Global Markets Analyst

Dollar Direction and the Election (Cahill)

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- Recent developments reinforce the pillars that have supported the Dollar's high valuation for much of the last decade. But the approaching US election could change this big picture in a number of ways. Tariffs have a direct influence on exchange rates, so we expect that to be the focus for FX markets in different election scenarios.
- More specifically, we expect the strongest Dollar response to come from a Republican sweep, which would open the door to larger tariff increases in combination with domestic tax cuts. We expect a narrower, smaller Dollar rally in response to a divided Republican government outcome. A Democratic sweep or divided Democratic government would likely result in some initial Dollar downside as markets reprice the prospect of more dramatic changes in tariffs. After recent market moves, we would expect some quick relief in China- and policy-sensitive currencies like MXN, CNH, KRW, EUR and AUD.
- Drawing from our previous research, we outline a number of ways to gauge the potential impact of tariffs on the Dollar. Using event studies from 2018-19 and the recent campaign, CNY could weaken to around 7.40 under our economists' baseline scenario for increased US tariffs on China under a Republican government. Diverging monetary policy implications for the US and Europe could weaken the Euro by about 3% in this case, or closer to 10% in the case of a global baseline tariff and commensurate tax cuts.
- Competing influences on the safe-haven Yen cloud the outlook for USD/JPY, so it is not our preferred FX expression in this particular case. Fundamental analysis generally points to smaller FX impacts than event studies or policy-focused analysis, so we think investors should treat estimates based on the 2018-19 experience with care. And we think markets will not fully reflect our tariff expectations immediately. As a result, we favor longer-dated trade expressions in Republican outcomes than Democratic ones.
- US policies are just one (important) part of the FX outlook. We see upside risks to our baseline expectations of shallow Dollar depreciation off the 2022 peak from continued 'US exceptionalism', but downside risks if China stimulus has a bigger influence on rebalancing global growth than we currently expect.

Dollar Direction and the Election

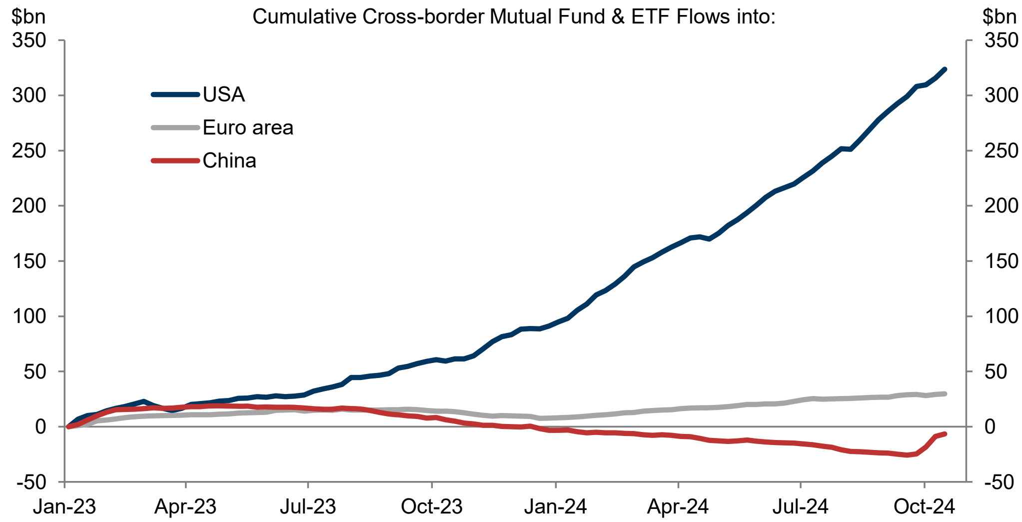
Recent developments reinforce the pillars that have supported the Dollar's high valuation for much of the last decade. We expect that high valuation to gradually fade as global activity and policy settings move into better balance. But, with mounting evidence that 'US exceptionalism' is still very much intact, we still think the risks are in favor of the Dollar being 'stronger for longer' than in our baseline forecasts. The approaching US election could change this big picture in a number of ways, but we continue to think the risks around different policy outcomes are also skewed towards more Dollar strength. This is mostly on the prospect of much higher tariffs, which would shift relative terms of trade and create divergent policy impulses in the Dollar's favor through a number of different channels.

