

Posted on April 7, 2022

# The Beginning of the End for Bretton Woods Implies De-Dollarization

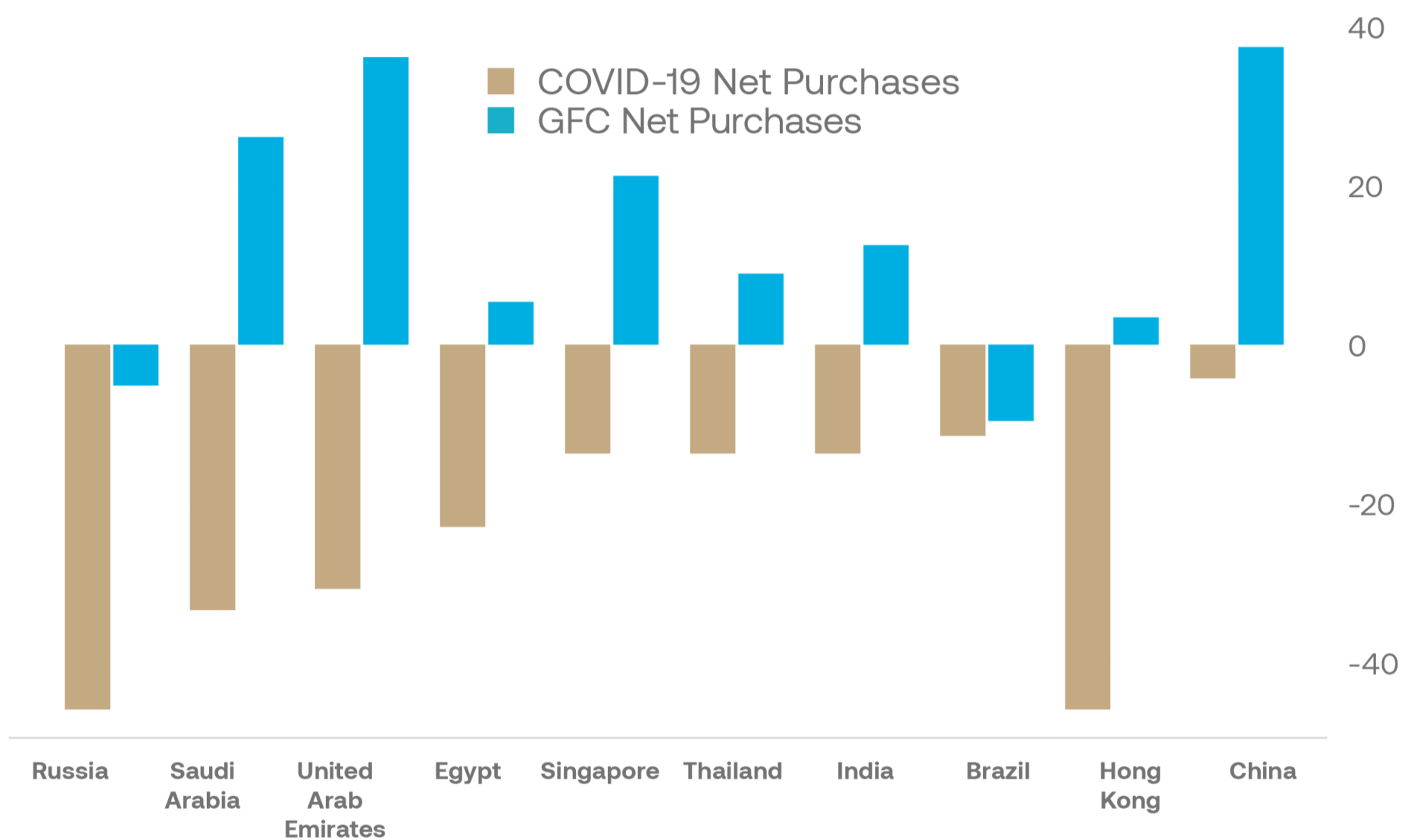
As I mentioned before, we believe globalization peaked around 2008 and has been slowly but steadily declining ever since the Global Financial Crisis. Moreover, the two most recent global events – the pandemic and the Russian invasion of Ukraine – have only accelerated that trend by exacerbating policymakers' reliability concerns when dealing with less-than-friendly state actors. Whether they manifest themselves as US shortages of masks made in China during the pandemic or Russia holding its oil and natural gas exports over Europe's head as it invades European territory, these issues are forcing Western governments to reassess the benefits of the hyper-globalization that occurred during the Pax Americana. In other words, they are realizing that the efficiency of the global supply chain may not be worth the trade-offs in both security and stability. On balance, redundancy and reliability of inputs may be worth the cost to consumers of higher prices. All else equal, globalization is a deflationary force, while de-globalization is an inflationary one.

