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Investment roadmap

JULY 2023

AT A GLANCE

- The US dollar has for many decades been the world's dominant currency, widely used in global trade and finance, and the currency of choice for the reserves of overseas central banks.
- However, its role as the dominant currency has diminished somewhat in recent decades, and the dollar is trading at a multi-decade high. Might continued erosion of the dollar's status trigger an extended period of weakness?
- We are sceptical that such a development is in prospect. The US's financial markets remain deeper and more liquid than elsewhere. Moreover, there are no feasible alternatives. For example, China is a large economy, but its capital controls and high political risk mean that the renminbi is not a realistic competitor.
- It is likely that the increased use of financial sanctions by the US in pursuit of foreign policy objectives will incentivise greater use of non-dollar assets, but this process is likely to proceed glacially, with no major implications for the currency's trend.

Will the US dollar retain its reserve currency status?

1. The dollar remains very close to a multi-decade high

The US dollar has been in a bull cycle for over a decade. Despite a moderate pull back in recent months, it remains at a very high level by historic standards. Indeed, in the past fifty years, it has been at a higher level in fewer than five (chart 1). In this article, we consider a possible longer-term challenge which may emerge over time – the status of the dollar as a reserve currency.

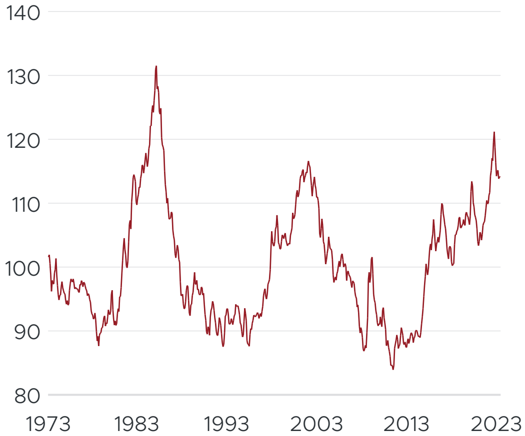
2. The dollar's status as a reserve currency: declining but still dominant

i. The dollar as a reserve currency

A simple definition of a reserve currency is one which is held as an asset by overseas central banks – for example dollar assets held by the Bank of England – in addition to other reserve assets such as gold. Reserves are traditionally held to allow central banks to intervene in foreign-exchange markets to support the domestic currency in difficult market conditions, and to ensure the maintenance of orderly markets. However, there is a broader definition of the dollar's reserve currency status, incorporating for example its role as the invoice currency for global trade, and the currency denomination of issuance of loans and bonds.

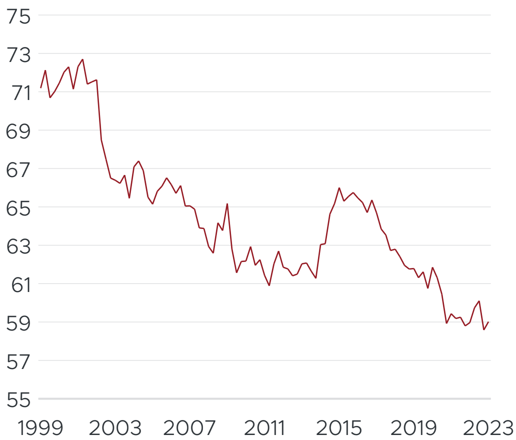
On any measure, the dollar is by some considerable margin the world's leading reserve currency, and has maintained that status over several decades. For example, some 60% of foreign-exchange reserves are held in dollars (chart 2). In addition, around 45% of international trade is invoiced in dollars, and over 50% of global loans and securities are dollar-denominated. In foreign-exchange markets, the dollar is still involved in over 90% of transactions.

