CURRENCY EXCHANGE RATE ASSUMPTIONS

Is the U.S. dollar unassailable as the premier reserve currency?

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IN BRIEF

- During the pandemic-induced global recession, the USD was a more resilient safe haven than other currencies; today, it remains well behaved while demand rebounds. We continue to view the currency as overvalued but have some reservations about forecasting the magnitude and timing of its depreciation.
- A narrowing in global yield differentials as relative growth tilts in favor of economies outside the U.S. suggests an erosion of the USD's secular strength.
- As in last year's projection, we think that a weaker starting point for the U.S. economy in this cycle can act as the catalyst for our long-held expectation of secular USD depreciation; however, we do not see an imminent catalyst.
- Vs. the USD, we expect that:
  - the eurozone's strong external account, union-wide fiscal risk-sharing and robust fundamentals will drive the euro's appreciation;
  - the pound sterling will appreciate as the end of uncertainty over Brexit outweighs the still-adverse reality of a narrow Brexit that is hurting export growth;
  - the Japanese yen, whose purchasing power has reached a half-century low, will appreciate at least nominally;
  - although the Chinese renminbi enjoys strong secular support, it will not become a premier reserve currency in the near term, and geopolitical tensions will limit its appreciation to less than fundamentals alone would imply.
- Our methodology for estimating the purchasing power parity of developed market currencies has been refined: We now systematically remove housing inflation from our calculations.

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OUR CONVICTION ON U.S. DOLLAR DEPRECIATION HOLDS – WITH SOME RESERVATIONS

We maintain our conviction that the USD is due for a secular decline, but several recent developments temper what we expect to be the magnitude and timing of that decline (**EXHIBIT 1**).

Demand for the USD over other reserve currencies remained reliably resilient throughout the severe, sharp global recession induced by the COVID-19 pandemic. Once again, the dollar asserted its historical safe haven characteristics. Since growth began recovering aggressively, the U.S. dollar has continued to perform remarkably evenly within a narrow range. Even while exposed to an unprecedented mix of macroeconomic, geopolitical and monetary and fiscal conditions, the USD has experienced relatively tame volatility. What's noteworthy amid the growth recovery is the narrowing of yield differentials among global economies as relative growth differentials begin to tilt in favor of economies outside of the U.S.

Looking ahead as the cycle unfolds, how do we reconcile the tension between the forces that favor a stronger U.S. dollar and those that indicate weakening? On the one hand, we expect that even in the post-recession regime the U.S. dollar's position as the premier global trading and reserve currency will remain unassailable. On the other hand, the reduced relative global growth differentials and narrowing bond yield differentials indicate that U.S. exceptionalism in cyclical economic performance has been eroded. On balance, this should allow the U.S. dollar to remain resilient but over time to become less overvalued than is currently the case.

The structural forces favoring a relatively stronger USD have limited impact on our currency assumptions from year to year, as these factors have been in place for quite some time and are not expected to change significantly over the Long-Term Capital Market Assumptions (LTCMA) horizon. We maintain our view from last year that the U.S. dollar has remained significantly overvalued in purchasing power parity (PPP) terms when compared with a broad basket of other currencies, and the inflation differentials we project are likely to eventually exacerbate this overvaluation over our assumption horizon.

We therefore continue to expect a secular decline of the U.S. dollar, although we expect the magnitude of the decline to be marginally less than what we had assumed previously. We also expect that a successful rotation of growth leadership away from the U.S. toward other regions of the global economy is a prerequisite.

DIVERGENT CENTRAL BANK POLICIES; UNCERTAIN CONSEQUENCES

Our currency assumptions are contingent on a successful reflation of the global economy as a whole rather than a successful reflation of just the U.S. economy. While the initial signs are encouraging, there remain considerable uncertainties in the form of ongoing global supply chain issues, geopolitical tensions, the meandering path of COVID-19 infection rates and the pace of vaccination campaigns around the world.

