BNY

iFlow

MACRO MORNING BRIEFING

July 5, 2024

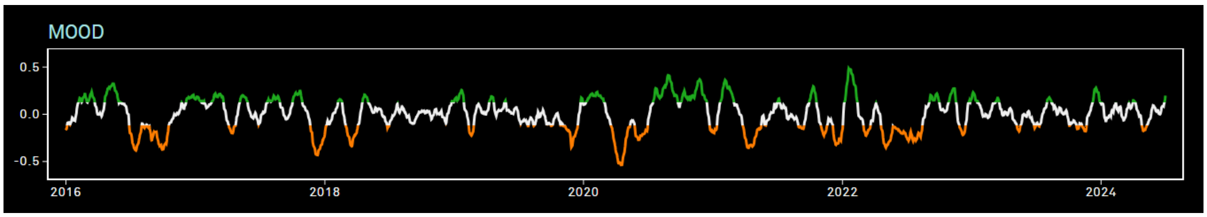
Risks in Europe for 3Q

The third quarter of 2024 starts with a bang as markets focus on elections in France and the UK, and price in new US election risks, all but ignoring the role of Fed or ECB policy in the months ahead. There are other surprise risks in the third quarter to consider, and looking at our iFlow data, none of these are priced in either. The flows of our clients around half-year end suggest more caution and fear than aggressive confidence in growth and global recovery. The US data continues to drag lower with 2Q GDP nowcasts running below 2% making clear that high for longer hurts. There are plenty of reasons to worry about the USD, but the EUR has its own set of problems.

- The rising risk of bird flu turning into a pandemic is underappreciated. The role of pandemic risks post-Covid seems strangely underpriced. The EU is not immune from this risk.
- The risk of a German snap election following along the UK and French surprises is not reflected in Bunds or the DAX. The next test comes in September with state elections.
- Ukraine/Russia peace talks and deal potential over the summer may be fleeting, with doubling down by the US and EU to support Ukraine, even as the EU elections on June 9 made clear voters want peace.

The iFlow data changed significantly this week – with the risk indicator for Mood – which measures our flows of equity buying or selling vs. under 1-year G10 buying or selling for bills. This turned positive for the first time since March. The average over the last 8 years for significant positive mood index duration is 19 trading days, with the median a bit lower at 16. The distribution of significant positive vs. negative is about equal (36 positive and 37 negative). What is interesting is what happens when things are positive in stocks vs. our flow mood indicator. The contrast today shows up in the FOMO (fear of missing out) quality of this market, with the materials, industrials, health care, IT, communications, utilities and real estate sectors – 7 out of 11 sectors – chasing the tape, with our flows both leading and lagging the tape. But of these, six are selling not buying the sector. What also stands out is the flip in the correlation of equities to bonds in the last two weeks, from negative to now positive at 0.547%, which implies our clients are not buying equities as much as buying bonds and selling bills – with the hope that the FOMC will ease in September.

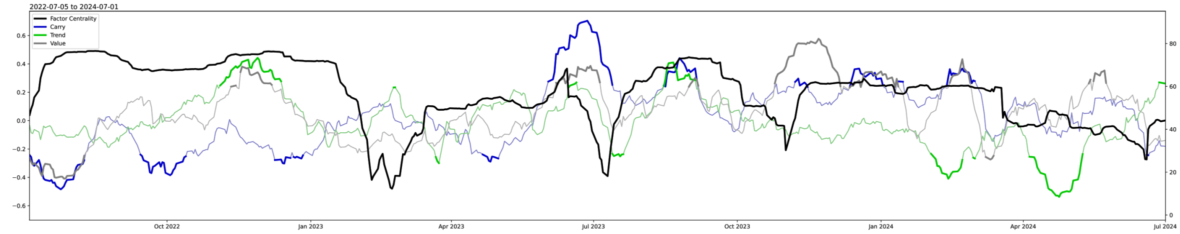
Exhibit #1: iFlow Mood is significantly positive