Chart 1: US$ trade-weighted index (1973 = 100)
Against basket of currencies, adjusted for inflation



Source: Federal Reserve

Chart 2: US$ share in global foreign-exchange reserves (%)



Source: IMF

The current debate over the dollar's diminishing status, and even possible replacement as the global reserve currency, is a hardy perennial, not a novel topic.

ii. Declining dollar reserve status currency over many decades

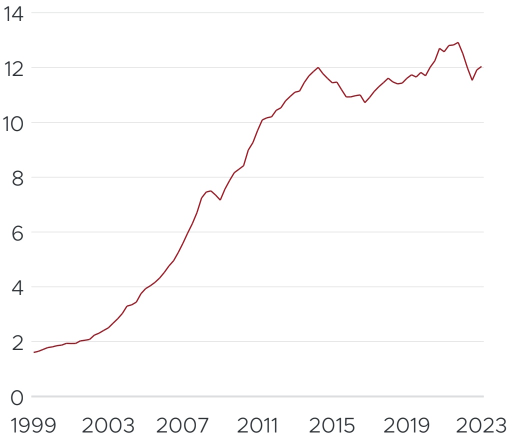
This dominant role notwithstanding, the dollar's role as the leading reserve currency has on some measures already been eroded, slowly but materially, over many decades. From this perspective, the current debate over the dollar's diminishing status, and even possible replacement as the global reserve currency, is a hardy perennial, not a novel topic. For example, under the Bretton Woods global currency system created in 1944, the dollar was pegged to gold, and all member currencies were pegged to the dollar, with very limited scope for fluctuating. Intervention by central banks to maintain this system was almost solely in dollars, so that in 1973, the share of dollar reserves in total reserves was around 80%.

As noted, the current level is 60%, so the long-term downward trend is very evident, although it is not linear. In the 1990s, for example, the share of dollar reserves bucked the long-term trend, rising from 50% to 70%, so that the current 60% share is broadly similar to the level in the early 1980s. The decline in share from 70% to 60% in the past couple of decades should also be seen in the context of a rise in global reserves by a factor of six since that time, so the inflows into the dollar from this source have still been considerable, despite the lower share (chart 3).

From this longer-term perspective, the dollar has already become progressively, if erratically, less dominant. Importantly, however, its somewhat diminished status has not been associated with an enhanced status for a single competitor currency. For example, the Euro, which accounts for some 20% of global reserves, has not benefited. Rather the beneficiaries of the dollar's relative decline have been 'second-tier' currencies – the Australian and Canadian dollars, the Chinese renminbi and a long 'tail' of much smaller currencies (chart 4).

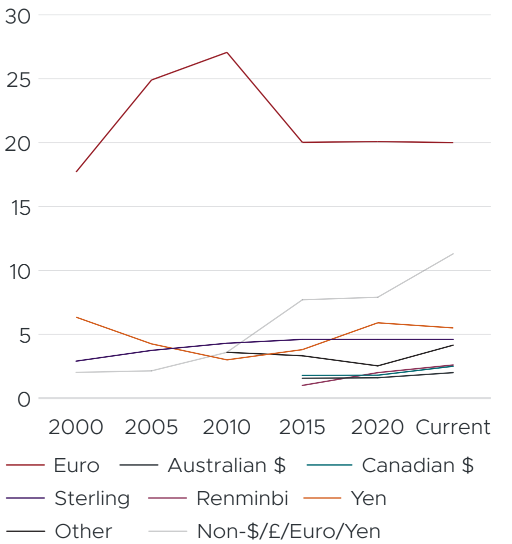
Moreover, on other measures of reserve currency status, there has been no similar erosion of status over the past couple of decades. The proportion of global trade invoiced in dollars has retained a centre of gravity around 45%, with no discernible long-term trend. In addition, the share of public external debt denominated in dollars has risen to some 80%, up from 60% in 2000.

Chart 3: Total global reserves (US$ trillion)



Source: IMF

Chart 4: Reserve composition by currency (%)



Source: IMF

Several reasons have been cited as to why the dollar's role should have become less relevant, including the emergence of alternatives such as the Euro and the diminishing share of the US in the global economy.