The setup

It is notable that the two most prominent periods of sustained Dollar depreciation in the recent era were in 2017 and 2021, both conspicuously right after US elections. But we think the global circumstances were more important, with both episodes driven primarily by strong growth optimism in the rest of the world. A repeat of 2017- or 2021-style broad, sustained and significant Dollar depreciation seems unlikely to be driven by the US election outcome alone. That kind of shift would likely require some assistance from the outlook for the rest of the world, such as a stronger impact from China stimulus measures than we currently expect. However, with the market becoming more focused on 'tariff trades' in recent weeks, there is a building case for more two-directional near-term hedges into the event.

In our previous note about how the election would influence FX markets for much of this year, we argued that US outperformance and uncertainty associated with the approaching US election would limit Dollar downside. This has largely played out. Though there have been a number of ups and downs, Dollar downside proved to be mostly short-lived. More importantly, even in periods when US data softened, portfolio flows into other jurisdictions were moribund (Exhibit 1). However, outside of the last few weeks, we attribute the majority of the Dollar's strength to divergent economic outcomes and commensurate shifts in policy expectations. Our basic refrain remains that the Dollar's 'challengers' are falling short of what would be required to reverse the portfolio flows into US assets that have formed the pillars of the Dollar's high valuation, and the election seems unlikely to undermine that position.

Exhibit 1: Strong portfolio inflows to the US are the pillars of Dollar strength



Source: EPFR, Haver Analytics, Goldman Sachs Global Investment Research

The scenarios

We believe that FX markets will turn initially on the prospect of higher tariffs and other potential changes in US trade policy, which means the presidential outcome matters more for FX than the composition of Congress. This is partly because our economists expect only minor differences on fiscal policies, but mostly it is because tariffs have a direct impact on currencies. There are a number of channels at work; tariffs raise the cost of US imports, reduce demand for foreign products, and so on. Flexible exchange rates can offset this shift in countries' terms of trade and respond to the diverging growth and inflation impulses tariffs create.

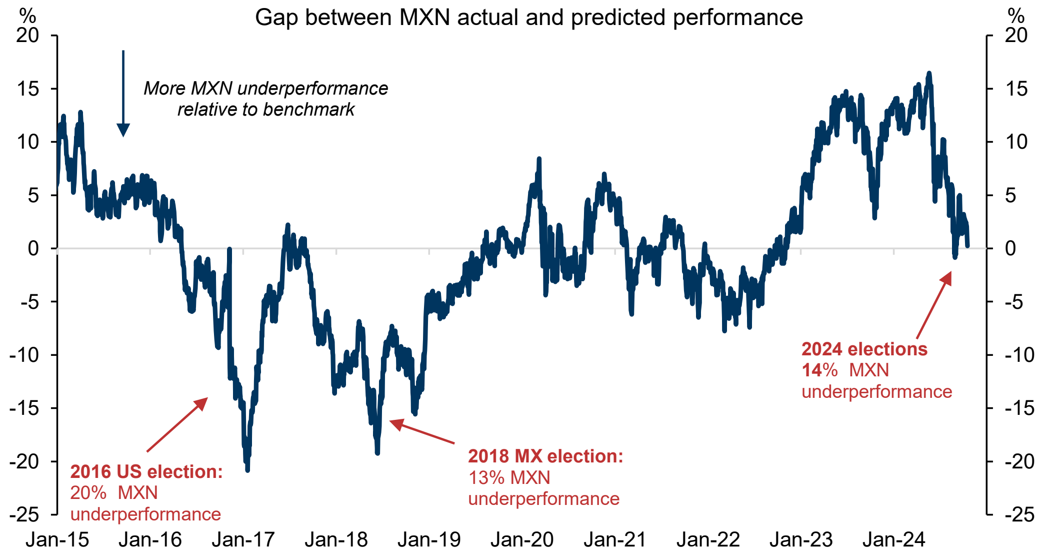
We expect the strongest Dollar response to come from a **Republican sweep**. Even though some tariffs can be imposed by executive action alone, this scenario provides the widest potential for broad tariff changes as some of the proposals could require congressional action. It is also important to note that the Republican party platform has proposed using revenue from a 'baseline tariff' to cut domestic taxes. This would support the Dollar even more as it would act as a domestic fiscal stimulus. In effect, this combination would raise the cost of US imports and lower the cost of doing business domestically. We believe this would have direct and powerful implications for the Dollar on a broad basis.

