

Strong Dollar scenario likely to persist and could intensify

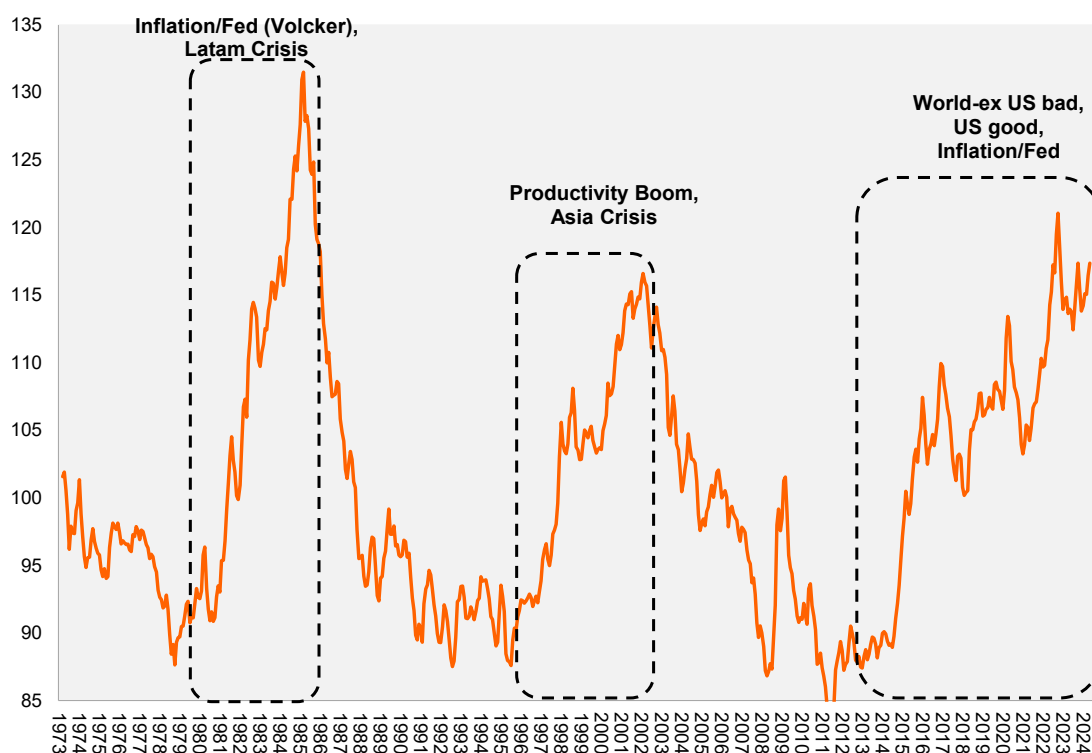
- ▶ This is the first in a series of two articles that seek to explain the recent strength of the dollar and prospects for the currency. In this report, the goal is to identify the fundamentals for this movement, assess whether there is room for additional appreciation, and point out the implications for Brazil and other emerging economies. In the second report, we will investigate whether there is a trend for the American currency to lose its dominant status in international markets.
- ▶ We attribute two main reasons for maintaining a historically high level of the dollar in real and broad terms: (i) the divergence of US monetary policy from the rest of the world, given the country's so-called "exceptionalism" in terms of resilient growth and more persistent inflation, which is leading to a postponement of Fed cuts and an increase in the US interest rate differential compared to other economies; and (ii) the increase in geopolitical risk amid the war in the Middle East, the conflict in Europe, and the growing trade tension between China and the US.
- ▶ Looking ahead, considering our scenario for developed central banks (four Fed cuts and seven ECB cuts by the end of next year), we estimate an additional dollar appreciation potential of around 1.5% by the end of the year. We assess that this appreciation could intensify, depending on global geopolitical tensions. Specifically, we estimate that every 10% increase in the ratio between gold and copper prices (a metric we evaluate as the most representative of geopolitical risk at the moment) leads to a 2% appreciation of the dollar, all else constant.
- ▶ For emerging countries, a stronger dollar should contribute to more contained interest rate cut cycles going forward. We note that the currencies of countries with relatively low interest rate differentials compared to historical standards are the ones that depreciated the most this year. One of these is the Brazilian Real, whose movements have a high historical correlation with the dollar. Our expectation of a strong dollar ahead, combined with a challenging domestic environment, recently led us to revise the BRL to R\$ 5.15 per dollar (from R\$ 5.00) in 2024 and R\$ 5.25 per dollar (from R\$ 5.20) in 2025, and the terminal Selic to 10.25% (from 9.75%).