A corollary to deglobalization may be de-dollarization or the breakdown of the Bretton Woods system where the US dictated the terms of the post-World War II landscape by pinning the US Dollar at the center of the global financial and trading system. The concerns I mentioned around security, stability, and reliability are universally reverberating around the world. Non-western governments are also reassessing the trade-offs. Specifically, they are questioning the desirability of the US Dollar as the global reserve currency. As this next chart suggests, unlike during the Global Financial Crisis, many central banks around the world were net sellers of US Treasuries during the Covid-19 pandemic. This disdain for Treasuries was not limited to foes like Russia but extended to close US allies like Saudi Arabia, the United Arab Emirates, and Singapore. To borrow a Cold War era phrase, even non-aligned nations like Brazil and India sold rather than bought US government bond obligations. In other words, the demand for US Dollars is waning around the world, among friends and enemies alike.

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### Your Dollars Are Not Good Here Anymore: COVID vs. GFC Purchases of US Treasuries Among “Friends” & “Foes”

Source: Weiss, C.R., (January 28, 2022) “Foreign Demand for US Treasury Securities during the Pandemic” FEDS Notes, Board of Governors of the Federal Reserve System

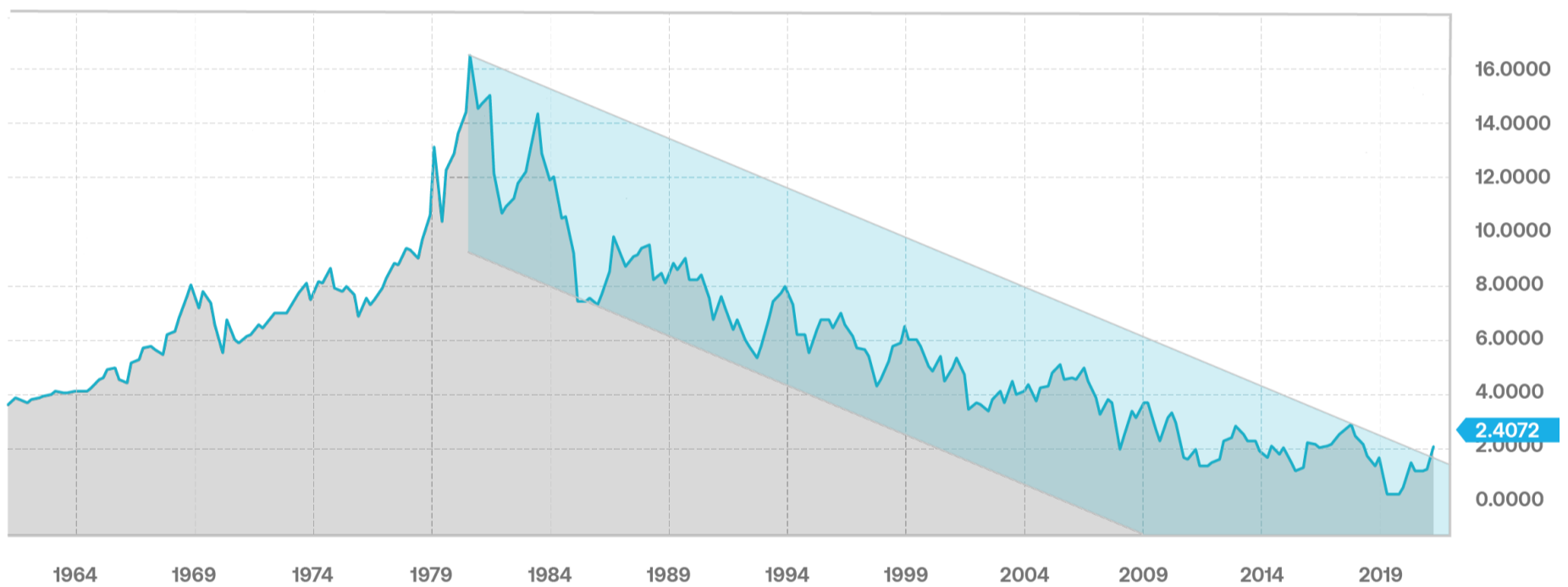


While Putin may have made a grievous mistake when he invaded Ukraine, he may not have been the only one that committed an error in judgment, although he is certainly more obvious. However, the Americans, Europeans, and Swiss may too have committed a major policy blunder, even if a more subtle one that may not be apparent for many years. By freezing the Central Bank of Russia’s foreign currency reserves, the West has announced to the rest of the world that their Dollars, Euros, and Swiss Francs are no good anymore. When the Dollar is weaponized as an instrument of foreign policy, it is reasonable to expect defensive maneuvers.