A **divided Republican government** would likely result in a narrower, and somewhat smaller, Dollar rally. While Republicans could still pursue broader tariff increases through executive action alone, we think markets would ascribe a smaller probability to this outcome given the uncertainty, and the prospect of combining it with a comprehensive change in tax policy would diminish considerably (our economists have estimated that recycling tariff revenues into tax cuts reverses about 60% of the impact on real GDP). In this outcome, we expect FX markets would initially focus on the US-China trade policy implications because the 'groundwork' has already been laid for potential action soon after the next term begins. That is not to say that FX moves would be limited to USD/CNH. As we discuss in the next section, US-China trade policy still has far-reaching implications for FX markets.

On the other hand, a **Democratic sweep** or **divided Democratic government** would likely result in some initial Dollar downside as markets reprice the prospect of more dramatic changes in tariffs. The extent of this reset is a moving target, but we expect the downside to grow in coming weeks as the market will likely continue to price some event risk as the election draws near. The difference between these two Democratic outcomes hinges on the small fiscal boost our economists expect under a sweep, but this should be relatively minor (for FX in particular) relative to shifting tariff probabilities. More broadly though, our main expectation under a Democratic outcome is that FX markets should revert relatively quickly to trading the current macro backdrop rather than political developments. In the current context, that means the Dollar should remain relatively well supported following the initial reaction.

Still, we previously argued that markets were not obviously pricing big dislocations from fundamentals, so there did not appear to be much room to 'price out' tariff risks. That is no longer true. With the moves in recent weeks as markets have focused more directly on the election, there are building trade opportunities for a Democratic outcome that preserves something close to the status quo. For example, recent underperformance in the Mexican Peso now rivals its underperformance vs macro factors heading into the 2016 election, although domestic political factors have also played a role for MXN this time (Exhibit 2). Therefore, we think investors should consider hedges like short USD/MXN, USD/KRW and USD/CNH or long AUD/USD and EUR/USD if market probabilities continue to drift, targeting moves back towards (but not all the way back to) levels that prevailed just after the September US employment report a few weeks ago. That said, we would be more inclined to keep these tenors on the shorter side, unlike under Republican outcomes where we would expect markets to price our policy expectations over a longer period.

Exhibit 2: MXN underperformance now rivals the lead-up to the 2016 election



Source: Bloomberg, Goldman Sachs Global Investment Research

The sources

There are many ways to study the impact of tariffs on exchange rates. These can be broken down into three categories: (i) event studies, (ii) potential policy responses, and (iii) fundamental analysis of the impact of tariffs on trade. In general, the magnitude of predicted FX responses based on the 2018-9 experience runs roughly in that order, with event studies producing the largest moves and fundamental analysis the smallest.

