

Verbal Intervention

Market Viewpoint: September 30, 2019

Summary: As we wrote last month, the sustained strength of the Dollar has become a serious impediment to US trade and current account balances, as well as corporate earnings. The President has recently upped his attacks on the greenback, calling on the Fed to take on larger cuts to short-term rates. However, since most Fed policymakers believe the economy is still running strong, all things considered, they're likely to continue their measured easing approach. Regardless, lower rates appear to have already stoked inflation, which will push down US real rates that have already flattened and, in turn, weaken the Dollar through 2020.

Last month, [MRP suggested that relentless Dollar strength might precipitate intervention in FX markets](#). While no direct action has yet been taken, speculation continues to fly concerning the rapid rise of the Dollar, a potentially damaging factor for the US economy.

In the simplest terms, a stronger Dollar versus other currencies means that exports become more expensive in international markets, pricing out US goods and expanding the already enormous trade deficit. The Trump administration has been critical of the now \$54 billion gap between imports and exports since the President took office back in 2017, yet deficits in the balance of trade and current account have only widened.

MRP has previously discussed actions that could be taken to start driving down the Dollar, including injections from the Treasury Department's Exchange Stabilization Fund and other assets, totaling around \$95 billion, into FX markets. Other options, outlined by the Wall Street Journal, include "warehousing" a portion of the fund's foreign currencies with the Fed, pledging its assets in exchange for newly created dollars, or simply having the Fed work with the Treasury to sell Dollars.

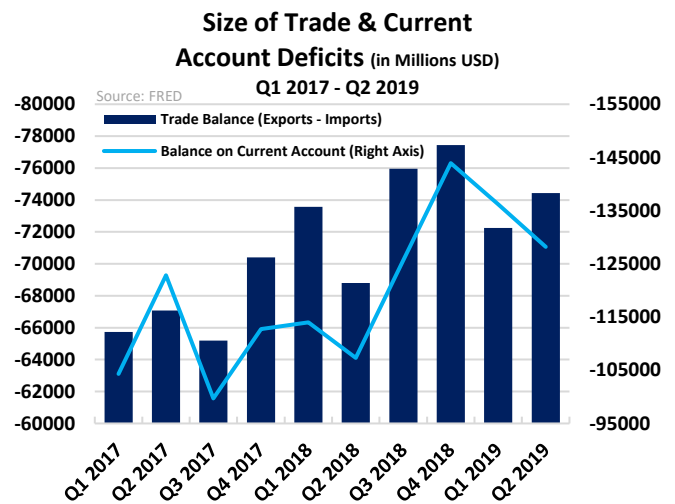
However, the most powerful weapon in moving the market may simply be words, ie: verbal intervention. To paraphrase the old adage, the pen (read tweet) can be mightier than the sword (coordinated intervention).

The Plaza Accord, an agreement between finance ministers from the US, West Germany, Japan, France, and the UK to simply talk their way into intervening in currency markets, is an event worth citing. As the New York Times wrote over 30 years ago, after the Dollar fell by more than 20% against a trade-weighted basket of currencies from the first quarter of 1985 through the third quarter of 1986.

Certainly, President Trump understands the bully pulpit strategy very well, given the amount of publicity his tweets generate – JP Morgan has even created a "Volfefe Index" to track the impact of Trump tweets on US bond yields and interest rate derivatives.

