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MACRO MORNING BRIEFING

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# Intervention Risks Add To Focus On Treasuries

## Central banks may need to react to dollar valuations

- Hawkish Fed could trigger intervention in APAC
- Reserve rundown to add to pressures on Treasuries
- Overseas demand to become a structural issue for the US

## Externalities of dollar strength catching up with the Fed

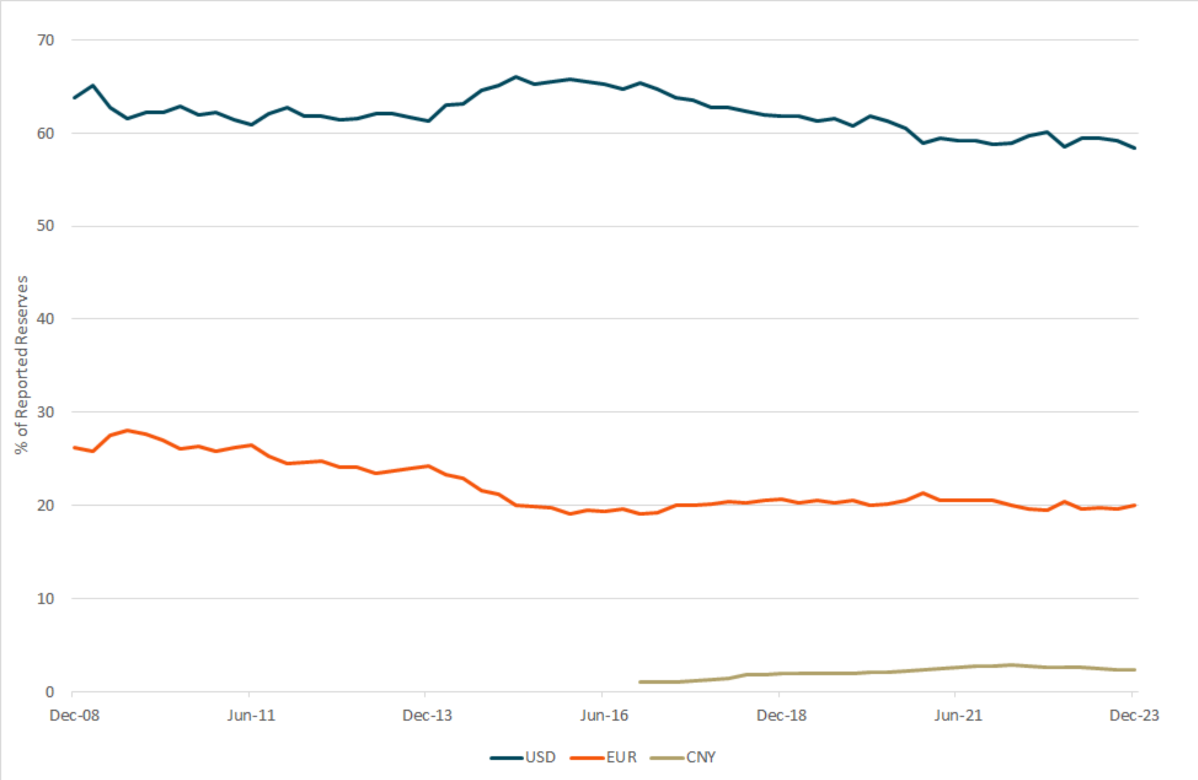
The jury is still out on the efficacy of Japan's yet-to-be-confirmed yen intervention this week, but this could become viewed as an opening salvo in a new round of intervention by Asian central banks. As much as the Federal Reserve and US Treasury might like to continue a long-standing policy of benign neglect, we believe that dollar dynamics can no longer be ignored and see a chance that developments in Asia soon spill over into US policy. Despite the dollar's exorbitant privilege, externalities from its strength exist – not all are positive.

Unlike for G7 peers such as Germany and Japan, the dollar does not generate excessive pass-through inflation (in both directions) for the US. As a services-based economy based on domestic demand, there is also less of an income effect through FX translation of foreign earnings by US firms. As a result, the dollar represents the least important component in financial conditions. Furthermore, over the last two years its high yield has anchored asset allocation, and there hasn't been a substantial decline in the dollar's share amongst reserve holdings (exhibit #1). However, during phases of intervention, volatility itself can become a restraining factor for economic agents globally, even the US.

