



MARKET *view*

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Will the US dollar depreciate in 2023?



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We expect the supply shock to end at some point in 2023. If this hypothesis proves true, then the safe-haven currencies from 2022 - USD and CHF - should correct again and the EUR, appreciate.

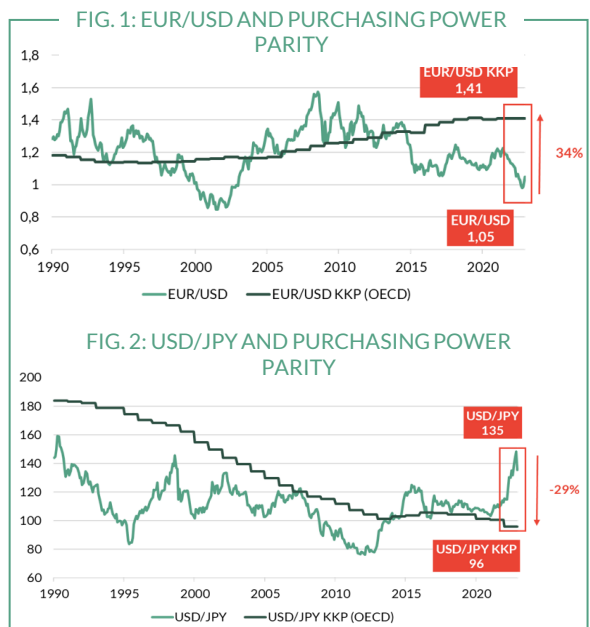
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With a daily trading volume of 6.6 trillion US dollars, the foreign exchange market is the largest financial market in the world. Around the clock, one currency is being exchanged for another around the globe. The motives to exchange currencies are as diverse as the market participants themselves, making currency changes difficult to forecast. But there are some indicators that can help identify the long-term direction of a currency pair's development.

Purchasing power parity

One of these indicators is purchasing power parity, according to which goods and services should trade at the same price after adjusting for exchange rate effects. For example, a Big Mac burger at McDonald's in July 2022 cost €4.65 in the eurozone and US\$5.15 in the US. According to purchasing power parity, the "fair" exchange rate for EUR/USD would be 5.15 USD/4.65 EUR=1.11. Comparing this with the actual exchange rate, the euro should have appreciated by around 7.5% against the US dollar in July 2022. Using broader baskets of goods instead of the Big Mac, the euro should currently appreciate about 34% against the US dollar and the US dollar should depreciate about 29% against the yen, thus preserving the principle of uniform price (purchasing power parity) (see Figures 1 and 2).

Purchasing power parity does not adequately take into account transportation costs, political and speculative influences in the foreign exchange market.



Source: Refinitiv Datastream; Period: 01. 01. 1990 - 01. 12. 2022

But figure 1 clearly shows that currency rates fluctuate around currency parity in the long run. The US dollar should therefore depreciate - at least in the long term.



Yield differential

A second important indicator is the interest rate or yield differential between two currency areas. In principle, the following rule of thumb applies to the foreign exchange market: if, for example, the US central bank raises its key interest rate, the yield for US dollar-denominated bonds rises and thus, the yield differential between the USD and EUR bonds. Consequently, USD investments become more attractive for investors, capital flows into the dollar area, demand for US dollars increases and the currency appreciates. This situation is illustrated for EUR/USD in Figure 3 and for USD/JPY in Figure 4. Higher yields in the US were the central reason this year for the EUR depreciating against the USD. The same applies to USD/JPY: if the USD-JPY yield differential rises, the yen tends to depreciate. Looking at Figures 3 and 4, it should be noted that USD/JPY is quoted in price terms, whereas the EUR/USD is inversely quoted in volume terms. We expect key interest rates in the US to peak in June 2023 and to rise for longer in Europe. The yield spreads will therefore decrease. This speaks in favour of investments in the euro zone.

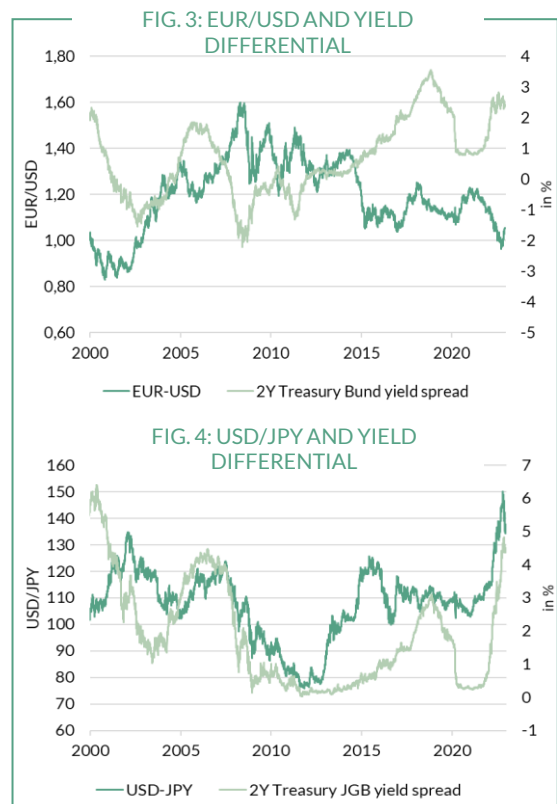
Debt and politics

If we look at the sharp rise in public debt, we have to worry about all three currencies. The astronomical increase in Japanese public debt from 63% of GDP in 1990 to 264% in 2022 is striking. The origin of this situation lies in the real estate bubble that burst in 1990. As a consequence, Japanese households and companies saved and reduced debt. Cash was hoarded in large quantities instead of being spent. Consumption remained subdued and the economy experienced years of stagnation and deflation. To break out of this vicious cycle, the Japanese government launched countless fiscal packages. Government debt in Japan increased as a result. Risks for Japan's currency could result from further increases in budget deficits, a decline in the high level of private savings and a decrease in current account surpluses.

In the US, the debt-to-GDP ratio has doubled since 1990 to now 122%. With chronically high current account deficits, declining foreign demand for US government bonds and a central bank reducing its bond holdings, the risks in the US have not diminished. In the euro zone, government debt now stands at 93%. The threat of a second euro crisis looms, if Italy does

not get its enormously high debt under control. Potential policy mistakes make all three currencies vulnerable to high volatility. Given the debt orgies of the past, we have no overconfidence in any of the three currencies. The choice remains between the plague and cholera.

Diversification across the major currency areas can help cushion short-term fluctuations. In the long term, it is best to hold capital in real assets such as stocks and to spread assets across different currency areas. The positive news for EUR investors: in 2022, the USD and CHF benefited from the flight to supposedly stable currencies as a result of the supply shock. We expect the supply shock to end at some point in 2023. If this hypothesis proves true, then the safe-haven currencies from 2022 - USD and CHF - should correct again and the EUR, appreciate. Hope dies last in the euro area.



Source: Refinitiv Datastream; period: 01. 01. 2000 - 07. 12. 2022; Bonds = bonds, JGBs = Japanese government bonds

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