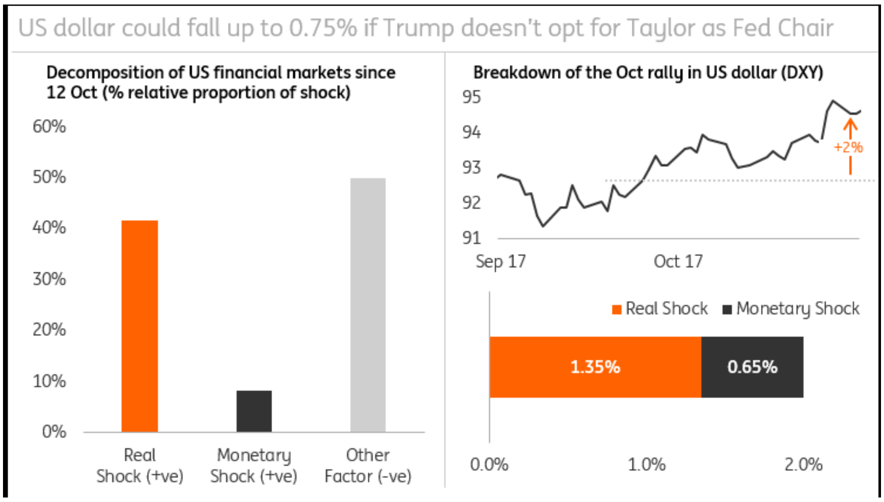
USD: A swift Taylor shake off?

The US dollar could still fall by around 0.50-0.75% if President Trump were to opt for Powell over Taylor as Fed Chair this week



Source: Source: ING FX Strategy

Tinker with Taylor or soldier on with Powell?

We would view the widely speculated nomination of Jerome Powell as mildly negative for the US dollar as some of the 'Taylor premium' is priced out of US markets. Our estimates suggest we could see up to a 0.50-0.75% reversal in the DXY dollar index. The downside could be muted by the fact that a positive reassessment of US economic fundamentals – driven by both tax reform speculation and solid macro data – has contributed more to the US dollar's rally over October. Plus, Taylor could still find himself on the FOMC within the vice-chair capacity.

Powell is Trump's Goldilocks pick

What our economists describe as the continuity candidate, a Powell-led Fed is likely to stick to the script of a gradual policy normalisation. This policy stance also poses much less of a risk to potentially inflated stock markets, something which the President clearly uses as a gauge of his economic success.

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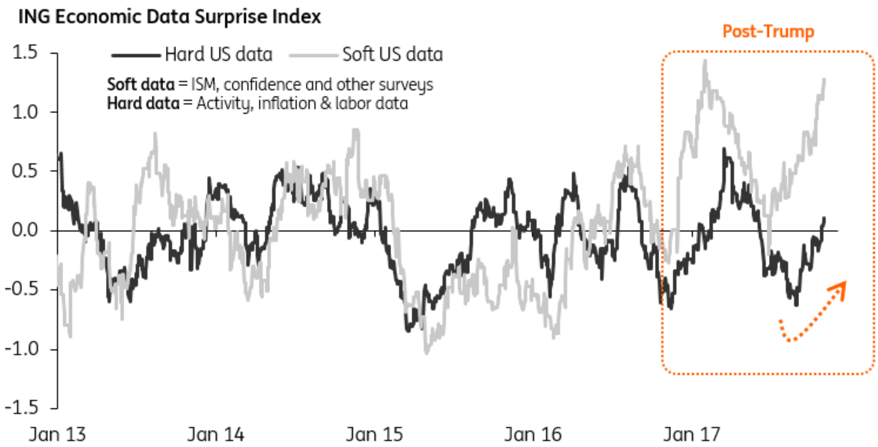
While part of this real story is undoubtedly greater hype over US tax reforms, strictly speaking, it also incorporates the fact that US economic data has been fairly constructive in October – with our US Data Surprise Index having moved sharply higher on the month (see below).

Read our economists Federal Reserve meeting preview

Soft and hard US economic data moving in the right direction



Source: Source: ING FX Strategy

Taylor as vice chair? Don't completely rule it out

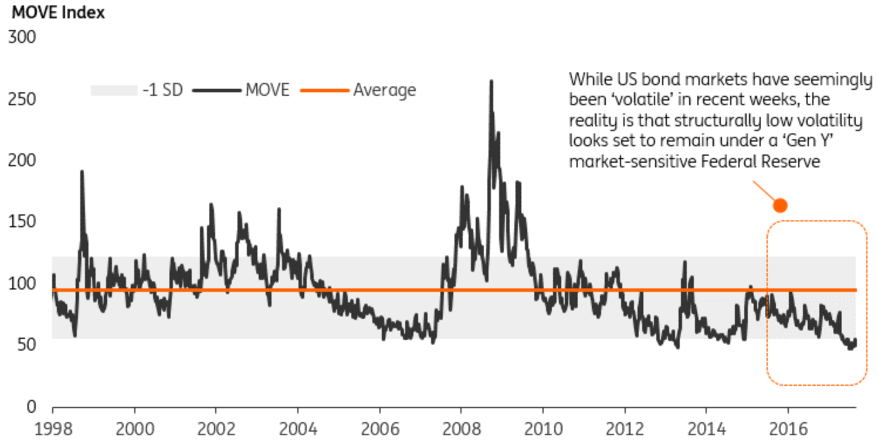
The fallout in the US dollar might be muted for the added fact that Taylor could still find himself on the FOMC in some capacity, with the President still set to appoint three additional FOMC Governors, including a new Vice Chair to replace Stanley Fischer.

Yet, the bigger question we're asking ourselves is whether Taylor as Chair or Vice Chair would actually be game-changing in the long-run? Assessing his recent rules-based academic literature, there are there areas where we note Taylor differs from the Fed's current ideology: (1) his estimate of what the real neutral interest rate (r*) is; (2) QE as central bank policy tool; and (3) the role of the USD in the Fed policy reaction function:

- **It's highly unlikely that Taylor can single-handedly shift the FOMC's thinking on interest rates.** From what we know, Taylor sees the real neutral interest rate (r* adjusted for inflation) at 2%. This is around 150-200bps more than what the Fed currently estimates; Janet Yellen in September noted that the real neutral interest rate in the US was 'close to zero' – and at best may slowly move higher over time. The question is whether Taylor – as Fed Chair or Vice-Chair – would be able to go in and convince the largely more dovish FOMC members that the assumptions that they've been using are wrong. This seems highly unlikely given that the concept of a time-varying r* has been a major development in central bank thinking since the crisis.
- **Where Taylor may have greater success is through a quicker unwinding of the Fed's balance sheet – and that poses upside risks to long-term US yields and the USD.** It's clear that Taylor has been anti-QE, viewing it as a policy that has fuelled competitive

devaluations globally. Fed officials overall may be less opposed to a slightly quicker run-off in the balance sheet – especially given its fairly benign impact **o**n markets thus far (see for example Move Index below). Moreover, Taylor's more free-market approach to capital flows and exchange rates means the USD would also move higher in this scenario.

Only Taylor tail risk might mean higher bond volatility



Source: Source: ING, Bloomberg

Methodology

Our variance decomposition of US financial markets is based on imposed restrictions on the relationship between US Treasury yields and a basket of risky US assets. A 'real' shock is one where US assets are positively correlated due to a reassessment of US fundamentals. A 'monetary' shock is one that has opposing effects on US yields and risky assets (Fed policy related). The decomposition allows us to describe daily changes in the DXY index.

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