Source: iFlow Mood index BNY Mellon

The other notable shift was in trend factors in FX markets, which also turned significantly positive, which last happened in July 2023. The flows behind the mood indicator are not in equities but in bills, while those of trend are not from the carry trade as was the case last year, but rather from the unwind of CHF, SEK, MXN and BRL. The average duration is just 8 days and the median 3.4 days – suggesting this is a short-term story – with the distribution of significant outstripping negative by 36 vs. 30 in the last 8 years. Most of the time this is neutral. The chasing of trend in FX is interesting as a signal for other asset classes. This suggests CTA or trend-following models across markets are positive. The contrast with risk parity programs that usually need lower volatility to perform well shows up in our carry index being negative. It has been just at the edge of significantly negative, coming in at -0.18 today in the 20.5% percentile. The implication for all markets is that while mood is up, it is not just about stocks, nor is it chasing trends in quiet markets, but rather big, noisy positioning moves.

Exhibit #2: FX factors trend up, carry down?



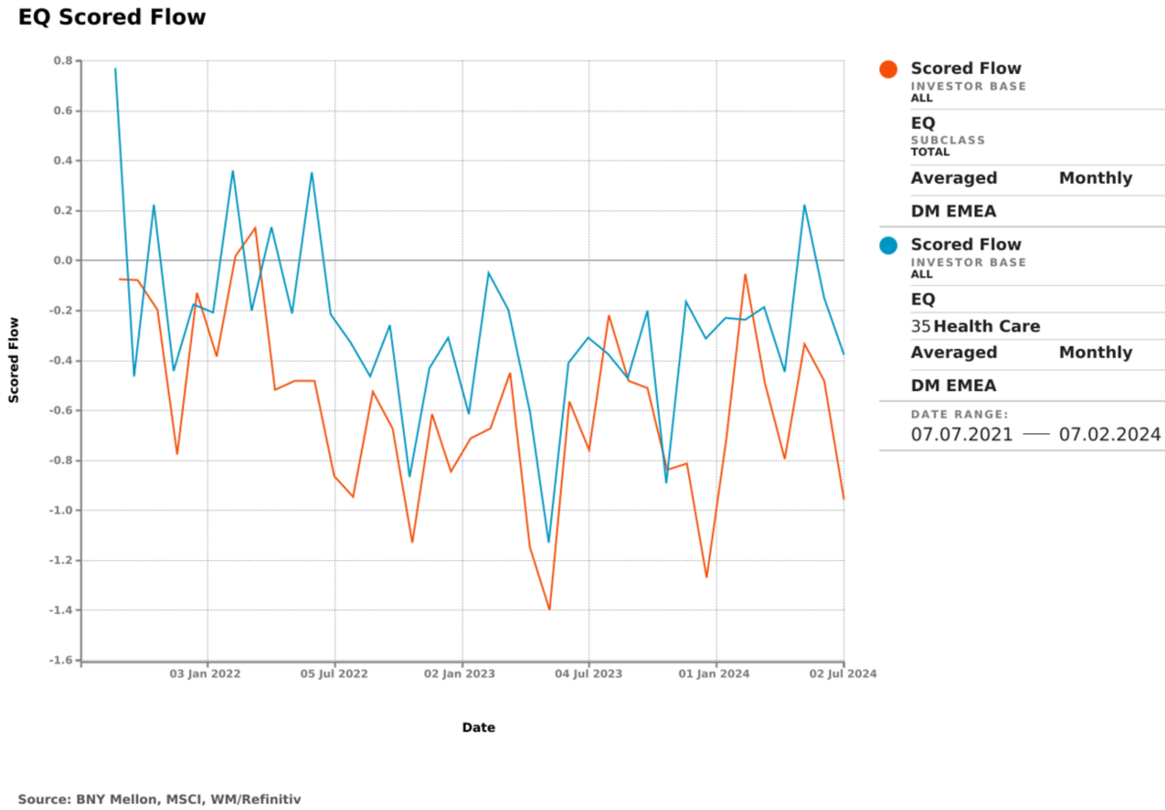
Source: iFlow FX Factors, BNY Mellon

The potential for sharply weaker 3Q growth making this a summer of discontent with recession risks rising or stall speed fears is not priced in for either the US or EU markets.