As central banks desire to be over-funded in dollars while being active in the market, immediate rebalancing could even drive the dollar higher on an aggregate basis. The euro comprises most non-dollar reserves and the yuan's share has been rising. Even if USDJPY stabilises or falls, sales of EUR and CNY to rebalance portfolios can drive the USD trade-weighted index (TWI) higher through other channels. Repeated iterations of such behaviour –

especially if the activity is generated by minor central banks – would consistently support dollar valuations to a point where it can start to affect the Fed's inflation views through the import price and foreign income channels on a marginal basis.

**Exhibit #1: Dollar's Reserve Share Holding**



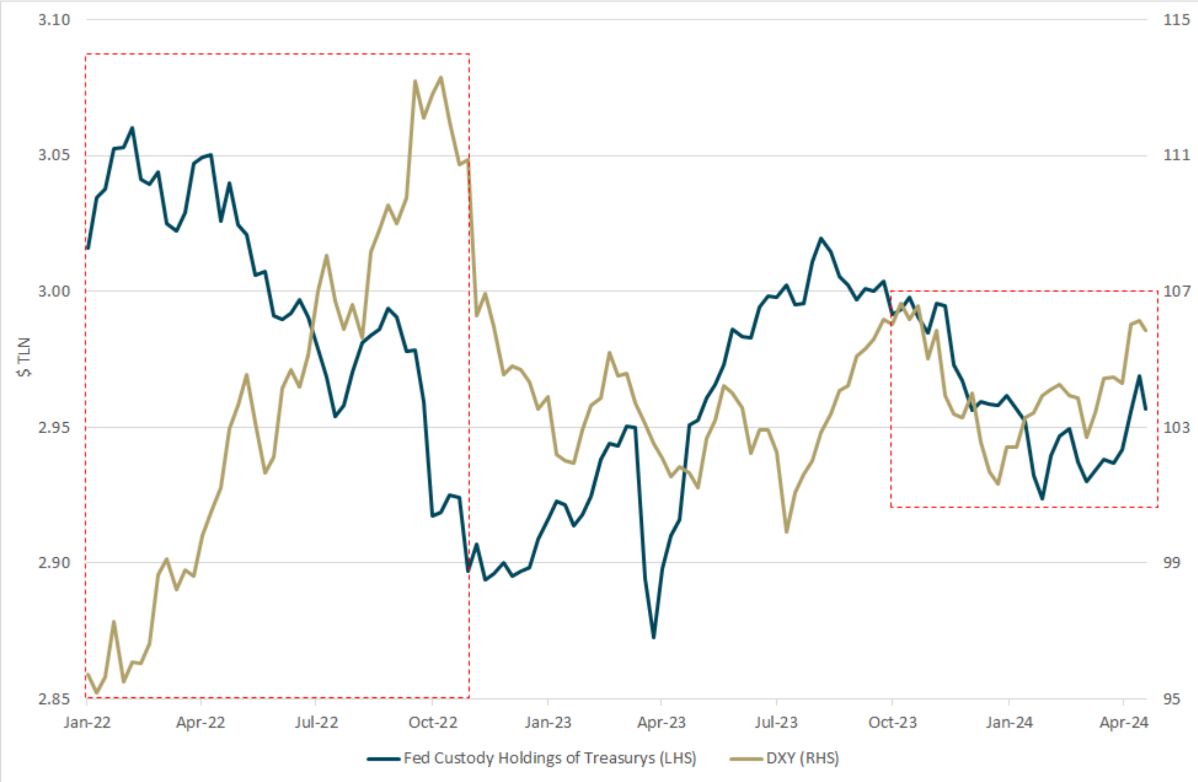

Source: Bloomberg, BNY Mellon

Even if intervention is executed through the foreign exchange market, funding the processes will affect other asset classes, especially US Treasuries. In 2020, during the initial stages of the pandemic when demand for dollar liquidity was acute (exchange rates played a secondary role at the time), the Fed clearly saw the risk of a severe tightening in domestic financial conditions due to mass liquidation of Treasury assets held in reserve by global reserve managers. The creation of the Foreign and International Monetary Authorities (FIMA) repurchase facility was designed to avoid such an outcome. However, FIMA (now a standing facility) is not designed to provide dollar liquidity for intervention purposes, and exchange-rate misalignments would be under the purview of the Treasury. As such, should global central banks choose to act, direct Treasury sales would likely materialise.

