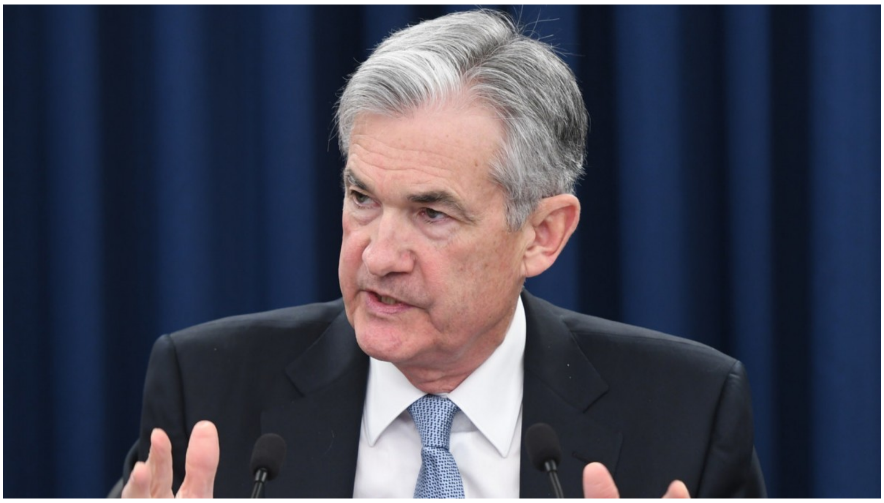
USD: Good luck Mr. Powell

The market focus turns to Fed Chair Jay Powell's semi-annual testimony to the Senate today. We identify three contentious topics that he may face in the Q&A portion



Source: Federal Reserve

USD: Flat yield curve is a warning sign for the Fed

Markets will turn their attention to Fed Chair Jay Powell's semi-annual testimony to the Senate today – and while Powell will likely stick to the script in his opening remarks, we identify three contentious topics that he may face in the Q&A portion:

1. **How will the Fed deal with an escalation in the global trade war?** We have been mystified as to why markets haven't acknowledged the US economic risks to a brewing trade war but there are signs that the tide may be turning (and the US dollar is a pretty good gauge for this). The Fed's policy outlook currently does not take into account a possible trade war – and we don't feel that this is a valid assumption. It may be remiss for Powell not to talk about the risks.
2. **Will the Fed seek to avoid an inverted US yield curve?** As FOMC member Neel Kashkari discussed in a recent op-ed, the argument that the low term premium may be overstating the current flatness of the US yield curve was the same argument used in 2006 – ahead of the Great Financial Crisis. The Fed must tread with caution here as it's clear that bond investors don't buy into the central bank's rosy outlook for the US economy (but of course no central bank will ever explicitly forecast a recession). Chair Powell opening up to the possibility of a tightening hiatus if the curve were to further flatten towards zero would

certainly help to stem any policy mistake fears – giving a welcome boost to risky assets while taking away support for the dollar.

3. **Is the Fed's independence at risk?** This will most likely be a question posed by a Democrat senator looking to 'get one up' on the US administration. As Powell noted last week, there is nothing giving him concern about the central bank's independence. Still, policy-related comments by Larry Kudlow – the head of the NEC and the president's chief economic adviser – may just have given the Democrats some fuel to start a potential fire with today.

Bottom line: It'll be a tricky day at the office for Powell – but given the external challenges facing the US economy, it's hard not to see a more cautious policy being struck today. This will come as a dovish surprise to markets. A quiet day in Europe, means EUR/USD's focus will be on Powell (we look for 1.17 to hold).

GBP: Unfazed by the political mess in Westminster

The UK government narrowly avoided defeat in the Commons over the Cross-border Trade Bill after accepting the eurosceptic ERG's hard-line amendments that effectively render PM Theresa May's Chequers agreement as null. Yet, whether it's Brexit fatigue or general confusion (and we wouldn't blame investors here), GBP still remains unfazed by the political mess taking place in Westminster. In part, markets have learnt to focus on the economic data – and a solid UK jobs report today could keep GBP/USD supported above 1.3250 (EUR/GBP below 0.8850).

NZD: Positive inflation surprise makes the case for tactical outperformance

The New Zealand dollar jumped overnight after the central bank's core inflation measure (sectoral factor model) moved up to 1.7% year on year in 2Q18. The positive inflation surprise coupled with a flat NZD OIS curve, short NZD/USD speculative positioning at five-year lows, signs that the USD may be turning lower and a potential pause in trade war risks means that we see short-term NZD outperformance. We prefer tactical long positions against AUD and CAD (both more vulnerable to US trade policy).