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King Dollar Reclaims Throne - Outlook 2022?

It has been an exceptional year for the US dollar, which defied all the doom and gloom predictions to gain 10% against the Japanese yen. The resurgence of inflation has turned the tables with many central banks hitting the brakes, and this theme will likely persist into 2022. The dollar could continue to perform well as the Fed tightens and global growth cools, although inflation is a wild card. Politics will also return to the spotlight, with the French presidential election and the US midterms coming up.

How quickly narratives can turn around. This year started with the assumption that the major central banks were nowhere close to normalization as the global economy was still licking its wounds from the lockdown shock. The overwhelming consensus was that the dollar would continue to crumble under the weight of fading safe haven demand and a patient Fed. All that fell apart once inflation fired up. The dollar sliced through its competitors as traders priced in several rate increases by the Fed to cool inflationary pressures, pushing US bond yields higher. Looking into 2022, relative monetary policy will likely remain the most dominant theme for FX performance.

In that sense, the dollar could continue to shine for now. The US economy is booming, with the labor market tight by several measures and inflation roaring, enabling the Fed to raise rates with some force. There's also the prospect of global growth slowing now that government spending is fading, which typically favors the greenback. But the dollar's spectacular performance from 2021 is unlikely to be repeated. Instead, any future gains may be concentrated mostly against the currencies whose central banks won't be raising rates. Those are mainly the euro, the Japanese yen, and the Swiss franc. With carry trades coming back into fashion, these low-yielding currencies seem the most vulnerable.

That said, there are a couple 'known unknowns' that could clip the dollar's wings later in the year. The first is a sharp slowdown in inflation that leads markets to dial back bets for powerful Fed tightening. A combination of cooling energy prices, supply chains coming back online, and tougher year-over-year comparisons from April onwards could do the trick. The second is the Democrats losing both chambers of Congress at the midterm elections in November. Opinion polls currently suggest that's a very strong possibility, setting the stage for two years of political deadlock. Government spending would essentially be limited to only bare necessities, helping to cool US yields and by extension curb the dollar's rate advantage.■