Based on the Fed's weekly report on its custody holdings of reserve assets (exhibit #2), we can see that during the round of rising yields and stronger dollar in 2022 and much of 2023 there was a stark decline in holdings to meet dollar liquidity needs. Yet the dollar kept on strengthening as yield differentials and growth divergence arguably justified exchange-rate movements. Reserves were also under pressure amongst energy importers but, similarly, there was a large increase in holdings amongst energy exporters, even if a large part of such receipts did not materialise in reported holdings in the International Monetary Fund's (IMF) composition of foreign exchange reserves report (COFER) displayed in exhibit #1.

Ultimately, as the recent decision by the Bank of Korea not to act on the won's valuation pressures shows, those Asian central banks which continue to hold most of the US Treasury securities as part of reserve assets are registering their own version of benign neglect for currencies and choosing not to push back aggressively against policy differentials, be it against the Bank of Japan or the Fed.

**Exhibit #2: Fed Custody Holdings vs. DXY**



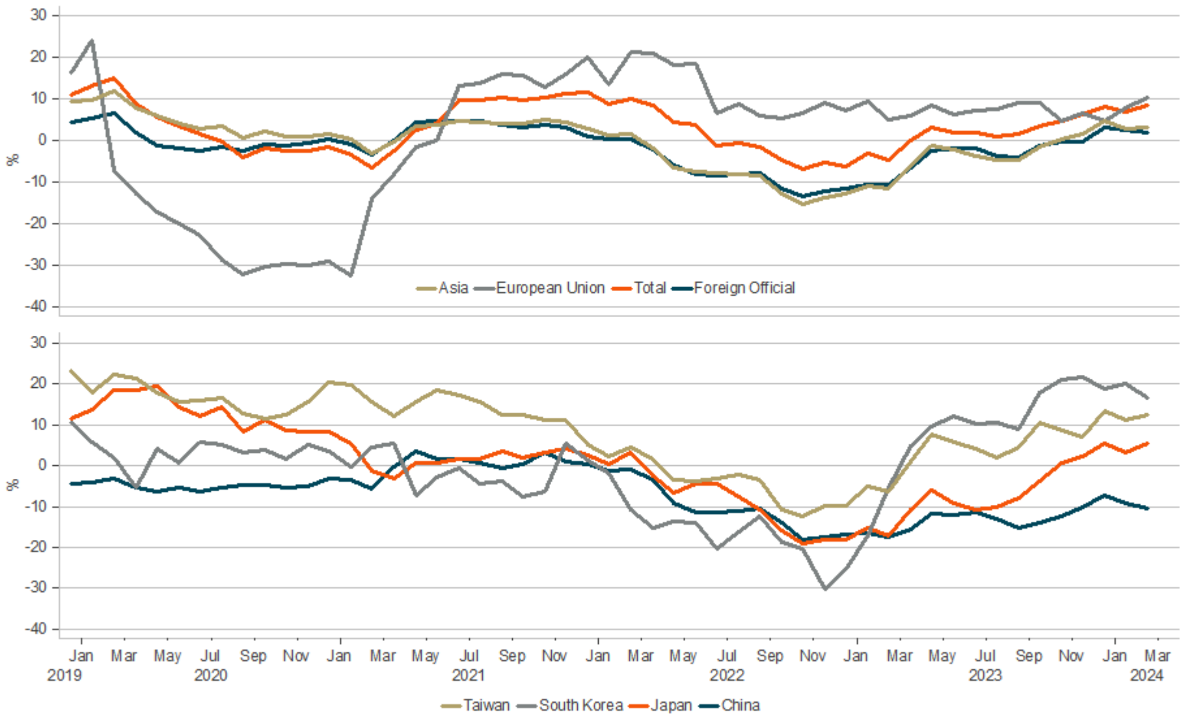

Source: Bloomberg, BNY Mellon

It may be just as well that these reserve managers are limiting Treasury sales, or even starting to restock Treasury assets, as concerns over the US's fiscal position continue to rise. The US Treasury Department's latest quarterly refunding passed without much incident despite a larger-than-expected requirement. Ample revenue generated during tax season is an anchoring factor, but the US cannot rely on external support indefinitely.

Even without fiscal largesse, a strong dollar will likely continue to exert an impact on global balance of payments and limit the ability of foreign central banks to accumulate reserves and recycle back into Treasuries. The US's own industrial policy may, in time, permanently alter trade flows and the corresponding impact on financial accounts in global balance of payments. We can see (exhibit #3) that over the last two years, key Asian exporters have been reducing their Treasury holdings, mostly out of necessity, but, with the exception of China, light accumulation is starting again.

