BNY

iFlow

MACRO MORNING BRIEFING

July 22, 2024

Cautious with Summer Carry

Real rates back on the horizon

- US and European political risk and fiscal push starts to limit monetary policy space
- Carry trades can work, but positions are volatility-dependent
- APAC losing luster as funding source, valuations more in play

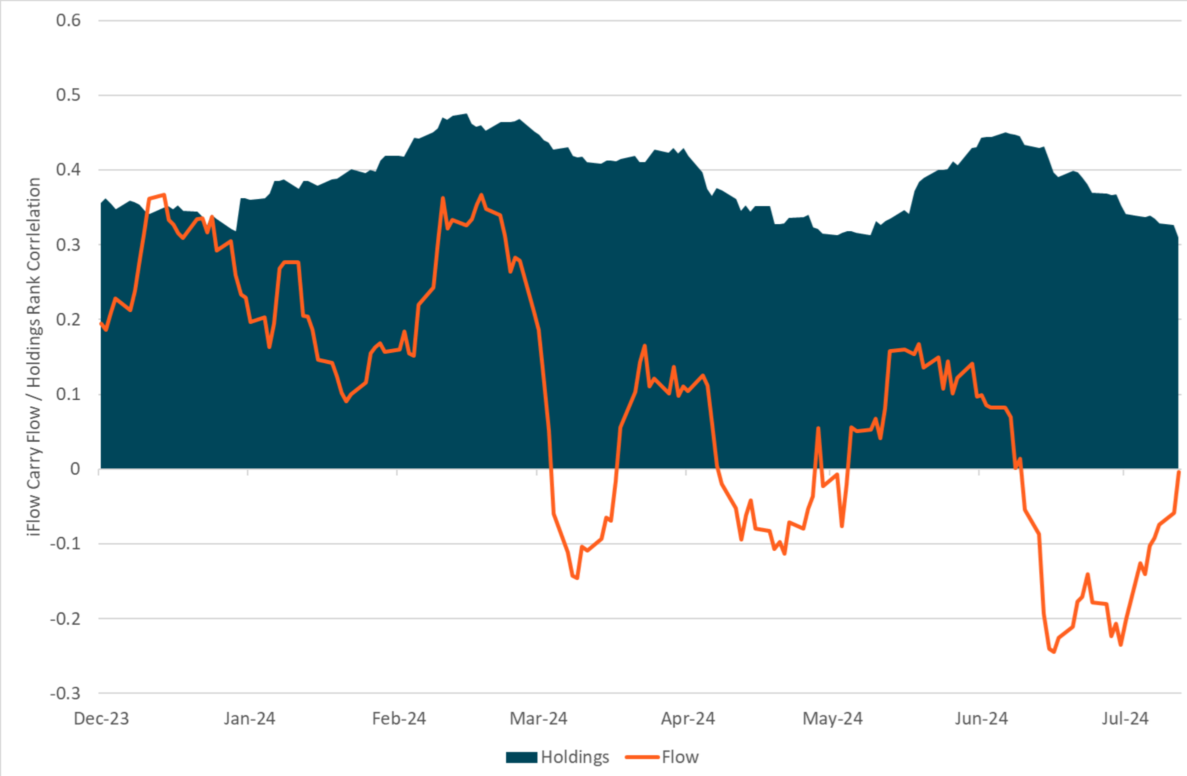
Carry holdings doing well amid renewed yield risk

The past week has been difficult to navigate for asset allocation. Rotation has become a core theme within equity markets, but the price action does not point to a full-scale retreat from risk appetite yet. Politics – especially US politics as we have seen over the last 24 hours – will remain at the forefront of market dynamics, but developments are not likely to change some of the fundamental drivers for currency markets. Tariffs and stronger fiscal impulse are now almost consensus views across the political divide on both sides on the Atlantic, and central banks have all but acknowledged that equilibrium rates will likely remain elevated as a result. In this context, real yields will remain a core driver for asset allocation.

In currency markets, we have identified in iFlow that recent outflows in high yielders have come to an end. Over the past week, iFlow Carry (Exhibit #1) has clearly moved back to neutral after a period of negative statistical significance, which indicates that the highest-yielding currencies ranked the lowest in their flow performance throughout much of Q2. This was the logical view during that period, as US price data and general weakness in the global growth environment opened up additional easing space for central banks across high yielders in emerging markets (EM). Additional risk premia from various election results in key EM economies also played a role in the process. However, developed market politics have taken over proceedings and this has renewed pressure on real yields for core currencies. Higher dollar terminal rates were always a risk, but now even some ECB members have started to express misgivings about committing to an easing cycle this year, and this is already having an impact on rate expectations in EM economies in the region. For example, the Hungarian Central Bank could choose to keep rates unchanged at this week's decision, aligning itself with the National Bank of Poland. If these central banks assess that the EUR and USD will generate bigger-than expected pass-through impact due to limited rate cuts, they must match accordingly.

