Results from our FX market survey on potential US policy shifts

Greg Anderson, CFA, PhD – Global Head of FX Strategy

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An introduction to our survey on US policy initiatives

Between February 10 and March 3, BMO FX Strategy conducted a survey of those who are subscribed to receive our publications. The survey covered FX-related policies that the Trump Administration and Republicans in Congress have discussed. We asked respondents to give opinions on how likely it was that policy initiatives would be initiated and what the FX response would be. The objective of the survey is to help our readers to understand what 'market consensus' is on these issues so that they can get a better idea of what is currently 'priced in' and how exchange rates may evolve as the probabilities and timetables of policy initiatives shift.

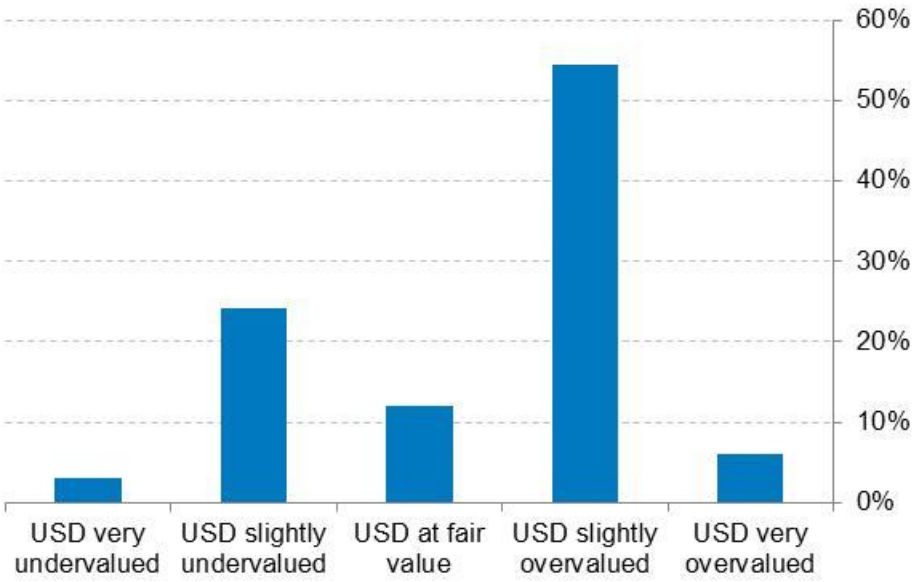
We emailed an invitation to participate in the survey to roughly 1000 individuals. We sent only one request to participate to the vast majority of people on that list, but about 40 got two requests. The survey was built using the SurveyMonkey web tool. We set the tool to restrict ISDNs from participating more than once, but we did not otherwise track the identity of respondents. We sent a different web link to different geographic regions to allow us to track whether opinion varied by location. We ended up receiving 33 unique responses. Of those, sixteen were from respondents identifying themselves as US-based. The remainder of respondents were not US-based, with most of them being in Canada (as would be expected given BMO's footprint). The low number of data points is disappointing, but a 3% response rate to a market survey is not unusual. Whether it is a 'representative' sample is an open question. We suspect that the sample of respondents is skewed toward those who have the greatest interest in policy initiatives, but we don't think there is any reason to suspect any other biases.

In general, the survey responses suggest that there are diverging opinions regarding what the US is most likely to do on the policy front and how the USD will react. Opinion only approaches what we would consider a consensus on a few minor points. As a result, the survey has led us to believe that potential policy shifts aren't 'priced in' to the USD for the most part. Consequently, if and as policy initiatives roll into the frame, the response of the FX market should be relatively straight forward and not constrained by positioning.

Our views do differ from the most common survey response in a few instances, which we identify at the end.

General USD valuation and direction

What's your view on USD valuation?



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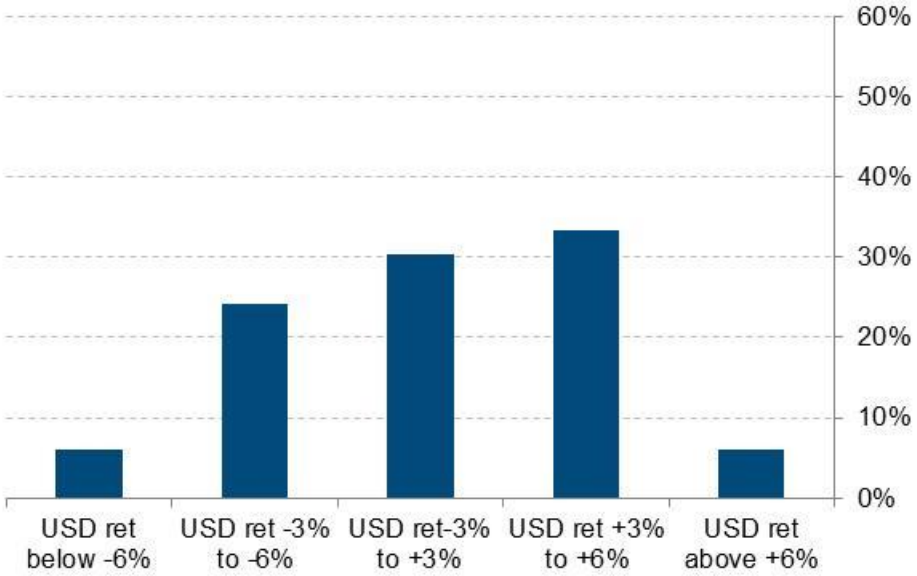
Projected 2017 USD return if no major policy shift?



