



Three Reasons the Dollar Should Stay Strong

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After a decade of weakness, the U.S. dollar has appreciated strongly over the past couple of years, with a particularly strong surge in the first three months of 2015. Some market observers have begun to wonder if the rally has run its course. PIMCO doesn't think so. Although the currency markets will likely experience bouts of volatility, we believe the dollar should remain strong over the next several years. Here are three reasons why.



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1) Diverging global growth and monetary policy trends

Recent economic data has raised some concerns that the U.S. economy may be cooling a bit. Nevertheless, we continue to believe the pace of growth in the U.S. will lead the developed world, while the eurozone and Japan will fall well short of self-sustaining growth.

On the policy front, the U.S. Federal Reserve has clearly signaled its intent to embark on a monetary tightening cycle in 2015. The first rate increase could come as early as June, though a disappointing jobs report for March and other soft economic data may make a September move somewhat more likely.

Other central banks, however, are on a very different path. Since December, a parade of some 27 central banks from around the world – including most major central banks, save the Fed – have eased monetary conditions by slashing policy rates toward zero or even below zero.

FIGURE 1: CENTRAL BANKS LOWER RATES AROUND THE GLOBE

CENTRAL BANK	DATE	ACTION
National Bank of Romania	7 Jan 2015	Rate cut -25 bps
Reserve Bank of India	15 Jan 2015	Rate cut -25 bps
Central Bank of Egypt	15 Jan 2015	Rate cut -50 bps
Central Reserve Bank of Peru	15 Jan 2015	Rate cut -25 bps
National Bank of Denmark	19 Jan 2015	Rate cut -15 bps
Central Bank of Turkey	20 Jan 2015	Rate cut -50 bps
Bank of Canada	21 Jan 2015	Rate cut -25 bps
National Bank of Denmark	22 Jan 2015	Rate cut -15 bps
European Central Bank	22 Jan 2015	Announced QE of €60B/month
State Bank of Pakistan	24 Jan 2015	Rate cut -100 bps
Monetary Authority of Singapore	28 Jan 2015	Reduced slope of its policy band for the SGD NEER
Bank of Albania	28 Jan 2015	Rate cut -25 bps
National Bank of Denmark	29 Jan 2015	Rate cut -15 bps
Central Bank of Jordan	2 Feb 2015	Rate cut -25 bps
Reserve Bank of India	3 Feb 2015	SLR cut -50 bps

CENTRAL BANK	DATE	ACTION
Reserve Bank of Australia	3 Feb 2015	Rate cut -25 bps
People's Bank of China	4 Feb 2015	RRR cut -50 bps
National Bank of Romania	4 Feb 2015	Rate cut -25 bps
National Bank of Denmark	5 Feb 2015	Rate cut -25 bps
Riksbank (Sweden)	12 Feb 2015	Rate cut -10 bps & launch of QE of approx. \$1.2B
Bank of Indonesia	17 Feb 2015	Rate cut -25 bps
Bank of Israel	23 Feb 2015	Rate cut -15 bps
Central Bank of Turkey	24 Feb 2015	Rate cut -25 bps
People's Bank of China	28 Feb 2015	Rate cut -25 bps
Reserve Bank of India	4 Mar 2015	Rate cut -25 bps
National Bank of Poland	4 Mar 2015	Rate cut -50 bps
Riksbank (Sweden)	18 Mar 2015	Rate cut -15 bps & expanded QE
State Bank of Pakistan	21 Mar 2015	Rate cut -50 bps
Hungarian National Bank	24 Mar 2015	Rate cut -15 bps
National Bank of Romania	31 Mar 2015	Rate cut -25 bps