Valuations, albeit with less vigor, continue to signal dollar depreciation

EXHIBIT 1: ASSUMPTIONS FOR CHANGES IN SELECTED CURRENCY EXCHANGE RATES VS. USD, NOMINAL AND REAL

	NOMINAL			REAL			FORECAST LEVEL (CONVENTIONAL)			
	2022	2021	Chg	2022	2021	Chg	2022	2021	Chg	Chg %
Australian dollar	0.20%	-0.10%	0.30%	0.10%	0.20%	-0.10%	0.74	0.71	0.03	4.23%
Brazilian real	-0.70%	1.00%	-1.70%	1.00%	3.50%	-2.50%	5.96	4.97	0.99	19.92%
Canadian dollar	0.50%	0.80%	-0.30%	0.10%	0.60%	-0.50%	1.19	1.21	-0.02	-1.65%
Swiss franc	1.60%	1.10%	0.50%	-0.10%	-0.40%	0.30%	0.76	0.80	-0.04	-5.00%
Chinese renminbi	1.60%	1.20%	0.40%	-0.40%	0.10%	-0.50%	5.29	5.85	-0.56	-9.57%
Euro	1.30%	1.40%	-0.10%	0.50%	0.70%	-0.20%	1.36	1.39	-0.03	-2.16%
British pound	0.90%	0.80%	0.10%	0.80%	0.80%	0.00%	1.51	1.43	0.08	5.59%
Japanese yen	1.70%	1.40%	0.30%	0.10%	0.10%	0.00%	90.13	88.63	1.50	1.69%
Mexican peso	-1.90%	0.00%	-1.90%	-0.35%	1.90%	-2.25%	26.18	22.04	4.14	18.78%
Swedish krona	1.40%	1.50%	-0.10%	0.90%	1.10%	-0.20%	7.37	7.43	-0.06	-0.81%

Source: J.P. Morgan Asset Management; data as of September 30, 2020 and September 30, 2021.

Global monetary policy at the time of writing is extraordinarily easy, but developed market (DM) central bank policy biases have become increasingly differentiated. This differentiation is a consequence of central banks' varied past experiences achieving their stated policy objectives, and the lessons they have drawn for future policy. The lessons primarily impact their policy objectives and their policy reaction functions. Based on these, central banks can be sorted broadly into four groups: leaders, experimenters, laggards and the undecided.

THE LEADERS: Leaders in monetary normalization are the central banks whose policymakers are content with their track records and have neither shifted their policy objectives nor their reaction function materially following the COVID-19 recession. In those countries, inflation expectations are credibly at or approaching target. The Bank of Canada, the Bank of England and Sweden's Riksbank, among them, consider current conditions adequate to allow for a tapering of support in the near future. Within the LTCMA framework, we find that these economies' FX rates are already fairly close to fair value, and we do not project much widening in their inflation differentials vs. the U.S.

THE EXPERIMENTERS: These central banks' policies have become more experimental, as they failed to achieve their objectives in the past. They have adjusted their objectives and/or policy frameworks, implying a much slower withdrawal of monetary support than before. The Federal Reserve (Fed) headlines this subset. Fed policy communication has emphasized within its reaction functions prioritizing targets apart from inflation, such as sustainable employment. Also central to the Fed's new policy frameworks: a willingness to persistently overshoot the inflation target for some time, at least in the initial stages of an economic cycle.

There's also an experimental tone to the Reserve Bank of Australia's (RBA's) dovish lurch, which pushes back heavily on market pricing of monetary policy normalization. At this point, however, the RBA's change in stance seems to reflect Australia's severe undershoot of the inflation target just before the pandemic more than the kind of change in policy that informed the Fed's shift.

The experimenters' shift away from orthodox policy increases the uncertainty about the consequences of these policy innovations over time. Our 2022 LTCMA inflation forecasts, of 2.3% for the U.S. and 2.2% for Australia, reflect our "in dubio pro reo" (roughly, "innocent until proven guilty") approach, but the range of plausible outcomes has certainly widened compared with the past.

