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FX Special Report

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Three long-term forces shaping the dollar

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We share three key points on the dollar's long-term trajectory, incorporating reflections from recent global travels:

1. Geopolitics versus technology: a rotation in flows should mean a riskier dollar. There is an important long-term rotation underway in how the US funds its external deficit. Geopolitical ruptures have been hurting long-term appetite for USD debt by the foreign official sector. This could deepen as the world builds strategic autonomy in areas from defence to energy which may necessitate a draw on savings held in USD. At the same time, technology has been pulling enormous equity capital into the US by other types of foreign investors like retail (Figure 1). The gap between net equity flows to the US (increasing) and debt flows (falling) has never been wider.

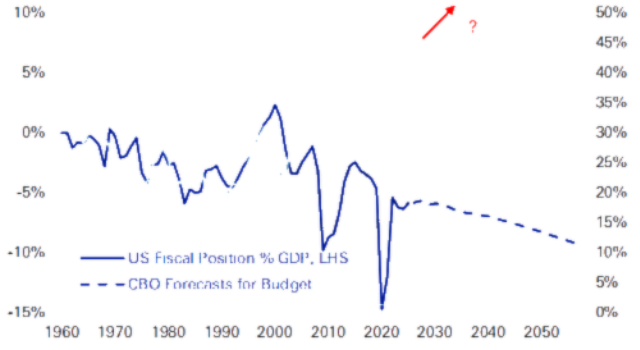
It is not just US dominance in the AI trade which is attracting money, but the ease of access with falling frictions for retail investors, epitomized by Korea (seohakaemi) and Japan (NISA). The shift in foreign interest from US public debt exposure to US corporate equity exposure also reflects divergence in underlying balance sheets. The US fiscal position is weakening, while US corporate profitability is going from strength to strength (Figure 2). AI could accelerate this as companies get richer and the redistributive pressures on governments grow.

Figure 1: The US is now funding itself more through foreign equity flows than debt flows



Source: Deutsche Bank Research, Haver Analytics

Figure 2: This partly reflects a sharp divergence in US public and corporate sector balance sheets



Source: Deutsche Bank Research, Federal Reserve Bank of St Louis, CBO

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IMPORTANT RESEARCH DISCLOSURES AND ANALYST CERTIFICATIONS LOCATED IN APPENDIX 1. U
2021 INCOMPLETE DISCLOSURE INFORMATION MAY HAVE BEEN DISPLAYED, PLEASE SEE APPEND
DETAILS.



What are the implications for the dollar of a shift from more debt-based to equity-based funding? The risk profile of the dollar will change. Demand for US Treasuries has tended to be countercyclical, supporting the dollar in times of recession or risk asset correction. These diversification properties encouraged unhedged USD exposure. A shift to more cyclical, retail driven equity funding should make the USD both more risky and more leveraged to AI. See pieces here and here.

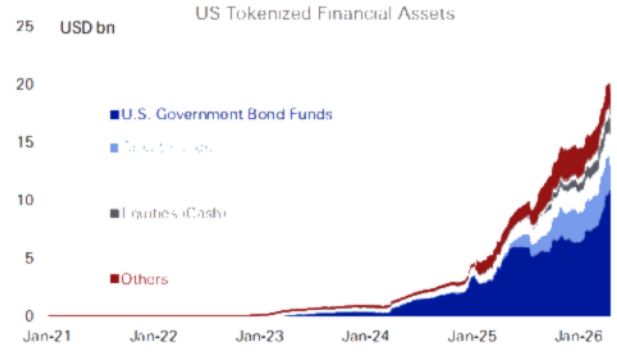
2. San Francisco to Singapore: US tokenization to RMB internationalization.

We spent the last few weeks meeting clients in San Francisco (fintechs and real money) and colleagues in Singapore. The slide pack we discussed can be found here. The differing focus of conversations between East and West were telling.

In the West Coast, there was tremendous energy around - not just AI and US exceptionalism, but also - blockchain technology. It was described as the new financial infrastructure on which money will move globally, expanding access to the US dollar, US finance, and US capital markets. If global leadership is linked to accessing the most and cheapest global capital – then financial innovation could widen the US's lead by lowering the walls to attracting capital. We have written about how stablecoins could support USD dominance in payments. Their forthcoming power could be as a settlement tool for tokenized assets which the US is now actively pushing (Figure 3). DTCC begun tokenizing its real-world custody assets (universe: USD115tn) this month. We found there was not enough appreciation of this outside the US. Equally though, in the US, there was not enough appreciation for trends across the Pacific.

