PORTFOLIO INSIGHTS

Why is the potential for US currency intervention a topic of interest?

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IN BRIEF

- The potential for unilateral US intervention in the currency markets to weaken the US dollar is increasing as the US administration becomes more frustrated with the dollar's persistent strength.
- Discussions over intervention could intensify if expected US interest rate cuts fail to weaken the currency, or if other countries intervene to weaken their own currencies as US rates fall.
- Historically, such intervention has had mixed results. The main questions are whether the Federal Reserve would join the Treasury in any intervention programme, and whether any intervention in the currency markets would be accompanied by accelerated rate cuts.
- Other countries could respond to weaken their own currencies, escalating existing trade tensions, while the US dollar does not look excessively overvalued according to our research, which could lessen the impact of any intervention.
- The likely size of any intervention is also likely to be relatively small compared to daily US dollar turnover in the currency markets.

> "China and Europe playing big currency manipulation game and pumping money into their system in order to compete with USA. We should MATCH, or continue being the dummies who sit back and politely watch as other countries continue to play their games - as they have for many years!"

D.J. Trump, July 3, 2019

What has caused investors to think about US intervention in the currency markets?

The potential for unilateral US currency intervention arose as a topic of research interest last year. At the time, the subject was not something we felt should be central to any investment debate. However, discussion surrounding the potential for unilateral US intervention has intensified over recent weeks.

The catalyst appears to have been a number of high profile tweets from President Trump on currency policy, along with a consultation by the US Commerce Department on whether it would be possible to implement tariffs on countries with significantly undervalued currencies as a result of government/central bank policies.

The US administration is technically able to undertake intervention in the foreign exchange (FX) markets, at the discretion of the Treasury secretary and subject to approval from the president, via the $94 billion Exchange Stabilization Fund. Traditionally, the Federal Reserve (the Fed) has joined the Treasury in any currency intervention measures, with half the financing typically coming from each to effectively double the intervention capacity—although the Treasury cannot require the Fed to participate unwillingly.

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Does currency intervention work?

From a historical perspective, the success of intervention programmes globally is mixed. Generally they have been more successful when the intervention has been multilateral, unsterilised and backed up by the relative monetary stance, and when it has occurred at a time of extreme currency valuations and when there was the potential for intervention to change the flows driving currency appreciation.

Would US unilateral intervention work this time?

When thinking about the potential for US intervention to be successful, we would make the following observations:

1. We would not expect any international support for such a policy amid the current trade tensions, and other countries might take offsetting measures.
2. There is room for debate as to whether the Fed would only act as agent on behalf of the Treasury or whether it would act in coordination. In the past the Fed has coordinated even when it disagreed with the Treasury's motives for intervention. The uncertainty now is that the Fed's independence is already perceived to be under attack. Would breaking with historical precedent be deemed to be more politically motivated than continuing with it? The twitter tirade that would undoubtedly follow against the Fed if it failed to coordinate with the Treasury makes the market reaction difficult to gauge.
3. While it is not clear that the Fed would accelerate its easing as a complement to currency intervention, the US central bank is already providing a reasonably supportive backdrop. Conversely, if the Fed did not coordinate and instead argued that financial conditions were being unduly eased, the Trump administration could still intervene significantly, but in this scenario the US dollar might only weaken a couple of percentage points, and then only initially. There is also the possibility that equity markets could react poorly to any perceived conflict between the Trump administration and the Fed, somewhat perversely still ultimately weakening the dollar but for reasons more associated with the degradation of the US dollar's reserve currency status.
4. Our research suggests that the US dollar is overvalued relative to purchasing power parity estimates of fair value, but not excessively so. We therefore do not believe valuation alone is sufficient reason to believe intervention would be successful.

The final condition for a successful intervention, flows, is a tricky one to evaluate. Current account flows are not US dollar supportive at present as they were during past periods of failed intervention in the Japanese yen and Swiss franc. Would intervention send US equities up or down? If the answer is up, due to easier financial conditions and a boost to translated foreign earnings, private asset flows supporting the US dollar would unlikely be deterred. Of course, markets could perceive US policy making as having entered a chaotic phase, which would be less US risk asset supportive.

In recent times, enormous resources have been spent on failed unilateral intervention programmes (over 80% of GDP in the case of the Swiss National Bank and hundreds of billions of dollars in the case of Japan) and we doubt the $20 billion to $70 billion available to the US Treasury in isolation (without Fed coordination) would generate more than an initial 3%-5% move in the dollar—most of which would subsequently be retraced as a result of the international backlash. Such a level of intervention is also tiny when compared with the $4.4 trillion daily FX turnover in the US dollar.

Ultimately we do not think unilateral currency intervention, in the absence of significant Fed rate cuts, would be very effective in generating a sustained weakening of the US dollar, although initial volatility could be significant. It would, however, represent a significant escalation in trade tensions, to which risk assets would likely react poorly.

Conclusion

The probability of US unilateral intervention has risen from a tail scenario to one of low-to-moderate probability. However, the Trump administration's frustration with a persistently strong US dollar is clearly rising and should rate cuts by the Fed fail to push the dollar down, partly as a result of offsetting easing by other central banks, we should expect the administration's focus on currency policy to continue to increase.

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