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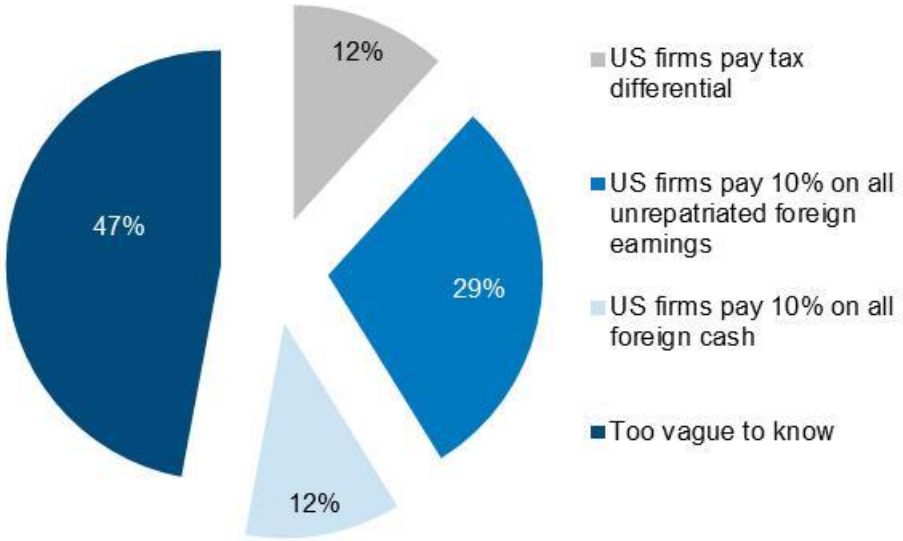
- 61% of respondents said that the USD is either slightly or very overvalued
- 27% of respondents said the USD is either slightly or very undervalued
- 39% of respondents thought the USD would rise by 3% or more in 2017
- 30% of respondents thought the USD would fall by 3% or more in 2017
- A rough calculation of the weighted average return expectation is +0.4% for the year (with the USD index down roughly 2% on the year during the period of the survey)
- The expectation of the 2017 USD return from inside the US was slightly lower than the expectation from survey participants from outside the US (data not shown for brevity)

The meaning of Trump's 'deemed repatriation' international taxation proposal

What does 'deemed' mean (US-based respondents)



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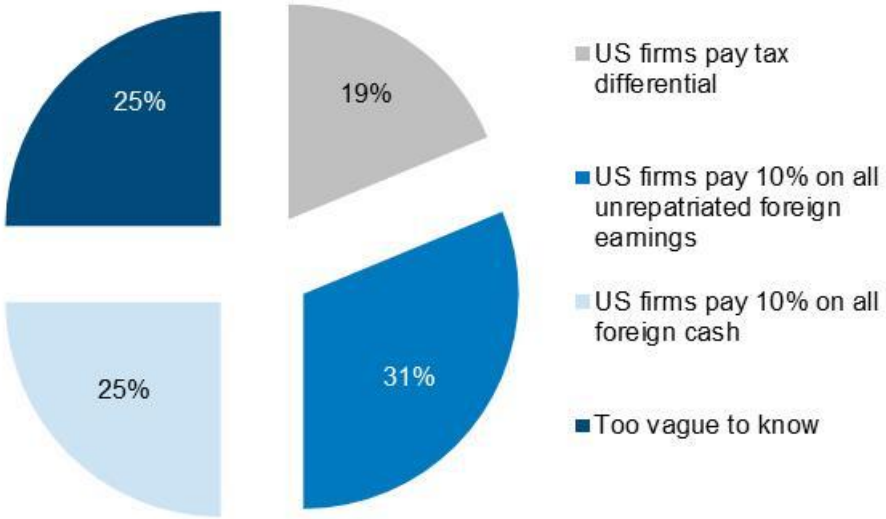
What does 'deemed' mean (non-US respondents)



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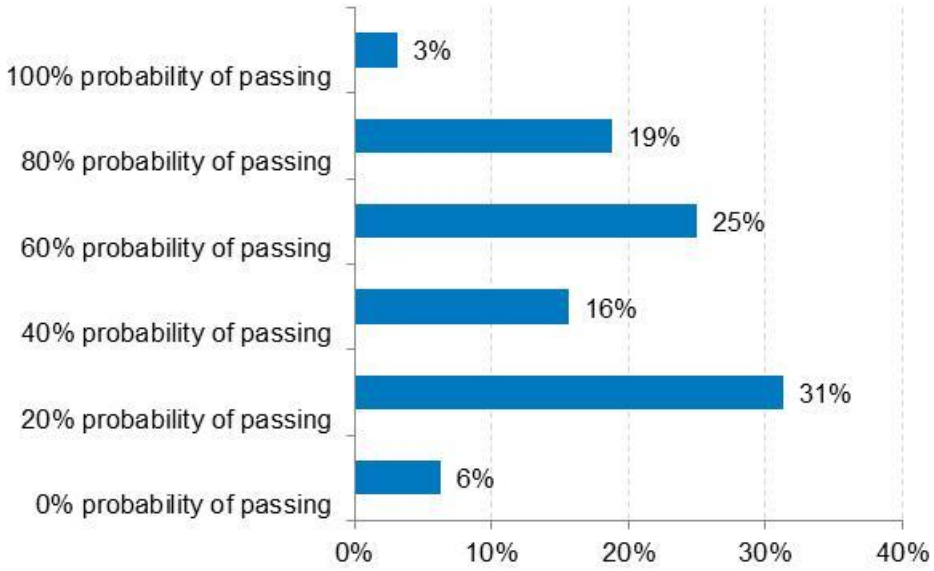
- The precise question of the survey was the following: "Trump's campaign documents promised a 'one-time deemed repatriation of corporate cash held overseas at a significantly reduced 10% tax rate, followed by an end to the deferral of taxes on corporate income earned abroad.' What is your understanding of this statement?
- For the whole sample, the most common response was "too vague to know." It was selected by 36% of respondents. Interestingly, those based in the US were twice as likely to choose "too vague to know" as those outside the US.
- The ''tax differential' response included a qualifier that said "(since most countries have tax rate above 10% that means no additional tax paid to the US)". It was chosen by 15% of respondents.
- The lack of consensus on this policy idea suggests that FX markets haven't yet 'priced in' a repatriation window.