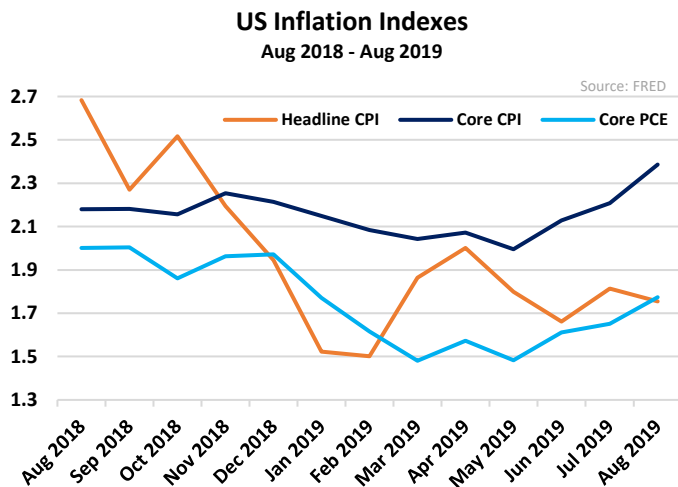


Joseph J. McAlinden, CFA, is the founder of [McAlinden Research Partners \(MRP\)](#) and its parent company, Catalpa Capital Advisors. He has 50 years of investment experience. Mr. McAlinden founded Catalpa Capital in March 2007 after leaving Morgan Stanley Investment Management where he had spent 12 years, serving first as chief investment officer and later as chief global strategist. During his 10 year tenure as chief investment officer, he was responsible for directing MSIM's daily investment activities and oversaw more than \$400 billion in assets. As chief global strategist, he developed and articulated the firm's investment policy and outlook. Prior to Morgan Stanley, Mr. McAlinden held positions as chief investment officer at Dillon Read and as President & CEO of Argus Research.



The President's latest social media offensive has been calling for rates to head toward zero, or even negative territory, writing in a Twitter thread that "The Federal Reserve should get our interest rates down to ZERO, or less, and we should then start to refinance our debt... The USA should always be paying the lowest rate. No Inflation!" He followed that up a few days later by criticizing the continuous appreciation of the dollar: "Dollar strongest EVER! Really bad for exports... Jay Powell & the Fed don't have a clue. And now, on top of it all, the Oil hit. Big Interest Rate Drop, Stimulus!" Trump continued his criticism of Fed Chair Jerome Powell following the FOMC's decision to reduce the Fed Funds rate by only 25 bps in Mid-September by calling out what he perceives as his lack of "guts", "sense", and "vision".

Tweets aside, the President's outspoken disapproval of the current strength of the Dollar is a defiant departure from the typical etiquette of the office. Usually, Presidents and their officials in the Treasury Department avoid rhetoric that criticizes the strength of the Dollar. On the campaign trail in 2016, Trump frequently mentioned that he was not at all against a weak dollar policy, but hit the mute button on that kind of rhetoric in the first half of his term. His renewed and bold support for a weaker dollar is causing mixed signals to emanate from the White House. While Trump's advisers have said intervention is off the table, the President has insisted he has not ruled it out. The Wall Street Journal Reports that analysts don't expect intervention is imminent, but notes that Morgan Stanley strategists have recently said the longer the Fed disappoints Mr. Trump's demands for rate cuts, the more likely intervention becomes.



Meanwhile, [the inflation intermission](#) that has held growth in the headline CPI at 2% or below throughout all of 2019 over may be coming to a close. Inflation ticked up to 1.8% in July and August, a more robust rate than the 1.7% average in the 6 months prior. More impressively, the Core CPI jumped to nearly a decade high in August. This indicates that prices for products, ex food and energy, are rising faster following the Fed's first rate cut since 2008.

Most significantly, the Core Personal Consumption Expenditures Index (PCE) rose to a 2019 high of 1.8% - nearing the Fed's closely-watched 2% target for this critical measure of inflation.

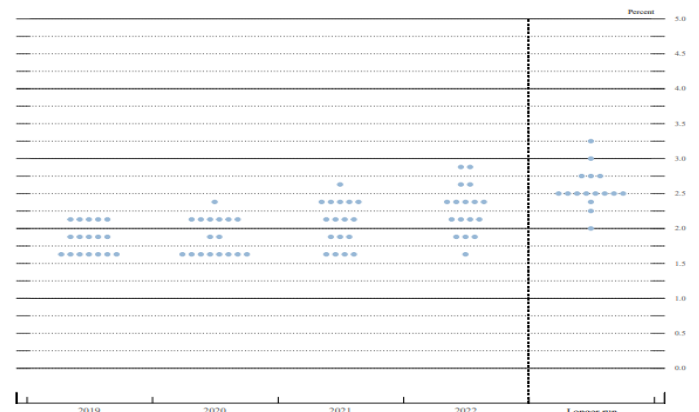
The uptick in inflation correlates with the Fed's first rate reduction in July. Now, the Fed Funds rate has been lowered yet again this month, driving the Fed's target range to 1.75% - 2.00%, the lowest in a year. This cut is likely to continue pushing inflation higher in the coming months. One notable alteration in the FOMC's official statement was that household spending is now "rising at a strong pace", as opposed to August's statement that said spending had "picked up from earlier in the year". This apparent acceleration of household spending could indicate further inflationary pressures going forward.

