Decoder Series
ARTICLES

#4 OF 6

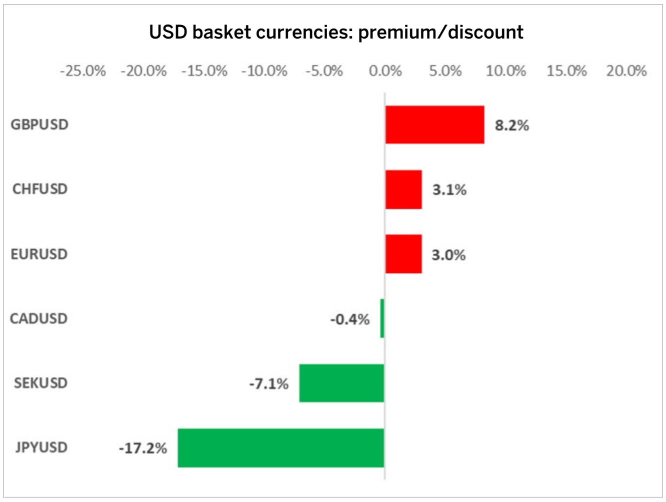
THE ANALYTICS CURRENCY DECODER

INSIGHTS INTO THE US DOLLAR

The US dollar is a fundamental structural component of the Analytics Currency Decoder. On the assumption that the US dollar (as the world's reserve currency) is the driver of global currency behaviour and trends, it sits at the core of the Decoder. The US dollar spot index is denoted by Bloomberg as DXY, and it is an index or measure of the value of the United States dollar relative to a basket of foreign currencies representing major trading partners of the USA. The index goes up when the dollar gains strength when compared to other currencies and the index goes down when the dollar weakens against other currencies. The US dollar spot index was started in March 1973 (at a level of 100) soon after the dismantling of the Bretton Woods system and the demise of the gold standard. The DXY index has traded as high as 164.72 (in February 1985) and as low as 70.70 (in March 2008). It is interesting to note that on 20 July 2023 this index was very close to its 1973 starting level when it bottomed at 100.88. It currently sits at a level of 104.70.

The trading partner currencies that are used to "price" the US dollar on a dynamic basis are the Euro (EUR), Japanese Yen (JPY), Pound Sterling (GBP), Canadian Dollar (CAD), Swedish Krona (SEK) and the Swiss Franc (CHF). This dynamic pricing is done by Intercontinental Exchange, Inc (ICE) and the spot level of DXY is made available on a real time basis. The make-up of this "basket" has been altered only once when several European currencies were subsumed by the Euro at the start of 1999.

To gain a better understanding of the US dollar spot index and its influence on cross currencies, a two-step approach is required. Firstly, the Analytics Currency Decoder mines each of the six abovementioned Developed Market currencies to determine a fair value level relative to the US dollar. The results of this first step are shown in the next chart, where the fair value residual is given for each currency, as at 27 May 2024.



The chart shows that, relative to the US dollar, the Pound Sterling (GBP) is the most expensive of the six basket currencies and the Japanese Yen (JPY) is the cheapest. Three of the six basket currencies are currently strong and three of the basket currencies are weak. The result for the JPY is not surprising and entirely expected since the Bank of Japan still implements a Negative Interest Rate Policy (NIRP) and exercises Yield Curve Control (YCC) in its domestic bond market to keep yields and interest rates very low, although this policy is expected to change very gradually in the coming months.

The second step in the process of understanding more about the US dollar is to calculate the changes in the six basket currencies and through the formula used to price the dollar on a dynamic basis, actually calculate an internally simulated value for DXY. This simulated value can be compared with the actual quoted DXY value to determine the accuracy of the internal simulation. Historical results show that our simulations for the US dollar spot index movements are indeed pleasingly accurate. By way of example, the US dollar spot index reached an interim low of 100.99 on 27 December 2023. On 22 April 2024 the level was at 106.11. This was a move stronger by 6.3%.

