The Almighty Dollar

October 10th, 2022

Currency In Motion

- The U.S. dollar remains a headwind to international stocks and corporate revenues, but may not continue to rise indefinitely

Unabating Inflation Pressures

- Persistent inflation pressures are likely to keep the Fed on its path in keeping policy restrictive in the near term

Slowing Earnings

- If earnings begin to turn over, there may be further downside to this bear market, justifying an underweight to risk

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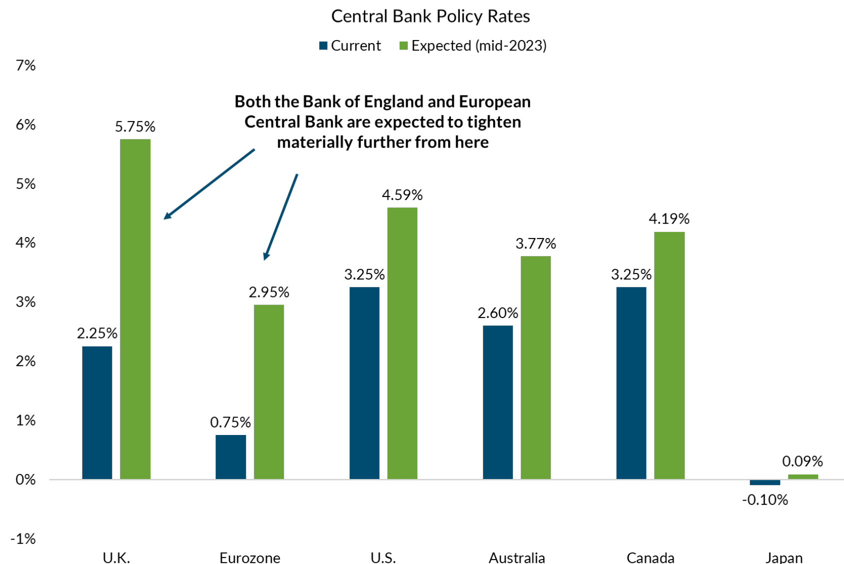
Currency In Motion

- **Dollar On the Rise.** The U.S. dollar has risen sharply off its May 2021 low, as it now stands near its highest level in decades versus major currencies like the euro, the British pound and Japanese yen. Since the beginning of the year, the U.S. Dollar Index, which measures the value of the U.S. dollar against a broad basket of global currencies, has soared more than 17%, now sitting near its 20-year high.
- **Who Will Take the Hit?** When the dollar appreciates, overseas investments for Americans become less valuable when converted back into the home currency, impacting both foreign equities and bonds. However, domestic stocks are not fully insulated given that roughly 40% of the average S&P 500 company's revenues are derived from overseas; some domestically produced goods and services become less competitive abroad as the dollar's strength increases their price. Only the more domestic-focused sectors, such as real estate and utilities, are less exposed to these effects.
- **The Outlook.** The dollar's march to record highs this year is largely driven by an aggressive tightening from the Fed as higher real interest rates continue to attract foreign capital. With other central banks seen as lagging the Fed's commitment to taming inflation, the widening gap in interest rate differentials between the U.S. and other nations is currently providing support for a stronger dollar. However, the Fed may be among the first few central banks to slow its rate hikes, and this interest rate differential could begin to close as other central banks catch up with the U.S. and may eventually reduce upward pressure on the dollar.

The U.S. dollar remains a headwind to international stocks and corporate revenues, but may not continue to rise indefinitely

Chart of the Week:



Source: Glenmede, Bloomberg Data through 10/9/2022
Data shown are the central bank policy rates for each country shown, with current levels in the blue bars and expected levels for mid-2023 in green, derived via futures and overnight index swaps. Actual results may differ materially from projections or expectations.

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Unabating Inflation Pressures

- **Still-Tight Labor Market.** September's jobs report confirmed that the labor market remains tight, with the unemployment rate ticking down to 3.5%, well below the Fed's estimate for the natural rate of unemployment of 4%. Labor force participation fell modestly in September as the U.S. economy continues to fight a demographic headwind, further driving an imbalance in the job market. The dearth of available labor has been a primary driver of still-hot wage inflation, with average hourly earnings clocking another 0.3% m/m rise last month. This further fuels cost-push inflationary factors, something the Fed is actively seeking to rein under control.
- **CPI Preview.** The September print of the U.S. Consumer Price Index (CPI) will be released this Thursday, with consensus expectations calling for an 8.2% annual pace of inflation. The Cleveland Fed's Inflation Nowcast shows September's month-over-month Core CPI reading, which excludes the typically more volatile food and energy components, is tracking 0.5% month-over-month, a level that is still well above the Fed's preferred target range of 0.0-0.3%.
- **Energy Price Volatility.** While the recently sustained decline in gasoline prices has helped offset some cost pressures, there remains much uncertainty over the inflation outlook due to Russia's war in Ukraine and the associated risk with energy supplies. Notably, U.S. gas prices appear to have been on the rise again, following an announcement that OPEC+ would cut their production target by two million barrels per day. While a softening economic backdrop may dampen demand for gasoline, the oil market is likely to see tighter supply in the coming months, which could further boost prices.

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Slowing Earnings

- **Sneak Peek into Q3 Earnings Season.** With the third quarter in the rearview mirror, investors are eagerly awaiting the first glimpses at profit trends into the second half of 2022. Consensus estimates project 2.3% year-over-year earnings growth for the S&P 500 in Q3, a swift drop from Q2's 6.2% annual growth pace. The driving forces for growth are likely to remain inflation sensitive sectors such as energy, industrials, materials and real estate.
- **Growth in 2023.** 2023 earnings growth expectations for the S&P 500 currently sit at 7.9%, a deceleration from its 9.5% estimate as of the end of last quarter. Notably, despite rising fears of recession, consumer discretionary and the industrials sectors are expected to be the primary driving forces of growth in 2023. Meanwhile, tech remains the largest contributor to overall earnings, representing ~30% of the profit base for the broader index and, barring an improvement in the sector, downward revisions are likely to ramp up.
- **Earnings at Risk.** Despite the economic uncertainty surrounding the Fed's campaign to cool inflation, earnings estimates have so far appeared unfazed. For example, consensus earnings per share for the S&P 500 in 2022 sits at $224, only marginally lower than its all-time high of $230. However, the Institute of Supply Management's Manufacturing PMI release last week suggests a slowdown in earnings growth may be in the making, as there is a strong correlation between the two data series. The latest PMI reading of 50.9 follows a previous reading of 52.8, which indicates that the decline may be slow for now, though the data still directionally points to a weaker profit outlook.

If earnings begin to turn over, there may be further downside to this bear market, justifying an underweight to risk

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