



Philequity Corner (September 12, 2022)
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Dollar smile

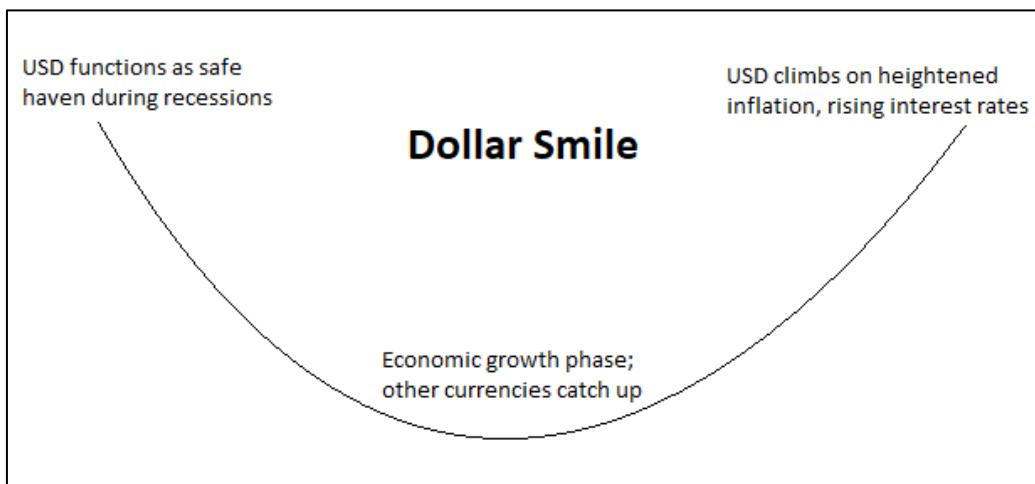
The peso continued to make new all-time lows last week. The magnitude and speed of the peso depreciation grabbed headlines and caused alarm among investors. However, it is not only the peso that is weak. It is actually a very strong US dollar that is causing all currencies to depreciate.

Dollar smile theory

Some economists and equity strategists have used “dollar smile” to describe the unique behavior of the US dollar. According to this theory, the US dollar strengthens as investors flock to it during times of heightened uncertainty and challenging economic situations. Below, we show the three-year price chart of the US dollar index (DXY). By drawing a line under the price chart of the US dollar, one can see an outline that resembles the smile of a person.



The chart below illustrates the dollar smile and its three distinct phases.



When the US sneezes

Among investors, there is a popular adage that “When the US sneezes, the world catches a cold.” This is understandable because the US is the world’s biggest economy. Whatever happens to the US would inevitably affect the whole world. Currently, the US is confronting the highest inflation in 40 years. This prompted the Fed to hike interest rates sharply, thereby raising concerns that overtightening may lead to a recession. If the US catches a cold, there are apprehensions that some countries may suffer pneumonia.

Reasons behind the strong US dollar

We enumerate below the reasons that drive the strength of the US dollar.

- 1. Heightened inflation, Fed tightening.** US inflation has risen to the highest level since 1982. This has forced the Fed to raise interest rates aggressively.
- 2. Higher for longer.** In his Jackson Hole speech, Fed Chair Jerome Powell explained that the Fed will have to maintain “a restrictive policy stance for some time” and keep interest rates higher for longer in order to bring inflation back down to their 2% target.
- 3. Interest rate differential.** Faster rate hikes by the Fed compared to major economies and most other countries have resulted in a narrowing interest rate differential which favors US dollar assets.
- 4. Russia-Ukraine war.** The conflict between Russia and Ukraine provides a level of geopolitical and economic uncertainty. The war has affected many commodity markets and is one of the main drivers of high inflation. Investors fear that Russia will continue to restrict gas supplies to Europe.
- 5. Safe haven.** During times of heightened uncertainty and extreme fear, the US dollar functions as the ultimate safe haven. The US is the strongest economy and military superpower in the world. The US has the largest and most liquid financial markets, and the US dollar is the world’s primary reserve currency. As such, the US is typically in a better position to withstand economic or geopolitical turmoil.
- 6. Weakened Chinese economy.** The yuan is down 9% ytd. The Chinese economy is weighed by its zero COVID policy, its worst heat wave on record, and a major property crisis.

Watching the dollar smile

The peso made all-time lows last week due to the might of the US dollar. When there is trouble in the world, the US dollar smiles. We are currently in the phase of the smile where the US dollar strengthens amid heightened inflation and rising interest rates. It will be crucial to watch what the Fed says, how inflation behaves, and how the economic picture evolves. Markets may stabilize and US dollar strength may abate if inflation starts coming down and central banks pause from their rate hikes. Watching the “dollar smile” phenomenon can therefore help us navigate the financial markets better.

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