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US dollar policy. It really matters

Alan Ruskin
Macro Strategist
+1-212-250-8646

- Mnuchin's comments on the USD and trade in the immediate wake of protectionist measures, made it tough not to conclude that the USD is being seen as part of trade policy.
- Simulations show the impact of USD weakness on trade is large and the passthrough on inflation is modest. One Fed trade model cited by Stanley Fischer suggests a 10% USD TWI decline can support real GDP by 1.5% over 1 years, but add only 0.25% - 0.5% to core inflation over a year.
- Based on simulations, the USD weakness in President Trump's first year, can boost growth more than tax reform.
- If equities like a weak USD then there is a good chance that the US Administration will like a weak/weaker USD too. The most obvious factor that could put a brake on many policies, not just US official attitudes to the weaker USD, is if policy actions start to undermine the US equity market.
- The one country where retaliation matters in a way that would give US equities second thoughts remains China. It is early days and so far China has greeted US actions on trade with barely a blink, but generally China has a policy approach of 'proportionality' or proportional retaliation.
- Does this change the directional call for additional moderate USD weakness? No, although it's contingent on China's response. If China does not up the ante on trade, risk appetite should trade ok, and the USD will trade weaker against most currencies. If China responds in a way that is risk negative, EM will start to get hit, and USD weakness will be concentrated against the G10 majors.
- Washington's door to a weaker USD has long been open, and USD bears are increasingly availing themselves of the invitation to walk through. This is a notably more conducive environment for a pick-up in asset market and FX vol.

Context matters a great deal. This is what Mnuchin is quoted as saying: "Obviously a weaker dollar is good for us as it relates to trade and opportunities," adding that the currency's short term value is "not a concern of ours at all." "Longer term, the strength of the dollar is a reflection of the strength of the U.S. economy and the fact that it is and will continue to be the primary currency in terms of the reserve currency". Now the Treasury Secretary could say he was simply stating the obvious that a weak USD was good for US trade, and that the comments on long-term were far from USD negative. Context matters.

But here are at least another three ways in which context matters:

i) The Treasury Secretary highlighted the USD's weakness as helpful for trade, in the immediate wake of a variety of trade protectionist measures. The Treasury Secretary made it tough not to conclude that the USD is being seen as part of trade policy.

ii) These comments were said on a preeminent world stage – if you want maximum impact Davos is not a bad place to start. The corollary is if you don't want a reaction, it is easy enough not to comment, or find a benign FX policy 'mantra' fast.

iii) The USD was trading particularly badly, closing yesterday's NY session through a variety of key levels versus all the majors and the DXY. The USD has been responding much more to bad news than good news for weeks. The Treasury Secretary should have been alert to this vulnerability - if he cared.

Figure 1: US Treasury Secretary term of office and real USD TWI performance

USD real broad TWI			Wall street/policymaker	Main street/Corporate	Govt & Academic
Treasury secretary	Term	USD broad TWI %chg	USD broad TWI %chg	USD broad TWI %chg	USD broad TWI %chg
William Simon	Aug 9, 1974- Jan. 20, 1977	0			0
Michael Blumenthal	Jan. 23, 1977 - Aug. 4, 1979	-6		-6	
William Miller	Aug. 6, 1979 - Jan. 20, 1981	2	2		
Donald Regan	Jan. 22, 1981 - Feb. 2, 1985	43	43		
James Baker III	Feb. 3, 1985 - Aug. 17, 1988	-26			-26
Nicholas Brady	Sep. 16, 1988 - Jan. 17, 1993	-4	-4		
Lloyd Bentsen	Jan. 22, 1993 - Dec. 22, 1994	-3			-3
Robert Rubin	Jan. 10, 1995 - Jul. 2, 1999	13	13		
Lawrence Summers	Jul. 2, 1999 - Jan. 20, 2001	6			6
Paul O'Neill	Jan. 30, 2001 - Dec. 31, 2002	1		1	
John Snow	Feb. 3, 2003 - June 29, 2006	-10		-10	
Henry Paulson Jr.	Jul. 10, 2006 - Jan. 20, 2009	-3	-3		
Timothy Geithner	Jan. 26,2009 - Jan 25, 2013	-11	-12		
Jacob Lew	Feb. 28, 2013 - Jan. 20, 2017	23			23
Steven Mnuchin	Feb 13, 2017 - Present	-8	-8		
Median		**-3**	**-3**	**-6**	**0**

Source: Deutsche Bank, Datastream

It is going to be hard for the market not to conclude that the US FX policy extends beyond a simple benign neglect, to something a little more active in its encouragement of currency weakness.

What might change things? The most obvious factor that could put a brake on many policies, not just US FX policy, is if policy actions start to undermine the US equity market. If equities like a weak USD then there is a good chance US policymakers will like a weak/weaker USD too. The same holds true for trade policy. In the immediate wake of the Mnuchin comments and before that the trade actions, US equities have again traded well; so far. A weak USD can help on trade competitiveness, repatriated foreign earnings, and cheapen USD assets for foreigners. One of the better papers on official thinking/modeling of the impact of an exchange rate shock comes from Stanley Fischer's November 12, 2015 speech, " The Transmission of Exchange Rate Changes to Output and Inflation". There he noted that simulating on a Fed trade model, a 10% TWI reduction can boost real exports by 7% over three years and have a positive 1.5% impact on GDP, if there is no monetary policy offset. By these calculations, Mnuchin, has already presided over enough USD weakness to boost GDP 1% through the end of the President's term, or substantially more than the tax reform package!

A weak USD will mainly hurt US equities if the inflationary impact undermines bonds. Here the Fed trade model suggests it needs a large 10% TWI decline to add 0.25% - 0.5% to core PCE deflator over a year. While USD weakness has accelerated, it is less obvious that the bear market for bonds is about to immediately accelerate sharply with it, in no small part because inflation pass through is so modest.

Another possible reinforcement to the bond bear scenario is if US/geopolitics generates bond sales, particularly official selling. This is why we are now all on 'China watch'. Mnuchin's comments linking trade to the USD, is not going to be helpful in persuading other countries not to follow course. The one country where retaliation matters in a way that would give US equities second thoughts remains China. So far, China has greeted US actions on trade with barely a blink, but generally has a policy approach of ‘proportionality’ or proportional retaliation. As noted in a recent Alpha Alert piece, China retaliation via Treasury sales would not be a logical proportional response because it hurts China's own interests, and besides, alternative yields in other sovereign G7 liquid markets are minuscule when compared with the US.

Even though the pass through to inflation could be limited, almost all the other US inflationary signals are pointing higher (lagged demand, output gaps, oil/commodity prices) and the weak USD can only reinforce DB’s call for 4 rate hikes this year, eventually acting as some restraint on USD weakness.

Does this change the directional call for moderate additional USD weakness? No, although it's contingent on China’s response. If China does not up the ante on trade, risk should trade ok, and the USD will trade weaker against most currencies. If China responds in a way that is risk negative, EM will start to get hit, and USD weakness will get concentrated against the G10 majors. All of the above also works with greater vol across all asset classes and currencies.

In the end, Mnuchin said what many market participants believed was the Trump Administration’s thinking on the USD to begin with - that a weak/weaker USD reinforces trade policy, and that there would be no US Treasury push back if the market favors a weaker USD. The political door to a weaker USD has long been open, and USD bears have been calmly walking through it well before the latest comments. It is local equity bulls in tandem with China that hold the key to the door.

Appendix 1

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Sydney, NSW 2000
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Tel: (61) 2 8258 1234

Deutsche Bank AG
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

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