Of course, the Western retort would be that this sort of pariah status is only reserved for “aggressors” and “enemies.” But in the world of geopolitics, your friend in one generation can be a foe in another. Two current and strident allies of the US were our main enemy combatants in World War II – Germany and Japan.

Eighty years is a long time, but central banks should have the long view when deciding where to place their country's surpluses. Another issue that looms against the demand for Dollars is the US's deteriorating fiscal position. American fiscal deficit spending because of the pandemic reached 25% of GDP. In Europe and China, those figures were much lower, 15% and 5%, respectively. According to IMF forecasts, structural budget deficits in the country will average 4.9% of GDP until 2026, versus 2% before the pandemic. Over time, persistent budget deficits will reduce savings and ultimately drive the neutral rate of interest higher. A higher neutral rate, in turn, will push bond yields upwards as well. Even though the move up has been quite dramatic so far this year, look for yields to grind higher over the next several years, characterized by successively higher highs and higher lows. Nothing lasts forever and trends always reverse. This chart shows that US treasury yields peaked in the early 1980s amid Fed Chair Paul Volker's inflation-fighting regime and have been making successive lows ever since – lower lows and lower highs. Has this 40-year bond bull market ended? We think this may be likely and would position for a reversal of this Reagan-era trend.

**End of the 40-Year Bond Bull Market? US 10-Year Treasury Yield Hit a Peak of 15.84% in 1981** | Source: Bloomberg, data as of 3/29/22



Now, let us be clear, we are not arguing that the US Dollar is about to lose its place as the global reserve currency overnight or even suddenly. It is not easy to dislodge the world's reserve currency because there is a certain inertia to that standing due to positive network effects. The Greenback's pole position is underpinned by the strength of the US economy, the depth of its capital markets, and the fact that most of the global trade is still settled in US Dollars. As the next chart shows, the level of Dollar reserves has held rather steady over the past five years. In fact, more than 60% of all foreign bank reserves and 40% of the world's debt are denominated in Dollars. But the most important reason it still dominates is that there is no credible alternative out there currently.

