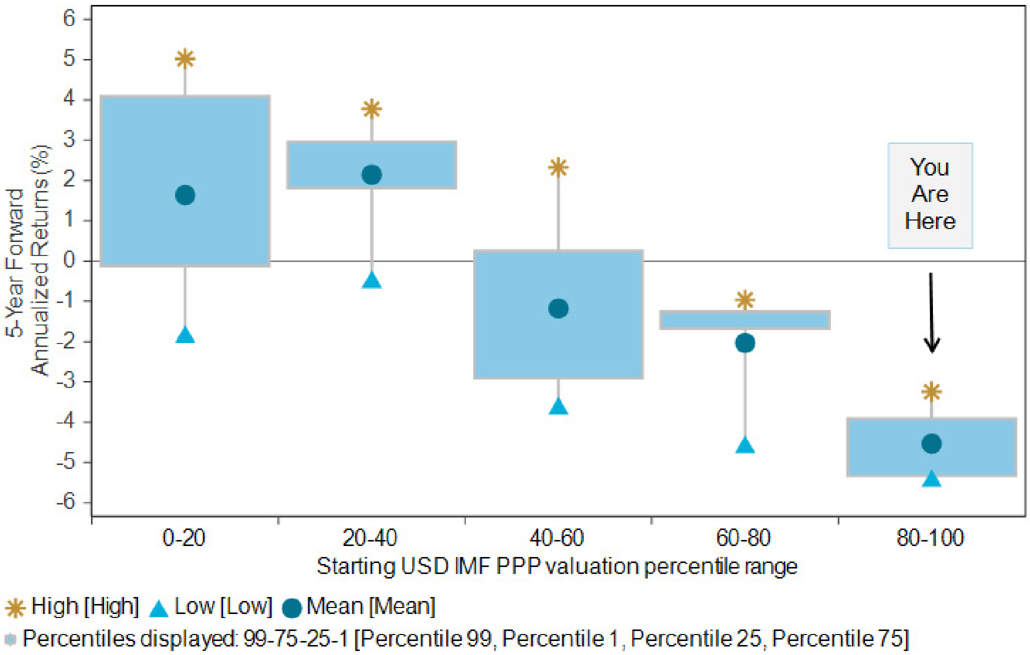
Much dollar overvaluation is structural due to EM dollar demand for reserves. But the Fed's recent dovish pivot suggests less support ahead. History also shows the dollar tends to move in multi-year cycles. Given record-high overvaluation, the risks seem tilted toward years of declines.

When the dollar has been extremely overvalued on the IMF's PPP data, the Fed's trade-weighted index has tended to decline over the next five years at an average pace of 4.5% per year **(Figure 10)**.

There is no guarantee that history will repeat itself. But with the dollar having hit record overvaluation in 2023, it makes the case for international portfolio diversification quite compelling right now from a currency perspective.

FIGURE 10

US Real Trade-Weighted Dollar 5-Year Future Returns From Different Starting PPP Levels (1985 – 2023 data)




Sources: GW&K Investment Management, IMF, Bloomberg, and Macrobond

When the dollar has been extremely overvalued, as it is now, the Fed's trade-weighted index has tended to decline over the next five years at an average pace of 4.5% per year.

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