

April 12, 2023

U.S. Dollar Discussions

- Currency fluctuations are normal and influenced by relative economic strength and differences in interest rates.
- Russian sanctions and a debt ceiling debate have increased discussions around the role of the U.S. dollar.
- We remind investors that sensational headlines aim to capture short-term attention.

Over the years, we have received many questions around the strength of the U.S. dollar and its worldwide status. Historically the U.S. dollar strengthens in times of global economic stress and in periods of rising interest rates as investors overseas seek higher relative stability and higher returns. The dollar tends to weaken when U.S. interest rates are lower, or when the rest of the world grows faster in comparison.

The U.S. dollar is also held as a reserve currency by central banks and is the dominant currency in reserve balances. With the growth of international economies, especially China, which is now the world's second biggest economy, fewer reserve balances are now held in dollars. Keep in mind this rate of change is slow and the U.S. dollar is still the preeminent reserve currency globally. Recently, U.S. sanctions on Russia raised questions on whether countries may want to hold fewer U.S. dollars to avoid possible U.S. influence in the future.

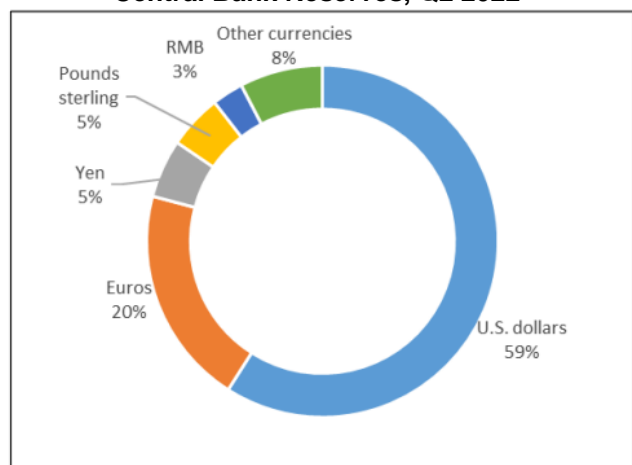
Currently, around 60% of all central bank reserves are U.S. dollars. For comparison, the second most held currency in central bank reserves is the Euro at 21% and the Chinese Yuan makes up less than 3% of these reserves. In 1999, the dollar accounted for over 70% of central bank reserves, so it has been declining slowly. Over time, the International Monetary Fund (IMF), anticipates that central banks will shift away from the dollar as they seek further diversification. However, the dollar should remain the dominant international reserve currency because of the well-developed regulatory framework, free trade, and large economy within the United States. While China is growing, it has strict capital controls, and its regulatory framework is less transparent to the rest of the world. Also, in foreign exchange markets, where currencies are traded, U.S. dollars are involved in nearly 90% of all transactions.¹ America is the world's largest importer, and countries and companies need to hold dollars to conduct trade. China, on the other hand, is the world's largest net exporter.

While we do think the U.S. dollar could lose some of its importance over time, the move in reserves has been slow so far, and we also think that a lot of the questions around the dollar's waning importance have been sensationalized.

Another concern around the dollar arises from the U.S. government's spending. This is due to a significant debt level compared to GDP and the dispute with Congress regarding increasing the debt ceiling to pay the existing debt. High fiscal spending can lead to more debt, which can lead to inflation or a dollar that is worth less relative to other currencies. Also, if Congress does not agree on a debt limit, that could lead to a default on U.S. Treasuries, which would make countries less willing to buy America's debt (Treasury bonds). In 2011, a credit rating agency downgraded the U.S. from AAA to AA+ partly due to a debt limit battle.

It is possible (but in our view not probable) a fight over the debt ceiling could cause a default on U.S. debt. However, we have seen government shutdowns in the past and a default has never happened. Unfortunately, government shutdowns are becoming more common. There have been three in the past 10 years and 20 since 1977. If a default did occur, the government would likely just delay payments to bondholders, but it would pay a steep price. There would

Central Bank Reserves, Q2 2022



Source: International Monetary Fund. Notes: 149 reporting countries.

likely be credit downgrades and borrowing costs would surely rise. There is often a lot of political brinkmanship, but a default would not be desirable for either party. It is interesting to note, the U.S. Treasury missed interest payments in 1979 due to back office technical issues which they paid a price for as well. With such high debt levels, higher borrowing costs would just make matters worse. Keep in mind this is also relative. Other countries around the world are also experiencing inflation and high debt levels. And political gridlock is not only an American phenomenon.

So, while we expect the U.S. dollar may slowly become less of a percentage of central bank reserves, we still expect the dollar's global importance to remain high. The U.S. is still both the largest economy and importer in the world. Its well-established legal system and free market make its currency the most desired currency in the world, and we see this the most during times of turmoil when investors around the globe flock to the dollar for safety. That being said, the dollar has gone through a period where it strengthened against much of the other world currencies. We expect U.S. interest rates and growth to slow in the future, which could mean a relatively weaker U.S. dollar. It is possible that the U.S. dollar may weaken relative to other currencies which is normal and could provide opportunities. For example, international equities appreciate for U.S. investors when the U.S. dollar weakens. This has been a headwind for international investments for the past decade, but this may change. Multinational companies can also earn a lot of profits abroad, which means their earnings could be higher if the dollar weakens. A depreciating dollar can also boost U.S. exports because U.S. goods and services become relatively less expensive when the dollar depreciates. Lastly, assets priced in dollars, such as commodities, could also benefit from a weaker dollar.

As we navigate mixed market signals and growing uncertainty, please continue working with your financial professional to make sure you are properly diversified to help mitigate market volatility. Also, make sure your portfolio is aligned with your long-term investment objectives. It is easy to get distracted by the noise and headlines. Creating a financial plan that you can monitor and follow helps to avoid the distractions and to stay focused on what you can control.

¹ Congressional Research Service, "The U.S. Dollar as the World's Dominant Reserve Currency", Updated September 15, 2022

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