3. The dollar as a 'hegemonic' reserve currency

However, the dollar has not been dislodged as the dominant reserve currency. What explains the maintenance of this status? Two factors in particular have been important.

i. Size and liquidity of US financial markets

An important element underlying the dollar's reserve currency status has been the size and liquidity of a wide range of financial markets in the US, the absence of capital controls, and a broadly stable economic and political environment for most foreign investors. These features have not been uniformly evident elsewhere. More generally, the relationship has worked both ways: as overseas investors have invested in dollar assets, the depth of US markets has grown, costs have declined, and these markets have become more attractive for overseas investors.

ii. Single 'hegemon' is the norm for reserve currencies

The longer-term history of reserve currencies is that there tends to be a single 'hegemon', reflecting the efficacy of a single dominant country for the stability and efficient functioning of the global financial system. For example, the dollar replaced the pound, which had previously been the hegemonic reserve currency, after the second world war, although the full transition took decades. The financial stresses on the UK economy and sterling associated with two world wars were also required for this change to occur.

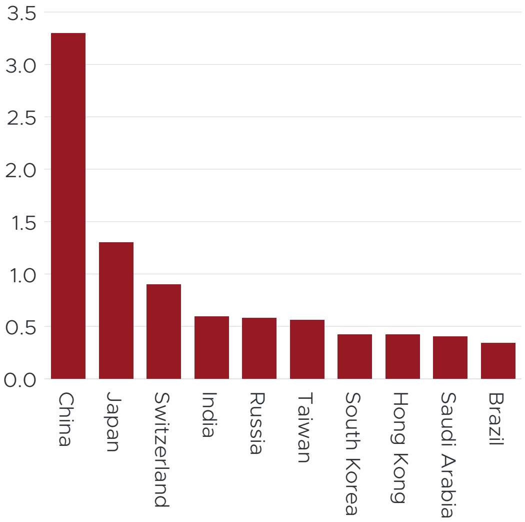
4. The dollar's slowly diminishing reserve currency status

Given the dominance of the US dollar under the Bretton Woods system, it is unsurprising that there should have been some loss of status since its demise in 1973. Several reasons have been cited as to why the dollar's role should have become less relevant, including the emergence of alternatives such as the euro and the diminishing share of the US in the global economy. We would emphasise three other developments.

i. Declining transactions costs

Some of the advantages which the dollar has enjoyed as a reserve currency may be eroding, but glacially. As noted, one reason why US markets were attractive to non-US residents was low transactions

Chart 5: Reserve by country (US$ trillion)



Source: IMF

costs. Consider a Mexican importer wanting to pay a Canadian exporter. In principle, a spot transaction between the peso and the Canadian dollar is a straightforward solution. However, this market in the past has been relatively illiquid, so the transactions costs would have been relatively high, and a cheaper route would have been to do the separate legs against the more liquid US dollar. However, as the cost of dealing in the less liquid currencies has declined, so the need for transactions to be routed through the dollar has weakened. This effect, is however, very slow-moving.

ii. Reserve diversification

Another factor underlying the dollar's share of global foreign-exchange reserves has been the opportunity for some central banks to diversify their reserve holdings. In this context, the distribution of holdings of global currency reserves is important. China is of particular significance, the legacy largely of the material cumulative current account surpluses run over time. In principle, these might have been expected to cause the renminbi to rise, but the Chinese authorities systematically sold renminbi and bought dollar assets to attenuate the latent currency appreciation. As a result, China has over $3 trillion in reserves, with Japan a distant second at $1.3 trillion and Switzerland third with $0.8 trillion. (chart 5).

China's reserves are materially higher than those required to achieve narrowly defined economic goals, such as intervention to stabilise the currency in speculative market conditions. In these circumstances, other objectives such as attaining higher returns and adequate diversification have come into play. A targeted diversification of reserves by China has probably had a material impact on the increased share of non-dollar currencies in recent years. However, even in China's case, the rate of diversification remains low, and the bulk of its reserves are still dollar-denominated.

It is also relevant that China has always held a smaller proportion of its reserves in dollars, so that as it has accounted for a greater proportion of global reserves, the relative demand for dollars across all central banks has diminished.

