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Is the U.S. dollar overvalued?

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The U.S. dollar is overvalued and, if history has any lessons for investors, it's that the dollar is set for a multi-year fall, according to Mondrian Investment Partners Ltd.

"The way that we look at currencies generally is to take a valuation approach," says Kevin Fenwick, portfolio manager for global fixed income and currency at Mondrian. "We don't try to forecast short-run currency movements. And the reason for that is we don't believe that we can do that. In fact, we don't believe anybody really can forecast fluctuations in the [foreign exchange] market in the short run."

Instead, the firm looks at purchasing power parity, says Fenwick, which involves deflating all the bilateral exchange rates by the ratio of producer prices in each economy. "The reason why we use producer price indices — and this is quite a standard thing to do — is because producer prices have a strong tradable component, which is particularly pertinent to currency valuations."

Using this approach, it's apparent the U.S. dollar is overvalued compared to other international currencies, he says.

This overvaluation has happened three other times in history: the late 1960s due to high inflation; the mid-1980s, following Federal Reserve policy under chairman Paul Volcker; and in the early 2000s, driven by the technology boom. In all these situations, the U.S. dollar dropped over a multi-year period.

Indeed, Fenwick says the U.S. dollar has followed a regular cycle of overvaluation and undervaluation.

In the past, catalysts have caused a reckoning, and it's difficult to know what the next catalyst will be and when it will occur. Yet, if history is any guide, this will likely be soon and the catalyst is perhaps ultimately what's going on in the world at the moment with coronavirus, he says noting he thinks the world is already in the throes of a global recession.

If the dollar falls as it has historically — all else being equal — institutional investors will see capital losses on the U.S. assets they hold in dollar terms, Fenwick says. However, he notes this isn't a reason to abandon the U.S. dollar because it's the world's most important reserve currency.

"But I think investors and pension plans do need to be cognizant of these long-term swings that we can see in currencies. They do need to step back and look at the long term, and we believe that a globally diversified basket of stocks and bonds is the most prudent course of action."