Bird Flu

- The new H5N1 avian flu strain has spread to 129 dairy cow herds in 12 US states. Infections have been transmitted to mammals, including alpacas, house cats and four humans, including one person in Mexico who contracted a different H5 strain. Cases involving different strains have also been reported in India, China and Australia. What isn't noted in the news but remains problematic is that over 105 cases have been recorded in poultry in Europe – including in Italy, Norway, Poland, Bulgaria and the UK. **The earlier the warning of a jump to humans, the sooner global health officials can take steps to protect people** by launching vaccine development, widescale testing and containment measures. While bird flu is not a new worry, the effect on global trade, growth and consumers should not be ignored. This is a legitimate tail risk into 3Q end.

Exhibit #3: Health care sector isn't overheld



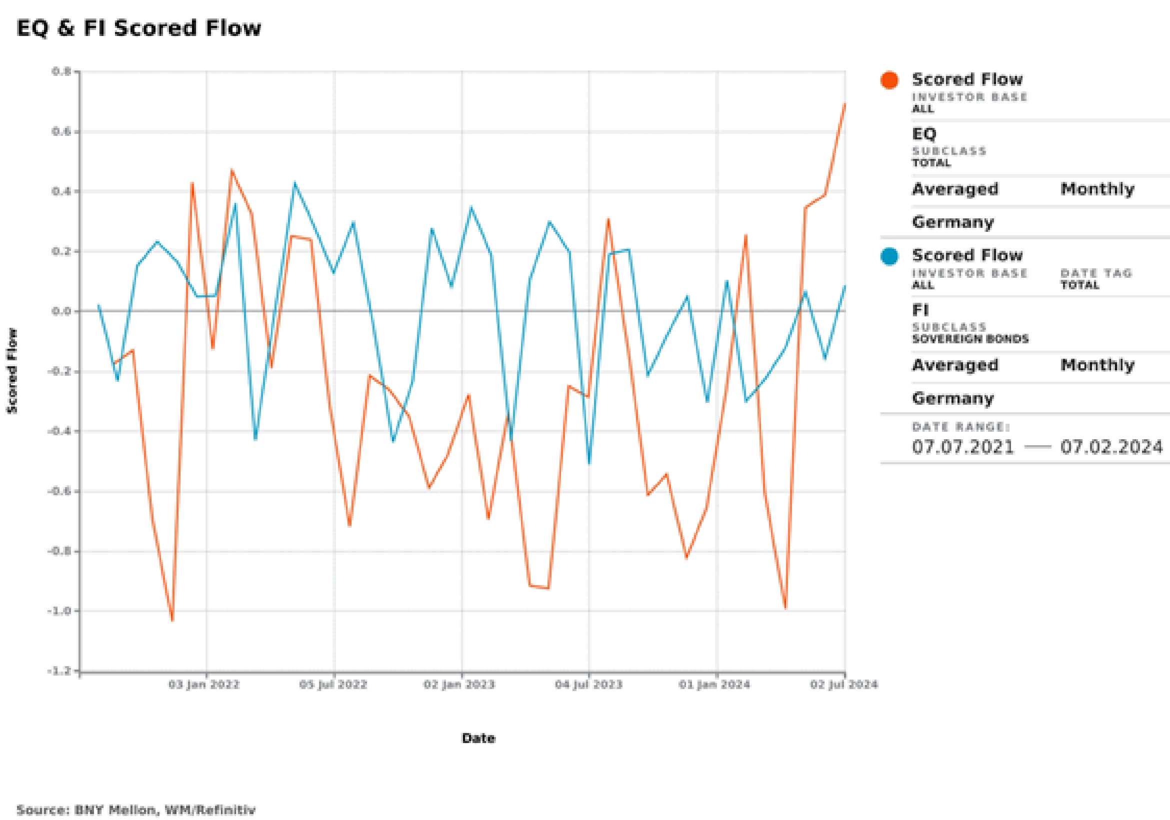
Source iFlow, BNY Mellon

- The problem is in catching the bird flu transmission. Some pandemics, including COVID-19, arrive with little warning. In the last flu pandemic, caused by H1N1 in 2009, the virus and its predecessors first spread among animals for several years making it clear more surveillance would have helped health authorities to prepare. Some countries are taking steps to protect people against H5N1. The United States and Europe are securing doses of “pre-pandemic” flu vaccine that could be used for high-risk groups, including farm or lab workers. Finland is expected to become the first country to inoculate fur and poultry farm workers, as well as animal health response workers.
- **What are the market risks**? The focus on US risks runs with the exports of food and risks to trade more than in Europe but the effect of human transmission risks on global growth are underpriced, with governments needing to again spend on healthcare.
- **How is the market positioned**? The health care sector over the last three years highlights that the post-pandemic world is not convinced that another global risk is looming, in Europe or the US.

