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No Bite in Dollar Diversification Bark

Dollar's status under scrutiny but little being done about it globally

- Dollar valuation has decoupled from reserve flow
- Lack of fiscal discussion during campaign has not caused large outflows
- New correlations vs. gold the only source of discount

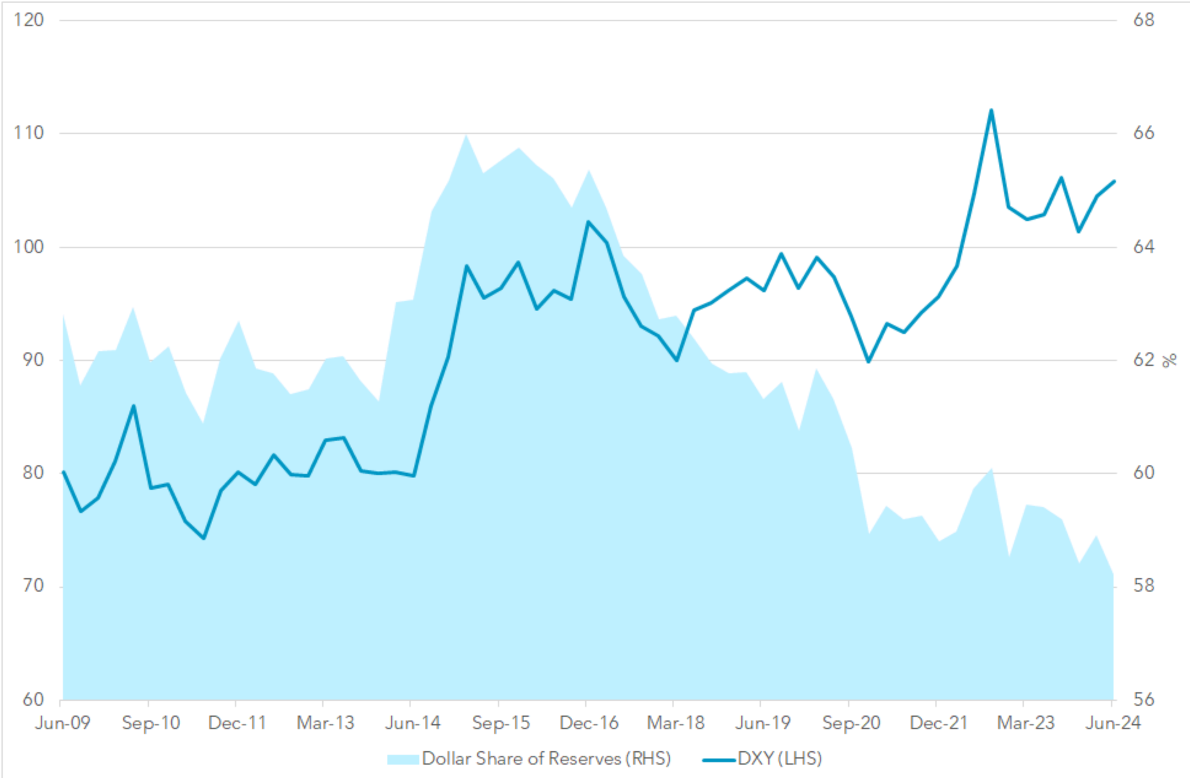
Post-Bretton Woods settlement resilient against US developments

As markets digest the result of the US election, strategic asset allocators will start taking stock of their dollar exposures and perhaps revisit their capital market assumptions for the coming years, especially on the longevity of "US exceptionalism," which in turn has helped sustain the dollar bull cycle, not to mention the reserve status of the currency and US Treasury securities. Despite clear policy differences between the two candidates, US demographics and productivity growth will likely remain robust on a relative basis over the medium term, especially compared to Europe and medium-/high-income Asia Pacific countries, which in the past have been seen as strong candidates for diversification of portfolios heavily overweight the dollar. On the other hand, sceptics have pointed to the lack of a serious fiscal discussion throughout the campaign as a key risk. Meanwhile, the undoubted rise of geopolitical factors such as the application of sanctions on dollar transactions and dollar-denominated assets has fuelled growth in alternative financial architecture, both in the private and official sectors. From decentralised finance to talk of a "BRICS currency," putative challenges to the dollar status will not go away because a US electoral cycle is complete.

