TAKING STOCK: U.S. DOLLAR TRAJECTORY

An NEPC 2023 Key Investment Theme

By NEPC Research

March 2023

NEPC Key Investment Themes represent our view of important macro-economic drivers of the global economy in 2023. Themes evolve and interact, influencing asset values, allocations, portfolio implementation and opportunities. A disruption of a theme likely alters market dynamics and our investment outlook.

U.S. DOLLAR TRAJECTORY

A stronger U.S. dollar is laying bare the cracks within a world economy already hobbled by high inflation and rising interest rates.

The rise of the U.S. dollar is fueled by the Federal Reserve's hawkish stance to quell mounting inflation. The trajectory of the Fed's monetary policy relative to other central banks will heavily influence the momentum of the U.S. dollar in 2023. If the Fed continues to tighten monetary policy, pushing real interest rates higher, we are likely to see the dollar strengthen to levels unseen in 25 years. Conversely, if we see the Fed Funds rate peak near 5%, we could see moderate dollar weakness as other central banks normalize policy, and a benefit for U.S. large-cap stocks as a softer dollar could bolster profitability later in 2023.

While the current profile of the dollar appears relatively benign, it remains a tail-risk for the global financial system should we see intensifying stagflation trends and rising real rates propel the dollar higher. A stronger U.S. dollar, reminiscent of the currency's strength in the early 1980s, has the potential to inflame inflation, make commodities costlier, and endanger the economic welfare of developing markets by destabilizing their debt and triggering an outflow of foreign investment capital.

Currency risk is an outsized source of volatility for portfolios and developed market currencies have generally been an uncompensated risk over the last 30 years, delivering meaningful returns only over brief periods. We believe hedging developed market currency exposure reduces risk, allowing for a more efficient use of the portfolio risk budget. A hedging program captures the excess risk associated with developed market currency exposure and allows for risk to be re-deployed to other return-generating assets in the portfolio. That said, the recent strength of the dollar has provided outsized gains for currency hedges, and we suggest evaluating the scope of strategic currency hedging programs.

At NEPC, we believe these trends call for a more defensive portfolio bias. In this environment, fixed-income assets are relatively more attractive. As equities lose some of their shine amid lower valuations and eroding profit margins, we recommend value-oriented stocks for their strong relative gains. Furthermore, we encourage assessing the benefit of diversifying assets as they offer greater efficiency and value for a portfolio especially with the uptick in macro-economic volatility.

We also remind clients to hold greater levels of liquidity and to be prepared for the opportunities to rebalance equity that are likely to arise as markets try to make sense of these tumultuous times.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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