Gauging the Strength of the Fed Put

• Recovery in sentiment on the back of Powell's comments more muted than might have been expected

• Suggests skepticism over the ability of central banks to contain market turbulence

• USD/JPY likely particularly sensitive to a fresh deterioration in sentiment

Quite what the trigger was for the Fed’s shift in rhetoric ahead of its upcoming blackout period remains open to question - although the comment from Chicago Fed President Evans on Tuesday about having to pay attention to market signals was telling.

The primary impact was easy to see, however, with the VIX sliding around 150 bps in the aftermath of Chairman Powell’s comments while key JPY crosses (AUD/JPY, JPY/KRW, CAD/JPY) all reacted pretty instantly.

In other words, even if there was no particular intention to provide a “put” for markets, this was the effect. The key question therefore is how strong actually is the support for markets?

One way to look at this is to consider the strength of the initial rallies that emerged. From the perspective of equity markets (at least US equity markets), the answer was simple enough, with the S&P 500 staging its strongest one-day rise since January.

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Newswatch

1. **Mexico/US:** President Donald Trump (@realDonaldTrump) tweets: “If no agreement is reached, Tariffs at the 5% level will begin on Monday, with monthly increases as per schedule. The higher the Tariffs go, the higher the number of companies that will move back to the
Equally, the TOPIX (presumably reflecting the impact of a weaker JPY on the crosses) put in its fourth-largest gain of the year. However, elsewhere, recoveries in equity indices were muted.

Similarly the JPY crosses (which responded aggressively in January to a shift in Fed rhetoric) only made relatively modest moves on Tuesday, with the rallies having no more force behind them than some of the counter-trend recoveries in mid-May.

**Even if there was no particular intention to provide a “put” for markets, this has been the effect**

It could be argued that this should have been expected, given that markets had already moved to factor in two Fed rate cuts by year end.

However, much the same could have been argued at the start of the year (remember that the first sign of a shift in Fed rhetoric emerged in November 2018), yet the response then from markets proved robust.

It could also be argued that perhaps the muted response reflected a collective memory that realized volatility had come under significant downward pressure from mid-January onward, as the soothing effects of the Fed’s shift in stance took effect.

While possible, that seems unlikely given how negative sentiment had been, even at the start of this week.

**This suggests that the real answer is that markets overall remain skeptical about the ability of the Fed to contain market turbulence**

This suggests that the real answer is that markets overall remain skeptical about the ability of the Fed to contain market turbulence should the trade tensions...
reemerge/deepen in the days ahead or signs of a meaningful slowdown intensify (all eyes on tomorrow’s NFP number following the ADP surprise yesterday as well as on the continued slide in oil prices).

With this in mind, it’s worth recalling that recent years have typically seen a rise in equity market volatility from August onward.

From an FX perspective this suggests keeping a close eye on USD/JPY, given that it has consistently seen sharper rises in volatility than either EUR/USD and USD/CHF - pertinent comparisons given the negative policy rates in the eurozone and Switzerland - in the face of broader market turbulence in recent years (see chart below).

With this in mind it is worth noting a few key points. The first is that the post January 3 low for the USD stands at JPY 107.50.

Secondly, 25 days since 1971 having seen a net drop for the USD of 3% or more (with three of these coming in 2016 alone). Over the past 21 years these moves have typically been in reaction to broader market stresses (1998 & the

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**On the Radar**

June 6, 2019

- EZ Q1 GDP (revised) (1000 BST): Reuters consensus forecast 1.2% y/y; previous 1.1% y/y
- ECB policy meeting concluded (1245 BST) & press conference (1330 BST)
- US Apr trade balance (1330 BST): Reuters consensus forecast - USD 50.7 bn; previous - USD 50 bn

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**Featured Article**

**Market Stress Points**

With markets under increasing pressure it’s worth keeping an eye on a number of key stress points >
fallout from LTCM, 2008 and the fallout from Lehman Brothers, 2016 and the aftermath of Brexit). The shift from a low- to a high-volatility environment has usually been very rapid with little in the either the CFTC positioning data or options pricing to provide any early warnings of the push towards the exit door.

Finally, our iFlow data show only modest net flows back into the JPY so far. (see chart)

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