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WEEKLY ANALYSIS

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THE FED MUST CHANGE ITS POLICY TO AVOID SYSTEMIC RISK

The appreciation of the dollar and high yields disqualify other assets. Rising rates are proving to be a systemic threat. Default risks increase. Dollar liquidity declines. The Fed must change its policy.

Key points

- Long live the US dollar!
- The appreciation of the dollar disqualifies other assets
- A side note on money creation and debt
- 1.25T of additional costs for the Treasury in 2023?
- Rising rates are a systemic threat
- Is the Fed aware of the effects of its policy?
- Increasing systemic risks: the British example
- What will the Fed finally do?
- What are the possible effects on financial markets?

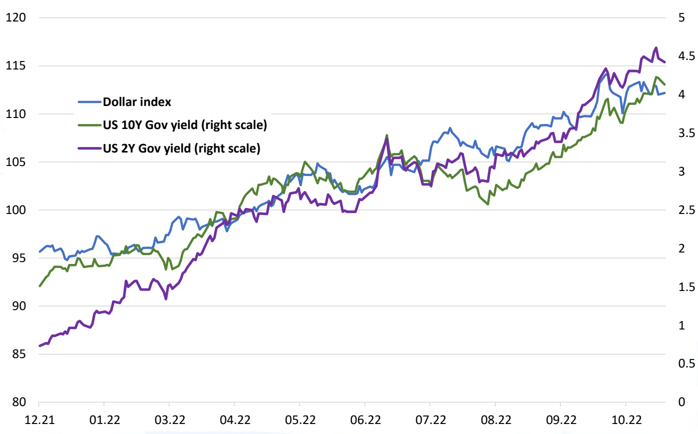
Long live the US dollar !

The dollar has so far been the big winner of the the Federal Reserve's abrupt monetary policy reversal in 2022. The rise in US policy rates from 0.25% to 3.25%, or 300 bps in just five hikes since March, has understandably pushed all government and corporate rates to historic levels in the dollar markets. But the consequences of this policy were global and were observed in all interest rate markets. The negative performance of -20% of the international bond indices is evidence of this exceptional phenomenon over the past nine months. The appreciation of the US dollar is indeed totally linked to the evolution of the Fed's very aggressive monetary policy. It has therefore largely benefited the greenback, whose overall increase measured by the trade weighted dollar index is currently +19%. This average appreciation was much higher for the yen (+30%), but it also included impressive increases in such a short time against the pound sterling (+21%), the euro (+15%), the yuan (+14%) and the franc (+8%).

Dollar appreciation disqualifies other assets

We have mentioned for several months in our economic and strategic analyses that the rise of the US currency could pose significant problems at various levels that would probably end up alerting the US Federal Reserve and would certainly lead it to readjust its monetary policy. The end of the year is looking increasingly likely for this change. At first, it may seem favourable and reassuring to see one's currency appreciate against all other currencies, but we will see that the consequences of a strong dollar can be more negative than it seems. The year 2022 has already shown that dollar cash has been the best asset to hold and that the reasons for its relative strength over the medium term have been the cause of the fall in all other asset classes. By offering the opportunity of a 'risk-free' asset, at least for dollar-based investors, delivering increasing returns throughout the year following Fed rate hikes, the Fed has disqualified all other asset classes that are negatively correlated to its rate hike policy and left only one winner: the dollar.

US government rates (2 and 10 years) and dollar index



Sources: Bloomberg, BBGI Group SA

A side note on money creation and debt

Before proceeding, it should be recalled at this point that dollar creation has been extremely important in recent years, long before the Covid crisis. The explosion in the size of the Fed's balance sheet dates back to the last financial crisis in 2008, which first required the doubling of the size of the balance sheet by creating $1 trillion in one year. The years that followed saw the creation of another 2.5 trillion to reach the colossal amount of 4.5 trillion dollars in 2014.