Such decisions will support real yields across EM, but we also do not see the current risk environment as heralding a renewed push for carry trades to perform strongly as well. The global growth environment is still difficult, and the lack of general easing does not imply a renewed hiking cycle. We have expressed surprise that even developed market central banks in this position, such as AUD, NOK and, until recently, NZD, have not seen material gains in currency valuations. Furthermore, we acknowledge that even though flows for high-yielding currencies are improving as we approach H2, the underlying positions (as indicated by iFlow Carry holdings; see Exhibit #1) have been strong since the heyday of the carry trade in July last year. The bottom line is that even though the need to maintain high real yields is back on the agenda, in currency markets these positions were never really taken off and asset owners are comfortably 'hedged' against resilient real rates in developed markets. Some tactical and selective additions are possible in the current environment, but there needs to be the right alignment of valuations, rate expectations and positioning for a more extended run.

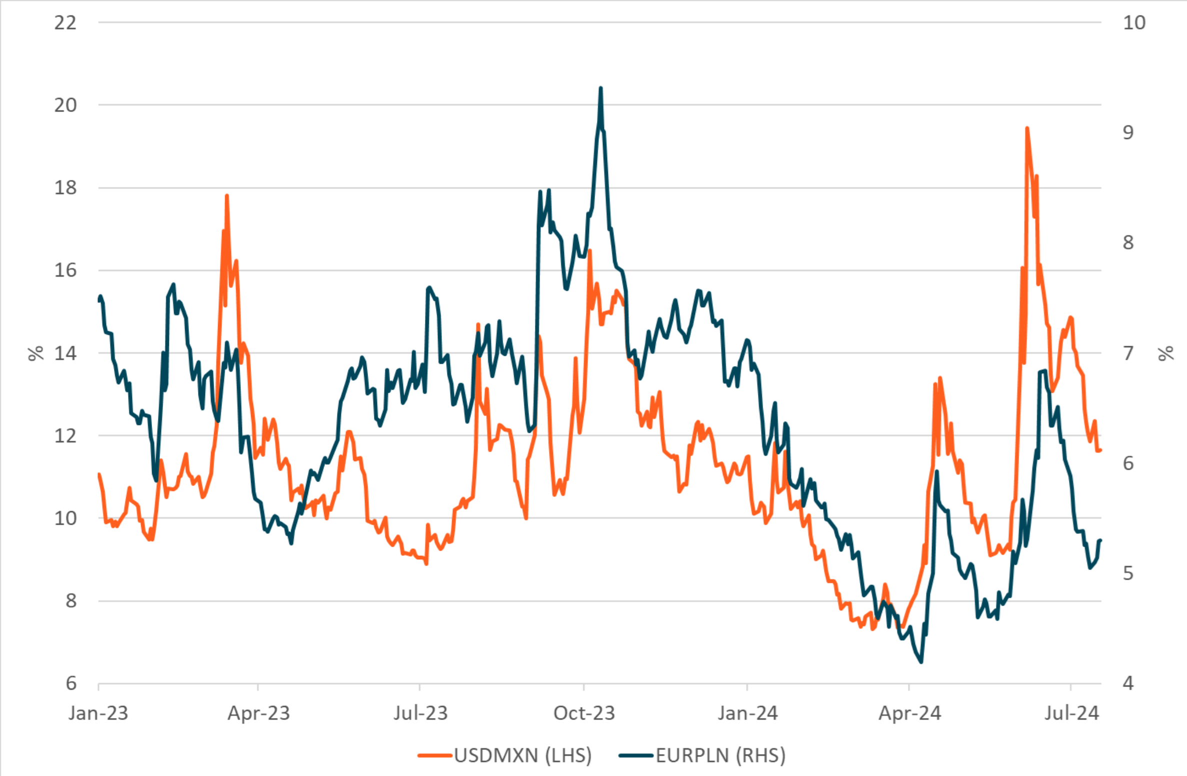
Exhibit #1: iFlow Carry and Carry holdings