Probability and market response to 'deemed repatriation'

What is the probability that 'deemed repatriation' is enacted in 2017?



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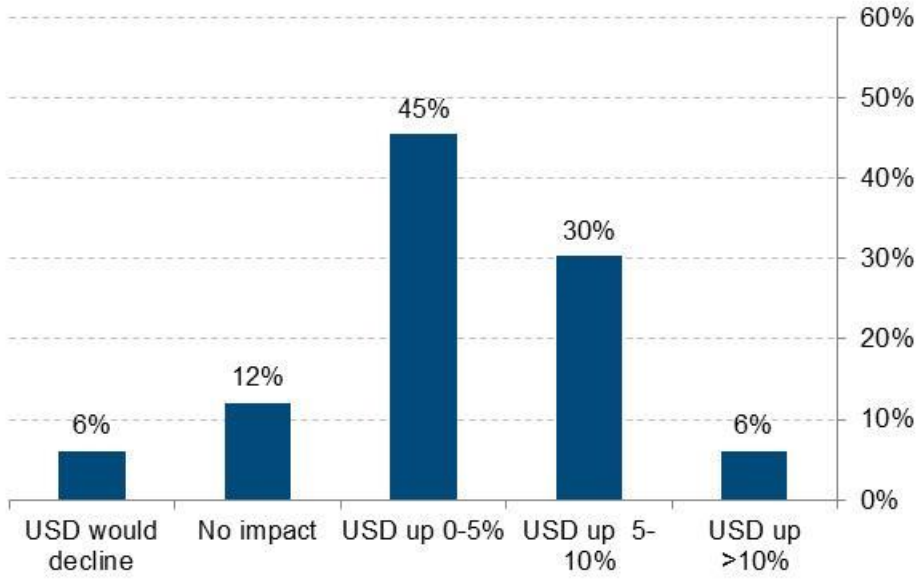
What would be the reaction in the Fed's broad USD index to enacting 'deemed repatriation' in 2017?



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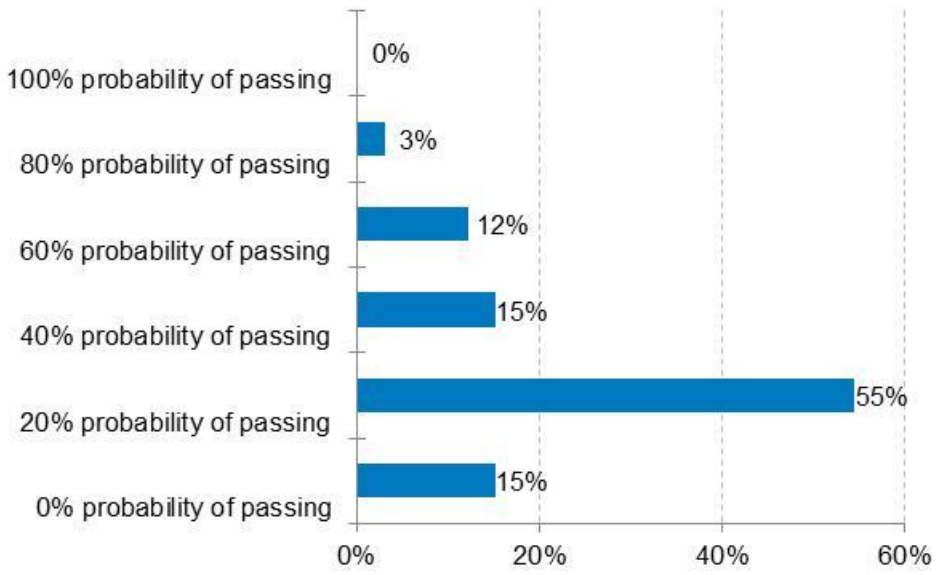
- The mode for the probability question was "≈20% probability", which was selected by 31% of respondents
- However, 47% of respondents thought the probability of passage was at least 60%
- The weighted average of the probability responses is 46%
- The mode for the market reaction question is a USD appreciation of 0-5%, but 36% of respondents thought the impact would be bigger than 5%
- A rough calculation of the weighted average expected USD return (if it passes) is +4.0%
- Although this measure is half expected, the small expected response suggests it probably isn't be 'priced in' yet

Probability and market response to the Brady-Ryan 'Better Way' tax reform

Your view on the probability of passage?