Financial innovation can often accelerate out of necessity and given the secular trend of deglobalisation in supply chains and investment flows, it is understandable for key stakeholders to look at alternatives. After all, the US itself is questioning the Bretton Woods settlement – with the dollar as the world's anchoring reserve currency at its core – which it was instrumental in establishing. Nonetheless, progress in establishing an alternative has been painfully slow and there has been very limited cooperation. There are major differences even within BRICS nations and most would not want to be in a position of having to choose between their bilateral relationship with the US and China as a condition of participation in any particular financial framework. After all, China itself has not made any sharp moves on its own currency exposures despite repeated expectations to the contrary over the past decade.

As efforts to reduce official exposures to the dollar have been hesitant but the US' own asset performance became too strong to ignore in the meantime, the dollar over the last few years has arguably strengthened its "anchoring status," or at least reduced any supposed risk premia related to fiscal or geopolitical risk. For example, based on the quarterly updates of the IMF's Composition of Foreign Exchange Reserves (COFER, Exhibit #1), we find that the dollar's value itself has managed to totally decouple from reserve interest from 2018 onwards. Even though its reserve share of allocated reserves has fallen by 8 percentage points from its peak in 2014, the dollar index has reached cycle highs. A rebound in US yields after 2020 helped accelerate the process, but we note that the decoupling between the dollar's value and USD's reserve share was well under way in 2018. China's structural slowdown began around this time and Beijing's struggles to establish a stronger narrative for the CNY continues, measured by both yields and allocation levels. For reference, even at 58.2% of allocated reserves as of Q2 2024, the dollar's reserve share remains far higher than the weights determined in the IMF's 2022 review of special drawing rights (SDR), which stands at 43.4%. The SDR basket composition is a better reflection of balance of payments exposures globally, yet reserve managers prefer to overallocate to dollars. In contrast, the renminbi's reserve share of 2.13% is far below its SDR weight of 12.3%. Even if the Bretton Woods institutions are struggling, its dollar anchor remains firmly in place, and we doubt any US administration would actively jeopardise sustained "exorbitant privilege."

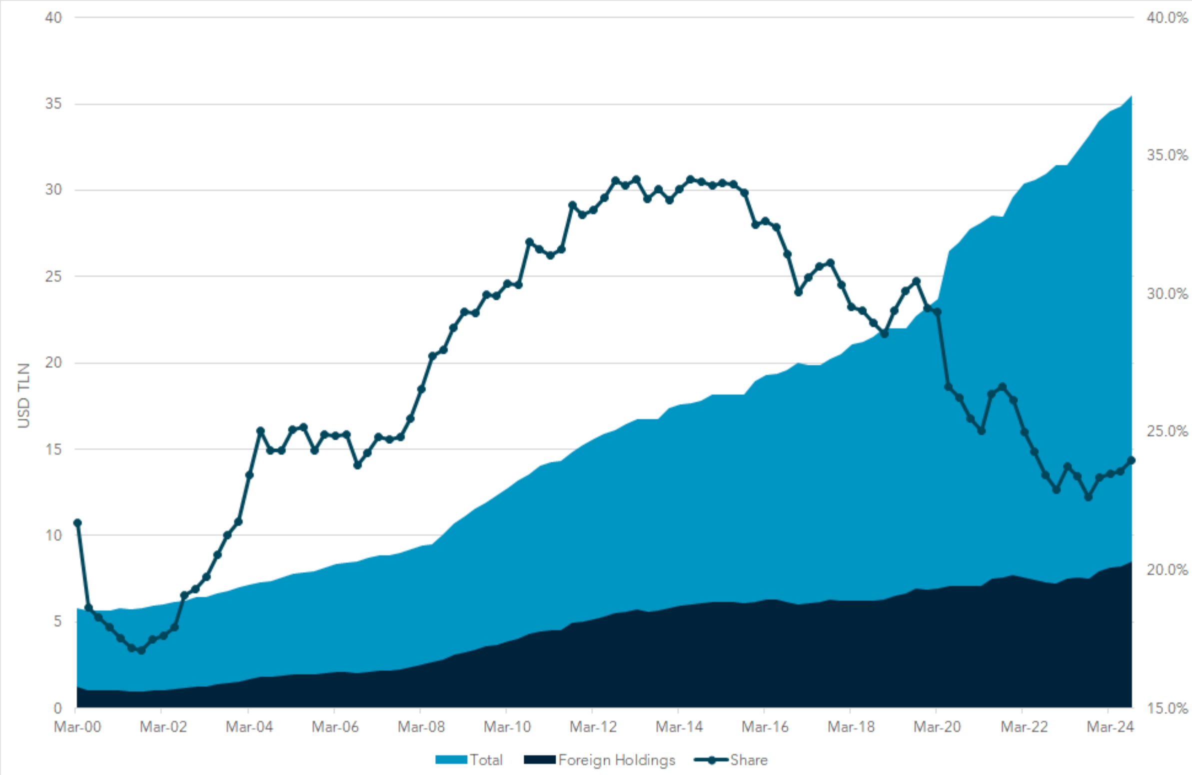
Exhibit #1: USD Share of Reserves vs. DXY



