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# 2021 Currency outlook

In the most unusual of years, 2020 will be remembered in FX for the market implications related to COVID-19, Brexit, and the US election. A culmination of factors led to significant US dollar weakness, calling into question the dominance of the US dollar and its status as the world's reserve currency. As the US dollar continues to weaken into the New Year, the rising adoption of digital currencies in investor portfolios has gained momentum.

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## US dollar weakness

US dollar weakness took center stage in 2020 as markets reacted to the global spread of the pandemic. In the early stages of COVID-19, investors rushed to the US dollar and other safe-haven currencies. Soon after, the US dollar index (DXY) experienced a peak-to-trough drawdown of over 12.5% from mid-March through the end of the year as risk assets climbed significantly over the same time period.

It is notable that this dollar weakness occurred in the face of great uncertainty, marked by the raging global pandemic, California wildfires, a record-breaking Atlantic hurricane season, a tense US election, and an erratic foreign policy stance by the US. Various factors contributed to the falling dollar and stronger markets during this time of adversity. As fear concerning the global economy emerged, central banks

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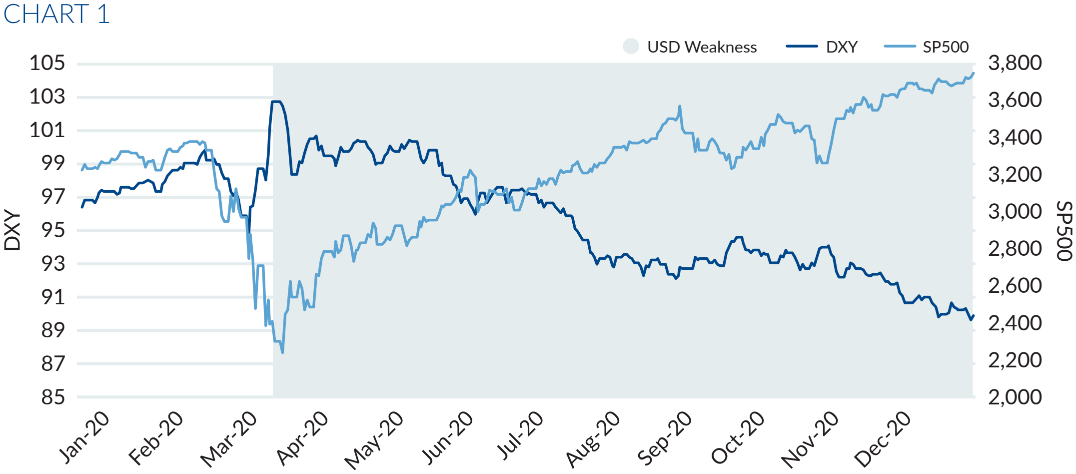
CHART 1




Source: Bloomberg. January 2020 to December 2020. Past performance is not necessarily indicative of future results. Actual results may materially differ.

played a pivotal role in buoying the markets by injecting massive amounts of liquidity and monetary stimulus into the marketplace, supporting an exceptionally fast rebound in capital markets and more dollar selling. While the global economy remains dollar-dependent, Trump's economic nationalism reduced the US role in global trade and revealed vulnerabilities in the US economy, resulting in a less attractive safe-haven alternative than in the past. As the year moved forward, the markets grew more confident as the US election outcome became more certain, vaccine advances were progressing, Brexit negotiations were headed toward agreement, and additional fiscal stimulus packages were passed.

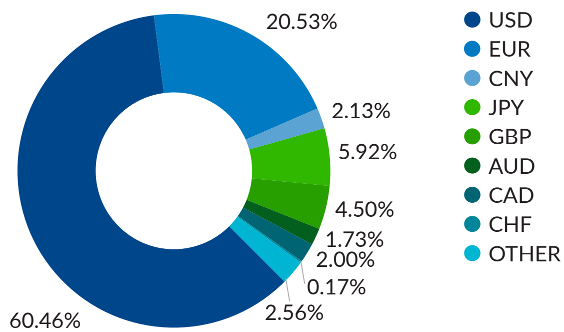
Going forward into 2021, US dollar weakness continues to be a prominent theme in the FX markets. As vaccines become readily available and the global economy has an opportunity to recover, improved market conditions should mute the dollar's safe-haven tendencies. The Fed's rate cuts during the pandemic have eroded the US dollar carry advantage, making it less attractive to investors, while the new average inflation targeting framework strongly implies that an expansionist monetary policy of ultra-low rates and further easing will remain in place for the next few years. Although weakening substantially in 2020, US dollar remains in the upper end of its trading range over the last decade, overvalued against many currency crosses on a long-term basis. While the consensus is generally risk-on headed into the New Year, we should remain cognizant of potential factors that could affect this risk-positive outlook, including disruptions in vaccine distribution, workforce impairments post-COVID, rising interest rates, or the many unforeseen events that will inevitably surface over the coming year.

The dollar's tumble in 2020 has raised concerns about its potential dominance in the global financial system. As the dollar is often considered a reflection of global perception towards the United States and its economy, the significant weakness experienced last year has called into question the US dollar's reserve currency status.