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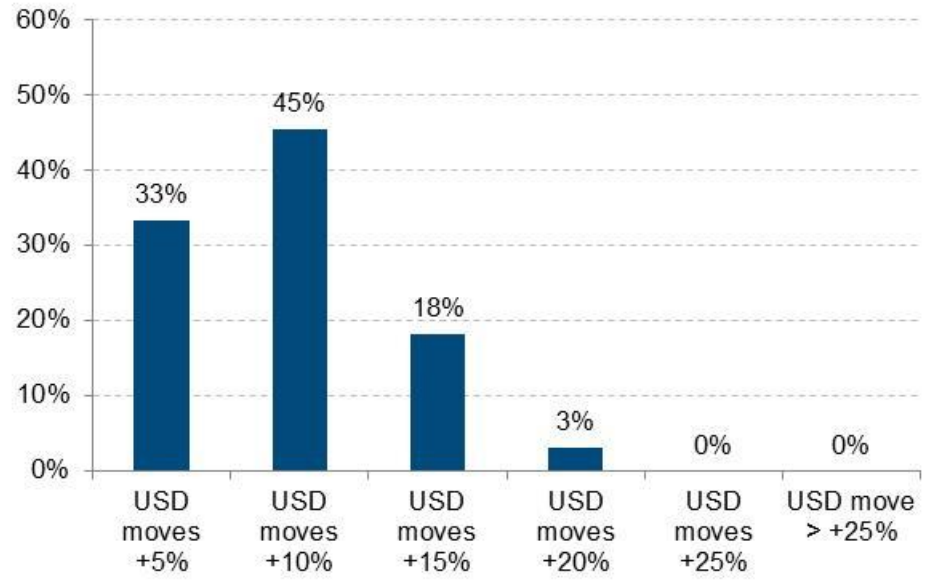
How much would the USD move?



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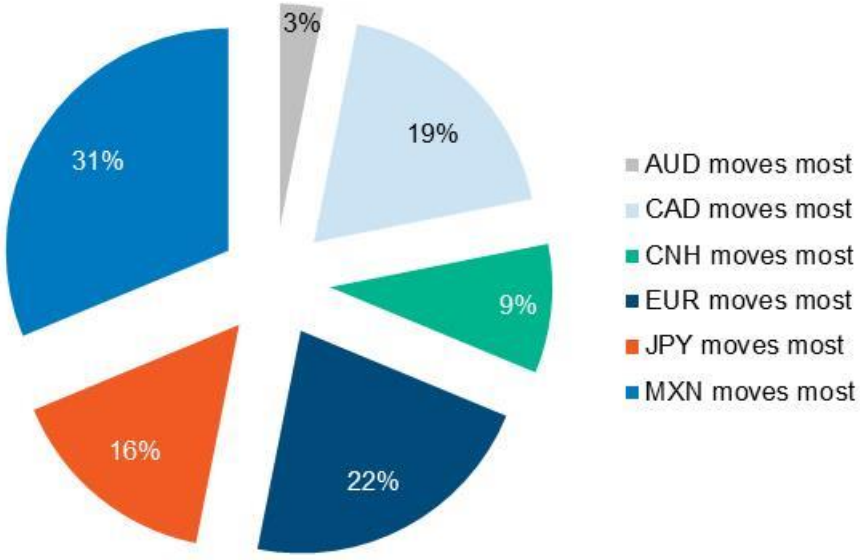
- The pronounced mode for the probability question was "≈20% probability" -- selected by 55% of respondents
- Only 15% of respondents thought the probability of passage was at least 60%
- The weighted average of the probability responses is 27%
- The mode was also pronounced for the market reaction question; 45% of respondents thought the USD gain would be +10% (half the tax rate)
- The weighted average expected USD return (if it passes) is +10%
- The low expectation of passage suggests this policy isn't be 'priced in' yet, but the large expected response suggests that the USD would rally to partially 'price in' this policy if it evolved to having a high probability

The impact of the 'Better Way' plan across the spectrum of currencies

Which currency would adjust the most?



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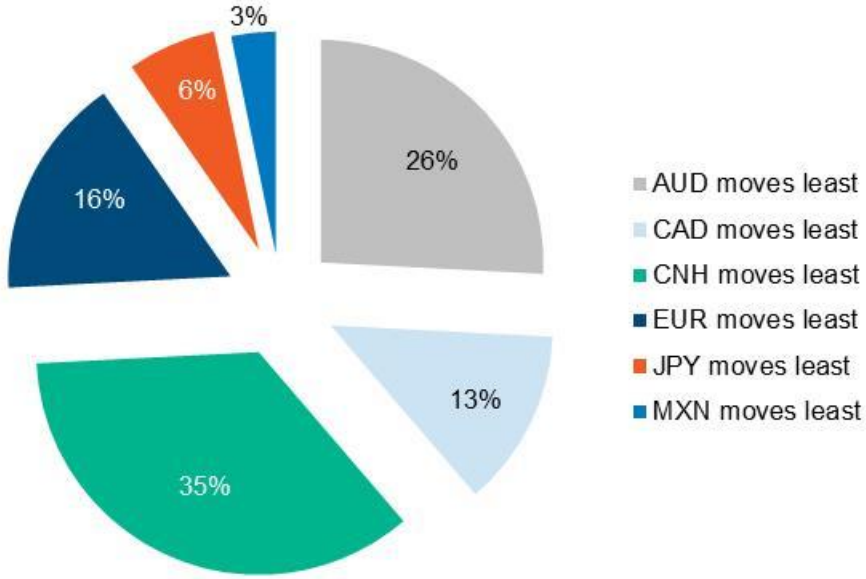
Which currency would adjust the least?



