

Dollar Index

The bull market no one wants!

Over the last few years the only stability in financial markets was that US dollar remained the asset to own. In this note, we delve into greater detail on the US dollar index - its history and composition, factors influencing USD, historical trends and its relationship to key asset classes.

What is US dollar Index?

The US Dollar Index or **DXY Index** is an index measuring the value of the US dollar relative to a basket of currencies. The index is a weighted geometric mean of the dollar's value relative to other currencies. The Index goes up when the US dollar gains "strength" (value) when compared to other currencies. The DXY Index contains six component currencies: *Euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc*. The weights of the six currencies are as below:

DXY Index Weights:

Currency	Weight (%)
Euro (EUR)	57.6
Japanese yen (JPY)	13.6
Pound sterling (GBP)	11.9
Canadian dollar (CAD)	9.1
Swedish krona (SEK)	4.2
Swiss franc (CHF)	3.6

History of the US dollar Index:

The US Dollar Index was created by the US Federal Reserve in 1973 after the ending of the 1944 Bretton Woods agreement (where a system of fixed exchange rates existed with exchange rate (+/-1%) tied to gold). US Federal Reserve Bank began the calculation of the DXY Index to provide an external bilateral trade-weighted average of the US dollar, as it freely floated against global currencies. The International Continental Exchange Futures compiles and maintains the index. The DXY Index is quite unique among currency indices in its fixed composition. It has changed only once since its 1973 introduction and that was when the euro was launched in January 1999, replacing a number of European currencies. Before the creation of the euro, the original US dollar index contained ten currencies—the ones that are currently included (but not the euro), plus the West German mark, the French franc, the Italian lira, the Dutch guilder, and the Belgium franc. The euro replaced the last five of these currencies. At its start, the value of the DXY Index was 100. It has since traded as high as 164.7 in February 1985, and as low as 70.69 on March 16, 2008.

Limitations of the US dollar Index:

1. DXY Index has fewer representatives (no emerging markets) and is less diversified (European countries make 77% of the basket).
2. DXY Index is not an adequate benchmark for the value of the dollar as it excludes major US trading partners like China, Mexico and Saudi Arabia.
3. DXY Index isn't structured to capture changes in global trade because it has no regularly scheduled adjustments or rebalancing (only once since 1973) and assigns fixed weights to countries.

What factors influence USD? There are primarily three factors which influence currency movements

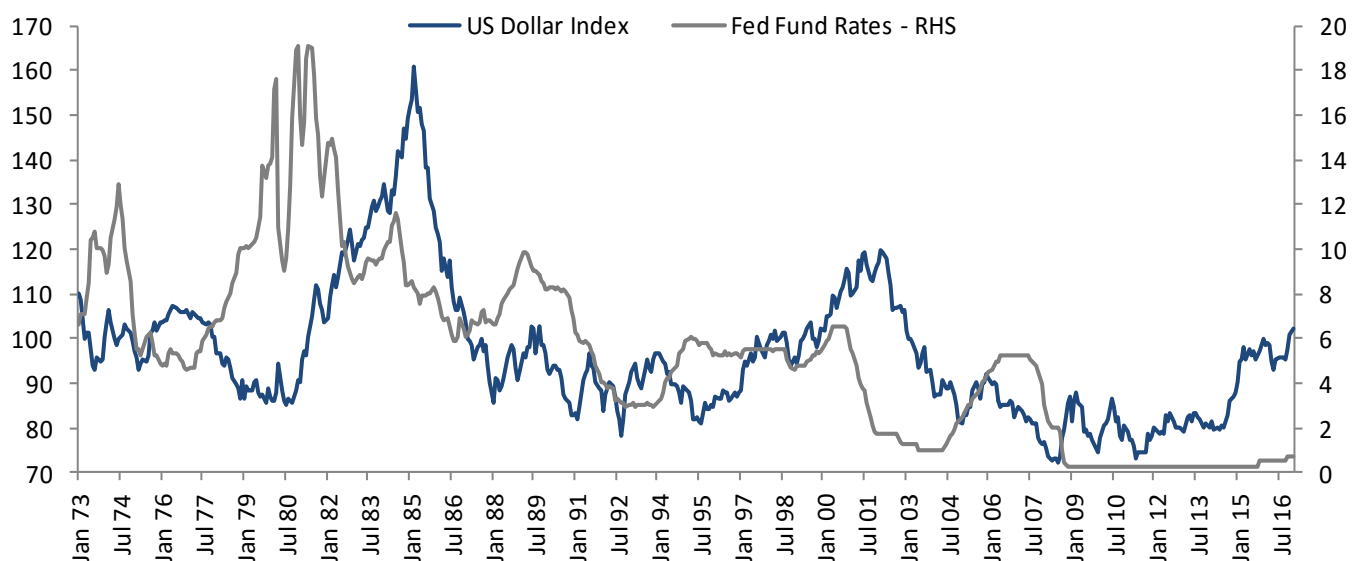
1. **Relative Economic strength:** Strong US economic growth compared to others would result in higher returns on investment and higher real interest rates, which could drive dollar higher.
2. **Interest rate differentials:** Divergence between central banks policies and relative economic fundamentals can lead to differences in interest rates, which also tend to influence currency. Currently, Fed raising rates is in contrast to ECB and BOJ expanding its respective balance sheets and adopting negative interest rates is driving the dollar higher.
3. **Trade movements:** A country with a trade/current account surplus tends to have a stronger currency than one with a deficit, all else being equal, because demand for the currency will rise along with its surpluses. US current account deficit has moderated from peak levels in 2009 on improving macroeconomic fundamentals, driving the dollar higher.