Source: BNY

While political developments are pushing up expectations for real rates, even if EM central banks calibrate their own monetary policies to match and generate higher rates, there is no guarantee that the process will be smooth, as there will also be commensurate political costs. Compared to rhetoric during tightening cycles, which severely affected fiscal space, governments have not been as assertive on the need for looser financial conditions to support government spending. However, tensions will remain in place if growth is challenged, while there will now be additional spillover effects from policies of larger economies, not just fiscal expansion in the US and Europe, but the lack thereof in China and much of Asia. Since the European elections, implied volatility in EUR-crosses have started to reflect such risks, while USD-pairs with key trade partners (i.e., economies potentially adversely affected by a more protectionist US) are reacting the same way. Exhibit #2 compares implied volatility in EURPLN and USDMXN: PLN and MXN have credible monetary policies in place to support high real rates for currencies, but implied volatility has picked up materially, which in turn will limit risk-reward to add to such carry positions. Furthermore, MXN was the best-held carry currency for much of the last 12 months and PLN is currently at the summit of iFlow's holdings list, which could further inhibit new longs, even though there is a good chance that neither Banxico nor the NBP will cut rates again this year.

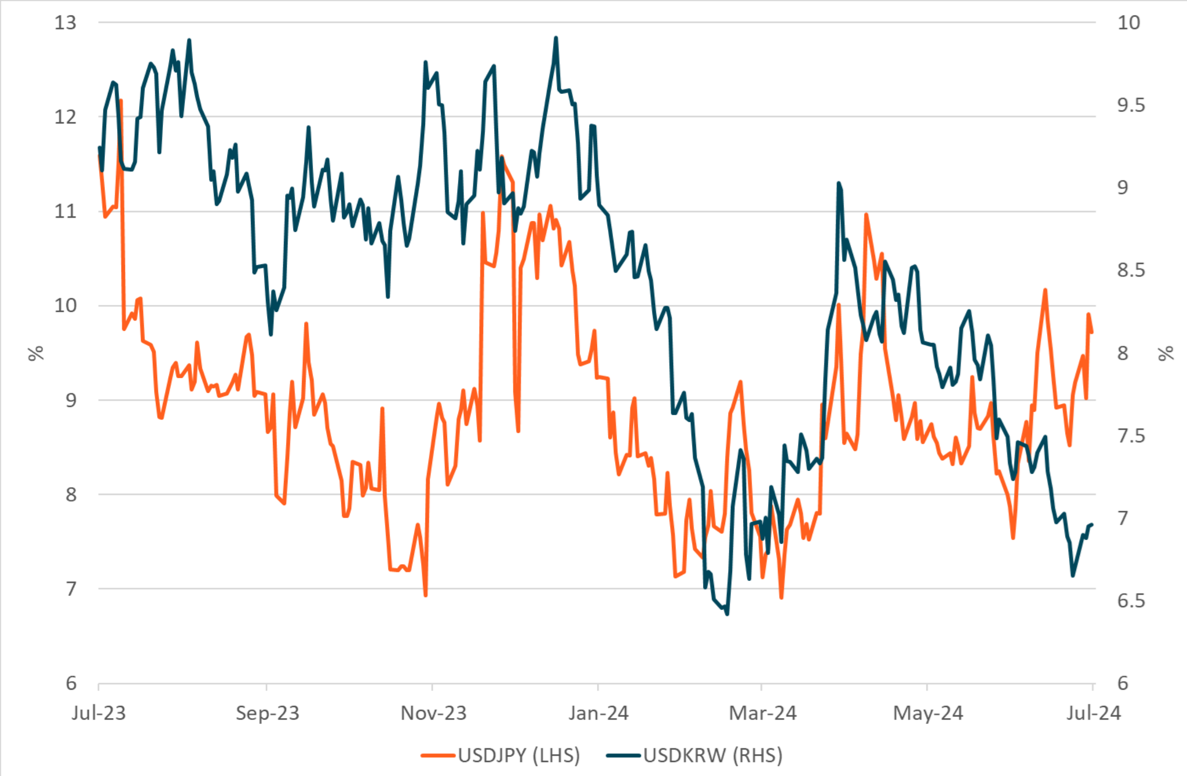
Exhibit #2: Differentiation in risk premia apparent



Source: Bloomberg, BNY

Even though the outlook is volatile, the Fed still looks set to continue easing this year, at least starting in September. The dollar itself is considered a carry currency against lower-yielding funders, which are mostly manufacturing exporters in Europe and Asia-Pacific. Due to longstanding concerns over sustained weakness in the CNY and JPY, many of these APAC funders have not been able to use currency strength to tighten financial conditions during inflationary cycles. However, the market is starting to look for value in currency as much as other asset classes, and the structurally underheld group of APAC currencies may now finally start to move, especially if domestic savers now face lower US yields and some elevation in political risk. After all, this is why gold prices continue to rise despite higher real yield pressure, which traditionally hurts gold. A basic shift can be manifested in lower hedge ratios on USD-denominated assets. We are particularly attuned to the KRW (see Morning Briefing, July 18), and surprisingly, even though APAC would not be immune to US trade policies by any stretch, USDKRW implied volatility has not surged. There doesn't even seem to be any spillover from elevated volatility in USDJPY as Japanese authorities become more active in the market.