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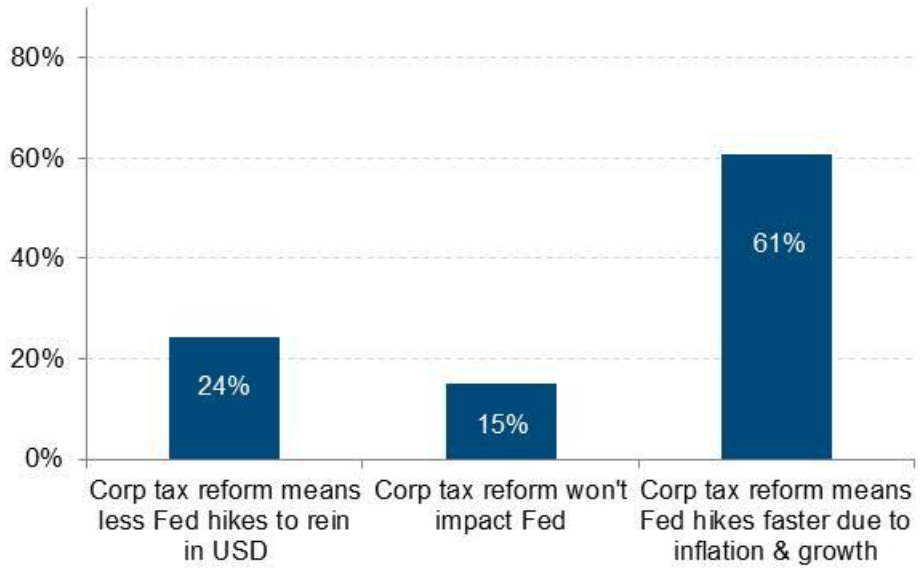
- The specific questions asked which currencies would adjust the most and least in calendar year 2017
- 31% of respondents thought MXN would most the most, while only 3% thought it would move the least ⇨ (+28)
- 16% of respondents thought JPY would move the most, while 6% thought it would move the least ⇨ (+10)
- 19% of respondents thought CAD would move the most, while 13% thought it would move the least ⇨ (+6)
- 22% of respondents thought EUR would move the most, while 16% thought it would move the least ⇨ (+6)
- 3% of respondents thought AUD would move the most, while 26% thought it would move the least ⇨ (-23)
- 9% of respondents thought CNH would move the most, while 35% thought it would move the least ⇨ (-26)

The impact of corporate tax reform on the Fed and the US's trade balance

Would corporate tax reform cause the Fed to alter its pace of tightening?



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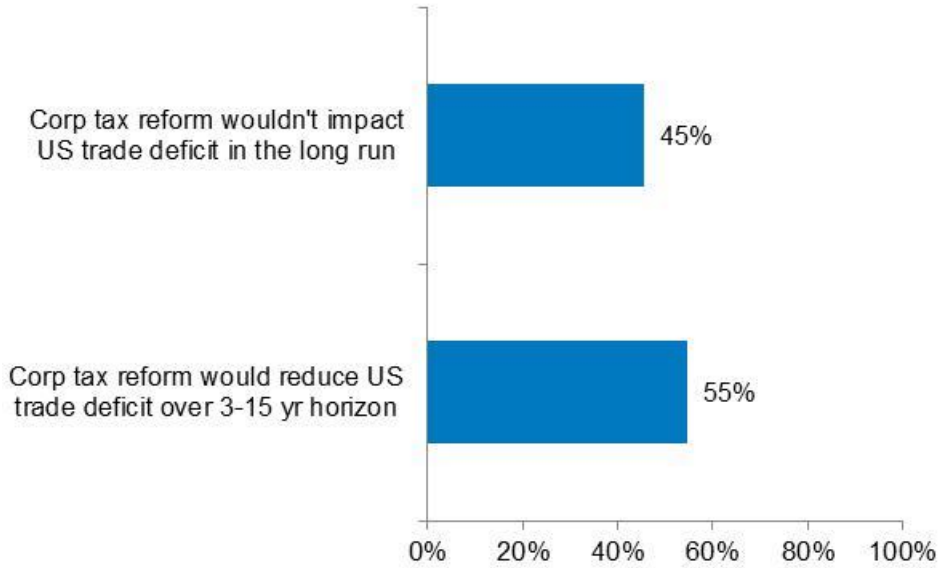
Would corporate tax reform change the US's trade balance 3-15 years down the road?