However, if US subsidies incentivise South Korean and Taiwanese semiconductor manufacturers to engage in more production in the US – several companies in recent weeks announced this would be the case – export earnings could decline if these companies opt to reinvest earnings in the US. Some funds may yet find their way into US Treasuries, but we doubt that the quantum will be the same. China's financial account, meanwhile, is also evolving to the detriment of reserve holdings, and there are other considerations which could also limit Beijing's interest in accumulating Treasuries.

**Exhibit #3: Change In Treasury Holdings**



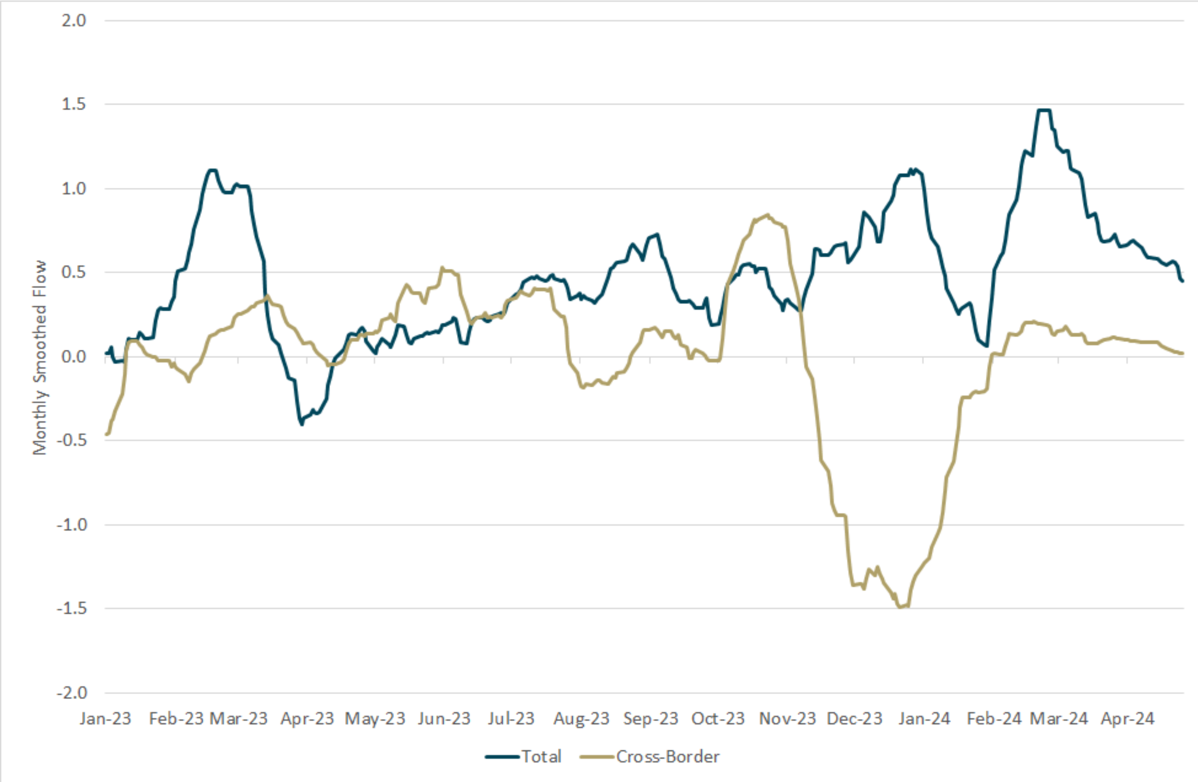

Source: Macrobond, BNY Mellon

iFlow indicates that in Q4, during the round of declines in US bond yields, there were significant outflows on the part of cross-border investors. However, this was easily offset by strong purchases by domestic parties. More recently, both onshore and offshore asset owners have added to holdings, though the latter appears less enthusiastic (exhibit #4).

No matter the outcome of the US election, fiscal restraint is unlikely to materialise in coming years and high yields remain an attraction. However, as external resources become increasingly constrained, demand for a fiscal premium on Treasuries could return. If dollar strength becomes more disruptive for APAC central banks, they may become more active – to the detriment of the Treasury market. As such, we believe external conditions, on the margins, also support the need for the Fed to slow its balance-sheet roll down.

While the FOMC today will continue to firmly anchor its decision based on domestic considerations, we think foreign developments need to move up the agenda speedily.

**Exhibit #4: Total And Cross-Border UST Flow**




Source: iFlow, BNY Mellon

## Disclaimer & Disclosures

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