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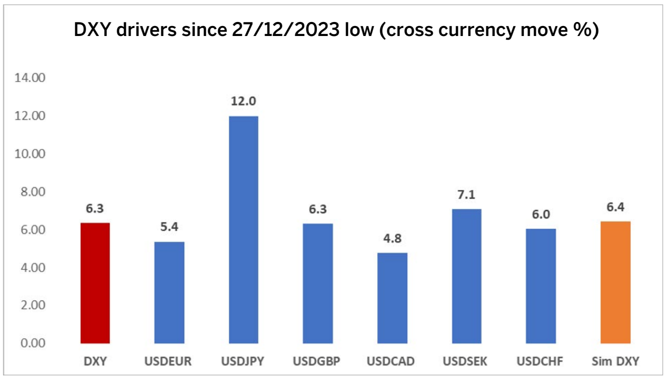
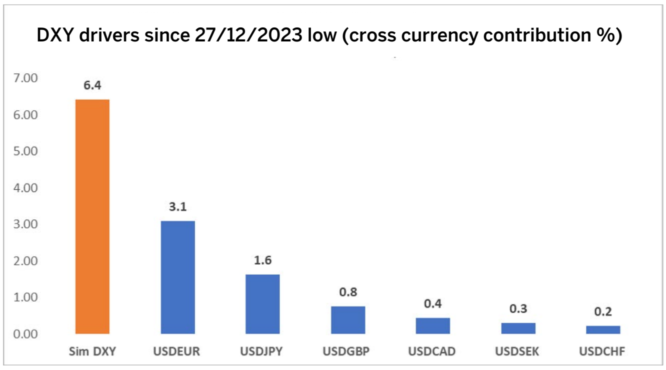
The chart below shows the moves weaker by each of the six basket currencies (led by the Japanese Yen (JPY)) that strengthened the dollar. The chart also shows that our simulated move for the DXY index was very accurate at 6.4%.



The next chart shows the contribution of each of the six basket currencies to the simulated US dollar move of 6.4% over that period of time, based on their weightings in the basket.



By virtue of its high weighting in the basket, the weakness in the EUR was the largest contributor to the stronger dollar, followed by the Japanese Yen and the Sterling. Weakness in the "Big 3" currencies generated 85% of the move in the dollar, while the minnows made up the rest. However, the bout of strength in the dollar was as a result of general weakness across all of the constituent basket currencies.

The ability to decompose the dynamics of the US dollar spot index allows us to tackle questions about the potential direction of the US dollar at any point in time. Currently, the question that we ask is to what extent we can expect sustained weakness in the dollar over the next 12 months. Knowing that the EUR, JPY, and GBP are the main drivers of US dollar direction, we can focus on these three currencies. As seen from the chart on the previous page, two of these three currencies (EUR and GBP) are trading at a premium to the estimate of fair value, while the JPY is at a significant discount. To drive the dollar lower, all three of these currencies will have to strengthen significantly from current levels.

The Analytics Currency Decoder tells us that the EUR is already at the strongest levels that we have seen in the last 15 years. Similarly, the Decoder tells us that the Pound Sterling is also very strong and at levels of strength relative to the dollar that were last seen 10 years ago. The risk of sustained further strength in these two basket currencies appears to be very low from current levels, particularly when we consider that implied forward Central Bank policy rates (from Bloomberg) suggest that over the next 12 months, the EU and UK policy rates will still be lower than those of the US Federal Reserve. If anything, these implied policy rate differentials suggest further dollar resilience and possibly some weakness in these two basket currencies over the next 12 months.

That leaves the Japanese Yen as an outlier. The Decoder suggests that strength in the JPY can definitely be expected from current levels since the weakness seen now last appeared 20 years ago. That period of weakness was followed by significant strength. However, the implied forward Central Bank policy rates show that in 12 months-time, the Bank of Japan policy rate will be 420 bps below that of the US Federal Reserve. This is not expected to be a catalyst for sustained JPY strength over the next 12 months.

In conclusion, when the fair value residual information from the Analytics Currency Decoder is viewed in conjunction with implied forward Central Bank policy rates from Bloomberg, the risk of sustained US dollar weakness in the next 12 months appears to be very low. In fact, while there may be short-term bouts of strength and weakness (as we have seen over the last 16 months), a resilient dollar at stubbornly high levels seems to be a more realistic view for the next 12 months.

Financial Services Providers: Portfolio Analytics Consulting (Pty) Ltd; FSP No 18490 and Analytics Consulting 1 (Pty) Ltd; FSP No 47564;
Tel (Jhb): (011) 463 9600 | Tel (CT): (021) 936 9500