German Coalition

- The EU election showed the weakness of the coalition as collectively they garnered 31% of vote. The Alternative for Germany (AfD) party has a real chance of winning elections being held in three of Germany's 16 federal states in September, as they came second in Germany in last month's European Parliament election with 15.9% of the vote, and party membership is at a record high (up 60% y/y to 46,000). At its Congress, the AfD doubled down on core positions of anti-migration and pro-Russia stances. Within the ruling parties, there's widespread agreement that the severely weakened coalition cannot survive another grinding dispute on the budget. While no one in the coalition wants to give up – they are likely to be forced to act in the interests of their party, particularly into the next round of state elections – there is a real risk (25% or higher) of a snap election.

Exhibit #4: German equity and bond flows don't reflect any political fears



Source: iFlow, BNY Mellon

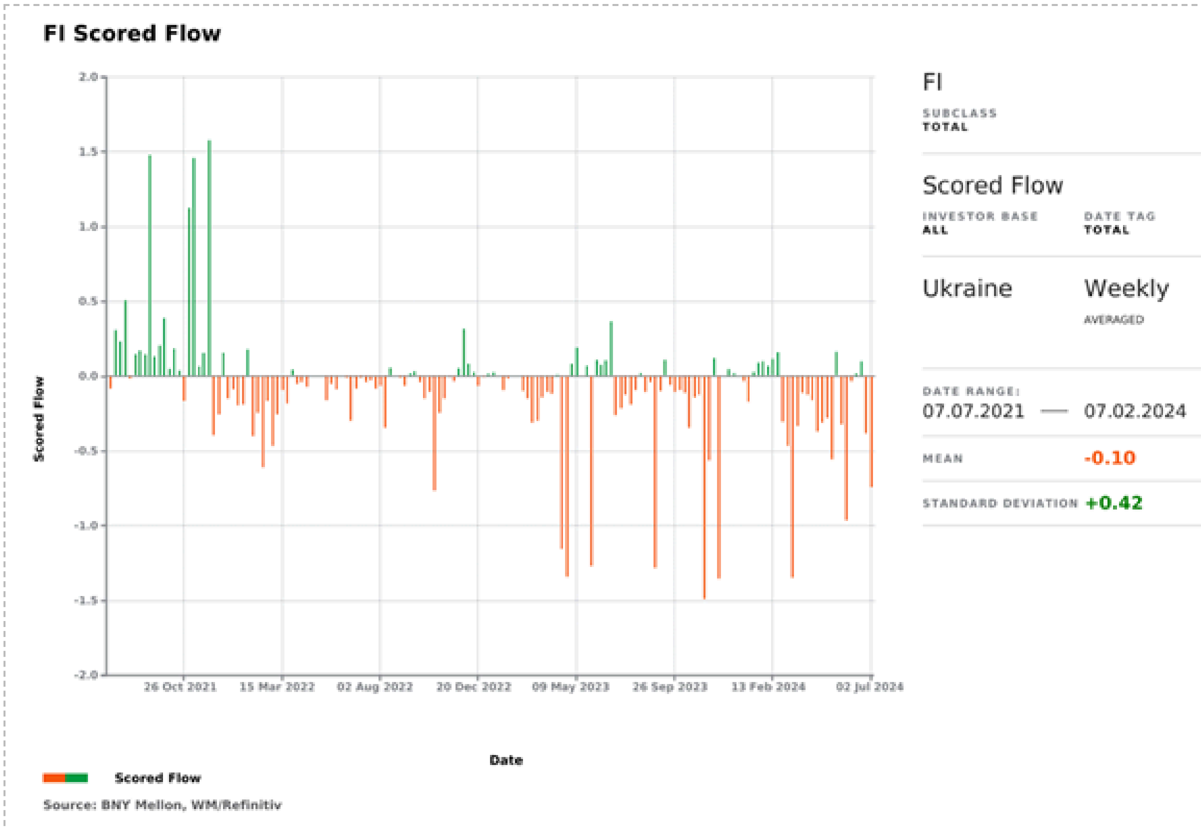
- Economy Minister Robert Habeck, Finance Minister Christian Lindner and Scholz are expected to come up with a draft budget by early July, before the Bundestag's summer break. Members of the left-leaning governing parties – the SPD and the Greens – are steadfastly against cuts to social programs and