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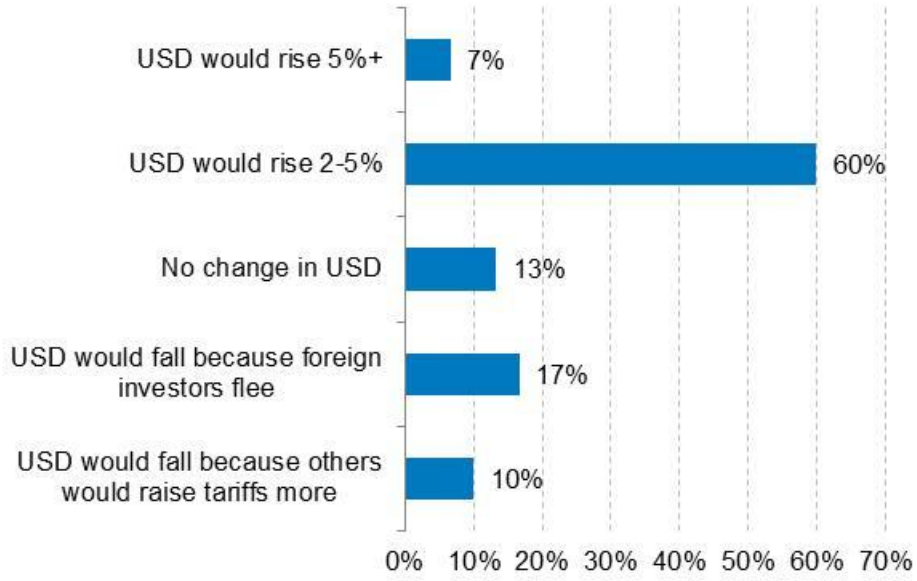
- The majority of respondents viewed the impact of tax reform on the Fed through a traditional inflation-targeting framework (meaning tax reform would cause growth and inflation to accelerate, which would cause the Fed to hike more aggressively to defend its inflation target).
- There was a small minority that viewed the impact of tax reform on the Fed through more of an exchange-rate-targeting framework (meaning the USD appreciation triggered by the tax reform would cause the USD to rally which would cause the Fed to hike less aggressively).
- The theoretical framework employed by market participants to explore the trade balance was almost evenly split. 55% of respondents had a neo-Keynesian view that policy can impact the LR trade balance. 45% had a neo-classical view that the LR trade balance drops out of (savings-investment) and therefore wouldn't change.

The USD response to an increase in tariffs and/or an exit from the WTO

How much would the USD rise if the US raised its weighted average tariff by 5%?



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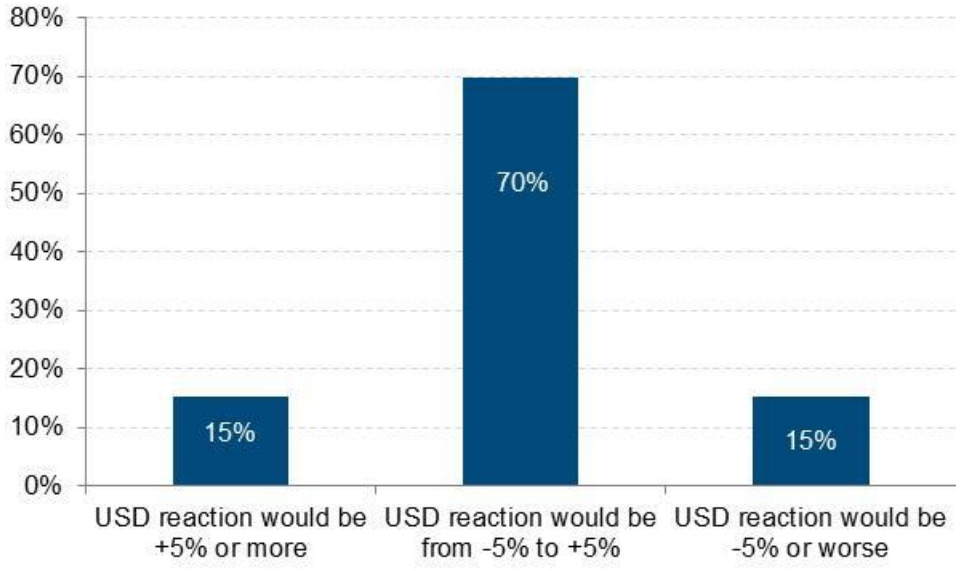
How much would the USD rise if the US were to exit the WTO and shift focus to bilateral deals?