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iii. Currencies linked to the dollar

Countries which are in some way linked to the dollar have a higher requirement to hold dollar reserves to manage the 'peg'. Over the past decade, there has been a slight decline in the countries which manage their currencies this way, reducing somewhat the requirement to hold dollar reserves.

5. The dollar's role as a reserve currency – looking forward

We set out below a range of influences which may lead to a further slow reduction in the dollar's role as a reserve currency. The emphasis here is on 'slow', because there is unlikely to be a viable competitor to replace the dollar in this role for a considerable period of time. Moreover, there are multiple influences on the dollar. The past couple of decades have seen a slight reduction in the dollar's dominance as a reserve currency, at a time when the US currency has in general been strong. Even if a gradual erosion of the dollar's reserve currency status were to take place, we would be sceptical that, as in the recent past, it would be a material driver of the dollar's underlying trend. The main influences we have identified in this context are set out below.

i. The renminbi as a reserve currency – possibilities and limitations

The increasing dominance of the US economy in the post-war years was an important influence in establishing the US dollar as the dominant reserve currency. Will the decreasing (though still considerable) dominance of the US in the global economy undermine the dollar in the same way that the relative decline of the UK economy proved to be inconsistent with sterling's reserve currency status some decades back? Similarly, will the economic ascent of China mean that at some stage the renminbi will inevitably replace the dollar as the dominant reserve currency, or at least become a more credible alternative?

This is unlikely in both the short-term and indeed the long-term. It is important to note that the size of an economy in isolation says little about its possible role as a reserve currency. Size is a necessary but not sufficient condition for reserve currency status. For example, the Euro area economy is broadly of a similar size to the US, but the Euro has clear subsidiary status as a reserve currency.

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The starting point for the renminbi is not auspicious in this context. It barely squeezes into the top ten in terms of reserves (2% of the total) or global payments. China's capital controls, the limited liquidity and breadth of its financial markets, and political risks associated with international tensions, as well as the unpredictability of the Chinese government's intervention in a wide range of markets, are major constraints on a potential international role for the renminbi. While these conditions persist, the potential for it to develop as a reserve currency will be highly limited.

ii. Digital reserve currencies and cryptocurrencies

One unknown in this context is the Chinese central bank's attempts to develop a digital reserve currency to influence global finance and e-commerce, and to diversify away from dollar financing. China is not alone amongst central banks in this respect, but its central bank seems to have made more progress than others, with several successful domestic and cross-border trials. By contrast, the Fed and the Bank of England have yet to make final decisions in this context.

Advocates of cryptocurrencies have suggested that these could also displace the dollar as reserve currencies, but for now, this claim appears fanciful. Unlike digital currencies issued by central banks, cryptocurrencies do not have the status of legal tender. In addition, they tend to be volatile niche markets which do not offer the liquidity and ease of access of more conventional markets. Moreover, some of the digital coins which have been issued – for example the JP Morgan coin – have been tied to the US dollar, so cannot be seen as an asset independent of the US currency.

iii. Global politics

The political risk associated with the dollar's reserve currency status lies less in China, and more in the US itself, as in recent years it has leveraged the dominant role of the dollar in pursuit of foreign-policy objectives. Even when dollars are held in financial institutions outside the US, access to the US is typically required to settle dollar transactions. The US has severely restricted access to its markets

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through sanctions on regimes such as Iran and Russia. For self-evident reasons, China is likely to attempt gradually to reduce further its exposure to the US dollar across a range of activities, but its ability to diversify quickly across other reserve currencies is limited by the lack of available opportunities. The 'nuclear option' involving widespread sales of dollar assets into renminbi seems infeasible, as the resulting inflows would lead to unsustainable currency strength.

Inevitably, as the US has exploited the dollar's reserve currency status in pursuit of diplomatic objectives, a range of foreign governments have attempted to reduce their reliance on the US dollar. These activities have included building up reserves in gold rather than US dollars, with the unexpected surge in gold prices at the end of 2022 attributed to a surge in central bank purchases. Other developments have been the development of contracts in non-dollar currencies, non-dollar swap lines, digital currencies and non-dollar payment processing systems.

