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The U.S. dollar is a crowded consensus

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Primarily because the Federal Reserve finally seems poised to raise interest rates, nearly everyone expects the U.S. dollar to rise in the next couple of years. Generally, higher interest rates attract foreign investment increasing the demand for and the value of the U.S. dollar. However, since 1970, the U.S. dollar has typically declined during major cycles when the federal funds rate was increased. Often, what moves the U.S. dollar is not interest rates per se but rather the "reason" interest rates are being lifted.

The Fed does not hike interest rates in isolation. Typically, interest rates are increased because of heightened inflationary fears. Wage and core inflation rates have risen noticeably in the last 18 months and recently inflation expectations are climbing. Consequently, even though interest rates do appear to finally be trending higher, investors should be cautious about joining a crowded consensus view expecting further U.S. dollar strength.

U.S. dollar and federal funds interest rate

Chart 1 illustrates the relationship between the U.S. dollar and the federal funds rate since 1970. In contrast to the consensus view, examination reveals that most major rises in the funds rate have been associated with a weaker U.S. dollar. The markers in Chart 1 highlight the start and finish of five major monetary tightening cycles since 1970. The diamond markers illustrate the rise in the funds rate and the circle markers show what the U.S. dollar index did over the same time period. The specific dates and movements in the funds rate and the dollar index are shown in Table 1.

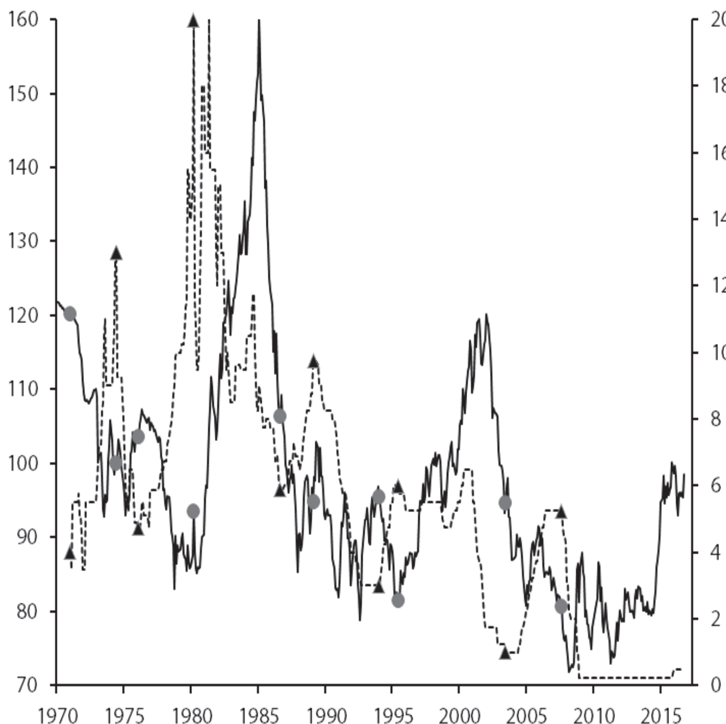
The surge in the federal funds rate during both the first half and again in the second half of the 1970s was associated with sustained and significant declines in the U.S. dollar. The dollar also declined meaningfully when the federal funds rate rose in the last half of the 1980s, during the mid-1990s and during the mid-2000s. Finally, most recently, the U.S. dollar has been essentially flat since the Fed raised the funds rate for the first time in this recovery at the end of 2015.

Most are expecting the U.S. dollar to rise once the Fed begins to regularly raise interest rates. However, every major Fed tightening cycle since 1970 has been associated with a weaker rather than a stronger dollar. Overall, the strong and consistent inverse relationship illustrated in Chart 1 is difficult to reconcile with a widely held contemporary consensus expecting the U.S. dollar to strengthen as the Fed raises the funds rate.

Chart 1

U.S. Dollar Index versus Fed funds rate

Solid (left scale) — Trade-weighted U.S. Dollar Index
Dotted (right scale) — Fed funds target interest rate



U.S. dollar versus expected inflation

Chart 2 provides a rationale for why a rising federal funds interest rate is often associated with a weaker U.S. dollar. Almost always, the Fed raises interest rates due to concerns about economic overheating and higher inflation. Other things constant, a higher interest rates would boost the U.S. dollar. However, when the Fed raises the funds rate, other things are rarely constant. Inflation expectations almost always are worsening.

