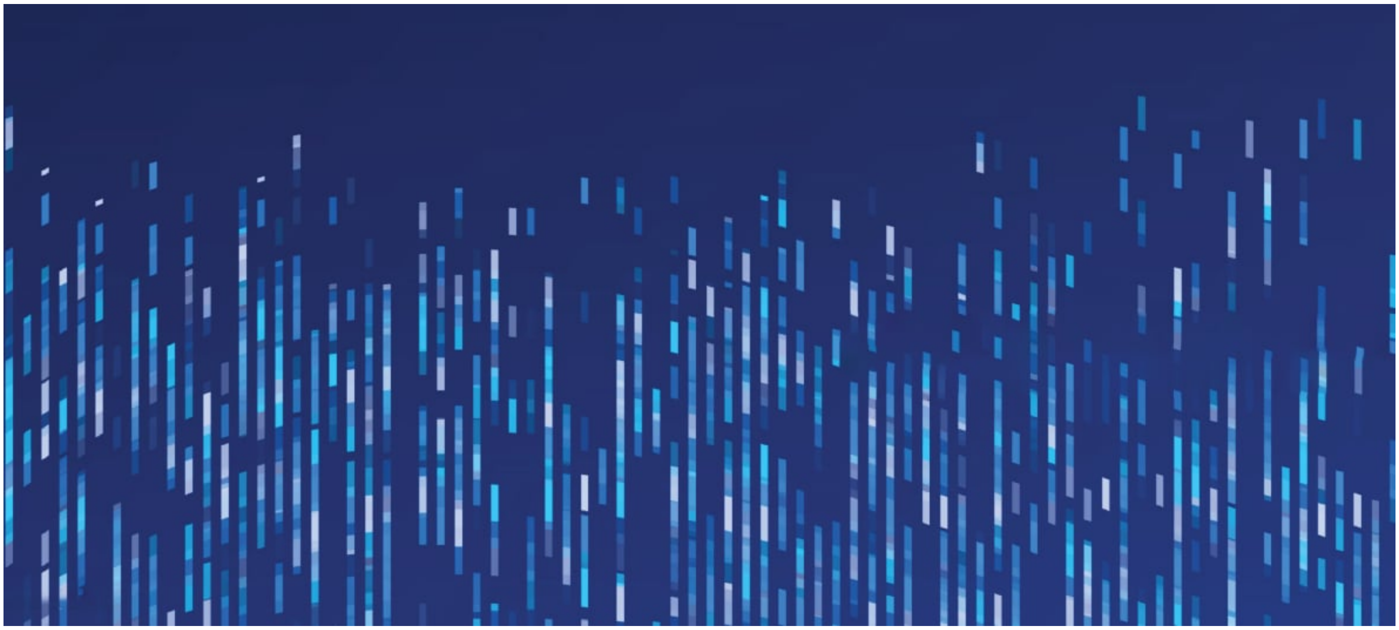

Capital Bytes – October 14, 2022

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Capital Bytes: Does Unusual Dollar Demand Spell Trouble?

Most of us know that the surging U.S. dollar (USD) is adding more stress to the domestic economy as multinational companies experience declines in overseas earnings due to FX conversions. At the same time, American-made goods are becoming harder to sell abroad and even domestically because competing foreign products are getting comparatively less expensive. Aside from the rise in our currency's value, demand for our safe-haven dollar and the cost to borrow the USD are increasing sharply as well. These trends have preceded some ominous financial periods, and the last time we saw USD borrowing costs at this level was in March 2020, just ahead of a global economic shutdown.

It's important to note that dollar demand has seasonal impacts that occur fairly regularly. Each year, the Basel Committee on Banking Supervision, a group of global central bankers and regulators, evaluates and determines how much systematic risk certain banks have. This is done under the Basel III international regulatory accord designed to mitigate risk across the international banking sector by requiring banks to maintain certain leverage ratios and specific amounts of capital on hand. Basel III was devised and adopted by the central banks of 28 countries just after the Great Recession to avert future disasters.

Let’s go back to the spring of 2020. The COVID-19 pandemic had begun to take hold of headlines around the world, stoking global fear as many countries sprang into action to stave off a systematic crisis. At the same time, demand for the safe-haven U.S. dollar surged as bankers across the globe sought to reduce risk. This demand also increases the cost to borrow or “swap” the dollar for foreign currency. We are seeing similar action in the USD right now.

As the Federal Reserve continues its unprecedented rate hike trajectory and carries on with the reduction of its balance sheet, costs to borrow the greenback are once again soaring to pandemic levels. Based on historical levels, the current rates on what are called “cross-currency basis swaps” may be signaling an increased chance of global market stress as demand for dollars jumps. There’s also been a marked increase in the use of the Federal Reserve’s “dollar swap line,” a sort of last-resort liquidity credit line created in 2013 to help deliver dollar-based funding to foreign central banks and keep money markets healthy. One could argue that the swaps market is simply reflecting normal market dynamics as the U.S. maintains a hyper-aggressive monetary tightening regime as most of our partners’ central banks are going the opposite way in an effort to counter recession. If anything, it’s important for market watchers to monitor, along with other data as it flows in.