THE LAGGARDS: In this category is a central bank whose inflation track record is essentially unanchored from its policy target: the Bank of Japan (BoJ), which has not even come close to achieving its inflation target in decades. Here, even experimental policies will not suffice to achieve the central bank's policy objective, and the onus rests on increased monetary and fiscal policy coordination. Given the scale and complexity of the task, even the LTCMAs' long time horizon is likely too short for a full convergence of the Japanese yen toward its PPP-implied fair value. As such, we adjust our assumption to reflect our expectation that JPY will not reach its fundamental fair value over our forecast horizon.

THE UNDECIDED, notably absent from the above groups, are led by the European Central Bank (ECB). PPP fair value signals a significant valuation tailwind for the euro (as for the yen), and, like the BoJ, the ECB failed in the prior cycle to achieve its inflation objective. Grouping the eurozone with Japan is therefore inviting, but we don't. As it stands, the ECB fails to fit neatly into any single group. It remains to be seen whether the ECB, after some further soul-searching, comes to sit with the experimenters or with Japan.

Our LTCMA inflation forecast for the euro area of 1.5% increases from last year but remains well below the ECB's revised 2% inflation target. (The target now is to realize 2% over time; before, it was defined as "close to, but below, 2%," suggesting a realized midpoint below 2% over time). The ECB will have to decide whether to settle for less, like the BoJ, or be willing to experiment more with policy, like the U.S., in order to achieve its target.

METHODOLOGY

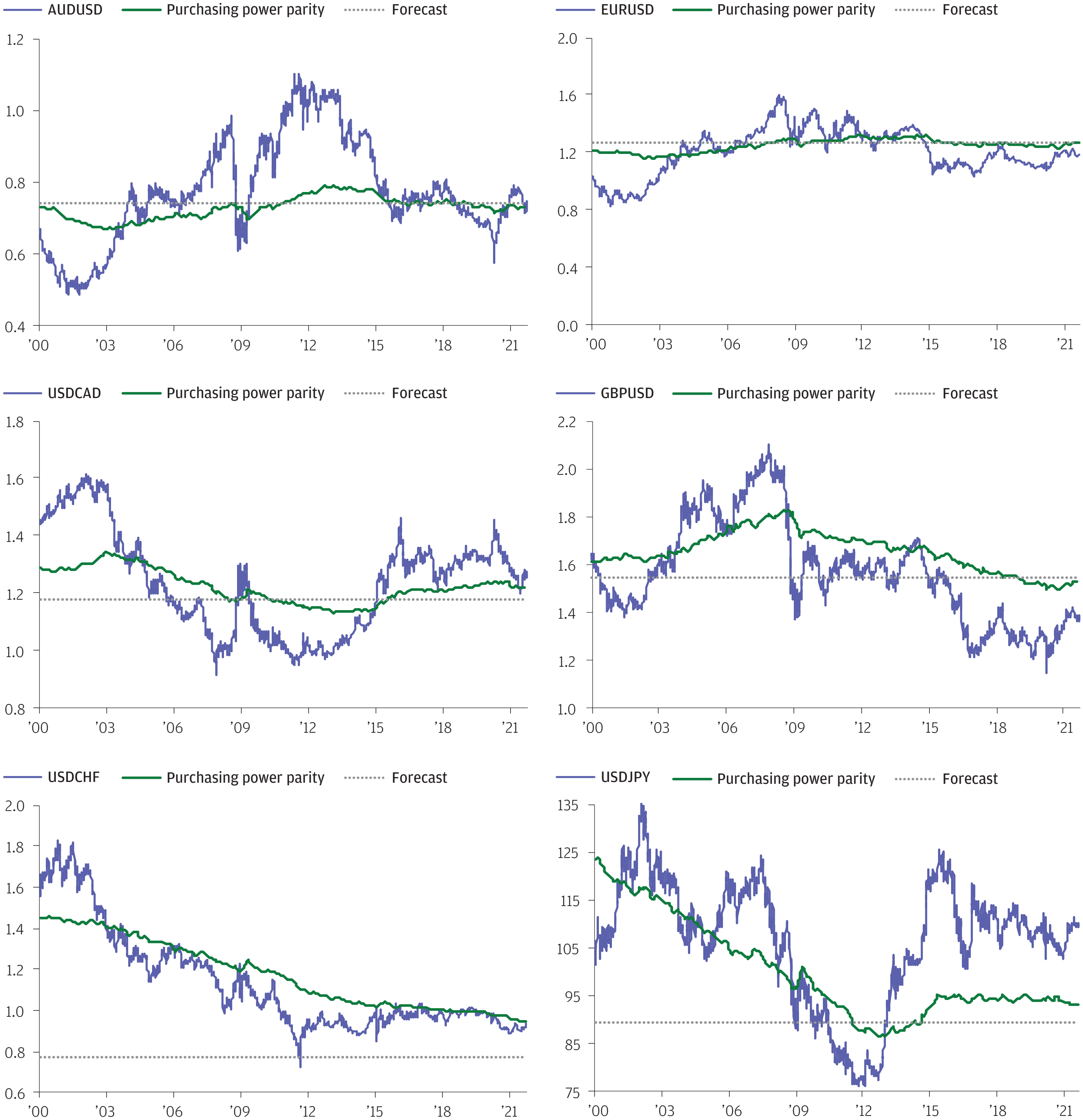
As in prior years, we continue to rely on PPP as the basis of our approach for determining today's fair value exchange rates. While the underlying concept of PPP is simple enough, there is a significant level of complexity in empirically measuring price levels and comparing data series across countries, given differences in the methodologies used by national statistical agencies. To better address one of the more notable differences, we extended our previous LTCMA methodology and now systematically strip out housing-related inflation from national price series data in our calculations of present-day fair value (**EXHIBIT 2**).

