USD Outlook—Fed Balance Sheet a Significant Negative but Checks and Balances on USD are Clear

The flood of dollar liquidity being unleashed on financial markets from the Fed’s assortment of monetary stimulus measures over the coming months is set to depress the value of the USD against most major currencies, though this may only materialize later in the year as the risk backdrop of uncertainty around the economic damage of the coronavirus outbreak is more clear. After the relaxation of containment measures, a number of factors may nevertheless serve to limit USD losses.

There is a lot of uncertainty in markets regarding the longer term consequences for exchange rates resulting from the collapse in global growth and the rapid and substantial response from the major central banks (and governments) to the COVID-19 pandemic. In the near term, we expect market volatility and risk sentiment will continue to influence the undertone for the major G10 and developing market currencies. Renewed funding pressures in the coming weeks could revive structural support for the USD that the significant expansion of USD central bank swap lines appears to have addressed. But, in the longer term, we think the USD is more likely to soften for the following reasons.

Firstly, we expect the Fed’s rapid and significant expansion of its balance sheet to effectively swamp the global financial system with dollar liquidity, as was the case in the aftermath of the Great Financial Crisis. Then, an overabundance of USD liquidity during the various iterations of the Fed’s QE programs weakened the USD and, as the US recovery developed, slowed the USD’s recovery. We expect the Fed has the willingness and ability to utilize its balance sheet more aggressively to blunt the economic impact of the virus outbreak if necessary. We estimate that the Fed’s balance sheet will expand by around $3-5tn by year-end relative to its end-2019 level to total between $7tn and $9tn (possibly up to $10tn) in December 2020. Based on previous Fed balance sheet expansions, bank reserves will likely grow by an amount equivalent to about 75-80% of this increase; the vast majority of this increase will take place by mid-year given the Fed’s massive front-loading of asset purchases.

Secondly, the USD’s broader resilience over the past year or so has been supported by the USD’s sustained growth and yield advantages over the rest of the developed world. US exceptionalism on the yield front is, however, much less evident now as global yields have collapsed around G10 central bank policy which has converged on the sole objective of dampening the impact of the COVID-19 outbreak. Growth differentials are somewhat meaningless while all major economies face significant contractions in output for this year overall.

Thirdly, the USD looks over-valued against a number of the major currencies. The deviation may not be all that significant but we think it is enough to tilt the balance of risks towards medium-term losses for the USD rather than further medium-term gains. We note that President Trump has started to focus on the value of the USD a little more again and that a somewhat weaker USD might be seen as beneficial for the US as it starts its normalization process in the next few quarters. The last two post recession rebounds in the US have been accompanied by a generally softer USD and some respite from the dollar’s relatively firm trend would help lift the US economy. We doubt foreign central banks or finance ministries would object to the rebound in their own (weak) currencies that this would imply.

The other side of the USD argument is that while the Fed’s pace of purchases will flood markets with several trillion of USDs in the coming months—beyond that which is expected from other central banks, comparatively—the greenback has a number of tailwinds that are likely to offset this surge in liquidity for the remainder of the year and into 2021 to prevent a more pronounced decline from its March peak.
Firstly, lower crude oil and other commodity prices have led to a weakening of some of the USD’s key peers such as the CAD, MXN, and AUD. With prices for raw materials set to remain subdued for at least the remainder of the year amid reduced demand, it is unlikely that these currencies will be able to gather much ground any time soon. We remain skeptical that OPEC+ and an extended number of countries (Canada, Mexico, US, etc.) will agree to a material (and long-lasting) curtailment of production that would offset a steep reduction in demand that would see WTI crude reach its end-2019 level of ~$60/bbl any time soon; the low in crude prices has probably passed, but gains will remain limited even with production cuts. Prices paid for other commodities such as metals are also dependent on the speed of the economic recovery, which at the moment looks uncertain.

Secondly, economic uncertainty may persist: the coronavirus-induced downturn is an economic disruption that has not been observed since the second world war on a global scale and, accordingly, there is a high degree of uncertainty over what shape the recovery will take, thus dampening the rise in non-USD (or haven) currencies. A v-shaped recovery has been all but discarded by most economists, with the most likely scenario being a slow return to pre-pandemic GDP sometime in early-2021 as businesses and demand gradually come back online. It is possible, however, that containment measures are reintroduced if virus cases rebound after the initial lifting of restrictions.

Thirdly, political uncertainty is just around the corner. The COVID-19 outbreak has been top of mind for the markets but beyond the virus headlines we will see the usual suspects rearing their head and provide support for the USD (UK-EU trade talks, Eurozone fiscal response to the virus, US elections and focus on how the Phase1 US-China trade deal will progress from here).

Overall, we think the balance of risks are tilted against the USD in the medium to longer term; the more beaten down the currencies over the past year (commodity FX, essentially) should see the stronger rebounds as global growth gets back on stream. We note that Bloomberg Intelligence’s latest survey reflected a consensus view (64%) that the USD would trade lower through the end of the year.