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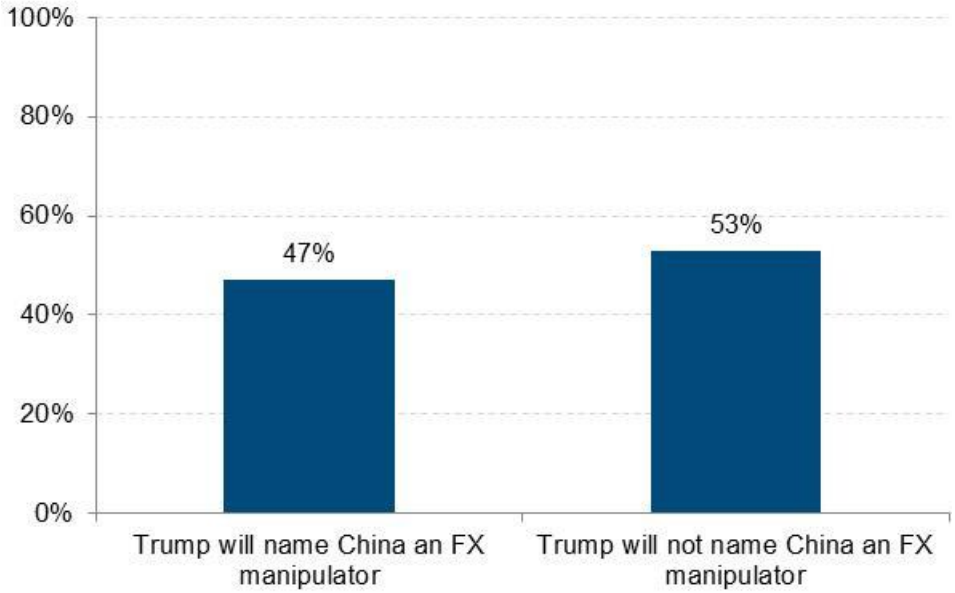
- The mode of the tariff question is that the USD would rise by somewhat less than a 5% tariff increase. The weighted average response to a 5% tariff increase is 1.7%.
- 67% of respondents think that the US hiking its weighted average tariff would cause the USD to rise, while 27% of respondents think that hiking tariffs would cause the USD to fall.
- The pronounced mode of the WTO exit question, at 70%, suggests that FX market participants generally don't think that WTO exit would trigger a big move in the USD.
- The symmetry of 15% thinking the USD would appreciate and 15% thinking the USD would depreciate upon WTO exit suggests a lack of consensus on the directional impulse of such an event.

The likelihood of the Trump Administration naming China an FX manipulator

Will Trump name China an FX Manipulator? (US-based respondents)



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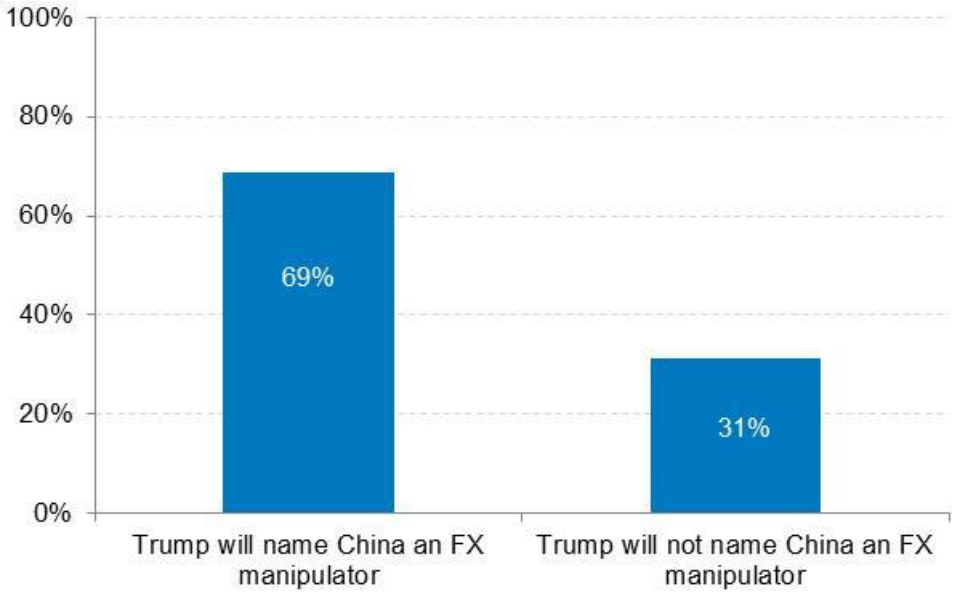
Will Trump name China an FX Manipulator? (non-US respondents)



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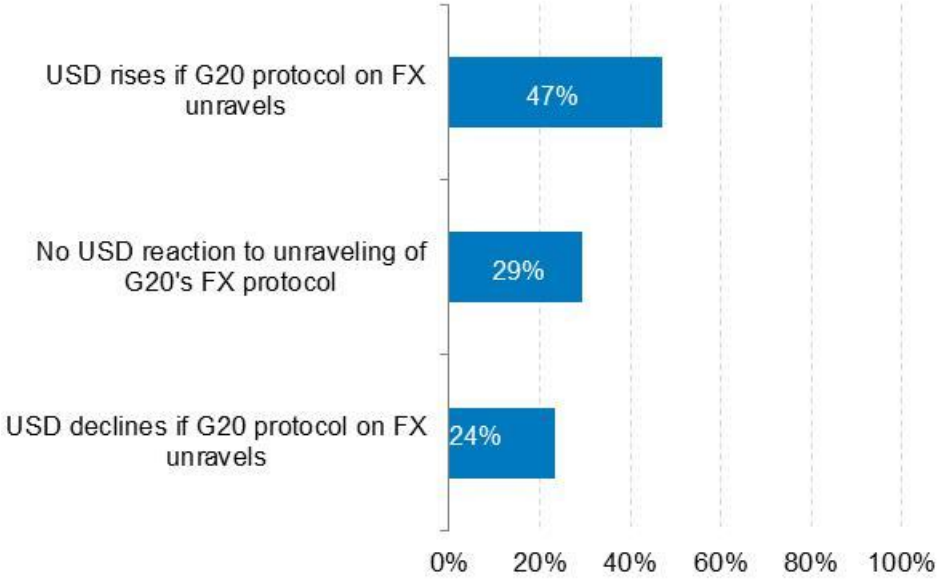
- The overall survey result was 58% thinking Trump (and his Treasury team) will name China as an FX manipulator and 42% thinking that he won't
- There was an interesting difference of opinion upon bifurcating the survey into US-based and non-US pools
- The majority (albeit slight) of US-based respondents DON'T THINK the Trump team will pull the trigger on the FX manipulator title and the fallout that it would bring
- A substantial majority of non-US respondents DO THINK that the Trump team will label China an FX manipulator

