While monetary policy certainly has a further role to play in addressing the economic woes that we face, its efficiency has deteriorated.

Since the global financial crisis, central bank policy has been driving markets. Yet the institutional arrangement of independent central banks addresses yesterday’s problem of too much inflation; the impact of this operational focus is being felt across markets today. Currencies are clearly affected by the policies that central banks employ to deal with today’s economic challenges, albeit in some rather unanticipated ways.

Markets have long recognized that central banks have the willingness and ability to act to limit inflation via monetary policy tightening regardless of the election cycle — their independence instills credibility. Now, faced with today’s problem of very low inflation, central banks have responded with aggressive “conventional” interest rate cuts coupled with “unconventional” quantitative easing (QE) in order to stimulate rising prices.

The credibility of independent central banks was certainly an advantage when attempting to reduce inflation, but may be a hindrance in trying to boost inflation. Consumers are likely to bring purchases forward only if they believe the central bank has a bias for higher inflation stemming from short-term growth. The market is arguably more likely to believe this from a politician who has an election cycle to worry about, rather than a central bank that must consider the consequences of a recession later and attempt to keep inflation under control over the long term.

**DOLLAR RESURGENCE?**

Ultimately, central banks respond to economics. While monetary policy certainly has a further role to play in addressing the economic woes that we face, its efficiency has deteriorated given rates have crossed the zero bound in many regions and, in some cases, entered negative territory. It has also created unusual consequences as we enter into a possible twin-speed recovery.
Economic data from the U.S. has recently been firmer than that of its main trading partners, having suffered a setback over the first quarter. It seems policy divergence is once again back on the agenda and U.S. dollar strength is likely to prove to be an increasingly important theme over the year ahead while the rest of the world is beset by economic headwinds.

The potential schism in economic paths has created unusual currency reactions over the first half of 2016 and these could well continue. When the Bank of Japan (BoJ) implemented a surprise negative rate policy at the end of January, conventional logic suggests that it should trigger a depreciation in the yen. Yet, the unconventional nature of the policy in already febrile markets concerned investors. Consequently, a flight to safety ensued and the yen traded up against the U.S. dollar.

The U.S. dollar fell further over the quarter in the wake of less convincing economic data. A lack of action from the Japanese central bank only served to strengthen the yen, particularly as markets expected measures akin to those implemented by the European Central Bank in the quarter, including further quantitative...
easing. It is evident that these central bank activities are having a less direct impact on the yen and euro than they would have in the past, when low inflation was not the issue. At the beginning of May, interest-rate markets were barely pricing in one hike this year in the U.S. Better economic numbers and comments from the Federal Reserve (“the Fed”) suggested that raising interest rates this summer would be “appropriate” so long as economic data held up. Consequently, the U.S. dollar trimmed some of its earlier declines. There were even suggestions the Fed was still open to raising interest rates two or three times this year — a much quicker pace than many expected, although these have since been scaled back.

Naturally, a rising U.S. dollar will put pressure on commodities and currencies that are underpinned by them. Questions remain about where we are in the commodity cycle and whether the lows tested in the first quarter represent its nadir. On one hand, the authorities in China stepped back from further stimulus, negatively impacting commodities where there are concerns about oversupply, particularly iron ore. On the other hand, oil has been supported by supply cuts and currencies that trade in line with crude should receive support.

Over the first half of 2016, we established long U.S. dollar positions when the currency dipped and took profits as it rebounded. We believe that market expectations have since been reset and we are likely to see trading in ranges punctuated by breakouts. In short, while the Fed is currently expected to hike rates this summer in response to stronger data, any stumble will produce strong countertrends and the narrative will change once again. Given this unstable equilibrium, and also the understanding that central banks will act independently of market reaction, caution is the order of the day.

Figure 1: Yen and euro versus the U.S. dollar year-to-date

<table>
<thead>
<tr>
<th>Jan 16</th>
<th>Feb 16</th>
<th>Mar 16</th>
<th>Apr 16</th>
<th>May 16</th>
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<td>Rebase JAPANESE YEN TO USD (BOE) to 100</td>
<td>Rebase EURO TO USD (WMR&amp;DS) to 100</td>
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Source: Thomson Datastream, as of May 31, 2016.