19 April 2017
Article

Deconstructing Trump's Dollar Talk

President Donald Trump said Wednesday that the US dollar "is getting too strong" and he would prefer the Fed to keep interest rates low. While we've seen attempts from the President to talk down the dollar before, the reference to interest rates puts a potentially credible action point on the latest jawboning efforts.

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Trump Dollar Jawboning 2.0: Why it may be different this time?

While we've seen attempts from the President to talk down the dollar before, the reference to interest rates puts a potentially credible action point on the latest jawboning efforts. Indeed, previous talk has often left investors asking how the Trump team could alleviate the positive dollar impact stemming from potential tax and infrastructure spending policies.

Changing the rules of the game for the Fed is one obvious way. Any assumptions around the interaction between Trump's pro-growth fiscal agenda and the Fed's reaction function have so far been hinged on US inflation remaining anchored around the 2% target; the typical view is that the Fed might be forced to tighten quicker if any fiscal stimulus was delivered. But it's clear that this chain of logic is becoming distorted and with the Trump administration set to appoint 2 new Fed Governors this year – and potentially a new Chair and Vice-Chair next year – the standard assumptions cannot be taken for granted.

Will the Fed comply with Trump's low interest rate wishes?

To clarify , it is the FOMC – not Congress – that sets the 2% inflation target in their statement of longer-run goals (see here). While a formal shift in the inflation target remains a tail risk for now (given the negative credibility effects), it's not inconceivable to see the Fed allowing for a sustained period of above-target inflation – without the need for much additional tightening.

The President's latest comments suggest that this is what the administration may be hoping for – and the risk of dovish Governors being appointed has increased. But if the Fed were to ever pursue an "inflation overshoot" approach, then they would certaintly need to communicate this clearly in order to avoid market confusion and limit any unnecessary mispricing of policy risks. It's worth noting that some Fed officials might already be moving in this direction; the March FOMC minutes made several implict references to allowing for a short-term deviation above the 2% target, while the statement itself noted the target was "symmetric".

US reflation + gradual Fed hikes = Bearish steepening of US yield curve

The obvious question stemming from all of this is whether underlying US inflation ever does get meaningfully above 2% inflation. While core US CPI inflation is expected to come in at 2.3% YoY tomorrow, the PCE equivalent measure – which the Fed may be watching more closely – remains at 1.8% YoY. Still, our base case is that the Trump administration will deliver some demand-side fiscal stimulus this year in the form of tax reforms – which even if watered down, is likely to generate some inflationary pressures given that the US economy is close to full capacity. Assuming the Fed retains a gradual normalisation path – and hence limited scope for any repricing of current policy expectations – we would expect the net effect of any Trump fiscal package to be a modest steepening of the US yield curve.

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