Source: IMF, BNY

The depth of US financial markets and ease of commerce transactions underpins the dollar's liquidity preference. However, much of the gains in US allocations in recent years have been driven by the US private sector, with technology being the most prominent. Meanwhile, the US deficit has continued to expand, and the topic has not featured prominently during the campaign. While this may point to a case for accelerating "intra-US" rotation away from government securities to private-sector securities, especially for international investors, the data suggest such efforts are halfhearted at best. Exhibit #2 shows that in absolute terms, foreign official holdings of US Treasuries have increased by a further 30% over the past decade, which admittedly is small compared to the doubling of the Treasury market. Even so, foreign official holdings' share has stablised at just below 25% and has even increased for four consecutive quarters. Even after the events of 2022 which showed sequestration of US Treasury assets is possible and at very short notice, there has been no active effort to divest.

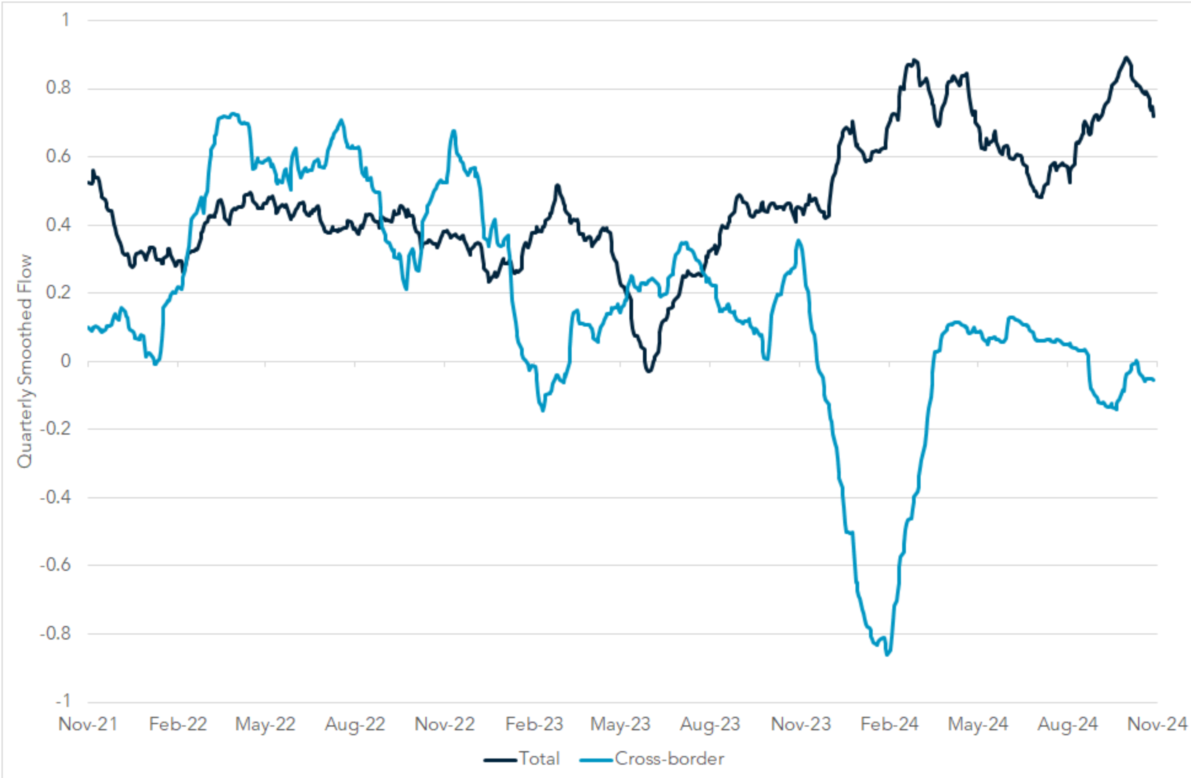
Exhibit #2: Foreign Official UST Holdings and Share



Source: Bloomberg, BNY

Preventing further increases is the best that “at-risk” counterparties have to offer, and the pace is very measured. Given China’s current growth model could lead to a sharp rise in its exports and current account, while other Asian exporters are also benefitting from a sharp rise in global chip demand, the risk to official reserve growth is to the upside and alternatives to US Treasury securities are still very limited. Our custody flow data (Exhibit #3) show that although material declines in cross-border flows into US duration (defined as US Treasury securities with maturities longer than 10 years) have materialised, the sharp selloff towards the end of 2023 and early 2024 was more likely related to Fed easing expectations rather than fiscal matters. This was repeated in Q3 this year, but to a far lighter extent. As we highlighted in June, the potential for a fiscal shock in France after snap elections were called generated a disproportionate reaction in French government debt markets, especially considering the OECD at the time expected the US’ debt trajectory to be even worse over the medium term.