Other than the above fundamental reasons that drive USD, the US dollar has two other additional benefits, which raises demand for the USD

4. **Safe haven demand:** Historically, the dollar enjoys safe haven status, strengthening during the global financial crisis and also at times of peak stress in the Euro area during 2011-12.
5. **Global Reserve currency:** On account of being the dominant currency in the world and most used in transactions, dollar enjoys reserve currency status with most central banks especially Emerging nations holding FX reserves in form of US treasuries.

Out of all these factors, monetary policy - as shown in Exhibit 1 is the largest driver for US dollar movements over longer periods of time as it encapsulates other factors.

Exhibit 1: US Dollar Index and US Fed Interest Rates

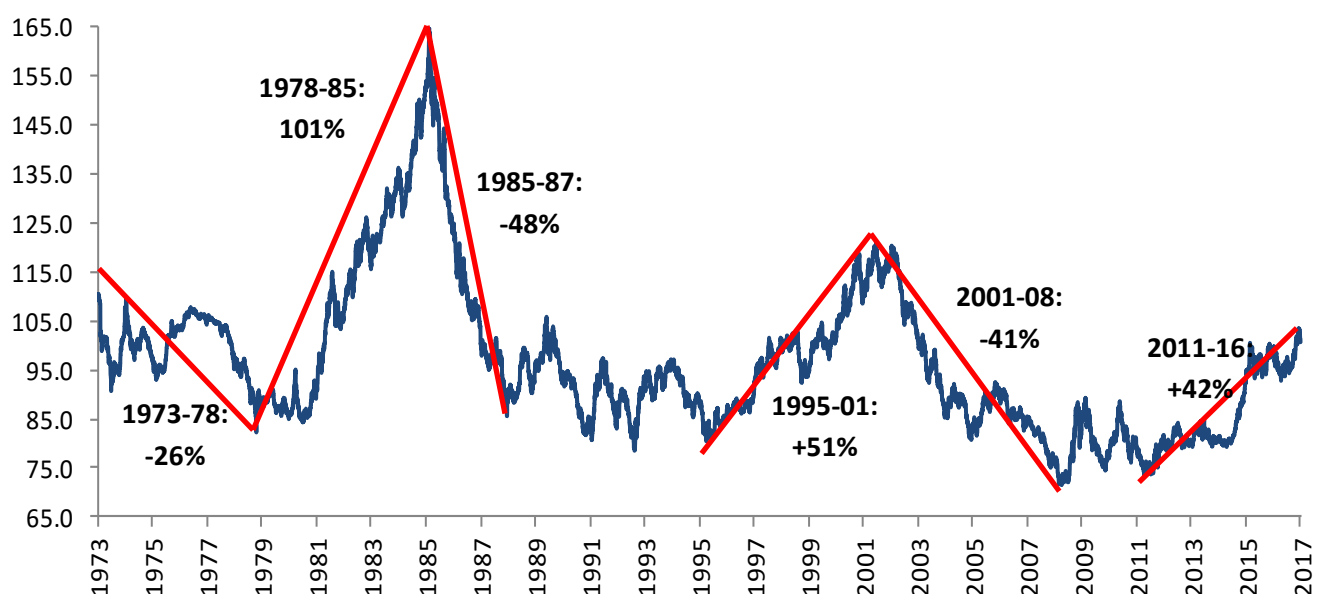


Source: Bloomberg, US Federal Reserve, ASKWA Research

US Dollar Index – Long cycles of ups and downs: Since its inception in 1973, the US dollar index has gone through six cycles (including the current) – 3 bull and 3 bear cycles (see Exhibit 1). Currently, we are in the 3rd bull cycle. Both the previous two bull cycles lasted for close to 6-7 years.