favor loosening strict spending rules, while the Free Democrats want to abide by those rules. Despite the intractable conflict, leaders of the coalition government say they will avoid the kind of prolonged feud that will only increase calls for a snap election, as is happening in France.
- **What are the market risks**? German economic risks have been well understood, but the inability of the coalition to hold is not in the price for Bunds or stocks. The risk is that Bunds will lose their place as the key anchor of European bonds. German equities have growth risks from political uncertainty, leading to fewer investments until tax and other policies are clarified.
- **How is the market positioned**? Germany has benefited from the French and UK elections. A surprise shift in German politics could lead to a washing-out of such positions.

Russia/Ukraine Peace Deal .

- The New York Times published what a 2022 deal looked like last month. How this sets up discussions now matters. Putin and Zelensky have both publicly stated that they would entertain discussions for a deal. The 2022 deal had some clear issues – "…including weapons levels, the terms of Ukraine's potential membership in the European Union and specific Ukrainian laws on language and culture that Russia wanted repealed. Ukraine's negotiators offered to forgo NATO membership, and to accept Russian occupation of parts of their territory. But they refused to recognize Russian sovereignty over them." Markets have been thinking that Zelensky would push for a deal before the November elections in the US. There is little surprise in these discussions, but there is also more risk as markets may be too sanguine about the costs of a "forever" war in the region.