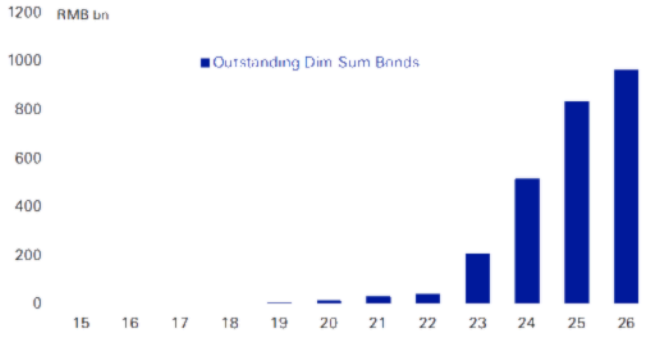
There is now a stale skepticism in the West that the RMB's global ambitions will be constrained by a capital account that is not fully open. In Asia (and Global South more broadly), however, there is much greater appreciation for RMB internationalization which is being powered by cross-border RMB lending and financing (Figure 4); as well as quieter policy innovations like the PBOC's new FIMA repo facility that will allow central banks and sovereign wealth funds to swap CGBs for RMB liquidity. The power of both US tokenization - pulling in capital to the US - and RMB internationalization - pushing capital out of China - should not be ignored.

Figure 3: Tokenization of US financial assets is just getting started and could help pull more global capital into the US



Source : Deutsche Bank Research, Federal Reserve

Figure 4: China is internationalizing the RMB by exporting and increasing access to RMB capital



Source : Deutsche Bank Research, Bloomberg Finance LP

3. A continent of cheap currencies: is Asia for turning?

The opposite side of the coin of USD strength has long been Asian FX cheapness. Six of the ten cheapest currencies on DB models remain in Asia. These are not small countries but include the industrial and demographic behemoths of Korea, Japan, India and China whose combined FX weight in the Fed's broad USD index is greater than the EUR.

China will likely continue to pull its FX weight, with growing geopolitical pressure by Europe (Figure 5) around currency undervaluation. A Plaza Accord style revaluation seems less likely given China's study of its impact on Japan. But with domestic demand in China weakening, China will need external markets and consumers to remain open to its goods and may be willing to pay a greater currency "price", particularly if competitiveness is more about innovation and quality now than just cost.

In India, the revival of the successful 2013 FCNR playbook is seen as providing a slip-stream for near-term strength, but the jury remains out on the long-term manufacturing potential and services outlook under AI. Korea continues to confound: exports are up 50%, equities nearly 100%, regulators have taken supportive action, BoK is priced to hike aggressively, but capital outflows have plagued the currency. Our Asia Strategy team has been writing extensively on these themes.

The greatest uncertainty perhaps lies in the JPY which is near 40-year lows versus the USD. Intervention has kept moves low vol, falling oil opens up USD downside, and speculative short positioning is near the extremes (see here). But risks lie in understanding how the JPY interacts with the government's ambitious industrial, fiscal and growth strategy. PM Takaichi's recent economic blueprint explicitly stresses high nominal growth as a means of bringing down debt/GDP (Figure 6). This could be consistent with a greater tolerance for inflation, precisely at a time when the Fed is getting more serious about it.

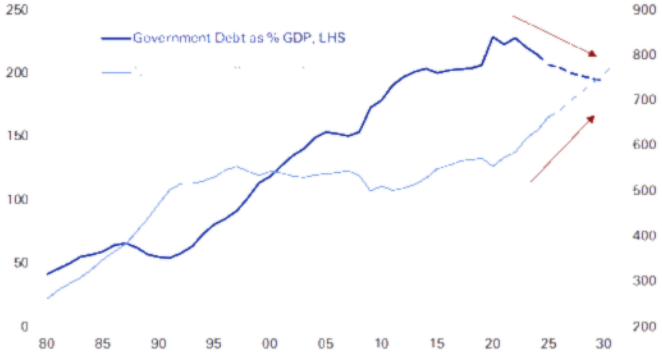
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Figure 5: Europe is getting more concerned about competitiveness versus China - currency politics may help close some gap



Source : Deutsche Bank Research, Haver Analytics

Figure 6: Japan's government is now explicitly linking higher nominal GDP with a declining debt/GDP



Source : Deutsche Bank Research, Haver Analytics; Note. Dashed lines are IMF WEO Projections