1. Why is the dollar so strong?

The Real Effective Exchange Rate (REER) for the United States¹ is near historical highs (see chart). In the past, moments of greater dollar strength were in the late 1990s and early 2000s, driven by the strong performance of the US economy and amid international financial crises, and in the 1980s with the monetary shock to control inflation.

¹ The Real Effective Exchange Rate (REER) for the United States is a measure of the dollar's strength, calculated by the Federal Reserve (Fed). It is a weighted average of the currencies of the United States' most important trading partners by bilateral trade volume.

USD REER



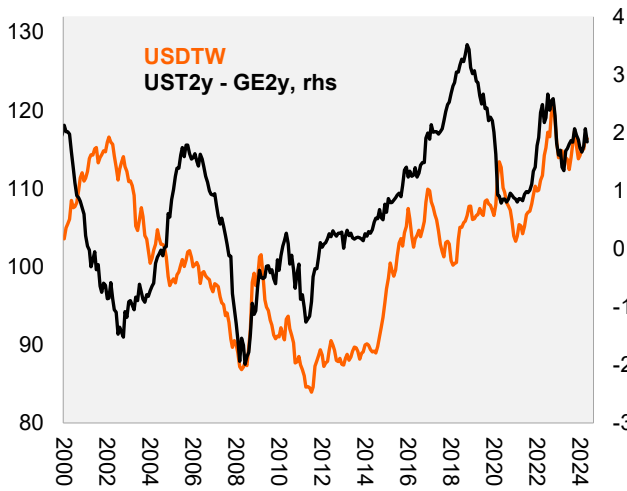
Source: Fed, Itaú

Currently, the moment is one of greater dynamism in the US economy compared to its peers (in a trend commonly characterized as "American exceptionalism") and a challenge of disinflation (see charts) amid geopolitical tensions with wars in the Middle East, between Russia and Ukraine, and greater barriers between the West and China. We will seek to model these effects below to decompose the dollar's variation and estimate the sensitivity of macroeconomic and geopolitical changes on the currency's strength.

We have simplified the level of the dollar in real terms over the years according to three factors: (i) the divergence of the US monetary policy cycle from the rest of the world; (ii) the geopolitical premium; and (iii) terms of trade, through the correlation with agricultural and metallic commodities.

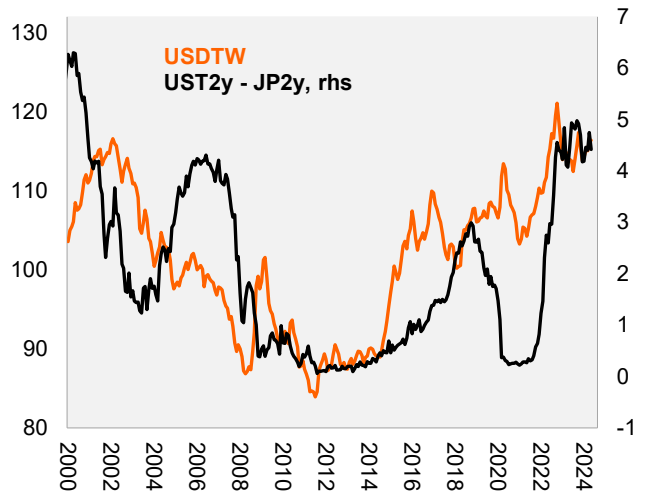
The monetary policy divergence factor is captured mainly by the US interest rate differential relative to other economies (see charts). In periods of higher growth and more pressured inflation, the US monetary policy is expected to remain more restrictive compared to the rest of the world, resulting in a stronger dollar. We considered the differential relative to Europe and Japan in the model due to their global economic relevance and the exceptional nature of Japan's monetary policy of extremely low interest rates.