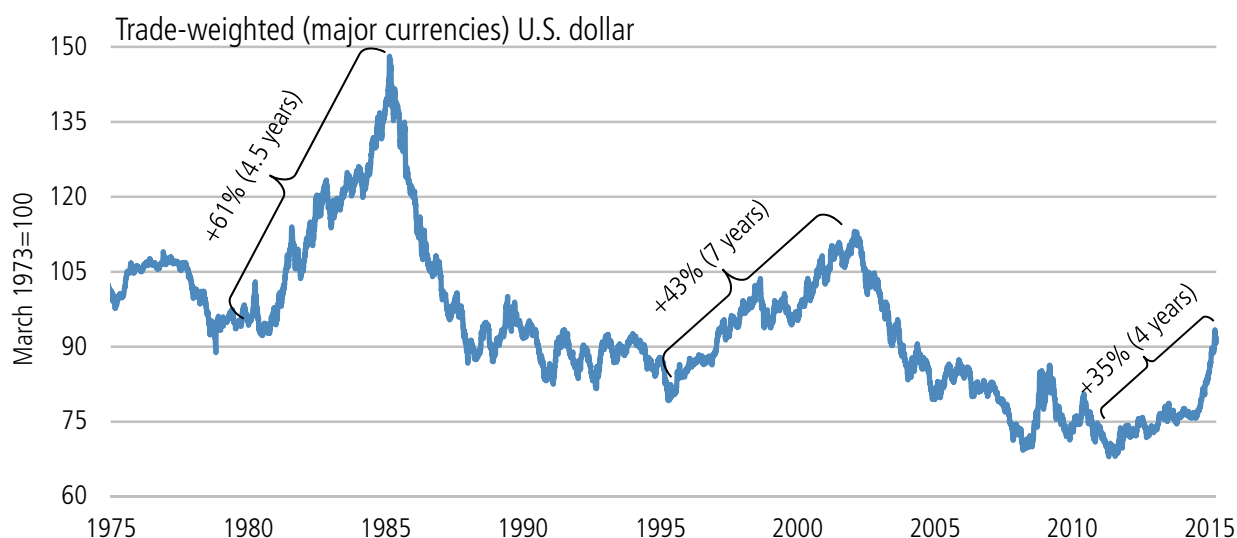
Source: Select individual central banks as of dates indicated. SGD NEER: Singapore dollar nominal effective exchange rate. SLR: statutory liquidity ratio. RRR: reserve requirement ratio.

But importantly, global central banks aren't just cutting policy rates; they are printing money through enormous quantitative easing (QE) programs. The European Central Bank (ECB) announced in January a €1.1 trillion QE program – much larger and more open-ended than the markets had expected. In December, the Bank of Japan redoubled its QE efforts by increasing its monthly purchases to ¥80 trillion. At this pace, the balance sheet of the BOJ will reach 70% of GDP by the end of 2015. So not only policy rate divergence, but also QE divergence, will drive the dollar higher compared with the euro and the yen.

2) The experience of past strengthening cycles

Moreover, it's important to put the recent strength of the dollar in context. First, as Figure 2 shows, the dollar started from a multi-decade low relative to other major trade-weighted currencies. So while the recent appreciation has been impressive, the dollar has a long way to go given how low it started. Second, when the dollar appreciates, it is typically part of a multi-year trend. Again referencing Figure 2, previous strengthening cycles have occurred over many years with ups and downs along the overall path to greater strength. From 1980 to 1985, the dollar appreciated by more than 60%, and by more than 40% from 1995 to 2002.

FIGURE 2: THE DOLLAR'S STRENGTHENING CYCLES



Source: Bloomberg, PIMCO as of 31 March 2015

3) The dollar's resilience as a reserve currency

Related to global monetary policy divergence, central bankers also recognize this imbalance and are choosing to hold more dollars than euros and yen. Remember, central banks rank among the biggest players in the foreign exchange markets and exert tremendous influence on perceptions in the currency market. To provide a frame of reference, central bank reserves totaled \$12.6 trillion in 2013, according to the World Bank. Following the 2008 financial crisis, central banks made a concerted effort to diversify the foreign exchange reserves they hold away from the dollar. In 2009, the share of foreign exchange reserves held in euros had risen to 28%. However, with Europe's debt crisis in 2010, the euro's appeal as a reserve currency began to decline. Last summer, in an effort to fend off recessionary pressures, European monetary policymakers reduced the central bank's deposit interest rate to less than zero for the first time in history. That, plus the ECB's aggressive program of quantitative easing officially begun in March, has made the euro significantly

less attractive as a reserve currency and heightened the dollar's appeal.

At the end of March, the International Monetary Fund reported that in the final quarter of 2014, central banks held 62.9% of their reserves in dollars – the highest level since 2009. At the same time, only 22.2% of central bank reserves were held in euros, the lowest share in more than a decade. Obviously, most of this shift was due to valuations – for example, the dollar strengthened by 5% in the fourth quarter and the euro weakened by 4.2%. But the point is that central banks are letting this shift happen without rebalancing their portfolios after significant currency movements. By our estimation, central banks will continue to let their euro exposure dwindle and their dollar exposure increase.

Investment implications

So what does this mean for investors? The dollar will likely continue to appreciate, though the extent and pace of further gains will depend in part on the timing of the Fed's initial tightening move. Nevertheless, given current

economic fundamentals, the divergence in global monetary policy, the length of prior dollar strengthening cycles and the dollar's persistence and prominence in central bank reserves, we continue to favor the dollar relative to the euro and the yen in particular. For those investors who find global stocks and bonds attractive – and PIMCO does – then carefully consider the currency exposure, lest the rising dollar sink your global gains.

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