While the Fed Funds futures market is still pricing in one more cut before year end, the Fed is not giving many clues about what their next step may be. The new Dot Plot showed that the midpoint expectations of Fed Governors implied no more cuts would be necessary this

Federal Reserve Dot Plot September 2019 FOMC

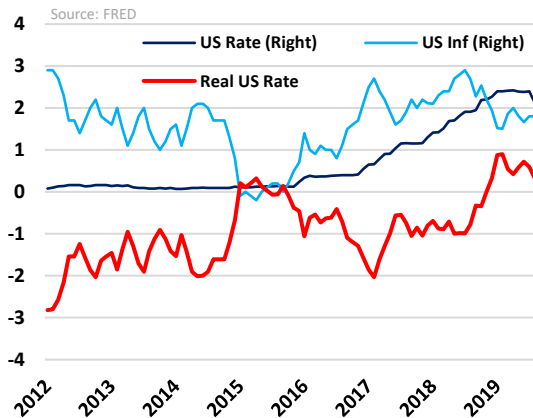
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Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate

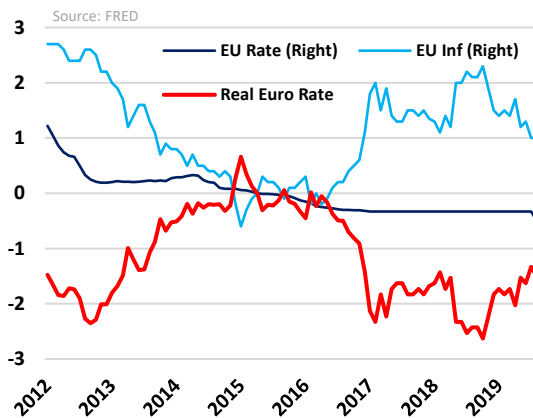


year in the post-meeting press conference. But responses were quite evenly distributed. Five officials indicated they believed rates should stay in their current range through the end of the year, 5 others indicated they believed there should actually be a rate hike before the end of the year, and 7 believe that another cut is warranted before year end. So, while the median of those marks falls within the current fed funds range, the largest support for a single option lies with further easing. While the Dot Plot gives us a sense of the Fed's attitude toward rates, it is limited by the anonymity factor; it is unknown which marks are being made by actual FOMC voters.

US Real Rate (Fed Funds - US CPI YoY Δ%)
Jan 2012 - Aug 2019



EU Real Rate (ECB Rate - EU CPI YoY Δ%)
Jan 2012 - Aug 2019



Powell did mention the possibility of an even more dovish turn, in the form of a “sequence” of rate cuts, if the economy were to head toward a sustained downturn – but he clarified that the central bank does not expect this. FOMC members generally see the economy as running strong, Powell said. TD Securities aptly described the message of the meeting, saying “They basically kept the door open to further cuts, but didn’t really walk through it or commit to walking through it in any way, shape, or form”.

As MRP has highlighted before, the most obvious determinant of where the money goes is short-term interest rates and their differences from other currency regimes. Other things equal, it makes more sense to keep cash in a currency that has a higher rate of interest. Still, there is another key consideration: inflation-adjusted or “real rates”.

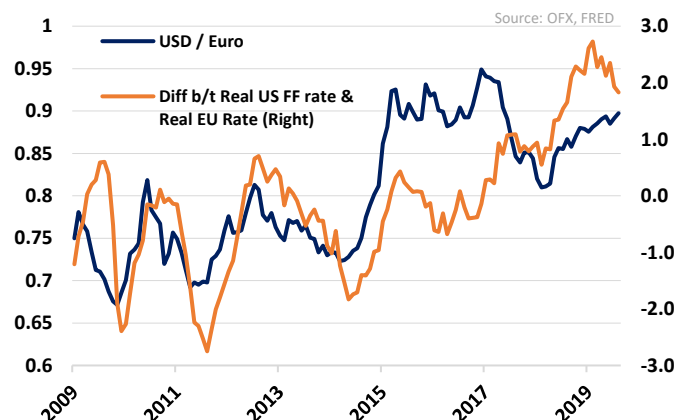
However enticing a short-term yield may be, it doesn’t buy much if the purchasing power of the currency diminishes by more than the interest earned; or it can buy even more if purchasing power improves. When overnight bank rates are adjusted for inflation, the swing in “real” rates is sometimes even more pronounced. International money flows usually chase “real” yield, however small the differentials may sometimes be. So, with rising inflation and lower short-term rates, the Fed has already set the stage for lower real rates and, in turn, a weaker dollar.