USD vs Rates Differential (US - GE)



Source: BBG, Itaú

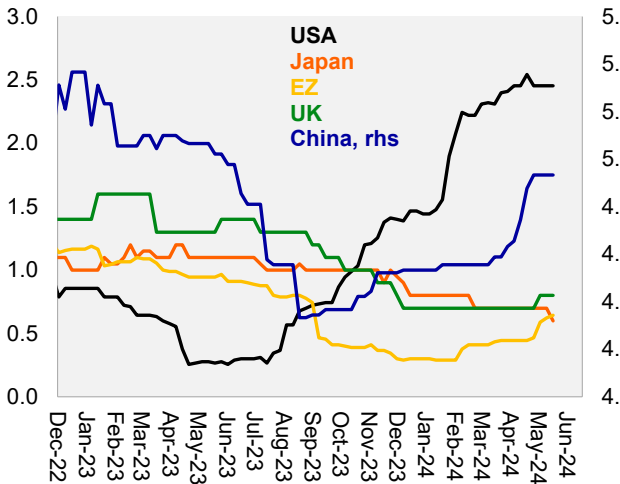
USD vs Rates Differential (US - JP)



Source: BBG, Itaú

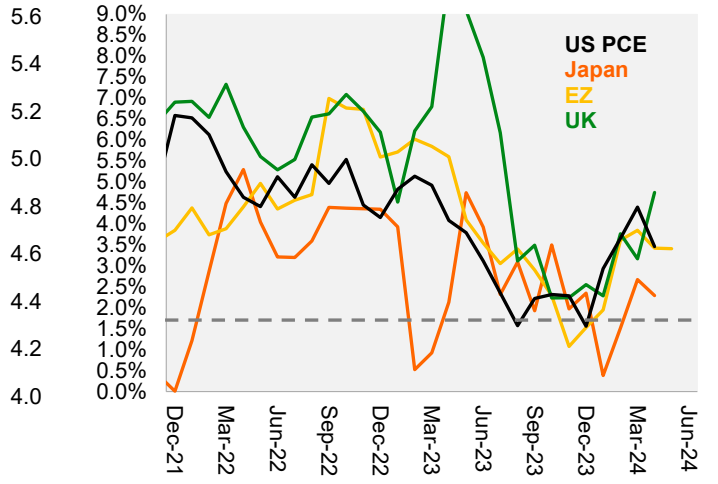
Specifically, since the beginning of the year, the Fed has been postponing the rate cut cycle amid more persistent inflation and resilient activity (see charts). On the other hand, in other developed economies, signs of falling inflation are a bit clearer, which should allow for an earlier start of monetary easing, as is the case with the ECB (see our latest scenario publication [here](#)). As a result, the US-Germany and US-Japan interest rate differentials have increased and pushed the dollar higher since the beginning of the year.