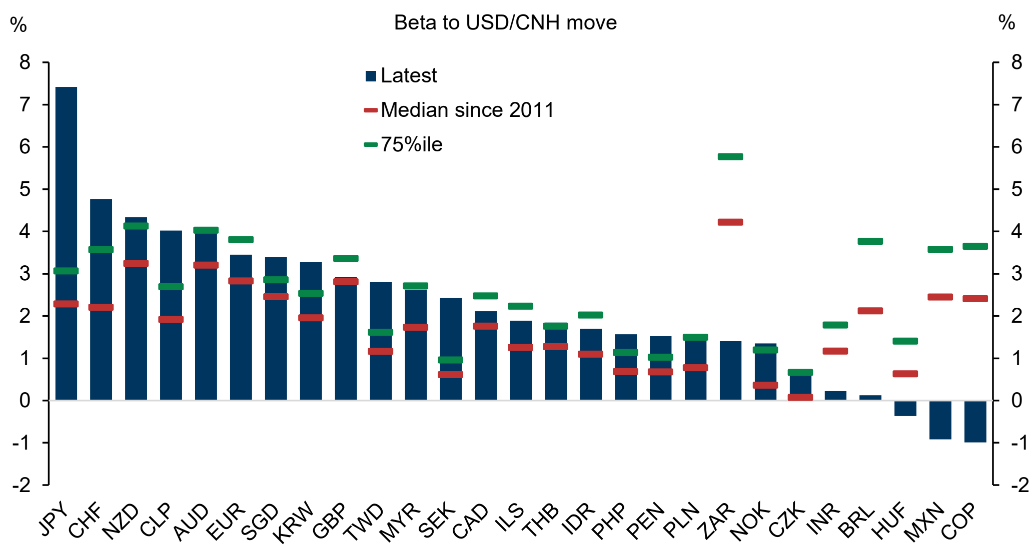
Event studies

Using event study analysis, we have found that USD/CNH increased about 0.7% for each $10bn in implied tariff revenue. Our China economics team estimates that a 60% tariff on all US imports of Chinese goods would raise about $250bn in revenue. Taking into account changes in the importance of US-bound exports to the Chinese economy over the last few years, this implies that USD/CNH could rise to around 8 if policymakers employ the same reaction function. Something closer to our baseline scenario under a Republican government of graduated tariff rates would imply that USD/CNH could rise to around 7.40 using the same analysis. We have found similar results using event studies around key election developments in this campaign.

Back in 2018, we also ran event studies to demonstrate that tariffs on China can affect FX markets through three different channels: (i) weaker China growth expectations, (ii) worsening risk sentiment, and (iii) weakening the Yuan, which is an important regional anchor. Notably, this analysis demonstrates competing influences on the Yen, which tends to depreciate with the Yuan (or higher inflation expectations and steeper curves), but appreciates in periods of rising recession risk. For this reason, we think JPY implications are not as straightforward, and it would not be our preferred vehicle for tariff hedges in either direction without being more confident on the risk market reaction.

In all cases, we expect smaller reactions than these event studies imply. This is partly because both policymakers and markets may be more confident about the resilience of Chinese exports to higher tariffs after the experiences of the last few years. Even in 2019, the FX market response was somewhat larger to the first tariff announcements than later ones. Today, policymakers, companies and investors would all have more experience dealing with shifting trade policies. This is especially important for China-centric moves, because the Yuan is a managed currency and a policy variable, and policymakers could choose to keep the currency more contained, while movements in other currencies would also be limited until it is clear how far the Yuan anchor moves (Exhibit 3). Relatedly, we would not expect the market to fully price these tariff scenarios immediately on election night or even in the subsequent weeks; one reason why event studies yield such large results is because markets do not price tariffs until a policy change is clear and imminent, especially when it is depends on China's currency response. In 2017, when a border adjustment tax was seriously considered in DC, FX markets never fully reflected this potential policy shift despite substantial FX implications. We think a debate around a new baseline tariff would follow a similar pattern.

Exhibit 3: The timing and magnitude of changes in USD/CNH are important components of the broad FX market reaction



Predicted move in each currency versus USD (versus EUR for CEE and Scandies) for a 5% move lower in USD/CNH. Calculated over rolling 1-year horizons and controlling for changes in US Cyclical vs Defensive equities, US 10-year real yields, MSCI China Index and oil and copper prices.

