BNY MELLON

The Aerial View

Morning Briefing

Fine Tuning

- **On the surface, the USD has been behaving slightly differently in recent days**
- **However, this might simply reflect a deeper relationship with risk sentiment**
- **This behavior has also led volatility to rise this year**

As seemed likely, this week's FOMC statement saw a slight strengthening of the language regarding inflation: "market-based measures of inflation compensation have increased in recent months, but remain low".

This, in turn, drove further declines in the 2018 Fed Funds Futures complex with the net result that the market is now pricing in a 36.5% probability that the funds target will stand between 200 and 225 bps by the end of the December meeting (up from 28.8% at the start of the year).

Further out, two-year Treasury yields traded above 2.17% (although they have backed off marginally), their highest level since just before the collapse of Lehman Brothers in 2008.

Given this, it's interesting to note that the USD appeared to briefly adopt a slightly different trading dynamic in the middle of this week (although this appears to be fading fast), tending to appreciate when Treasury yields headed

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Newswatch

1.

Japan: Finance Minister Taro Aso says he expects the Bank of Japan to proceed with monetary easing as before to achieve the 2% inflation target. >

2.

Japan: The BOJ conducts a special bond purchase heading higher - and vice versa. However, given the extremely muted nature of the currency moves, it would be stretch to argue at this point that this was evidence of a potential flipping of the relationship between yield and the USD that has dominated since September of last year.

> ***There is at least one alternative explanation for the USD's behaviour in recent days***

Perhaps a better explanation of the USD's behaviour in recent days is that it seems to be showing sensitivity to shifts in risk sentiment, with it tending to appreciate when the mood deteriorates (and vice versa).

This makes sense given that the USD's primary trend over the past 13 months has been lower and that this has mainly taken place in a risk on environment. As one measure of this, it's worth highlighting that the 200-day rolling inverted correlation between the performance of the S&P 500 and the USD Index (S&P up, USD down) now stands at levels that have only very occasionally been exceeded over the past 30 years (a topic we will return to on Monday).

It could therefore be argued that the USD's mild recovery on Wednesday evening reflected the cautious response by US equity indices to the FOMC's change of language, while the renewed currency weakness since then has coincided with more stable market conditions emerging.

> ***It has been the FX markets that have lead the way in the recovery in volatility seen this year***

There is one final point to be made: it has been the FX markets that have led the way in the recovery in volatility seen this year, with 21-day realized volatility for the USD index now within shouting distance of its 20-year average.

In contrast, the equivalent reading for 2-year Treasury yields is only just moving off the lows last seen in the

operation, offering to buy an unlimited amount of JGBs with more than five to ten years left to maturity. >

3.

Japan: A senior BOJ official says that the offer to buy "unlimited" amounts of long-term JGBs reflected recent sharp rises in long-term interest rates. >

4.

New Zealand: The ANZ-Roy Morgan consumer confidence index rises to 126.9 in January from 121.8 the month before. >

5.

US: Reuters sees a letter from a letter from steel companies and groups to the President calling for him to immediately act under "Section 232" of a 1962 trade law >

On the Radar

February 2, 2018

• GB Markit/CIPS January construction PMI (0930 GMT): Reuters consensus summer of 2007 while the recovery in S&P 500 realized volatility is still in its nascent stages.

In other words there is plenty of space for a rise in volatility in underlying US asset markets.

Please direct questions or comments to:

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forecast 52.0; previous 48.1

• US Jan NFP (1330 GMT): Reuters consensus forecast 180 k; previous 148 k

• US Jan unemployment rate (1330 GMT): Reuters consensus forecast 4.1%; previous 4.1%

Featured Article

Treasuries & The USD

A brief comment on CNBC earlier this week >