To arrive at a given exchange rate projection over our assumption horizon, which we also refer to as future fair value, we adjust today's fair value exchange rate using the LTCMAs' underlying macroeconomic assumptions, as follows: For developed market currencies, we reflect the expected change in a country's terms of trade over the assumptions horizon by adjusting today's fair value for the projected inflation rate differential between the two countries. For emerging markets, we make an additional adjustment for the expected differential in GDP growth per capita.[1]

[1] For a more detailed explanation of the approach, please see Roger Hallam, Nigel Rayment and Neil Weller, "Currency valuation methodologies," J.P. Morgan Asset Management, June 23, 2021.

Relative to recent history across DM currencies, the deviation between spot exchange rate to USD and PPP fair valuation is extremely narrow

EXHIBIT 2: : PPP FAIR VALUE AND SPOT EXCHANGE RATES RELATIVE TO OUR 2022 LTCMAS FOR SELECTED CURRENCIES



Source: Bloomberg, J.P. Morgan Asset Management; data and estimates as of September 30, 2021.

MAJOR CURRENCY PAIRS

The euro

Underpinning our euro assumption is the region's impressive external account position. As we discuss in our LTCMA Fixed Income Assumptions, we expect absolute short-term rates and their differentials to be historically muted this cycle. Amid collapsed interest rate differentials, the yield-seeking private capital outflows necessary to recycle the euro's current account surplus will likely be limited. This should over time create a cyclical catalyst to allow the euro's strong structural fundamentals to drive its appreciation.

Further supportive of the euro's external account surpluses are foreign investment flows into European equities. By avoiding another double-dip recession experience – a sharp contrast with the beginning of the last cycle – European risk assets' performance, particularly equities, has kept much better pace with their U.S. counterparts. What has likely played a role in this change of fortune is a chastened European Union (EU), now avoiding sovereign debt default risk and instead leveraging the economic distress from COVID-19 to introduce fiscal risk-sharing and investment-focused fiscal stimulus across the union through the EU Recovery Fund.

Long-term cross-border flows into the euro area look likely to be supported both by the progress toward further political integration and what we expect will be improved equity market returns as a result of a more vigorous cyclical recovery. Both cyclical and secular drivers have begun to align favorably for an appreciation of the euro.

