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Amid U.S. Dollar's Appreciation against the Yuan, Reversal is Inevitable due to Diminishing Impact of U.S. Monetary Policy Tightening

Executive Summary

U.S. dollar has showed strength against a basket of other currencies including the yuan since the Fed initiated the current interest rate hike cycle in March 2022 from near zero percent that is unrivaled for decades in terms of the scale and pace of the increases. Within a relatively short span of about 17 months, the Fed funds rate[1] has seen an upward spiral to the current level of 5.25%-5.50%. Arising from the rate differential, U.S. dollar has become more attractive to people abroad on the lookout for higher returns with minimal risk. Therefore, investing in U.S. dollar deposits and Treasury securities has been increasingly popular, which in turn help buoy the currency due to its heightened demand.

Future path of the U.S. monetary policy is uncertain. Some Fed officials opined that more hikes are needed to prevent inflation from regaining momentum after total (headline) Consumer Price Index ("CPI") has eased to 3.2% Y/Y in July 2023 from the recent peak of 9.1% Y/Y registered in June 2022. Alternatively, the Fed's preferred gauge, core Personal Consumption Expenditures ("PCE") Price Index, moderated only to 4.10% Y/Y in June 2023 after reaching the recent high of 5.42% in February 2022. However, other policy makers believe that current interest rates are already in the restrictive zone or close to it so that they are in favor of pausing rate hike for now and let the full impact of previous rate increases on economic activity and inflation to be reflected in macroeconomic data before making the next move. That is the rationale behind the current approach that forthcoming monetary policy decisions will be data dependent and on a meeting by meeting basis.

We believe the U.S. dollar index, a proxy for the relative strength of the dollar against six other currencies, may have been peaked after hitting a recent high of approximately 115 in September 2022. Ever since the index retreated back to the vicinity of 100 around mid-July 2023 before rebounding to the 103 level lately. It is because the following factors are serving as headwinds, capping further gains of the U.S. dollar.

- Although the debt ceiling impasse was resolved in early June 2023, skyrocketing budget deficits are worrisome. According to the projections released in June 2023 by the U.S. Congressional Budget Office ("CBO"), **total federal budget deficit** (primary deficit plus net interest outlays) **will account for 10% of the country's GDP in 2053**, a level not seen in the past 100 years except during the World War II and the COVID-19 pandemic, up from an estimated 5.8% in 2023. The dramatic increase is attributable mainly to anticipated higher net interest outlays and increased spending on retirement benefits and healthcare;
- **The fiduciary role U.S. plays is being questioned** after it and its allies froze almost half of the US$640 billion of gold and foreign exchange reserves of the Russian government as well as billions of dollars of assets owned or controlled by Russian oligarchs and officials. The move has raised concerns about the safety of assets held inside U.S. jurisdictions by foreigners. Moreover, the **dollar-dominated international payment system SWIFT** (Society for Worldwide Interbank Financial Telecommunication) **is weaponized** by denying most Russian banks' access to it; and
- **Creditworthiness of the U.S. government and health of the U.S. financial system may be at risk**. On 1 August 2023, Fitch Ratings lowered the U.S. credit (sovereign debt) rating to AA+ from the highest

[1] Interest rate at which depository institutions lend reserve balances to their peers overnight on an uncollateralized basis

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