Exhibit #5: Peace deal isn't driving Ukraine bonds

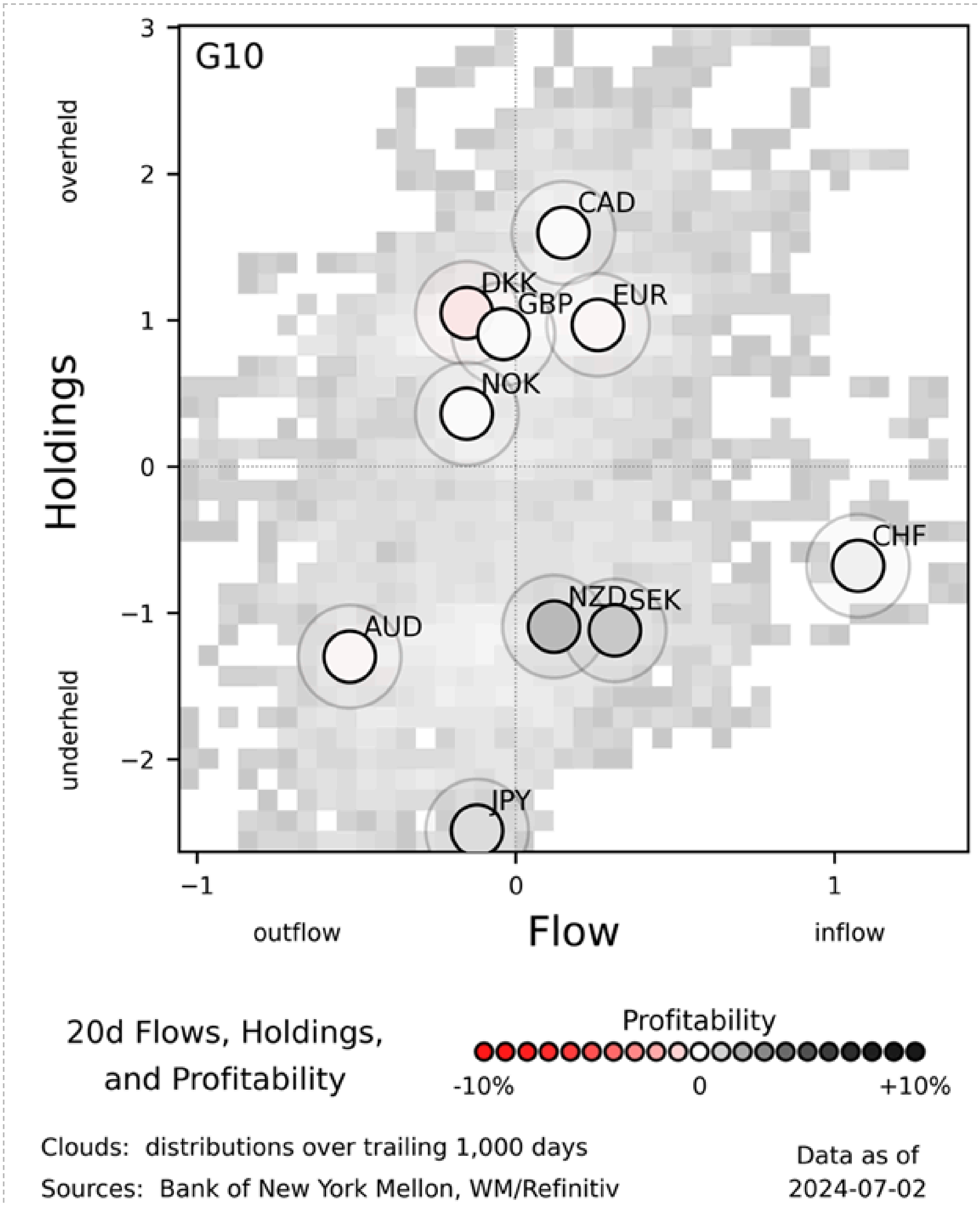


Source: iFlow, BNY Mellon

> There is support for negotiations in Ukraine, but not to accept Russian demands or to be against the present war. Many Ukrainians may be open to negotiations in theory, but they overwhelmingly do not trust Russia to negotiate in good faith. Most Ukrainians (86 percent) believe that there is a medium or elevated risk that Russia will attack again even if there is a signed peace treaty, and even more (91 percent) believe that Russia's motive for entering negotiations is to take time to prepare for a new attack. The risk for markets is that any relief from a signed deal may be short-lived as there will be many who expect any deal to fail.

Bottom Line: The biggest risk for Europe beyond the French election this weekend is in the way politics play out across the region. The war in Ukraine, the risk of natural shocks from weather to bird flu to immigration linked to climate change pressures – all are part of the risk. Longer-term fears about policy approaches to fix labor productivity and finance remain concerns as well. For the short term, the EUR looks vulnerable to being overheld and while the USD has seen a notable reversal in the last week thanks to slowing economic data, the EUR may prove to be a less-than-reliable alternative. The iFlow cloud chart makes clear CAD, EUR and GBP are all seen as alternatives now, but AUD, JPY, CHF and SEK are better choices given their current positioning.

Exhibit #6: EUR is not best choice for USD alternative



Source: iFlow, BNY Mellon

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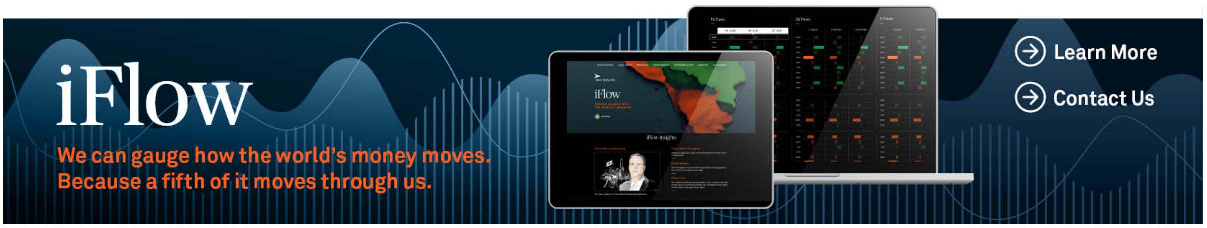

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