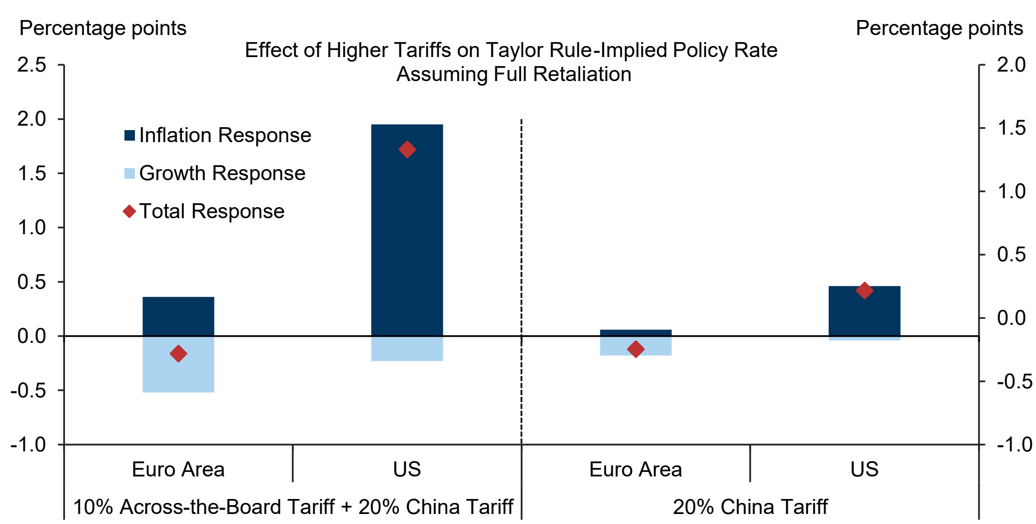
Source: Bloomberg, Goldman Sachs Global Investment Research

Policy responses

Academic research often focuses on the diverging policy implications of shifting trade barriers to gauge the impact on foreign exchange. In principle, higher US tariffs should reduce demand for foreign goods, which in turn lowers foreign inflation, while boosting US consumer prices. These diverging policy impulses have important implications for currency markets. For example, our economists have estimated that a 10% across-the-board tariff in addition to higher tariffs on China would result in around a 150-200bp change in the appropriate policy rate differential between the US and Euro area using a standard Taylor Rule (Exhibit 4). Mapping that into forward rate differentials for a policy-sensitive cross like EUR/USD, it could be worth an 8-10% depreciation on our models.

A narrower trade war focusing on US-China tariffs would follow the same pattern, but to a lesser degree. Our economists estimate this would be worth about 55bps on the Taylor Rule-implied US-EA rate differential, which translates to a roughly 3% depreciation in EUR/USD. Again, a few caveats are in order. There are layers of uncertainty in these estimates and it is far from clear that policymakers would follow the Taylor Rule prescription (or even that they *should*, because tariffs cause changes in price *levels*). But, as our economists have noted, more protectionist US trade policies would be yet another reason for lower rates in Europe, and the ECB has hinted that policy could be more proactive if trade policy uncertainty is back in play. Lately, US-EA yields have been remarkably correlated, frustrating EUR bears, and we think tariffs should put a limit on that. For this reason, we are inclined to 'bump up' these estimates a bit because tariffs would amplify the already-divergent outlook. But once again, the full effect would not be immediate.

Exhibit 4: Taylor Rule shows diverging policy implications from tariffs for the US and Euro area