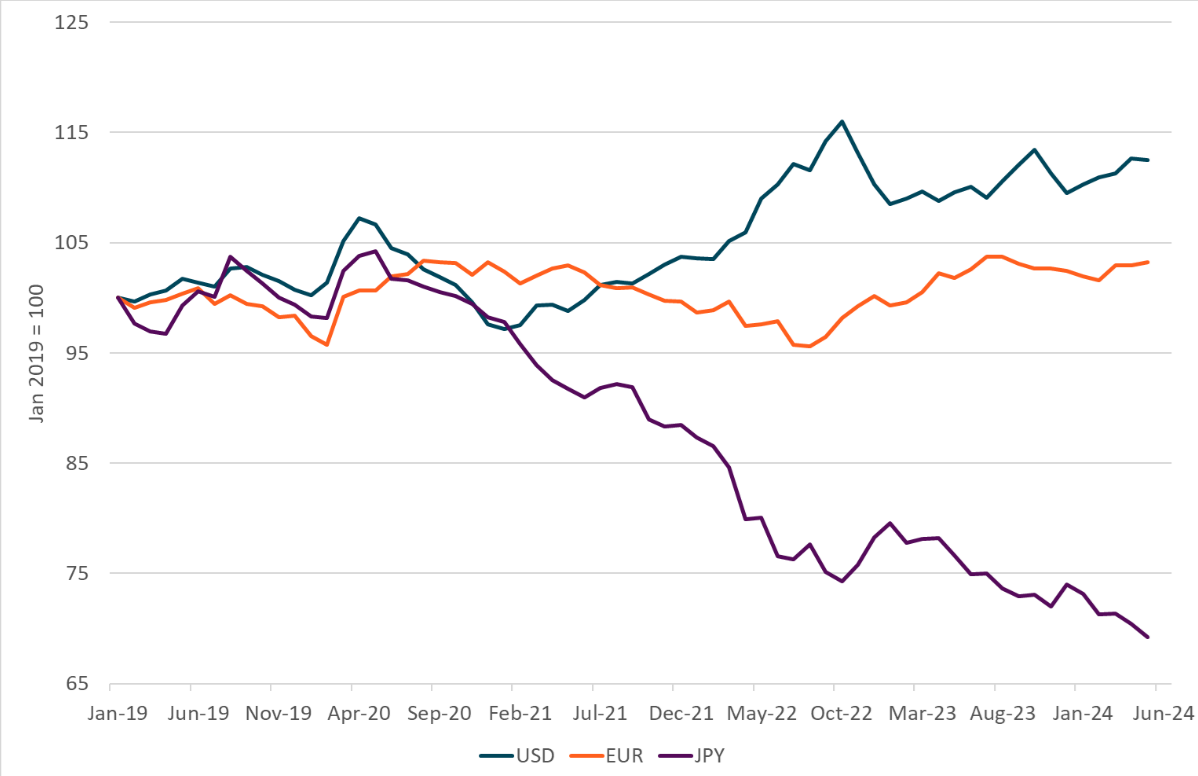
Exhibit #3: KRW leading APAC interest



Source: Bloomberg, BNY

Finally, on the matter of the JPY itself, which, being the lowest-yielding major currency, should remain the funding currency of choice, valuations can no longer support any form of renewed outbound carry surge. Official action and rhetoric appear to support this view and targeted activity could become more frequent up ahead. The JPY's undervaluation is now far more extreme than any supposed overvaluation in the EUR and USD in real terms. Japan is no stranger to facing a more challenging external environment when it comes to trade policy and exchange rate misalignments; many Asian countries see the country's experiences on this matter as a cautionary lesson on managing balance of payments. It is imperative now for APAC to get ahead of the political curve, especially with unique capabilities developing in high value-added products, such as microchips and electric vehicles. Just like global equities, rotation could be afoot in FX markets, but theme selection is no longer obvious.

Exhibit #4: JPY anchoring valuations for funders



Source: Macrobond, BNY

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