The impact of walking back the G20 protocol on the USD

"We reiterate that excess volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability. We will consult closely on exchange markets. We reaffirm our previous exchange rate commitments, including that we will refrain from competitive devaluations and we will not target our exchange rates for competitive purposes. We will resist all forms of protectionism. We will carefully calibrate and clearly communicate our macroeconomic and structural policy actions to reduce policy uncertainty, minimize negative spillovers and promote transparency."

USD response if protocol unravels? (US-based respondents)



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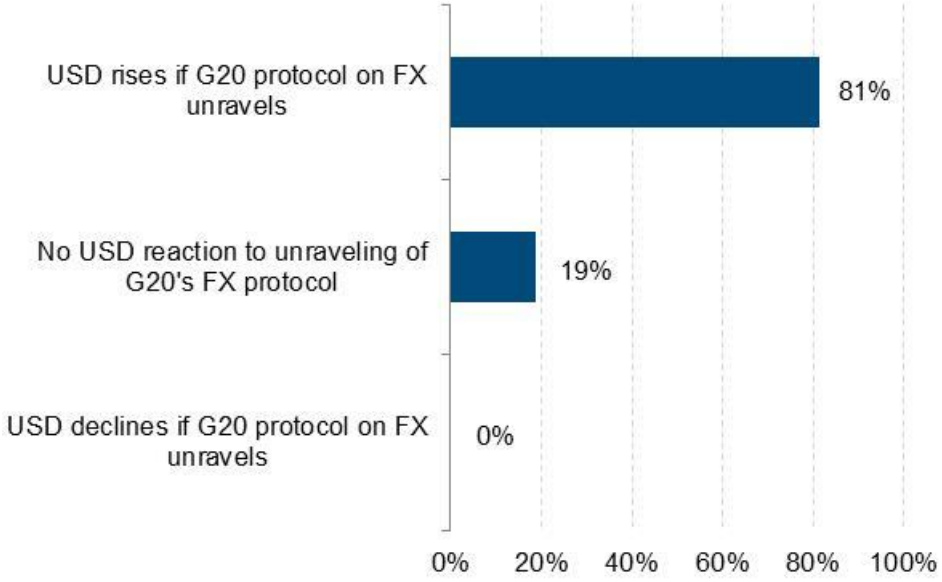
USD response if protocol unravels? (non-US respondents)



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- Most market participants apparently believe that the G20 protocol restrains other countries from talking down their currencies more than it restrains the US.
- Respondents outside the US were much more likely than those within the US to say that a scaling back or disintegration of the G20 protocol will result in a higher USD.

My views versus ‘consensus’ views revealed by the survey

- I agree with the market consensus that the USD is somewhat overvalued but nevertheless likely to rise further in 2017 (even if there are no major policy shifts). The overvaluation will eventually correct, but there is no obvious trigger for than in 2017—especially with US twin deficits smaller than their long-run averages and the US taking the lead on monetary tightening.
- I agree that Trump’s ‘deemed repatriation’ is somewhat more likely to get enacted than the House Republican leadership’s ‘Better Way’ plan. I further agree that the ‘Better Way’ plan would bring a substantially bigger USD appreciation than ‘deemed repatriation’. The survey response of 5% for ‘deemed repatriation’ seems a bit large to me, but it’s in the right neighbourhood. A USD appreciation of half the border-adjusted cash flow tax rate also seems about right. If it is truly a replacement for corporate income taxes, I don’t think the tax rate could be 20%, though. I think the tax rate would need to be 30%ish. I also don’t view the policy choice as one or the other. I could see both ‘deemed repatriation’ and ‘Better Way’ getting enacted.
- I disagree that MXN would depreciate the most if ‘Better Way’ is enacted. My logic is that MXN is already about 25% below its long-run fair value and that is why Mexican authorities have already intervened this year to deter USDMXN upside. I think they would do so aggressively if ‘Better Way’ went through. I think that CAD would adjust the most. CAD has the combination of tight economic linkages, a nearly unfettered float and an exchange that is only about 10% away from long-run ‘fair value’. I view EUR as being 15% away from ‘fair value’, so it’s got less room to run. Japanese authorities might want JPY to weaken the most, but the market would fret about Japan potentially getting labelled an FX manipulator if JPY weakened beyond 130. There is no such risk for Canada—even if USDCAD went to 1.60.
- I agree with the apparent consensus that a tariff increase would bring mild USD strength. I think that WTO would bring much greater USD strength, though. That event would be such a market shock that it would cause a flight to quality and the US normally appreciates in such moments.
- I don’t think the Trump team will label China as an FX manipulator. They may want to, and they may use stronger language in the FX report than the Obama team did, but there really isn’t a case for it right now. Yes, there was manipulation in the distant past, but the statute of limitations has run out on that so to speak. I believe that Mnuchin can see that and wants to avoid expending scarce US goodwill on an issue he can’t win on.

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