The USD out of Favor

- Evidence doesn't support the idea of yield being the primary driver for FX markets at present

- USD's reduced status in recent days likely directly connected to shifts in US/China and US/Mexico relationships

- Hard to make clear call for USD as safe haven currency at present

The argument in favor of a weaker USD would seem to be a straightforward one, given the sharp decline in yield support as expectations about the path of Fed policy have shifted rapidly.

However, there is a strong case to be made that something else is the primary driver of the USD at present.

Evidence for this comes from a variety of markets. For example, the 200-day correlations between EUR/USD and the two-year, five-year and 10-year Bund/Treasury yield gaps are deep into negative territory, while for GBP/USD the correlations with Gilt/Treasury yield gaps are rapidly approaching zero.

Similarly, for USD/CAD and even AUD/USD (note the AUD's respectable performance overnight) it's noticeable that the correlations between currency performance and yield have been weakening.

Arguing that shifts in yield differentials have been the
principal factor in the USD’s uninspiring performance against Asian currencies in recent days also doesn’t particularly stack up, given that interest rate support for the USD against currencies such as the KRW and CNY has been deteriorating for pretty well all of this year.

Indeed, it is only really USD/JPY that has shown any kind of meaningful pick up in correlation with yield differentials over the past month.

**The most likely argument is that the movements seen since the middle of last week have been related to deteriorating risk sentiment rather than a search for yield**

This suggests that while yields are certainly playing their part, they’re not the dominant driver right now. Instead, the most likely argument is that the movements seen since the middle of last week have been related to deteriorating risk sentiment rather than a search for yield per se.

This is certainly consistent with the increased bid for not just the JPY, but also the CHF and gold since Wednesday, along with the USD’s rather more uninspiring performance over the same period.

It’s also not particularly difficult to see what changed in the second half of last week.

Wednesday saw both a story in *The South China Morning Post* and comments from the National Development and Reform Commission that highlighted how deep the rift between the US and China has become, while Thursday saw President Trump announce tariffs on Mexican imports.

With the US central to all these stories, it’s understandable why the USD should have come under scrutiny. That point was made again over the 24 hours with the currency coming under pressure during the US trading session as concerns about Apple, Google, Facebook and Amazon mounted. However, this raises the interesting question of whether there will come a point in the current cycle when the USD will gain a safe haven status similar to that currently enjoyed by the JPY and CHF?
Despite broad perceptions, the evidence in favor of the USD ever performing as a safe haven currency is patchy.

Indeed, the only time that an unambiguous safe haven bid can really be said to have emerged for the USD in recent decades came during the 2008 crisis when it (along with the JPY, but not CHF or gold) became increasingly favored.

Perhaps tellingly, although this was also a time of rising geopolitical tensions (the Russo-Georgian War emerged in early August), the US was not directly involved in them.

Does this mean the USD won’t gain a safe haven bid to match that of the JPY and CHF should market sentiment continue to deteriorate?

No. However, it wouldn’t seem wise to count on it as a certainty.

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