The above impact is partially offset by our change in methodology for determining the euro's PPP-based fair value. The inconsistent treatment of imputed housing rental costs notably exacerbated the eurozone's persistent inflation deficit vs. the U.S. When we systematically correct this effect by excluding housing sector inflation from our PPP-derived fair value, it suggests that the euro is, in fact, less undervalued vs. the U.S. dollar today than hitherto estimated.

On balance, the impact of a widening U.S. vs. eurozone inflation differential is largely canceled out by the reduced undervaluation of the euro vs. the U.S. dollar on a PPP basis.

Reflecting these dynamics in our assumption, we expect the euro to appreciate by 1.3% per annum (p.a.), a small reduction from 1.4% per annum in last year's edition, with a fair value exchange rate at the end of the LTCMA horizon of 1.36.

Pound sterling

We have long noted the uncertainty premium overhanging sterling due to Brexit. At long last, a free trade agreement between the UK and the eurozone now exists in the EU-UK Trade and Cooperation Agreement. Admittedly, while the deal falls short of the economic integration that existed when the UK was an EU member state, it does provide the foundation for preserving bilateral cooperation. Naturally, our expectations for the sterling's fair value need no longer reflect an uncertainty premium associated with a no-deal Brexit outcome. Rather, our focus has moved to quantifying the adverse economic reality of a narrow deal.

Notably, the UK's surplus in trade of services to the EU has already begun to narrow as export growth lags – a medium-term downside risk to GBP fundamentals. Compounding this, supply chains in Northern Ireland have already shown an early indication of movement away from the rest of the UK, skewing further negative the outcomes for foreign direct investment inflows. As these and other consequences of what was de facto a fairly "hard Brexit" unfold, we have raised our target for sterling, but by less than what it would have been using the pre-Brexit path. In sum, we expect the sterling to appreciate by 0.9% per annum, up from last year's Brexit-uncertainty discounted 0.8% p.a., implying an exchange rate at the end of the LTCMA horizon of 1.51.

The yen

In an acknowledgment of Japan's stubbornly low rates of inflation, we have excluded the region from our broad upgrade to DM LTCMA inflation forecasts. All else equal, this widens the projected inflation differential vs. the U.S. such that the yen would have to appreciate even further on the path toward future fair value. As with the euro, our systematic removal of housing inflation from fair value calculations serves to partially offset this.

Japan's current account surplus and attractive long-term valuations together continue to imply a substantial nominal appreciation of the yen vs. the U.S. dollar. While these conditions have been present for some time, the absence of trend yen strength at the same time is noteworthy. Instead, the yen's purchasing power has fallen to levels not seen since 1973, when the country transitioned to a floating exchange rate regime.

Likely contributing to the yen's persistent undervaluation is the continued acceleration of net outbound capital investment, a direct result of the efforts of the Bank of Japan to reflate the economy through ultra-accommodative interest rate policy. As interest rates have collapsed and converged globally, we expect this dynamic to moderate. We expect these reflationary policies to be required for quite some time, limiting our enthusiasm about a vigorous appreciation of the yen.

Pulling this together in our assumption, we see the yen appreciating by 1.7% per annum, up from last year's 1.4%, and an exchange rate at the end of the LTCMA horizon of 90.13.

The Chinese renminbi

At least in the initial stages of this cycle, China's desire to attract investment flows and support its exports' competitiveness will limit the renminbi's near-term appreciation potential. Also, though Sino-U.S. geopolitical tensions have receded from the fore, the likely persistence of the two countries' strategic rivalry is a further structural headwind to the renminbi's appreciation over time.

Longer term, China's opening and transition to a more balanced growth model is central to the administration's goals and offers strong secular support for the renminbi's further appreciation. As such, we do not expect the risk premium for international investors for participating in Chinese markets to normalize fully in the near term. We also caution against expecting a swift ascent of the renminbi to a premier reserve currency status and therefore continue to reflect a somewhat smaller amount of appreciation than a full convergence to our PPP fair value would imply.

These dynamics are reflected in our assumption, with the Chinese currency appreciating by 1.7% per annum, up from last year's 1.2%, and an exchange rate at the end of the LTCMA horizon of 5.29.

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