Although other major economies are also easing, they do not have a whole lot of room to reduce their rates further. Rates in Japan and Europe are already in negative territory and cannot cut their rates with the same frequency or by the same amount as the US.

The power of real rates is very pronounced when comparing the difference in US real rates to real rates for the Eurozone. When this difference tightens, as it has recently, following Fed easing and a jump in inflation, it has historically correlated with a weakening of the Dollar and a stronger Euro. MRP believes this will be the case in the coming months.

The ECB’s recent cut in September was the first since 2016 and only reduced the Eurozone deposit rate by 10 bps. Although the ECB hopes to stoke inflation with this latest cut, as well as a new round of stimulus, it will likely

Real Rate Difference vs USD/EUR

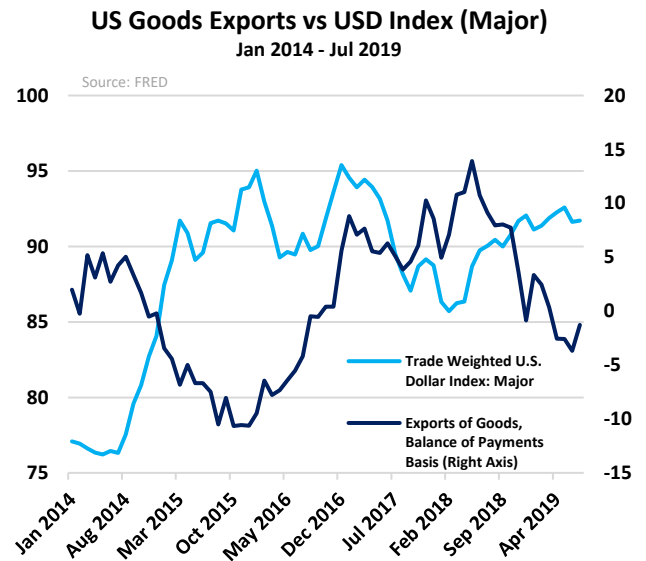


take some time before these efforts will make a significant impact on the data.

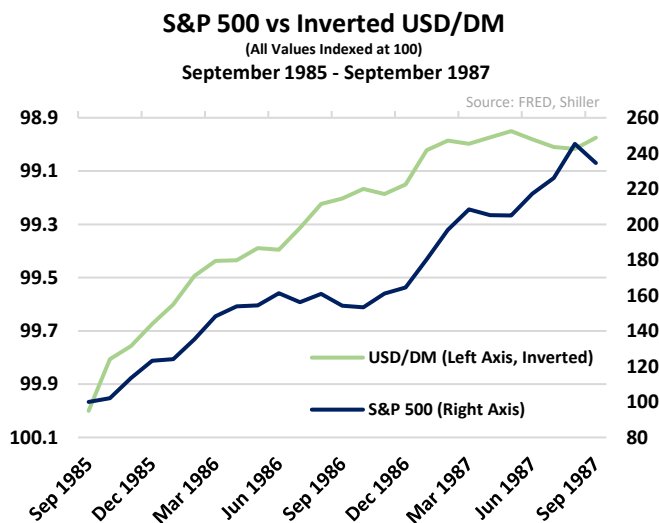
Eurozone inflation has been in freefall since the fourth quarter of 2018, hitting multi-year lows at 1% in July and August. ING notes that growth in producer prices, employment, and wages has fallen significantly in recent months. Businesses also indicate a stagnation of selling price expectations at the moment as downside economic risks are a top concern. As far as the stimulus goes, Bloomberg reports that demand was disappointingly low for the first round of ultra-cheap ECB funds at the bank's new rate of -0.5%. An offer for 3-year loans was taken up by 28 banks for a total of just 3.4 billion euros, well below predictions of 20-100 billion euros. If this kind of weakness persists, slowing inflation in the Eurozone will likely persist and, in turn, keeping real rates for the Eurozone on the upswing. If this is indeed the case and we do see a weaker Dollar, we could see a rebound in the US economic growth, as well as a stronger equity market going forward.

The strength of the Dollar can explain at least part of the slowdown in US manufacturing, given the increasing exchange rate of the US Dollar versus some of the US's largest trade partners' currencies including Mexico's Peso, Japan's Yen, China's Yuan, and the Euro. The ISM's purchasing manufacturing index (PMI) has been trending down through all of 2019, but dipped below 50% in August, signaling a contraction in manufacturing activity for the first time since 2009.