2024 GDP consensus



Source: BBG, Itaú

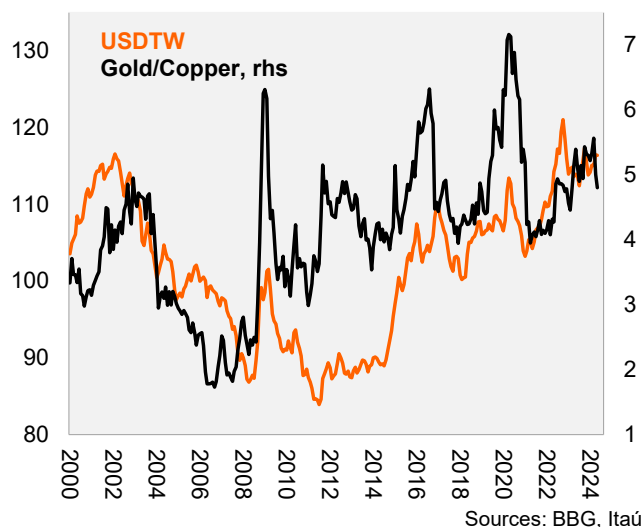
Core Inflation 3mma saar



Source: Haver, Itaú

The geopolitical risk factor is captured by the ratio between the price of gold and copper. The higher price of gold is associated with a weaker dollar as it is seen as a store of value and an alternative to the dollar and assets denominated in this currency, either for geopolitical or economic reasons. In a more uncertain global geopolitical environment, for example, countries may see risks in holding reserves solely in dollars, fearing sanctions or blockages. Additionally, gold, due to its intrinsic value, limited supply, historical retention of value, and universal acceptance, is seen as a good hedge against periods of high inflation. On the other hand, copper is a commodity representative of the global manufacturing cycle and the synchronization of growth among countries, which are associated with a weaker dollar. The ratio between the two commodities is, therefore, a good metric to capture the perception of geopolitical risk, as seems to be the case recently, with the war in the Middle East, the conflict with Russia, and the growing trade tension between China and the US, among other events in the past (see chart and table).

USD vs Gold/Copper



Gold-to-Copper reaction amid geopolitical or global economic events			
Event	Start (-1d) +60d	Gold-to-Copper ratio	Variation
Gulf War	Aug-90	2.88	17.7%
	Oct-90	3.39	
World Trade Center Attack	Sep-01	4.17	3.8%
	Nov-01	4.33	
Invasion of Iraq	Mar-03	4.34	10.9%
	May-03	4.82	
2008 financial crisis/ LB bankruptcy	Sep-08	2.39	86.1%
	Nov-08	4.44	
China-US trade war	Jan-18	4.17	8.2%
	Mar-18	4.51	
Covid-19 Pandemic	Mar-20	6.51	9.5%
	May-20	7.13	
Russia banned from SWIFT after invading Ukraine	Feb-22	4.22	1.6%
	Apr-22	4.29	
Russia cuts gas supplies to EU	Apr-22	4.27	14.5%
	Jun-22	4.88	
Israel attacks	Oct-23	5.05	5.9%
	Dec-23	5.35	

The terms of trade factor is incorporated through the price of agricultural and metallic commodities. A rise in commodities is associated with a weaker dollar because the US is a net importer of commodities. An increase in these prices, in addition to potentially impacting inflation and signaling more robust global growth, leads to a deterioration in the US terms of trade. We chose to exclude oil from the analysis due to the change in its correlation with the dollar over the years, likely reflecting the fact that the US has become a net producer of the commodity since 2020.

Thus, combining the three determinants mentioned, we estimate the following model (see performance chart below):

$$\ln(REER) = \alpha_0 + \alpha_1 * (UST2y - GE2y) + \alpha_3 * (UST2y - JP2y) + \alpha_4 * \ln(ICIx) + \alpha_5 * \ln\left(\frac{Gold}{Copper}\right) + \varepsilon$$

Where:

REER: Real Broad Effective Exchange Rate (REER) for the United States

UST2y: US two-year interest rate

GE2y: German two-year interest rate

JP2y: Japanese two-year interest rate

ICIx: Itaú-calculated index of metallic and agricultural commodities

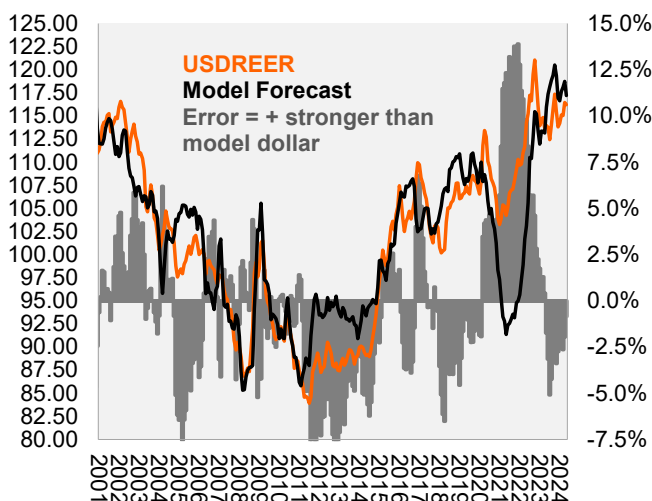
Gold: gold price in dollars per ounce

Copper: copper price in dollars per pound

ε : error term

The estimated coefficients are such that, all else constant: (i) each 0.25 p.p. Fed cut weakens the dollar by 1.3%; (ii) each 0.50 p.p. ECB cut strengthens the dollar by 0.4%; (iii) each 10% increase in the gold/copper ratio strengthens the dollar by 2%; and (iv) each 10% increase in agricultural and metallic commodities weakens the dollar by 0.7%.

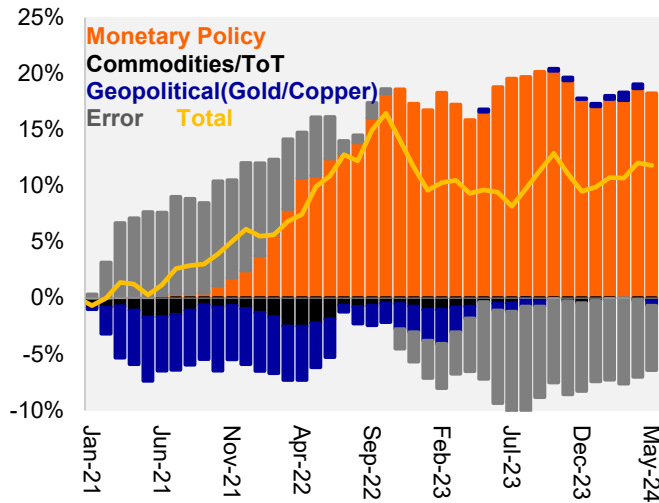
USD REER Model



Source: BBG, Itaú

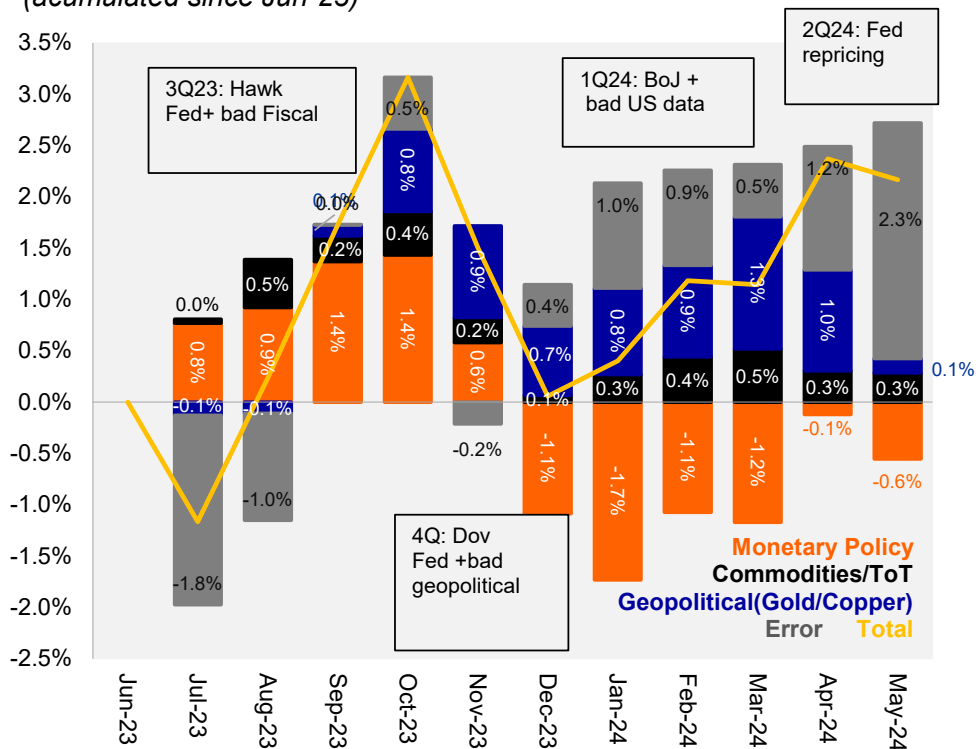
Based on the estimated coefficients, we decompose the weight of each of the three factors in the dollar's variation (see chart). In the accumulated movement since December 2020 (11.8% appreciation), the monetary policy component was predominant for the appreciation of the US currency (18.2%). The geopolitical premium, which consistently contributed to the depreciation side until April 2023, is now a recurrently appreciative force (-0.5% at the margin). Finally, the terms of trade factor had a more marginal contribution over the period (-0.2% at the margin).

