SPOTLIGHT | MAY 2023

# EXPLORING DE-GLOBALIZATION: THE US DOLLAR

## Key points

- Though the US dollar remains the dominant currency in both trade and FX transactions around the world, the Chinese yuan has seen its share rise meaningfully since 2019 as the Trump trade war with China came to a close.
- More surprising, however, while the US dollar has seen its share of global reserves fall from more than 70% to below 60% since the turn of the century, adjusting for the broad-based dollar strength since the Global Financial Crisis, the US dollar's share of valuation adjusted reserves has fallen much more sharply highlighting a more pronounced allocation away from the American currency by the world's central banks.
- These developments suggest that structural factors have now joined cyclical factors which portend materially weaker US dollar exchange rates in the coming years.
- The three previous US dollar bear markets since the 1960s lasted between 10-15 years and saw weakening of 5-9% per annum against other major currencies. Through the lens of the potential end of its reserve currency status, since the British pound de-pegged from gold in 1931, the former reserve currency weakened by 1.3% per annum relative to the new reserve currency, the US dollar.
- For currency investors, we see opportunities to mitigate the expected coming dollar weakness in EURUSD near 1.05 and gold below USD 2,000/ounce.
- For equity investors, the prospect of a prolonged US dollar weakening suggests that non-US investments which have lagged US investments since 2011 should increasingly be on investors' radars.

UNION BANCAIRE PRIVÉE

## US Dollar – Cyclical and secular headwinds building

The cyclical US dollar weakening narrative began in late-2022 as it became clear that the Fed tightening cycle would be joined by the ECB and lead to the interest rate differential between USD and Euro rates reversing the widening that drove dollar strength through much of 2022.

Now, with a pause in hikes expected from the Federal Reserve moving through the summer while the ECB is forecast to continue its hikes, this gap should narrow further, providing an impetus for further euro gains.

These interest rate headwinds that emerged for the US dollar were reinforced by the large improvement in Euro area terms of trade as the European winter proved warmer than expected and allowed for the well supplied continental economies to benefit from sharp falls in energy prices in late-2022.

As dollar headwinds built across the Atlantic, similar strains built across the Pacific as the Bank of Japan adjusted its yield curve cap from 0.25% to 0.50% for the first time, bringing about a 10% weakening in the US dollar since October, 2022.

With the new BoJ Governor Kazuo Ueda revisiting the yield curve control policy as his tenure begins, we expect further adjustments to allow for further weakening of the US dollar across this trans-Pacific axis.

These developments suggest to us that the fourth long-cycle US dollar bear market since the mid-1960s is now likely underway.

**The fourth long-cycle US dollar bear market since the mid-1960s has likely begun**

Sources: Bank of International Settlements, Federal Reserve Bank of St. Louis, and UBP

These cyclical headwinds to the US dollar have been augmented by more structural forces as well. Beginning with the Trump trade wars of 2018-2020, it became clear that a new relationship was being forced upon the world's second largest economy, China, by the United States.

As a result, China has sought to reduce its reliance on the US dollar. Indeed, since 2019, the Chinese yuan has raised its share of daily foreign exchange market turnover from 4.3% to nearly 7%. The yuan has overtaken both the Canadian dollar and the Swiss franc in the process, according to the Bank of International Settlements.

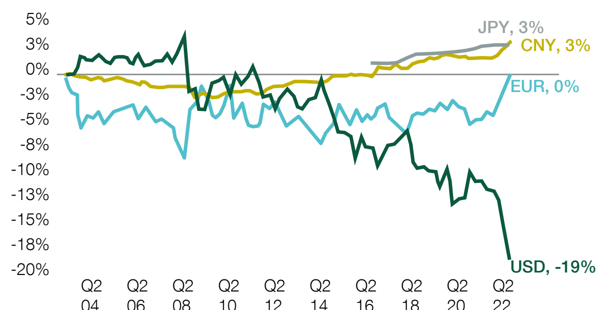
In 2023, alone, China has signed bi-lateral trade agreements with Russia, Brazil and Saudi Arabia as further evidence of waning in the use of dollars as the preferred currency for invoicing and transactions internationally.

More impressive has been the decline seen in the US dollar as a share of central bank reserves. On a nominal basis, the greenback has seen its share fall more than ten percentage points, from more than 70% of reserves at the turn of the century to below 60% by end-2022.

However, adjusting for relative currency movements and underlying bond investments, we can see an even more dramatic shift away from the US dollar in 2022 alone, favoring the Euro, the Chinese yuan and gold.