For example, the share of Russian exports to Brazil, India, China and South Africa invoiced in US dollar fell from around 85% in mid-2018 to around a third by the end of 2022. This move should, however, be seen in the context of the low level of Russian exports to these countries. While the direction of travel is interesting, the likelihood is that very substantial reductions in exposure to the dollar will be relevant only to a small proportion of global financial markets and trade.

A further political risk relates to the US itself. While there are benefits to being a reserve currency, there are also costs – for example a stronger currency than would otherwise be the case, potentially penalising the trade sector, or the need to supply dollars to the rest of the world in a crisis. If a more distinct 'America first' position were to be taken politically, involving a widespread diminished commitment to the US's overseas obligations, the reserve currency status could be lost – but in circumstances in which severe financial stresses would become evident, both in the US and elsewhere.

As the US has exploited the dollar's reserve currency status in pursuit of diplomatic objectives, a range of foreign governments have attempted to reduce their reliance on the US dollar.

5. Conclusions

The long-term decline in the dollar's importance as a reserve currency on some measures is likely to continue, but given the lack of feasible alternatives we expect this to occur very slowly. Moreover, since the dollar has been a very strong currency over the past decade, a period when its reserve currency status has on some measures diminished, we do not believe that there is an inevitable link between the currency's underlying trend and its reserve currency status.

Public markets

EQUITIES

Valuation

Earnings

Positive
Health care; Industrials; US

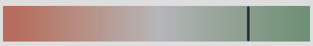
Negative
IT; Communication Services; UK

Market background
June saw equity markets move sharply higher as market breadth started to broaden beyond the large cap technology sector. It was the US equity market that led the way mainly driven by multiple expansion, the price to earnings ratio of the S&P500 has moved from 19x to 20x, although we have witnessed some marginal improvement in earnings revisions. Cyclical sectors like discretionary, industrials and materials moved decidedly higher whereas defensive sectors (utilities, health care and staples) lagged noticeably.

Targeted exposure
We have relatively low exposure to the tech sector due to our concerns over valuation and over-enthusiasm for all things AI. We find more value in defensive growth such as industrials and healthcare whilst energy is a long term structural theme.

GOVERNMENT BONDS

Short maturity



Long maturity

Positive
0- to 6-year US TIPS, nominal and inflation-linked Gilts

Negative
>5-year European sovereign bonds, Japanese government bonds

Market background
After hiking interest rate to 5-5.25% target range, we think the Fed is nearing the end of its tightening cycle. We think the Fed will then hold rates above 5% until core inflation shows cleared sign of cooling. With the 10Y treasury yield sitting 140bp below cash rates, we have limited appetite to extend duration at this stage. We believe the ECB will continue to hike up to 3.75%, leaving the bund curve steeply inverted as well, limiting appetite for long-dated EUR sovereigns. Despite an upside surprise on UK core inflation, with Gilts now yielding 200 bps above eurozone peers, we think there is a lot of bad news priced in. We also think the BoE may underdeliver in terms of rate hikes, creating attractive value in the 0-5Y segment of the Gilt curve.

Targeted exposure
We continue to target the 0-5Y segment of the US Treasury curve but are getting more constructive on UK duration. We expect the German sovereign curve to bear steepen, limiting appetite for EUR duration.

Public markets

CORPORATE AND EMERGING MARKET DEBT

– Asset class outlook +

Investment grade credit

High yield

EM debt

Positive
£IG credit, 0-5Y €IG & $IG credit, short-dated subordinated bonds, AAA/A securitisation, US Agency MBS

Negative
US HY, long-dated US IG, High Yield Emerging Markets

Market background
IG credit spreads tightened in June, but returns were overall muted across currencies, as sovereign yield rose. £IG underperformed due to the surge in Gilt yields. The move higher in Gilt leaves £IG yields at an attractive ~6.6% at the end of June, offering one of the highest premia against $IG (~5.6%) over the past 10 years. High Yield spreads tightened further in June, delivering positive returns. Within higher yielding part of the market, AT1 and corporate hybrids outperformed, benefiting our core credit strategy.

