The USD and Binary Risks

- **Friday's payrolls have set the immediate tone**
- **Risks to any sustained USD move are brewing**
- **Global central banks come into the equation**

The USD index is up more than 1% from its lows last month thanks in part to a non-farm payrolls report that has raised questions about the Fed’s desire to implement aggressive rate cuts this year. But whether bulls or bears prevail from here, potential risks to any sustained move are brewing.

Certainly for USD bulls, the potential significance of comments made by Donald Trump last week should not be overlooked: the President tweeted that the US should “match” China and Europe’s “currency manipulation game”.

This is not the first USD-related comment from the President and it could be the last, but talk of the US “manipulating” the USD might yet prove significant. And the clear lesson to be drawn from history is that rhetoric from Washington on FX matters and has certainly proved successful in driving currency movements in times past.

Probably the most pertinent example of unilateral US political pressure being applied in the currency markets emerged in 1993 when the very early months of President Clinton’s first term in office saw what looked like an explicit attempt to talk the JPY higher.

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The clear lesson to be drawn from history is that rhetoric from Washington on FX matters

Whether or not the Clinton administration was targeting a stronger JPY was, in retrospect, irrelevant. What mattered was that investors believed it was, and between February 1993 and April 1995 the USD fell by over 1/3rd against the JPY despite the fact that US yields rose steadily against their Japanese equivalents throughout this period.

Indeed, the policy proved so effective that by May 1993, US and Japanese authorities felt compelled to intervene to buy the USD although this provided only temporary relief from the broad downtrend that had kicked off three months earlier. By July 1994 the Treasury decided there was little point fighting market forces and largely stepped away.

Whether such pressure materialises remains to be seen, therefore, but another potential, though polar opposite risk presents itself due to the USD’s occasional role as a safe haven.

We say ‘occasional,’ because as we noted in early June, despite broad perceptions, the evidence in favour of the USD ever performing as a safe haven currency is patchy.

However, the one time that the USD unambiguously took on this role – during the 2008 crisis – is worth bearing in mind given the foundations of the current rally in stock prices and their ascent beyond levels that made talk of Minsky moments fashionable a year or two ago.

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The S&P500 has posted a 20% gain year-to-date, a scale of increase not seen since 20012 and BNY Mellon iFlow are registering some of the largest cross-border flows into US equities in years.

And although the bond/equity relationship has gyrated over time, rallies in both asset classes and the accompanying ascent of gold prices this past month leave little doubt about the prevailing driver: presumptions of central bank ‘puts’ after a week or so of startling revelations about the health of the global economy, Friday’s jobs data notwithstanding.

The stability of US and, by extension, global stock prices at current levels therefore continues to rest with the confinement of central banks to regimes of easy money. And each and every data release and official commentary that could challenge market assumptions on this front becomes a potentially pivotal moment for risk-based assets.

What a week we have in store, therefore, with the minutes of the June FOMC preceding the June US CPI and Fed Chair, Jerome Powell’s testifying before Congress on Wednesday and Thursday.

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