We suspect the US and European sanctions imposed following Russia's 2022 invasion of Ukraine which included seizing Russian central bank foreign exchange reserves were a catalyst for the dramatic shift, especially among non-US aligned nations.

**Adjusting for price changes, the US dollar has seen a dramatic loss in share among central bank reserves**




Sources: SLJ Eurizon, Bloomberg Finance L.P. and UBP

These developments suggest that structural factors have now joined cyclical forces which portend materially weaker US dollar exchange rates in the coming years.

## Investment implications of a weak US dollar regime

Previous US dollar bear markets have been protracted in nature, lasting 9-15 years with US dollar bull markets modestly shorter at 7-12 years. These long-cycle shifts in the global reserve currency have had wide-ranging implications for investors across global asset classes.

Indeed, in two of the three (1964-78 and 2002-2011) US dollar bear markets since the mid-1960s, US equity investors underperformed both inflation and US Treasuries. In both episodes, gold outpaced both Treasuries and equities handily.

**Gold has outpaced both Treasuries and US equities in 2 of the 3 US dollar bear markets since the mid-1960s**

| USD Bear Market | Duration (yrs) | S&P 500 TR (CAGR) | US Treasuries TR (CAGR) | Gold (CAGR) |
|---|---|---|---|---|
| 1964-78* | 14.3 | 0.9% | 6.1% | 13.1% |
| 1985-95 | 10.3 | 11.3% | 9.4% | 1.7% |
| 2002-11 | 9.3 | 1.7% | 5.8% | 20.0% |

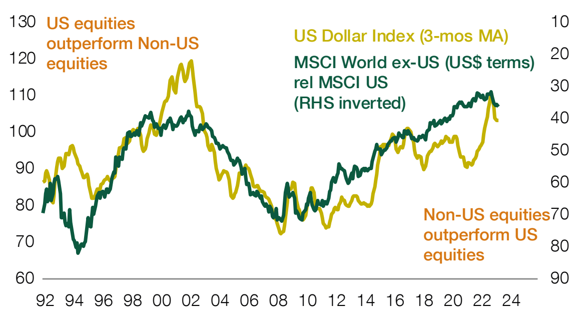
Sources: Standard & Poor's, LBMA, Bloomberg Finance L.P, and UBP * US Treasury performance data available only from 1973-78; comparable S&P 500 TR and gold returns from 1973-78 are 1.2% CAGR and 23.1% respectively

The disinflationary 1985-95 US dollar bear market (instigated by the Plaza Accords) was the exception, seeing US equity investors outpace both their bond counterparts and gold.

The geography of investment opportunities also shifts markedly amidst US dollar bear markets. Broadly, since the early-1990s, a weak US dollar has coincided with outperformance of non-US equity markets according to MSCI.

However, looking even further back, markets where we have sufficient historical data suggest this non-US equity market outperformance amidst protracted dollar weakness generally holds going back to the 1960s.

### A weak dollar has historically favored non-US equities since 1992…




Sources: MSCI, Bloomberg Finance L.P, and UBP

Admittedly and unsurprisingly, country selection has been important with UK and Hong Kong equities outpacing US equities across all three long-cycle US dollar bear markets. Interestingly Japanese equities in US dollar terms outpaced US equities amidst the 1964-78 dollar bear market but kept pace with US equities during both the 2002-11 and 1985-95 US bear market, with the latter encompassing the bursting of the Japan bubble in 1989.

### …as well as looking as far back as the early-1960s

| USD Bear Market | US | Germany | UK | Japan | HK |
|---|---|---|---|---|---|
| 1964-78 | 0.9% | (3.3%) | 3.9% | 15.2% | 12.1% |
| 1985-95 | 11.3% | 1.3% | 13.4% | 10.0% | 22.6% |
| 2002-11 | 1.7% | (1.8%) | 2.5% | 1.8% | 5.0% |

Sources: Standard & Poor's, DAX, Tokyo Stock Exchange, Hong Kong Stock Exchange, Federal Reserve Bank of St. Louis, Bloomberg Finance L.P, and UBP

Note: figures are total returns CAGR

Sectorally, with data only for US equities starting in 1974, we can see that the disinflationary US dollar bear markets of 1985-95 unsurprisingly favored healthcare and consumer staples stocks. In contrast, in both the 1964-78 and 2002-11 US dollar bear markets saw energy and basic resources outpace otherwise sluggish US equity returns.

Thus, looking through the lens of cyclical US dollar bear markets since the 1960s investors who have benefited from focusing on US equities since 2011 should widen their remit and seek opportunities outside of the United States.