Targeted exposure
We find best value in £IG, based on our constructive UK rates outlook and a spread pick-up over $IG. We maintain exposures to 0-5y $IG and €IG, which offer attractive yield for a limited duration risk. We maintain a defensive stance in High Yield as we expect credit defaults to pick-up. Similarly, we maintain an IG bias in EM corporate and sovereign debt.

STRUCTURED PRODUCTS

– Asset class outlook +

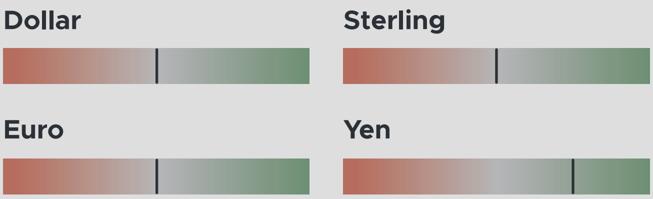
Market background
Over the course of the recent rally we have seen yield generating products begin to mature successfully, paying back their principal in the process. Rates volatility remains elevated, but the rest of the cross asset volatility space has repriced dramatically YTD, with equity volatility resting towards 5 year lows. Volatility selling structures are not attractive here – but given the spike in funding in the front end and cheap vol, capital protected notes or similar participation structures look interesting. We continue to look for attractive asymmetry in the space, this month initiating a trade which captures the outperformance of US small caps over the Nasdaq over the next 18 months – returning over double any outperformance, versus in line any underperformance.

Public markets

HEDGE FUNDS

Market background
Global macro: these strategies seek to profit by being on the right side of policy shifts and economic implications, both on a relative or directional basis. A more normalised interest rate and inflation environment may prove fruitful for systematic strategies that seek to capitalise on sustained momentum and trends in either direction, though sharp reversals can be harmful. Discretionary macro strategies, on the other hand, are generally nimbler and more dynamic in navigating change and pivots. Taken together, the two approaches offer significant diversification benefits to a portfolio, and we expect macro strategies will be critical in navigating through the environment ahead. Unencumbered cash levels now receive some return benefit, providing a slight tailwind for those strategies that use derivatives.

CURRENCIES

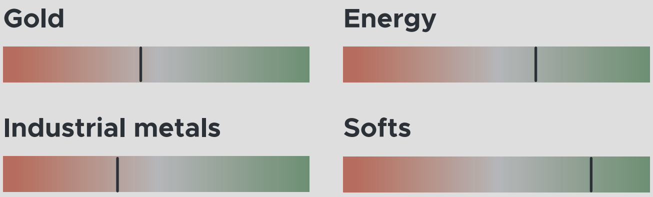


Market background
The trade-weighted US dollar has broadly round-tripped in the first half of 2023 and we maintain our neutral view on the USD in portfolios. We heard a very consistent story from the major central banks at this Summer's ECB Forum in Sintra, such that the Fed, ECB and Bank of England are all signalling to markets that they should expect continued resilience in the fight on inflation and that there is more to be done. As a result, we are not expecting a near-term divergence between the majors and this underpins our neutral stance.

Targeted exposure
We believe that the Japanese Yen is reaching levels where authorities may have to intervene in the build-up to the Bank of Japan's next policy meeting on July 28th, as a result we like adding JPY exposure at current levels. We have been tactically constructive on the Polish Zloty into this year's elections.

Public markets

COMMODITIES



Market background
Industrial metals have broadly continued to struggle over the last month as the stuttering Chinese recovery takes its toll and consumption figures have disappointed alongside hawkish commentary taking hold. Gold has struggled on USD strength whilst the US debt ceiling was also resolved, which was ultimately what drove the gold price to a peak in 2011.