USD REER movement decomposition
(acumulated since Dec-20)



In the last 12 months, the dollar appreciated 2.2%, with significant short-term movements, largely driven by monetary policy (see chart). In the third quarter of last year, the Fed's tougher stance and the perception of a worse US fiscal situation led to an increase in the interest rate differential and a stronger dollar. In the fourth quarter, weaker US and global inflation pushed the dollar down, but the higher geopolitical premium from the conflict in the Middle East offset it upwards. In 2024, in the first quarter, US inflation proved stronger, but the market's interpretation was that this could be a transitory rebound. At the same time, the Bank of Japan exited negative interest rates, contrary to the monetary policy cycle of the rest of the world, which also contributed to a weaker dollar. Finally, in the second quarter of this year, April was marked by a strong repricing of US interest rates, pointing to a delay in the start of easing with the persistence of strong activity and inflation data, although with some softening in May.

USD REER movement decomposition
(acumulated since Jun-23)



2. Is there more room for dollar appreciation?

The dollar's behavior going forward will depend mainly on the divergence of monetary policy between the Fed and other central banks and the evolution of geopolitical tensions.

We expect cycles of four 25 b.p. cuts by the Fed and seven by the ECB, while the market prices around five by the Fed and four by the ECB. In the US, strong activity, a resilient labor market, and a monthly inflation rate above what is consistent with achieving the target in the short term justify the Fed starting the cut cycle only in December this year and making just three more cuts next year. In Europe, weaker inflation and activity are in line with the ECB starting cuts at the June meeting and a total budget of seven cuts.

The realization of our scenario could lead to an appreciation of about 1.5% of the dollar (see table). The US-Germany and US-Japan interest rate differentials should increase, generating an isolated appreciation of 1.3%. Adding a small 2% drop in metallic and agricultural commodities by the end of the year, we estimate an appreciation of 1.5%. On the geopolitical side, each 10% rise in the gold/copper price ratio leads to an additional 2% appreciation of the dollar in all scenarios.

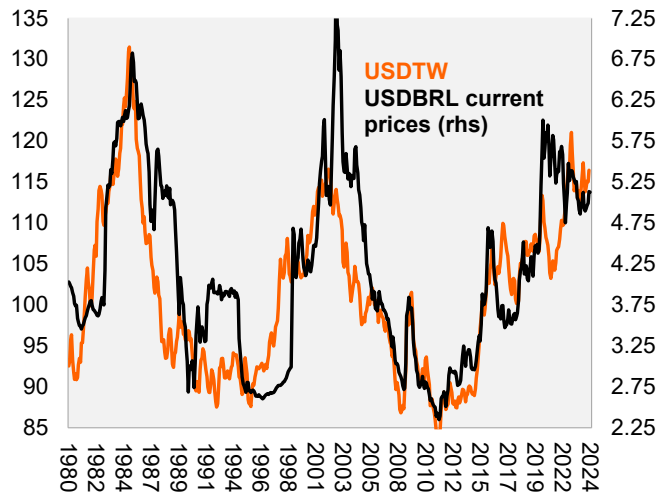
USD REER performance vs current: base case*						
Fed Cuts 25-23		0	1	3	4	6
ECB Cuts 25-23	3	5.7%	4.4%	1.9%	0.7%	-1.7%
	5	6.1%	4.8%	2.3%	1.1%	-1.3%
	7	6.5%	5.2%	2.7%	1.5%	-1.0%
	9	6.9%	5.6%	3.1%	1.8%	-0.6%

