Strong Dollar Policy at Risk?

President Trump's focus on the USD—and his willingness to comment on exchange rates in particular—is unusual by recent standards. While this White House has shown a willingness to break with convention in many respects, markets are rightly concerned that the president weighing in on exchange rates and monetary policy might generate more uncertainty and volatility, even if the broader USD trend is still driven by fundamental developments.

Since the 1990s, global currency markets have been largely free of friction on exchange rates between the US, Europe and Japan. The US Treasury has been broadly consistent on its messaging on the USD since the Clinton era and the "strong dollar mantra"— a strong USD was in the US' best interests—that was established by Treasury Sec. Rubin. The established "norm" is that the exchange rate is the purview of Treasury and it is only the secretary that comments on the dollar.

Both Republican and Democrat Treasury secretaries have embraced this position and while there have been varying degrees of enthusiasm for the stance, it has to be said, consistency has provided a backstop for policy credibility, provided a degree of comfort for investors in US Treasury product that the US would not purse a deliberate policy of devaluation amid a rising tide of fiscal red ink and provided an anchor in the tri-polar FX world for the promotion of market-determined exchange rates beyond the major currency bloc. This "hands off" approach has been especially evident in the absence of any official intervention to curb JPY strength by the Bank of Japan since 2011, following the March earthquake.

The Trump administration is clearly less enamored with the idea of doing things a certain way because that is the way it's always been done. Markets have broadly accepted that this administration has a new approach to policy making and a new way of dealing with issues. The dollar issue has been directly or indirectly addressed by various administration officials. White House advisor Navarro remarked that Germany uses a "grossly undervalued" EUR to its advantage. Treasury Sec. Mnuchin said a weaker USD would be beneficial for US trade—and early sign of a break with the past. Markets have reacted to these headlines in the short run but the longer-term impact has been limited.

The fact that exchange rates are now clearly on President Trump's radar should give markets cause for concern, not least because the risk of a tweet or "tape bomb" comment on the dollar has risen significantly. It is not clear yet whether this reflects a passing concern for the president or risks becoming a longer-term focus of his tweets. Market may look through occasional forays into FX policy but a steady drumbeat of USD-negative tweets or comments will be harder to ignore. The allegation of "manipulator" against Europe may reflect a harder stance in the Treasury's report on FX and economic policy due in the fall.

After falling steadily in the early part of the Trump administration's tenure, the USD has rallied relatively strongly in the past few months. This has reflected a combination of factors—firm growth expectations following US tax cuts, a preference for holding USDs amid rising trade tensions and—possibly—the impact of reduced USD liquidity as a result of tighter Fed policy on the one hand and repatriation of USDs back to the US on the other.

To a large extent, recent gains in the USD can be attributable to a greater of lesser extent to President Trump's policies. This morning's comments may represent an attempt to "manage" USD gains. There will be consequences in the short run—markets have been running long USD in recent weeks and positioning may be vulnerable to liquidation pressure. In the longer run, there could be consequences from an attempt to push the USD lower as well—rising imported inflation may

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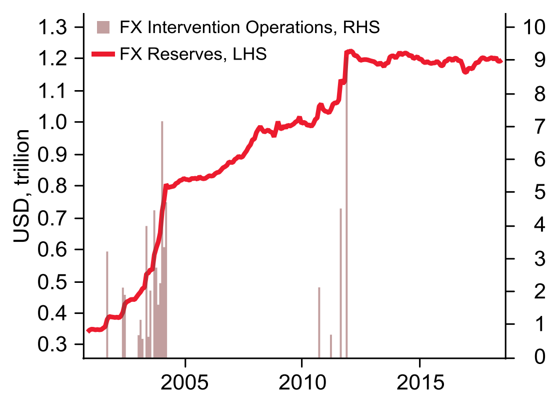
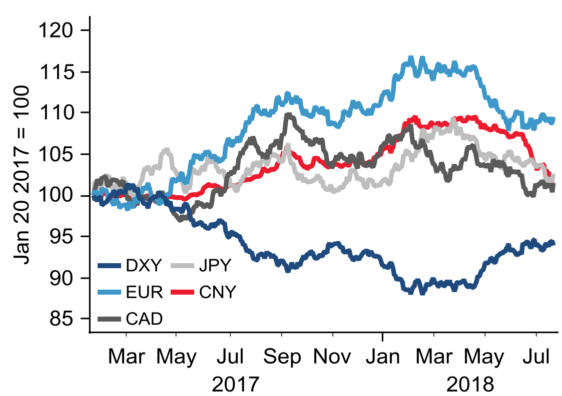
No Official BoJ Intervention Since 2011



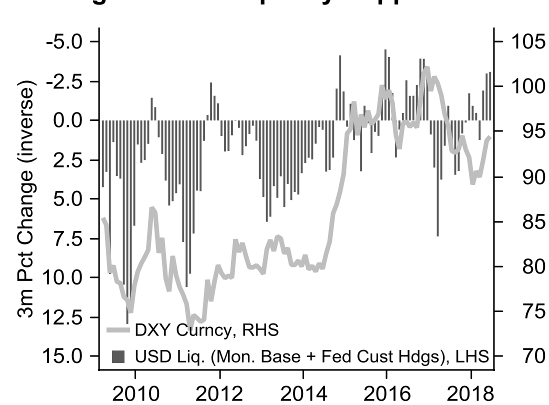
Source: Macrobond, Scotiabank FICC Strategy

USD Steady to Lower Under Trump



Source: Macrobond, Scotiabank FICC Strategy

Tighter USD Liquidity Supports DXY



Source: Macrobond, Scotiabank FICC Strategy accelerate the Fed tightening process and might depress foreign interest in US Treasury bonds, pushing longer term rates higher.