ALPHA SOURCES

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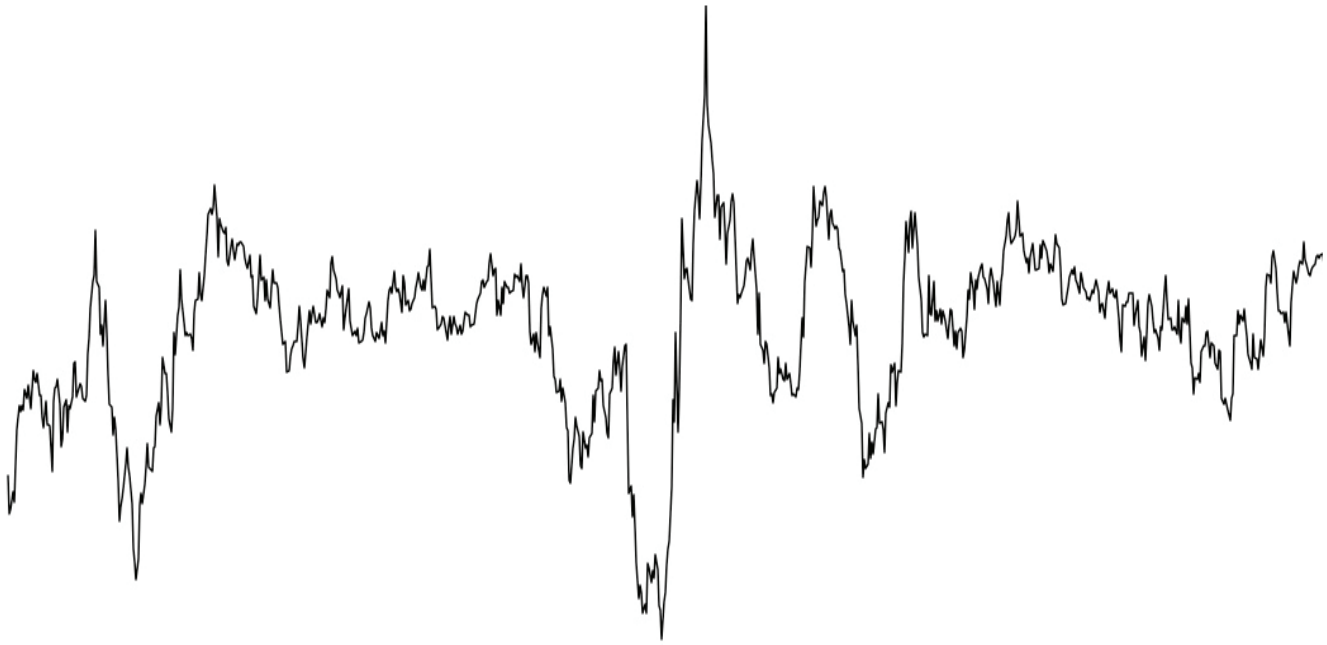

(FX) VOLATILITY TO MAKE A COMBACK?

I said my peace on what I consider to be the big market stories last week, so I won't belabour bonds and equities too much this week. FX markets, however, could well be the driver of the Narrative™ in the next few months, at least judging by the rustling of the grapevine.

This story starts with the notion of the "global Fed," which is not a new idea at all. Fed watchers tend to pivot between two extremes in their analysis of, and forecasts, for U.S. monetary policy. In one end, Fed conducts itself according to the reality of a relatively closed U.S. economy, without regard to the impact of its policy on the rest of the world, and the value of the dollar. At the other end, the Fed acts according to its role as a warden of the global reserve currency, taking into account the impact of its policy on the rest of the world. A more cynical version of this story is the idea that the Fed, in a world of free capital mobility, is constrained by the fact that other major central banks, in economies with large external surpluses, are stuck at the zero bound. This could happen in practice as tighter monetary policy in the U.S. drives the value of the dollar higher and/or leads to an increase in capital inflows. Both likely would drive up the external deficit, which would probably be counterproductive in an environment when the Fed

* / See additional charts on final page.

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would otherwise want to raise rates to curb inflation pressures.

It's probably unfair to pin the recent pivot in Fed policy entirely on a shift towards a more global outlook, let alone the strength of the dollar. The trade wars are, after all, a relatively idiosyncratic issue, and Mr. Powell also waxed lyrical last week about the death, if not flattening, of the Phillips Curve.

Mr. Trump's Twitter feed has been a key driver of this story. The president has been moaning about the Fed, and what he considers excessively high interest rates, for a while. But recently, the president has tied his critique to the dollar, which is he perceives to be too strong, and loose monetary policy in Europe and Japan, which he considers to be unfairly driving down the value of their respective currencies. This, in turn, has invited FX analysts to run with the idea that the U.S. is considering currency intervention, which will be directed by the Treasury, and that global markets are on the brink of a new Plaza Accord.

That seems a bit excessive, though it's *possible* that the White House is trying to squeeze the Fed from two sides. **To paraphrase: either the Fed pegs to the ECB/BOJ or Mr. Trump will enlist the Treasury in the fight to drive down the dollar.** It also *appears* to me that the consensus on the sell-side is converging towards the idea of a weaker dollar, to which my reply is: perhaps, but consider the following.

The U.S. CA deficit is small, about 2% of GDP, chiefly because of surging energy exports. A Dutch Disease story is in play here, which is bullish for the dollar. Also, it is not clear to me that the dollar is "expensive" based on its own history, though I have little view on the shorter-term horizon, which matters for traders.

Finally, winning the trade wars means losing the currency wars, and I doubt that FX intervention is a credible threat to counter that loop. *If* Mr. Trump decides to seek the route of intervening, he would quickly face nasty trade-offs between achieving his objective and imposing capital controls, the latter which wouldn't be kind on financial markets. Perhaps we can settle on this; FX *volatility* is about to make a re-appearance.

fig. 01 / It could be worse — fig. 02 / Expensive, or just about right?