*Gold stable at current levels; 2% metal and agro commodities drop

3. What are the implications for Brazil and other emerging markets?

The historical correlation between the Brazilian Real/Dollar exchange rate and the REER is high (correlation coefficient around 0.8; see chart). Our expectation of a strong dollar ahead, combined with an unfavorable external environment, recently led us to revise the BRL forecast to R\$ 5.15 per dollar (from R\$ 5.00) in 2024 and R\$ 5.25 per dollar (from R\$ 5.20) in 2025. Additionally, also partly due to a worse external scenario, we revised the terminal Selic rate forecast to 10.25% p.a. (from 9.75%).

USD REER vs. USDBRL current prices

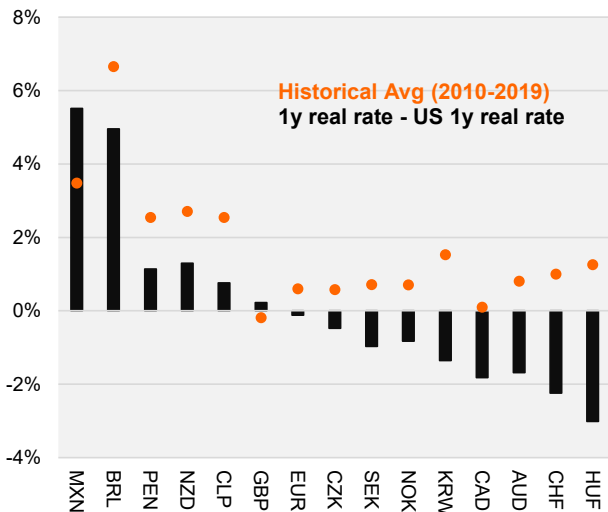


Source: BBG, Itaú

For other emerging markets, the consequences of a more hawkish Fed and a stronger dollar should be similar, with several central banks either delaying the start of the monetary easing cycle or reducing the pace of ongoing cuts, in addition to limiting the extent of cut cycles.

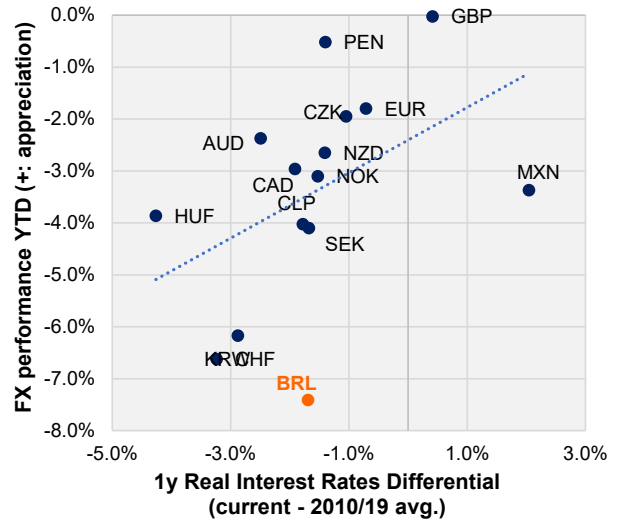
We note that currencies are responding to relatively low interest rate differentials compared to the pre-pandemic historical standard. Countries with low real interest rate differentials compared to the pre-pandemic period are seeing their currencies more penalized (see charts), which should contribute to generally maintaining more restrictive monetary policy. In short, with a delayed Fed cut cycle that also tends to have a reduced budget, we believe the strong dollar scenario should persist and may intensify, generating more negative consequences for currencies whose central banks have a lower interest rate differential relative to the historical average.

1y Real Interest Rates Differential



Source: BBG, Itaú

Interest Rates vs FX



Source: BBG, Itaú

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