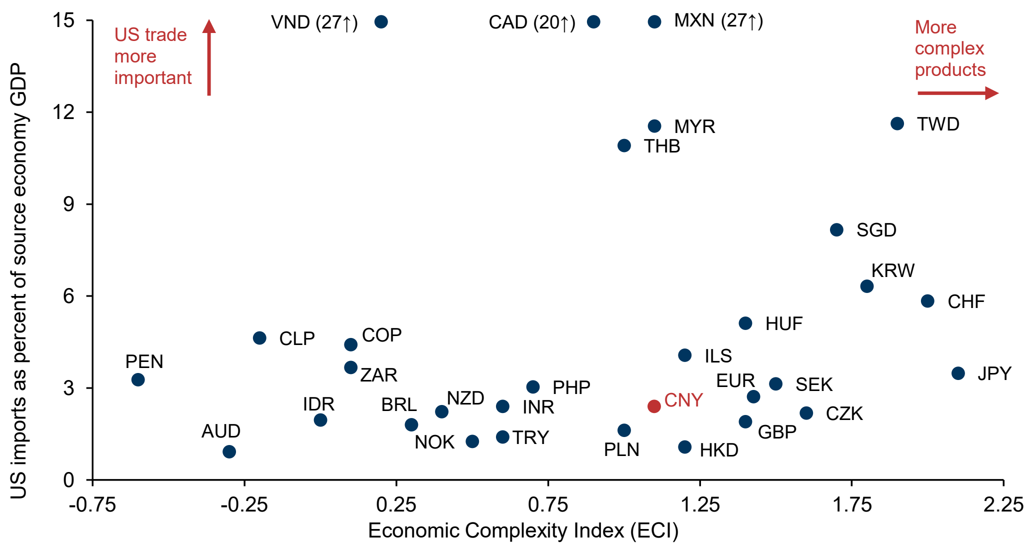


Source: Goldman Sachs Global Investment Research

Fundamental analysis

Other academic research focuses on how much currencies 'need' to respond to changing trade rules in order to offset the tariff impact. This is an oversimplification, but higher US tariffs can be paid through some combination of higher US consumer prices, lower US firm margins, and lower foreign firm margins. The more price-sensitive US buyers are for a particular import from a particular country, the more the exchange rate needs to adjust to shift the cost to foreign producers. Along these lines, we have tried to calibrate the FX impact on EM currencies and Asian FX more specifically by assessing the importance of US trade for different economies and the complexity of the products they produce (Exhibit 5). A growing body of literature has found that the 2018-19 US tariff increases were passed through completely to US prices, which suggests that the exchange rate did not 'need' to adjust much. While this runs counter to historical tariff episodes, it appears that China's more complex product mix and shifting supply chains help explain the surprising result.

Exhibit 5: China's fairly complex product mix and diverse supply chains likely help explain resilience to tariffs



Source: OEC World, Haver Analytics, Goldman Sachs Global Investment Research

The other side

We often encounter the argument that former President Trump frequently states that he wants a weaker Dollar, and would likely push back on the Dollar appreciation that we think his policies would entail. We think this is likely to result in occasional FX volatility, as it did many times in his first term, but not change the overall direction. In our view, if a president *wants* a weaker currency, that is certainly an achievable outcome. But it would require a concerted, cohesive policy effort that runs counter to the rest of the Republican fiscal and trade policies we have discussed in this report. And we are skeptical that a comprehensive 'currency pact' like the Smithsonian Agreement or Plaza Accord can be achieved without a substantially different policy mix. A more plausible (but still unlikely) path to a currency 'deal' in the current context would be if other countries respond to the threat of tariffs by substantially boosting fiscal spending.

It is also perhaps worth noting that we do not see a material downside risk to the Dollar from a 'Truss-style' episode in US fixed income and currency markets, which is another common investor concern we encounter. First, at least initially, the Fed may respond in a conventional hawkish fashion to the fiscal impulse. Second, the pressures on the Pound seem difficult to replicate in the world's global reserve currency. Although wider current account deficits could eventually undermine foreigners' willingness to hold Dollar reserves, higher interest rates could substitute for a weaker currency, and at any rate we have argued that there is currently no real alternative to Dollar assets.

As we mentioned in the introduction, it is conspicuous that the two most significant periods of sustained Dollar depreciation occurred in 2017 and 2021—right after US elections. But we think the context is important. With the benefit of hindsight, we see that Dollar depreciation in 2017 was strongly correlated with portfolio inflows to the Euro area following surprisingly strong growth that was likely catalyzed by China stimulus in 2016. And in 2021, the Covid vaccine discovery less than a week after the US election accounts for the shift in sentiment and growth outturns.

Still, these experiences serve as an important reminder that tariff policy and other fiscal decisions are just one component of a broad range of factors that can influence exchange rates. Estimates of the trade war impact on FX in 2018-19 are relatively small in the broader context, and there are reasons to believe this impact would not be linear if tariff rates rise more dramatically. As the 2017 and 2021 experiences show, there are also important uncertainties stemming from abroad. For example, the size and global impact of recent China stimulus measures are a proximate downside risk to the Dollar if they push global growth in a more balanced direction.

Michael Cahill

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