## US dollar reserve currency status

The US dollar has enjoyed reserve currency status due to its outsized role in global trade and history of monetary stability, as central banks across the world have accumulated the US dollar in reserves. Over 60% of all allocated central bank reserves are held in US dollar, with the Euro a distant second at over 20%. Over the last decade, the US dollar share has remained above 60%, reaching a high of 66% in 2015 before moving down towards today's value.

CHART 2: **GLOBAL FX RESERVES – 3Q2020**




Source: International Monetary Fund. Past performance is not necessarily indicative of future results. Actual results may materially differ.

The dollar's sharp decline in 2020 has cast doubt on its standing in the global marketplace. When COVID-19 first reared its ugly head, dollar dependency on a global scale was extremely evident as institutions and governments scrambled to accumulate dollars to cover their liquidity requirements in the face of an unknown future. However, strength quickly turned into sustained weakness, prompting many questions.

As the world continuously becomes more connected, the dominant role the US has played in global trade and commerce has eroded. The world's confidence in the US has been shaken as its share of global trade has fallen, notably during the trade war with China, and high levels of public debt challenge its assumed stability. The dollar's stance as the premier safe-haven refuge during times of crisis is being questioned more than ever by central banks and institutional investors.

While central banks have the influence to further erode the role of the dollar in international payments, there are no obvious alternatives that hold a high position in global trade and reflect the stable safe-haven characteristics sought during times of uncertainty. The euro and renminbi are the most often suggested currencies, as the second largest reserve currency and the second largest economy, respectively, yet each has its shortcomings. The euro has exhibited weak governance as well as public debt issues, while the capital controls and lack of transparency in China make renminbi a sub-optimal candidate. The US dollar has continued to showcase its global stronghold, representing one side of 88% of all FX transactions according to the BIS Triennial Central Bank Survey.[1]

While the US dollar is poised to remain the world's primary reserve currency for the foreseeable future, its sustained weakness in 2020 signaled to many that the United States no longer commands the same global trust and confidence, suggesting that the geopolitical world order is showing signs of age. Back in 2019, Mark Carney, Bank of England Governor at the time, deemed the world's reliance on the US dollar as a reserve currency as too risky, proposing a new digital currency to replace it that would provide more equilibrium between countries with zero or negative interest rates and those with positive interest rates.[2] While still in their infancy, digital currencies have continued to mature, with investors evaluating their potential as an alternative to gold, their portfolio diversification benefits, and their possible role within central banks.

## Digital currencies

Fueled by the meteoric rise of bitcoin, digital currencies have attained mainstream prominence within news outlets and the investing community, as speculators drove several volatile price swings. As the digital currency market has matured over the past few years, it has become more regulated, drawing the attention of a new kind of investor.

CHART 3


Source: Bloomberg. Past performance is not necessarily indicative of future results. Actual results may materially differ.

The rally in 2020 was spurred by more reliable sources of investment. According to a survey from Fidelity Investments, 36% of large institutional investors own digital assets, including pension funds, family offices, investment advisers, and hedge funds.[3] Investors and recent advocates include investment heavyweights Ray Dalio, Paul Tudor Jones, Stanley Druckenmiller, and Bill Miller.

As more credibility is given towards digital currencies, more investors have included it as part of their investment portfolio. With improved regulation, digital currencies are competing with gold as an alternative currency, exemplified by Fidelity Digital Assets allowing its institutional customers to pledge bitcoin as collateral against cash loans.[4]

With differing return and risk factors, digital currencies act as an alternative investment, providing portfolio diversification and return enhancement with little negative carry consequence. They have also become a topic of conversation among central banks, as seven major central banks and the BIS released a report in October assessing the feasibility of central bank digital currencies, the digital form of a fiat currency. The central banks involved included the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, Sveriges Riksbank and the Swiss National Bank.[5]

## Conclusion

As the US dollar plays a prominent role in not just US-based portfolios but also in portfolios across the globe holding a large percentage of US assets, the FX outlook is heavily guided by the US dollar as the dominant global currency. The market themes heading into 2021 point towards continued US dollar weakness to start the year.

We will be closely watching the US dollar's role in the global marketplace and any impact on its reserve currency status. As the landscape can shift quickly as it did in 2020, we recommend institutions refresh their currency hedging policies prior to seismic shifts in the FX markets, holistically managing currency risk and providing downside protection in falling markets.

We, at Mesirow Currency Management, wish you a healthy and prosperous 2021.

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1. BIS, https://www.bis.org/statistics/rpfx19_fx.htm

2. https://www.cnbc.com/2019/08/23/bank-of-england-governor-mark-carney-says-trade-war-is-having-a-confidence-effect-on-business-around-the-world.html

3. https://www.bloomberg.com/news/articles/2020-06-09/fidelity-says-a-third-of-large-institutions-own-crypto-assets

4. https://markets.businessinsider.com/currencies/news/bitcoin-price-considerable-upside-forecast-competes-gold-alternative-currency-jpmorgan-2020-10-1029716041,
https://www.business-standard.com/article/markets/fidelity-digital-assets-to-hold-bitcoin-as-collateral-for-cash-loans-120121000048_1.html

5. https://www.bis.org/press/p201009.htm

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