1. **Bull Cycle 1:** The first bull cycle was from 1979 to 1985 with the dollar nearly doubling in value. A key driver for the bull market was high US real interest rates (almost 10%). The Federal Reserve under Volcker along with President Reagan's prudent fiscal policies aggressively fought inflation by raising US Fed rates sharply. US interest rates soared in comparison to the rest of the world, attracting foreign capital to the US markets. The bull market ended when an agreement between the world's major trading partners in the form of the Plaza Accord was reached.
2. **Bull Cycle 2:** The second major bull market was from 1995 to 2001 driven by the technology boom in the US, which boosted economic growth and drew in foreign investments to US markets, pushing asset classes into a bubble. When the tech bubble burst, equity market declined as growth dropped and interest rates fell leading to a slowdown in foreign investment.
3. **Bull Cycle 3:** The current bull market for the dollar started in 2011. Initially, US dollar index moved marginally higher, primarily on US economy performing better than other major economies. However, since 2014 dollar index has increased significantly on diverging monetary policies as the US Federal Reserve first ended quantitative easing in 2014 and then has raised rates twice till 2016, while ECB and BOJ continues to expand its balance sheet. Trump's election has further driven the USD higher on the possible improvement in US trajectory through expected infrastructure driven fiscal stimulus, tax reform, and regulatory relief which should lead to higher growth, higher inflation, higher rates and a stronger US dollar.

Exhibit 2: US Dollar Index in historical perspective – Periods of significant movements (+/-20%)



Source: Bloomberg, ASKWA Research

US Dollar Index and Asset Classes

- **Commodity Markets:** *Commodity prices are **inversely** related to the dollar index.* Therefore, when the dollar index increases, prices of commodities falls and vice versa. Gold has a strong inverse relationship with dollar index, given gold's historical importance in the monetary system. In the first two bull cycles, commodities underperformed other asset classes and in the current cycle, commodities are in the red, falling 57% compared to a 42% rise in the dollar index. Gold has given negative returns in the last two bull markets.
- **Equity Markets:** *Historically, stronger dollar is accompanied by US equities outperforming its developed market and emerging market peers.* Emerging market equities come under severe pressure in a rising dollar scenario and underperform developed market equities. The current bull market (dollar index +42% from 2011-16) has followed the similar historical pattern with US equities rising 65% during 2011-16, outperforming both its developed markets (+26.1%) and emerging markets (-29.3%) peers.
- **Bond Markets:** *Historically, stronger dollar has been on account of Fed raising rates, which results in bond prices falling and yields rising.* However, US bonds have bucked this trend with bond prices rising and yields falling during last two dollar bull markets. Other markets (developed and emerging) have witnessed rising yields during dollar bull markets as when dollar index rises, FIIs sell bonds (investing in US treasuries which is more attractive) causing bond yields to rise and bond prices to fall. Dollar index also has an indirect impact on emerging bond markets especially those with current account deficit as higher bond yields makes it difficult for them to service its dollar denominated debt.

Exhibit 3: Asset Classes and US Dollar Index – EMs, commodities underperform while US equities outperform

Periods	% Change						
	US Dollar	S&P 500	US 10yr (bps)	S&P Commodity Index	Gold	MSCI Developed	MSCI Emerging
1973-78	-25.6	-20.0	239	149.6	279.8	-6.6	NA
1978-85	100.7	88.5	269	49.2	17.1	55.2	NA
1985-87	-48.2	37.9	-271	40.9	70.3	110.8	NA
1995-01	50.6	141.3	-165	57.4	-32.9	62.5	-27.5
2001-08	-41.0	12.9	-170	157.4	245.2	40.3	276.0
2011-16	41.6	65.0	-78	-57.9	-27.0	26.1	-29.3

Source: Bloomberg, ASKWA Research

Outlook: Global policy divergence with US guiding for higher rates on expansionary fiscal policy and rising inflationary expectations while ECB and BOJ continuing to expand their balance sheet would strengthen USD dominance, resulting in the reflation trade playing out with a shift in market positioning in two ways—firstly, broadly out of bonds and into equities; and secondly, out of EM and into US and developed markets owing to rising concerns on US trade policies and the Fed's stance on perceived fiscal stimulus.

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