Indeed, with non-US equities rising nearly 11% year-to-date versus the 8% for the S&P 500, the coming weakening cycle for the US dollar suggests this is only the beginning of the outperformance of global equities versus their American counterparts.

With the coming dollar bear market more likely to come amidst a backdrop of higher global inflation rather than the global disinflation that characterized the 1985-95 period, gold should continue the outperformance it has delivered against both global equities and global bonds since 2021.

### A brief look back at the end of the British pound as global reserve currency

The only example of a currency losing the 'exorbitant privilege' of reserve currency status over the past century has been the fall of the British pound during the war years of 1914-1945, with the US dollar formally assuming the role of global reserve currency following the 1944 agreements at Bretton Woods, New Hampshire.

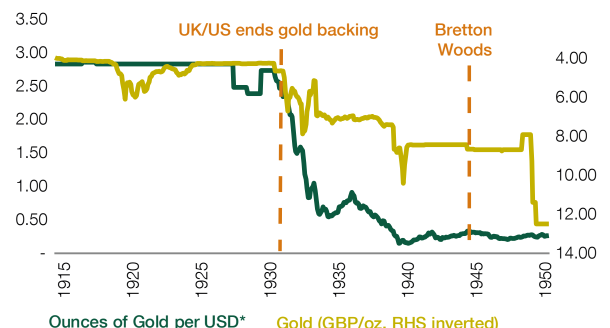
As with the US dollar today, the position of the British pound sterling as the global reserve currency was predicated on the globalization of the period, centered around the British Empire.

World War I was a significant catalyst in disrupting the 19th century structure of globalization according to Professor Nicolas Crafts at Leeds University in the UK. In addition, driven by wartime spending, debt-to-GDP rose from 25% to peak near 180% at the end of WWI. To assist in the funding the war, the UK temporarily devalued pound sterling relative to gold before restoring the backing at the end of the war.

The onset of the Great Depression and renewed hostilities on the continent in the 1930s proved to be the final catalyst for the UK currency, as debt to GDP rose once again, this time peaking at 250% of GDP by the war's end. In 1931, the UK suspended the UK gold standard due to a run on Bank of England gold stocks.

The devaluation against gold, this time proved durable, with the British pound losing 50% of its purchasing power relative to gold from 1930-1944 when reserve currency status was formally transferred to the United States.

### USD following the path of the British pound following ending gold backing of their currencies




Sources: Bank of England, Bloomberg Finance L.P, and UBP * data for Ounces of Gold per USD from 1915-1990 matched to end of gold backing of USD in 1971

Recall, the US was similarly forced out of guaranteeing the convertibility of US dollars into gold at $35/ounce in 1971 as central banks increasingly opted for the yellow metal rather than maintaining their US dollar exposure as US wartime spending in Vietnam combined with domestic social spending and accelerating inflation undermined the US currency.

Unlike the UK, however, when WWII brought the end of reserve currency status 13 years later, nearly 50 years since the US President Nixon removed the convertibility of the US dollar into gold, the US has maintained its exorbitant privilege of issuing the world's reserve currency.

A series of factors have helped the US dollar maintain reserve currency status despite the loss of gold as its anchor.

Many may forget that in the 1970s, Japan was expected to eclipse the United States in the following decade on the back of manufacturing and technological leadership. The bursting Japanese asset bubble in 1989 brought an end to the challenge that Japan posed to the United States economically.

Though many of Japan's missteps were self-inflicted the rise of the US technology sector in the 1980 and 1990s combined with the spread of globalization following the fall of the US' primary military threat, the Soviet Union, maintained the US dollar at the center of the global economy through the end of the last century.

## Investment implications from the end of the British pound as global reserve currency

With China leading the coalition driving the secular pressure for a dollar alternative in the global economy, expectations are building that the era of the US dollar anchoring the global financial system is in decline.

Drawing from the UK's experience, even if true, investors should expect that decline to take place over years and potentially decades.

However, even in the event of a protracted demise of the post-WWII system, investors can draw from the UK experience.

First, like in the period between the UK ending gold convertibility and Bretton Woods, increased cyclicality and volatility in the US dollar like seen since 1971 should continue (see Investment Implications of a Weak USD regime section above).

Second, real interest rates during the intervening period prior to the loss of reserve currency status were meaningfully positive until WWII allowed them to revert to a negative real yield regime.