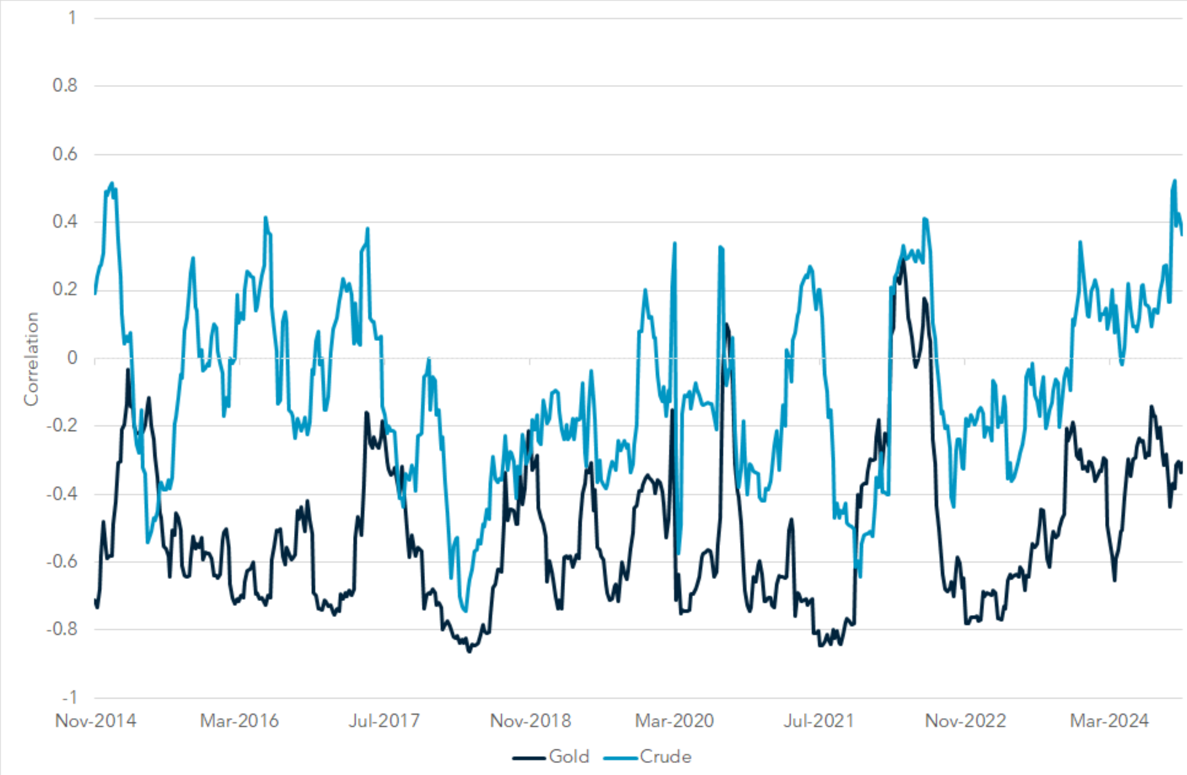
Exhibit #3: Total vs. Cross-border Flow into US Treasury Securities



Source: BNY

Despite the dollar's resilience against (vastly inflated) odds of diversification risk, some form of discount in favour of other systems have materialised. Digitalised media of exchange may represent the future, but the gains in gold prices (overnight price action notwithstanding), one of the oldest stores of wealth and another foundational element of the Bretton Woods framework, cannot be ignored. Over the last ten years, the dollar's correlation with gold prices has been consistently negative. If it were a simple "real asset" story, then a similar relationship should be in place against most key commodities. However, the dollar's correlation with crude prices (Exhibit #4) is now at its strongest point in a decade. The US' rising energy prowess over the past 15 years has been well documented, and we can argue that energy independence has strengthened dollar demand as historical balance of payments risk has been sharply curtailed. However, gold's historical financial purpose continues to serve it well and its strength throughout a period of high dollar real rates does point to a regime shift, and one that the next administration would do well to monitor.

Exhibit #4: DXY Correlation vs. Gold and Crude



Source: Bloomberg, BNY. Rolling 20-week correlation

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Please direct questions or comments to: iFlow@BNY.com

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

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