Targeted exposure
We still view the backdrop as constructive for gold over the medium term and hold it as a diversifier, with the broader backdrop of stubborn inflation and economic growth concerns still in play. Our views are relatively unchanged this month following the recent reallocation to target more direct soft ag exposure where we view supply side dynamics in the medium term as being particularly attractive.

Private markets

Quarterly returns (%)

Index	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Private equity	**1.2%**	**-3.7%**	**0.1%**	**-0.2%**
Buyout	1.1%	-3.1%	0.0%	0.0%
Growth/Expansion	1.5%	-7.8%	4.0%	-1.3%
Private debt	**2.1%**	**-2.3%**	**2.7%**	**0.4%**
Direct lending	1.0%	-2.6%	6.4%	3.4%
Distressed	2.9%	-1.6%	-0.8%	0.5%
Mezzanine	3.5%	0.0%	-1.7%	-0.7%

Source: Saranac

Private equity

With rising interest rates and a constricted leveraged loan market, borrowing costs have increased significantly over the last 12-18 months which have resulted in a negative market environment for large private equity funds. The current macroeconomic conditions have led to an unfavourable exit environment for managers that have positioned themselves to exit existing assets. The increased cost of debt has made leveraged buyouts assets, at the marked valuations, less attractive to potential buyers. As a result, valuations have been trending down, with multiples contracting more than two turns down.

However, whilst this could be an unfavourable environment for holders of assets, this could present an opportunity for those that are seeking to deploy capital. Historically, we've seen that the most successful vintage years for private equity typically follow challenging economic periods and bearish equity markets. The internet bubble (early 2000's) and 2008 global financial crisis has been examples of this. In addition, since 2010 we've seen that private companies have averaged a 20% discount relative to the S&P 500 on an enterprise value to revenue basis, in 2022 this discount widened, with private companies trading 40% cheaper than the public counterparts.

Private credit

Private credit has proven to be a viable alternative for investors amid rising interest rate environment. The pullback in leverage loan issuance and continued retreat of traditional lending institutions have positioned private debt providers with a favourable environment for deployment. Private creditors are now able to negotiate more favourable terms, higher premiums, and better downside protection. Therefore, lenders that have deep expertise and lead in underwriting capabilities are going to be in a position to underwrite very favourable transactions. However, we do expect to see pain in this area of the market, largely for those that hold existing paper, as increased borrowing costs deteriorate the financial health of many companies resulting in deteriorating interest coverage ratios and higher EBIDTA addbacks, resulting in losses for lenders in the form of lost interest income and potentially unrecovered principal. The surge in rates by private credit issuers could further increase these default risks, underlining the importance of thorough due diligence and credit analysis.

Sources

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UBS credit strategy report: "US outlook: from neutral to bearish credit into 2H as credit risks compound"

Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries

Record levels of secondary volume as investors seek to rebalance portfolios has resulted in a very attractive pricing environment

Special situations

Favourable market environment given the likely stress corporates will face in a higher rate environment

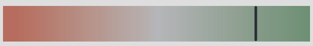
Venture capital

Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

Infrastructure

More attractive given supply chain issues and geopolitical uncertainties

Real estate



Pricing is unattractive given the narrow spread (in some cases negative) between cap rates and the risk-free

GP stakes and financing

Opportunity of higher yield and greater downside protection as a result of attractive secondary pricing dynamics

Real assets

At risk from weak growth environment

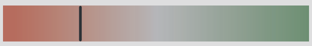
Private debt

A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

Leveraged buyouts

EBITDA multiples have begun softening and hence in time valuations could again become attractive

Mid-market growth



A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short-term

ABOUT SARANAC PARTNERS

We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

Our business combines the personal touch of a private office with the capability and breadth of a large institution. Our firm has strategic shareholders, outstanding technology, broad capabilities and the highest standards of corporate governance. Saranac Partners is a signatory to the United Nations Principles of Responsible Investing (UNPRI).

OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.

Strategy. Planning, governance and oversight

Financing. Access to diverse sources of capital

Investments. Allocation and deployment of capital

Corporate advisory. Supporting corporates and business owners

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