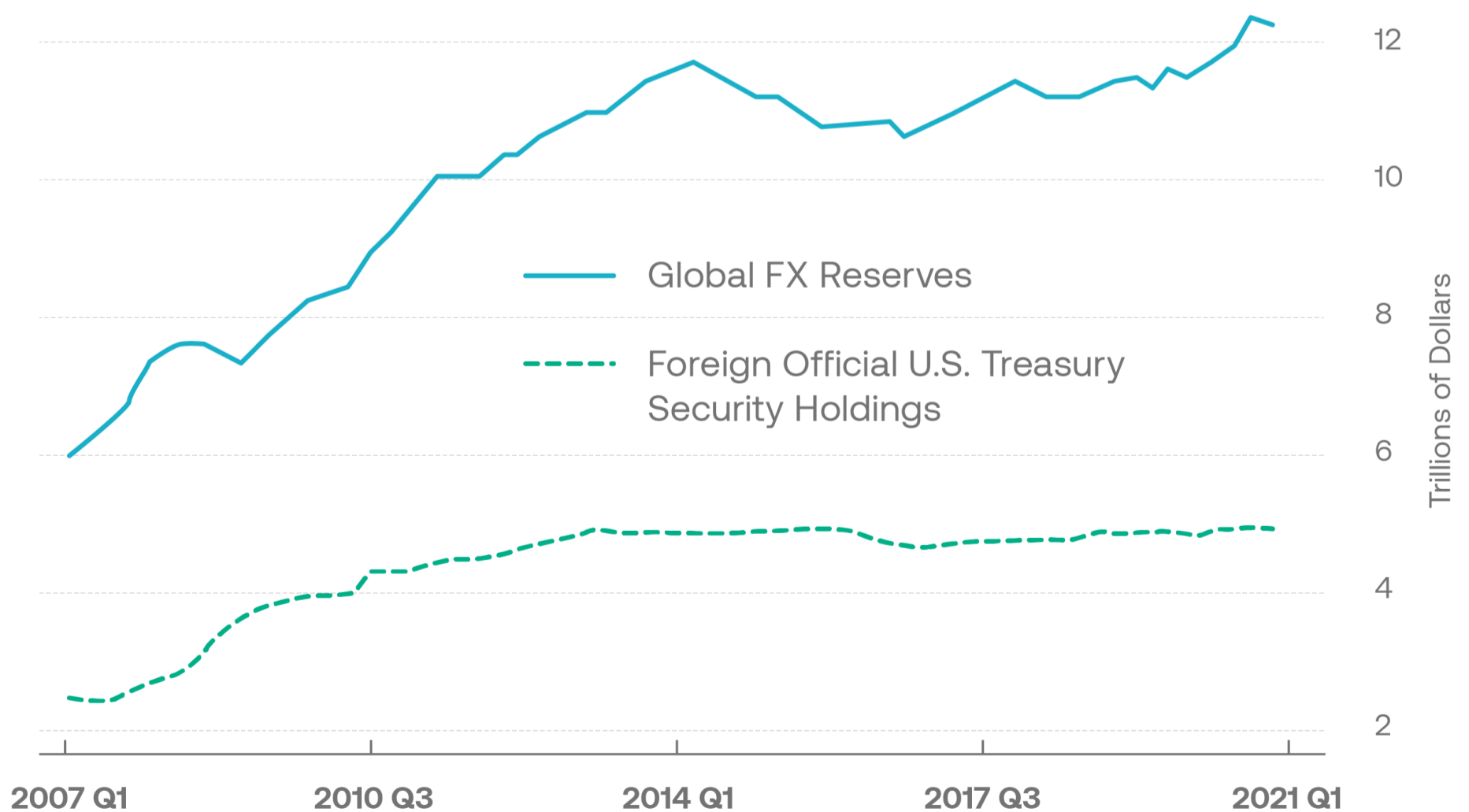


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The European Union is like the US in terms of economic size and the strength of its financial markets, but the Continent has many structural impediments to attaining dominant reserve status, primarily the lack of both a fiscal union and military power. The UK and Switzerland are both too small as a share of global GDP to seriously consider the British Pound Sterling or the Swiss Francs as alternatives. The Chinese Renminbi is an obvious candidate, but China too has issues that prevent this, namely that the country maintains a closed capital account and it is not freely traded. Indeed, the Renminbi only accounts for 2% of global foreign exchange reserves, despite the country approaching a quarter of global GDP. It is not surprising to read the news that the Saudis are negotiating with the Chinese to settle oil purchases in the Renminbi, and the Russians surely are accepting it as payment for their energy exports today to circumvent Western sanctions. Yes, it would be premature to signal the Dollar’s demise as it will not yet go the way of the Roman Aureus, the Spanish Real, or the British Pound Sterling until US power wanes significantly from current levels, and that is not likely soon. But we could see a situation where the level of Dollar reserves matches the geopolitical reality we mentioned earlier – the first among many – as the marginal demand for Dollars falls as central bankers continue placing less of their surpluses in Treasuries. In that sense, the most important development over the last few weeks may not be Cold War II, but the first stage of declining Dollar hegemony.

### The US Dollar Has Plateaued as a Global Reserve: Global FX Reserves & Foreign Official Investor Holdings of US Treasuries

Source: US Treasury International Capital Data and IMF COFER



“The level of Dollar reserves has held rather steady over the past five years.”

If this thesis holds, US rates will have to go up to entice further buying of Treasuries as they cheapen. The more likely asset bubble, then, exists not in US equity markets but in its sovereign bond market where real yields are still negative despite the recent selloff. As interest rates grind higher, investors would want to own real assets: rental properties, high dividend companies, farmland, agricultural commodities, and industrial metals. “Old” economy sectors like industrials, energy (both hydrocarbons and renewables), miners, and utilities. As central banks around the world purchase and repatriate as much gold as they can, investors would not want to stand in front of that trend either. The precious metal has the added luster of being an attractive geopolitical hedge and outperformer during periods of higher inflation and lower growth. Owning Chinese government bonds is also an attractive option as that, in our view, remains the most attractive bond market in the world. As more trade and reserves settle in Renminbi, it should keep them well bid and it has an attractive carry. Imagine the flows into that market if global reserves rise from the paltry 2% of current reserves to 5% or even 10%. These levels seem conservative in a world where the US has weaponized the Dollar and other countries have taken note.

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### Ahmed Riesgo – Insigneo’s Chief Investment Officer

Mr. Riesgo oversees all the company’s research and investment functions. This includes investment strategy, devising and implementing the firm’s global market views and asset allocation, communicating them to its clients and the public, and managing the firm’s model portfolios. In addition, he is the Chairman of the Insigneo Investment Committee.