USD: The Trump Trilemma

The conflicting market narratives of the Trump administration's 'America First' economic agenda highlight a "trilemma" which explains the dollar's weakness

USD: The Trump Trilemma helps to explain why the dollar is so NOT hot right now

The conflicting market narratives of the Trump administration's 'America First' economic policy agenda underscore the "Trump Trilemma" – which stipulates that out of three potential market dynamics, only two can co-exist at any one time. The three dynamics are as follows:

(1) rising bond yields (a function of greater government borrowing / rising supply of US Treasuries to fund fiscal spending)

(2) a weaker US dollar (to address US trade / external imbalances)

(3) confidence in the long-run US economy (at least relative to the RoW)

Right now, we're clearly seeing the first two operating in tandem – rising bond yields and a weaker dollar – which leads us to posit that investors might have reduced their confidence in the long-run state of the US economy. This is not surprising given the heightened focus once again on the US economy's 'twin deficits' – which has only been exacerbated by (i) the GOP's debt-financed tax cuts and (ii) the relative cyclical strength in other parts of the global economy.

The Trump Trilemma helps to put some context around the market reaction to yesterday's US inflation data. For the US dollar to re-couple with rising US bond yields – within our framework, we'd need to see a return in (relative) confidence over the medium-term US economic outlook. In effect, this requires a positive reassessment of the extent and duration of this US economic cycle; inflation numbers do not provide this (plus it didn't help that US retail sales printed soft). Broadly, we're scratching our heads at finding any new positive US demand or supply shocks that could change the landscape for an economy in the 10th year of its expansion cycle. Without this, it's easy to see the weak dollar story persist.

The speed at which the US dollar declines will be a function of US trade policy (see our note A 'Mercantilist and Mercurial' Dollar Policy). USD/JPY continues to breach new lows – and looks set on a path towards 100 (our year-end target). Japan's Finance Minister Taro Aso overnight gave de facto support to recent FX moves by stating that there is no need to intervene at this stage. A clearing of the 106.00-30 area might trigger a sharper fall towards the psychological 105 handle.

EUR: ECB will have to bear a higher EUR/USD given that it's not EUR-specific

A quiet day in the Eurozone data calendar means EUR/USD will be taking its cue from what happens on the USD-side of the equation. EUR/USD could easily clear 1.25 – but we argue that this won't necessarily see any credible ECB verbal jawboning.

GBP: There's only one thing on the mind of investors... Brexit transition clarity

Over the space of a week, we've had three key UK events and three muted reactions in GBP markets; the cumulative reaction to (1) the Bank of England's Brexit-contingent hawkish signal; (2) the positive UK inflation surprise (which confirmed the Bank's hawkish signal); and (3) a fairly inconsequential speech by Boris Johnson – was a 0.5% move higher in GBP against both USD and EUR. That's a pretty tame reaction – even by the Brexit-impaired pound's standards and to us, suggests that there is only one thing on the minds of GBP investors right now – and that's clarity over a Brexit transition deal. The period leading up to the 22 Mar EU leaders summit will be noisy – but GBP's relative resilience is telling of a different Brexit trading environment to what we saw in 2017 (see our four reasons). Look for GBP/USD to consolidate around 1.40 – with deferred upside on an agreed transition deal.

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