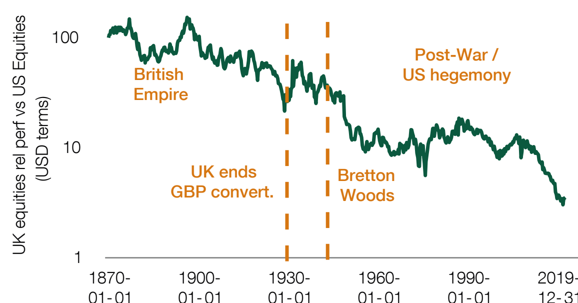
This development is similar to the current backdrop facing the US as it shifts from its pandemic-era negative real yield policy regime to a more sustained, we expect, positive real yield backdrop looking ahead.

This shift to a positive real yield environment made sense given, in retrospect, sterling bond investors needed to be compensated not only for the risks of inflation looking ahead, but also for the prospect of a weakening of the currency and the relative opportunities abroad (in assets of the new reserve currency issuer).

During this transition period, gold nearly doubled in value in the British pound terms from 1931-1944, rising nearly 5% per annum.

Only following Bretton Woods, did real interest rates rise sufficiently in the UK to mitigate the nearly 40% loss of its purchasing power relative to gold from 1944-1969 or, on average, 2.3% per annum.

**UK equities underperformed US equities after the loss of reserve currency status in 1944**




Sources: Bank of England, Federal Reserve Bank of St. Louis, and UBP

For British equity investors, the transition away from reserve currency status provided some stability after the underperformance of UK equities relative to US equities in the early-1900s. However, once the world transitioned to a US dollar regime, UK investors would have benefitted from looking abroad to secure equity returns rather than at home.

On balance, the lessons from the UK experience in its loss of reserve currency status are similar to the conclusions drawn from cyclical US dollar bear markets:

1. Investors should increasingly look outside the US, especially following its decade long outperformance, for equity opportunities in a weak USD environment or even the prospect for an end of the dollar's global dominance
2. Gold, which has provided investors bond-like returns over the past decade, has a role as an anchor to wealth preservation should the foundation of the post-war dollar leadership come under strain.

## Authors

**Michaël Lok**

Group Chief Investment Officer (CIO)
and Co-CEO Asset Management

michael.lok@ubp.ch

**Norman Villamin**

Group Chief Strategist

norman.villamin@ubp.ch

**Patrice Gautry**

Chief Economist

patrice.gautry@ubp.ch

**Peter Kinsella**

Global Head of Forex Strategy

peter.kinsella@ubp.com

### Disclaimer

This document is a marketing communication containing GENERAL INFORMATION on financial services reflecting the sole opinion of Union Bancaire Privée, UBP SA and/or any entity of the UBP Group (hereinafter "UBP") as of the date of issue. It is not and does not purport to be considered as an offer nor a solicitation to enter into any transaction with UBP, buy, subscribe to, or sell any currency, product, or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or solicitation. This document is meant only to provide a broad overview for discussion purposes, in order to determine clients' interest. It does not replace a prospectus, KID, KIID or any other legal document relating to any specific financial instrument, which may be obtained upon request free of charge from UBP or from the registered office of the issuer of the instrument concerned, where applicable. The opinions herein do not take into account individual clients' circumstances, objectives, or needs.

UBP performs analysis on the financial instruments based on market offer and may maintain and/or seek to develop business affiliations with third parties for that purpose; furthermore, UBP may create its own financial instruments. This generic information is therefore not independent from the proprietary interests of UBP or connected parties, which may conflict with the client's interests. UBP has policies governing cases of conflicts of interest and takes appropriate organisational measures to prevent potential conflicts of interest.

The information contained in this document is the result neither of financial analysis within the meaning of the Swiss Banking Association's "Directives on the Independence of Financial Research" nor of independent investment research as per the EU's regulation on MiFID provisions. EU regulation does not govern relationships entered into with UBP entities located outside the EU.

When providing investment advice or portfolio management services, UBP considers and assesses all relevant financial risks, including sustainability risks. Sustainability risks are defined by the EU's Sustainable Finance Disclosure Regulation (2019/2088) as "an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of the investment". For further information on our sustainability risk management approach please visit [www.ubp.com].

Reasonable efforts have been made to ensure that the content of this document is based on objective information and data obtained from reliable sources. However, UBP cannot guarantee that the information contained herein and gathered by the Bank in good faith is accurate and complete, nor does it accept any liability for any loss or damage resulting from its use. Circumstances may change and affect the data collected and the opinions expressed at the time of publication. Therefore, information contained herein is subject to change at any time without prior notice. UBP makes no representations, provides no warranty and gives no undertaking, express or implied, regarding any of the information, projections or opinions contained herein nor does it accept any liability whatsoever for any errors, omissions or misstatements in the document. UBP does not undertake to update this document or to correct any inaccuracies which may have become apparent after its publication.

