Goldman Sachs Exchanges: The Markets

Why markets will be living in a strong US dollar world

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Date of recording: December 8th, 2023

Sam Grobart: Markets have been focused on the direction of interest rates. But what does that mean for the US dollar? This is The Markets.

Hi, I'm Sam Grobart. Today, I'm joined by Kamakshya Trivedi, head of Global Foreign Exchange, Interest Rates, and Emerging Market Strategy at Goldman Sachs Research. Kamakshya, thanks so much for joining us today.

Kamakshya Trivedi: Thanks for having me.

Sam Grobart: Let's start with the big picture. The Fed, the ECB, and The Bank of England all entered 2023 with rate hiking programs. And they've all stopped, or at least paused those hikes this year. Will 2024 be the year that central banks start cutting rates?

Kamakshya Trivedi: In a word, yes. I think 2024 is the year you're going to see cuts from pretty much most of these central banks, and really central banks across the world. The main reason, really, is inflation. Inflation which was a big challenge that all of these policymakers were trying to address led to some of the most aggressive hiking cycles in 2022 and 2023, is not largely back down in the vicinity of inflation targets.

And that allows have to central banks to now start normalizing rates from those very high levels. Of course, as the year goes by, there will be more evidence building that inflation is, in fact, coming down. It's not just headline inflation, but also core inflation, excluding things like the volatile commodity prices. That is also declining. And that will allow central banks to start slowly easing policy back towards more normal levels.

There will be some sequencing in that process. We think a number of emerging markets, for example, have already started cutting rates already this year and will continue to cut next year. And then there will be others. We think the ECB is most likely of the majors to go first with, probably, the Fed and then The Bank of England bringing up the rear.

Even this past week, we've seen a move further, lower in interest rates as markets go even faster and even quicker towards expecting rate cuts next year. And alongside that, we've seen a sell off in the dollar.

Sam Grobart: So, one of the most out of consensus calls among our Goldman Sachs Research outlooks for 2024 is US GDP growth where we project growth of around 2.2 percent, about double the consensus rate. How does this impact your view of the US dollar in 2024?

Kamakshya Trivedi: That stronger, above consensus US growth view that we have is the key reason we think that the dollar strength that we've seen really for the last couple of years will erode only slowly and bumpily. Or to put it another way, I think we are going to be living in a strong dollar world, but even as that dollar strength slowly declines.

Now, why is that? Think about it this way. From a top-down basis, a world in which the US Fed is starting to cut rates, a world in which global growth is resilient, one where interest rate volatility slowly comes down and equity prices do well, those are typically periods where the dollar declines. And we think it will decline. But we think it will only decline slowly and bumpily because at the same time, from a bottom-up basis, FX is a relative game. For the dollar to really do badly, some other currency has to do very well. And when we think about the Euro area, this is a place where inflation is also coming down and where growth is lower. When we think about China, this is a place that is already cutting rates because growth is extremely weak.

And so, when you think about the bottoms up basis, we think this is still a world where the dollar will remain strong in relation to many of the other major currencies out there.

Sam Grobart: Right to my next question. Dedollarization has been a buzz word for several years. I guess I have two questions. First, what is dedollarization? And is 2024 the year challenger currencies emerge? It doesn't sound like there will be. But do you see any green shoots?

Kamakshya Trivedi: Yeah. So, look, dedollarization is the notion that a dollar is primary currency used as a means of payment, international transactions, store of value in the international monetary system. But that creates certain constraints for other countries which may be forced to use dollars even if their own domestic cycles, even if their own domestic needs drive them towards seeking out alternatives.

But the reality is there isn't really a clear alternative challenger to the dollar. There is just no other market that has kind of strong economy, deep liquid capital markets that the US dollar boasts.

When you think about the overall 2024, will you see challengers emerge? I still think dedollarization will remain a buzzword. At the end of the day, I think it will remain contained and constrained. And there are really two reasons for it. The first is dollar yields remain pretty high. When we've seen in the past dollar share of reserves come down, that's often gone into higher yielding currencies like the Canadian dollar or the Australian dollar at the expense of lower yielding currencies like the Japanese yen or the euro.

In the current environment, with dollar yields being amongst the highest on offer, I just don't see a lot of international reserve money managers moving out of the dollar in this environment.

And the second is there are motivations from geopolitical considerations to move away from the dollar and into other currencies. But what we've learned over the past couple of years is even in that case, you get a lot of the currency risks that come with taking on or investing in other different currencies without really the diversification or the solution to the underlying problem that comes with being in a dollar system.

So, from both of those standpoints, I think the dedollarization will very much remain a buzzword rather than become a reality next year.

Sam Grobart: I'm reminded, I'm paraphrasing, but it's like "dedollarization is the future and it always will be."

Kamakshya Trivedi: Exactly.

Sam Grobart: You sit as the head of EM Strategy, emerging markets strategy in GS Research. What are your views right now of emerging markets for next year given the struggles they've had with that strong dollar that you just referred to, as well as the weaker growth we've been seeing in China?

Kamakshya Trivedi: Emerging markets have had to deal with a pretty bad macro storm. We've had a couple of years where we've had a strong dollar, we've had one of the most aggressive rate hike cycles by the US Fed, and we've had China growth that has been slowing.

And so, going forward, we think all of these things are going to look a little bit better. We think the dollar strength will slowly erode. Interest rates are going to come down. And even China will be a little bit better as there is a floor underneath the growth slowing that you've seen.

So, I think it should be a better macro backdrop for emerging market assets more broadly. I think the challenge for emerging markets is twofold. One is that throughout this, what I would call a sort of pretty bad macro storm, EM assets have traded very resiliently. And so, they don't enter 2024 at very cheap levels. So, you have average valuations and that is going to give rise to average positive returns.

The second is inflows. You've had a couple of years now where emerging market assets haven't really seen a lot of fund inflows from investors. In part because they have all been going into developed market, especially the US run ten rates market [?] where you get a high yield on dollar assets.

I think as dollar rates start to decline, you should start to see bigger flows into emerging market assets, especially as they start delivering positive total returns. So, I think both from the overall macro backdrop were on the other side of the storm. And I think in terms of fund in flows and returns, I think there are grounds to be more optimistic in the year ahead.

Sam Grobart: All right, KT, last question. What's on your radar for next week?

Kamakshya Trivedi: It's the last Federal Reserve meeting of the year. I think interest rate cuts are coming. The question is, to what extent and how fast? And the market has run a long way in the past month in pricing these interest rate cuts. And so, what a lot of investors will be looking at next week's Fed meeting is whether the FOMC and Chair Powell endorse these cuts and what is priced into markets? Or whether they've gone a bit too far and we see a little bit of a pushback to that market pricing?

Sam Grobart: Kamakshya, thank you so much. A real pleasure.

Kamakshya Trivedi: Thank you very much.

Sam Grobart: That does it for another episode of The Markets. Be sure to listen and subscribe on Apple Podcasts, Spotify, or wherever you get your podcasts.

I'm Sam Grobart. Thanks so much for listening.