Chart 2 overlays the U.S. dollar index with investor inflation expectations derived from the 10-year U.S. Treasury Inflation Indexed (TIP) bond. At least since 1989, major movements in the U.S. dollar have been closely inversely correlated to changes in expected inflation. Higher inflation erodes the real purchasing value of U.S. dollars for international investors. Often, when the Fed raises the funds rate because inflationary pressures are building, the real interest rate is declining causing the U.S. dollar to weaken.

As shown in Chart 2, the U.S. dollar surged in 2014, not because the Fed lowered interest rates (the funds rate was unchanged over this period), but rather because of a significant decline in inflation expectations from about 2.5% to about 1.5% (which substantially raised the real dollar interest rate).

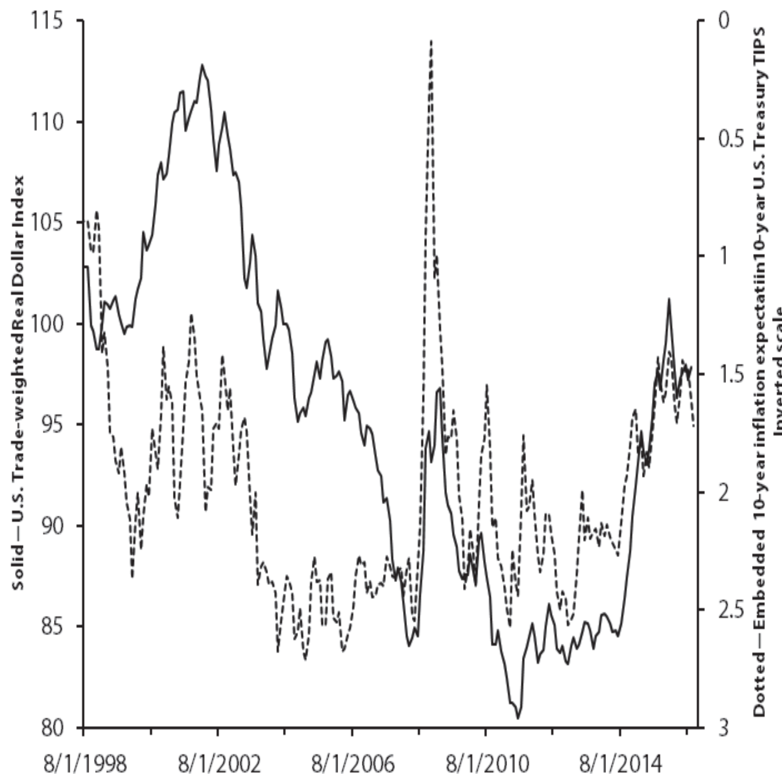
Table 1

Five major Fed fund hikes since 1970

Dates	Fed funds rate	U.S. Dollar Index
Jan. 1971	4	120.24
Jun. 1974	13	100.16
Feb. 1976	4.75	103.66
Mar. 1980	20	93.58
Aug 1986	5.88	106.39
Feb. 1989	9.75	94.91
Jan. 1994	3	95.59
Jun. 1995	6	81.58
Jun. 2003	1	94.73
Aug 2007	5.25	80.79

Chart 1

U.S. dollar versus expected inflation



Most recently, as wage and core inflation have accelerated, inflation expectations have also increased. The embedded 10-year TIP inflation expectation has risen from about 1.2% in February to about 1.75% currently. Moreover, since oil and other commodity prices have stabilized and the labor market remains healthy at a low unemployment rate, it appears likely that wage inflation and both headline and core consumer inflation are likely to head toward 3% in the next year. From Chart 2, if embedded inflation expectations in the bond market rise above 2%, the U.S. dollar is likely to suffer a significant decline even if the Fed raises interest rates.

Postition as a dollar contrarian

Most anticipate a modest and relatively slow tightening by the Federal Reserve primarily because a consensus believes tightening efforts will lead to a much stronger U.S. dollar. However, we suspect a surprising decline in the U.S. dollar will exacerbate inflation anxieties and accelerate the pace of Fed tightening from what is currently anticipated.

Looking into 2017, we recommend investors position portfolios as a dollar contrarian. Crowded consensus trades are not often fruitful and frequently prove risky. If the consensus is surprised by a falling dollar, many portfolios will need to be adjusted. Surprising dollar weakness will benefit commodity prices and penalize high-quality bond investors. It would also favor international stocks, particularly emerging market equities. Moreover, it would likely extend the leadership of small and mid cap stocks evident so far this year. Finally, a weaker dollar would probably focus investors on the materials, industrials, technology and financials sectors within the U.S. stock market.

Thanks for taking a Look!!

Written by James W. Paulsen, Ph.D.
An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.

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