Back in 2017 – 2018, however, a declining Dollar painted a completely different story. Exports rose strongly, and the PMI was hitting cycle highs, peaking at 60.8 – a 15-year peak. While trade tensions with China and resulting tariffs on US goods have also played a role in plunging exports, appreciation of the Dollar has also been a catalyst.



Additionally, as MRP forecast back in September of 2018, [the currency translation effect](#) has had a huge dampening effect on corporate earnings, especially for companies that do large amounts of their business overseas and must translate profits from other currencies back into Dollars. As the Dollar strengthens, the earnings the US companies report in Dollars become more and more devalued. A receding Dollar would ease some of the pressure on earnings growth.



Major US cruise operator Carnival Corp. and IT Consultancy Accenture Plc. are among the latest companies citing the strength of the Dollar as a detriment to their latest earnings reports, each released this past Thursday. Carnival President and CEO Arnold Donald said on the company's earnings call that "nearly 50%" of the company's guests are sourced outside of the US, and a strong Dollar has effectively discounted the revenues received from those international markets.

Historical precedent also provides an example of how a weakening Dollar can affect financial markets. After the Plaza Accord in the mid-80s, for example, the fall in the dollar coincided with a strong run up in equities over the next 2 years.

Additionally, beginning in 1987, the weakening dollar shored up GDP growth, leading to a spike in treasury yields. This created a period of divergence where stocks continued to climb higher, but bond prices declined.

Rapid depreciation in the Dollar did not come without market shocks, however. Although stocks rose strongly in the immediate response to a falling Dollar, some interpreted sustained greenback weakness, even in the face of rising interest rates through '87, as a negative signal for financial markets and Dollar-denominated assets. Ultimately, this probably played a role in the "Black Monday" crash of that same year when the Dow dove more than 22% in a single day. While a move in equities of that magnitude is unlikely, investors should understand that a dollar falling too hard could eventually lead to a rising negative market environment.

In the short-term, though, MRP expects the Dollar to maintain its current level or even go a bit higher as we wait for US real rates to decline further in coming months. On a broad basis, the Dollar made a new 17-year high in early September, but followed it up with a 2-week slide, indicating a possible flattening out of the rapid run-up we'd seen over the last few months. A moderate easing in the Dollar is likely to feed through to corporate earnings figures, helping stocks rebound out of the earnings recession the S&P 500 slipped into in the second quarter.

A weakening Dollar could also help US manufacturing and exports turn around, bolstering GDP growth and restoring investor confidence. For all the speculation of "recession" floating around, [which the financial media began raving about all the way back in late 2018](#), the economy has actually performed well this year in the face of a trade war and an unrelenting Dollar. Q2 GDP growth came in at 2% and the Atlanta Fed's GDPNow currently forecasts Q3 growth to come in at 1.9%, up from a dismal 1.5% projection earlier this month, on the back of robust housing, industrial, and producer prices data. President Trump has also stated that a deal to end a nearly 15-month trade war with China could happen sooner than people think, which would obviously be a shot in the arm for the US economy. China has acknowledged they've begun increased, tariff-exempted purchases of US agricultural products this month ahead of October negotiations, and an eventual trade deal would entail an agreement to buy billions of Dollars-worth of US exports.

As previously noted, though, FOMC voters generally see the economy as running strong, and the September Dot Plot indicates Fed Governor support is strong for either holding rates to some range between 1.5% and 2%, or even hiking the upper limit back to 2.25% in 2020. The combined effect of sustained GDP growth and a return to neutral monetary policy would boost treasury yields, leading to the same divergence between stocks and bonds we saw back in 2017 – 2018, as well as the mid-1980s.

One final complication that could play a role in the direction of the Dollar is the recent initiation of an impeachment inquiry against President Trump. A number of congressional Democrats had long-sought formal action on impeachment, but House Speaker Nancy Pelosi's (D-CA) change of heart on the issue, following controversy about the President's communications with the President of Ukraine, meant a probe could finally move forward.

Any news that strengthens the case for impeachment would be Dollar-negative, signifying unprecedented political uncertainty for the US and a drowning out of more quantitative influences. After the impeachment inquiry was announced last week, a quick downturn in the Dollar showed immediately how much of an influence impeachment could have on an already over-bloated greenback.

Although the strength of the Dollar seems to be the root issue of many concerns in the economy, and one that will be persistent through at least the fourth quarter, a disruptive change appears to be on the way from multiple fronts.



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