This document may refer to past performance which is not a guide to current or future results. All statements in this document, other than statements of past performance and historical fact, are "forward-looking statements". Forward-looking statements do not guarantee future performances.

The tax treatment of any investment depends on the client's individual circumstances and may be subject to change in the future. This document does not contain any tax advice issued by UBP and does not reflect the client's individual circumstances.

This document is confidential and is intended to be used only by the person to whom it was delivered. This document may not be reproduced, either in whole or in part. UBP specifically prohibits the redistribution of this document, in whole or in part, without its written permission and accepts no liability whatsoever for the actions of third parties in this respect. This document is not intended for distribution in the US and/or to US Persons or in jurisdictions where its distribution by UBP would be restricted.

Switzerland: UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA).

UK: UBP is authorised in the United Kingdom by the Prudential Regulation Authority, and is subject to regulation by the Financial Conduct Authority (FCA) and limited regulation by the Prudential Regulation Authority.

Dubai: This marketing material has been communicated by Union Bancaire Privée (Middle East) Limited, a company regulated by the Dubai Financial Services Authority ("DFSA"). It is intended for professional clients and/or market counterparties only and no other person should act upon it. The financial products or services to which this material relates will only be made available to a client who meets the professional client and/or market counterparty requirements. This information is provided for information purposes only. It is not to be construed as an offer to buy or sell, or a solicitation for an offer to buy or sell any financial instruments, or to participate in any particular trading strategy in any jurisdiction.

Hong Kong: UBP is a licensed bank regulated by the Hong Kong Monetary Authority (HKMA) and a registered institution regulated by the Securities and Futures Commission (SFC) for Type 1, 4 & 9 activities only in Hong Kong. The securities may only be offered or sold in Hong Kong by means of documents that (i) are addressed to "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO"); or (ii) are defined as "prospectuses" within the meaning of the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) (the "CO") or constitute offers to the public within the meaning of the CO. Unless permitted to do so under the laws of Hong Kong, no person may issue or have in their possession for the purpose of issuing, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the securities, directed at, or likely to be accessed or read by, the public in Hong Kong, except where the securities are intended to be disposed of only to persons outside Hong Kong, or only to "professional investors" within the meaning of the SFO.

Singapore: UBP is a bank regulated by the Monetary Authority of Singapore (MAS), is an exempt financial adviser under the Financial Advisers Act 2001 of Singapore to provide certain financial advisory services, and is exempt under section 99(1) of the Securities and Futures Act 2001 of Singapore to conduct certain regulated activities. This document has not been registered as a prospectus with the MAS. Accordingly, this document and any other document or material in connection with generic recommendations may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than (i) to institutional investors under Section 274 of the Securities and Futures Act 2001 of Singapore ("SFA"), (ii) to relevant persons pursuant to Section 275(1), or any person pursuant to Section 275(1A) of the SFA, and in accordance with the conditions specified in Section 275 of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This advertisement has not been reviewed by the Monetary Authority of Singapore.

Luxembourg: UBP is registered by the Luxembourg supervisory authority the *Commission de Surveillance du Secteur Financier* (CSSF).

Italy: Union Bancaire Privée (Europe) S.A., Succursale di Milano, operates in Italy in accordance with the European passport – held by its parent company, Union Bancaire Privée (Europe) S.A. – which is valid across the entire European Union. The branch is therefore authorised to provide services and conduct business for which its parent company, Union Bancaire Privée (Europe) S.A., has been authorised in Luxembourg, where it is regulated by the Luxembourg financial supervisory authority, the *Commission de Surveillance du Secteur Financier* (CSSF).

Monaco: This document is not intended to constitute a public offering or a comparable solicitation under the Principality of Monaco's laws, but might be made available for information purposes to clients of Union Bancaire Privée, UBP SA, Monaco Branch, a regulated bank under the supervision of the *Autorité de Contrôle Prudentiel et de Résolution* (ACPR) for banking activities and under the supervision of the *Commission de Contrôle des Activités Financières* for financial activities.

© UBP SA 2023. All rights reserved.

22 May 2023

**Union Bancaire Privée, UBP SA | Head Office**
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com

Signatory of: PRI Principles for Responsible Investment

Subscribe to our newsletter on ubp.com