iFlow
MACRO MORNING BRIEFING

August 7, 2024

Tracking the Unwinding

Shift away from U.S. assets will be multi-asset

- Equities risk is high, but adjustment depends on the funder
- CHF-funded positions holding up better than JPY
- Holdings also indicate JPY unwinding more at risk

Risk aversion to continue but funding currencies' performance will differ

As risk aversion continues to take hold, the unwinding of carry trades will draw further scrutiny. In FX markets, the key funding currencies of CHF, JPY and, to a lesser extent, SEK, are clearly exerting their impact on flow dynamics, having clearly led performance in G10 currencies since end of July. All three currencies have very healthy savings buffers, relatively high levels of liquidity and where asset allocation of domestic asset pools tend to favor overseas investments.

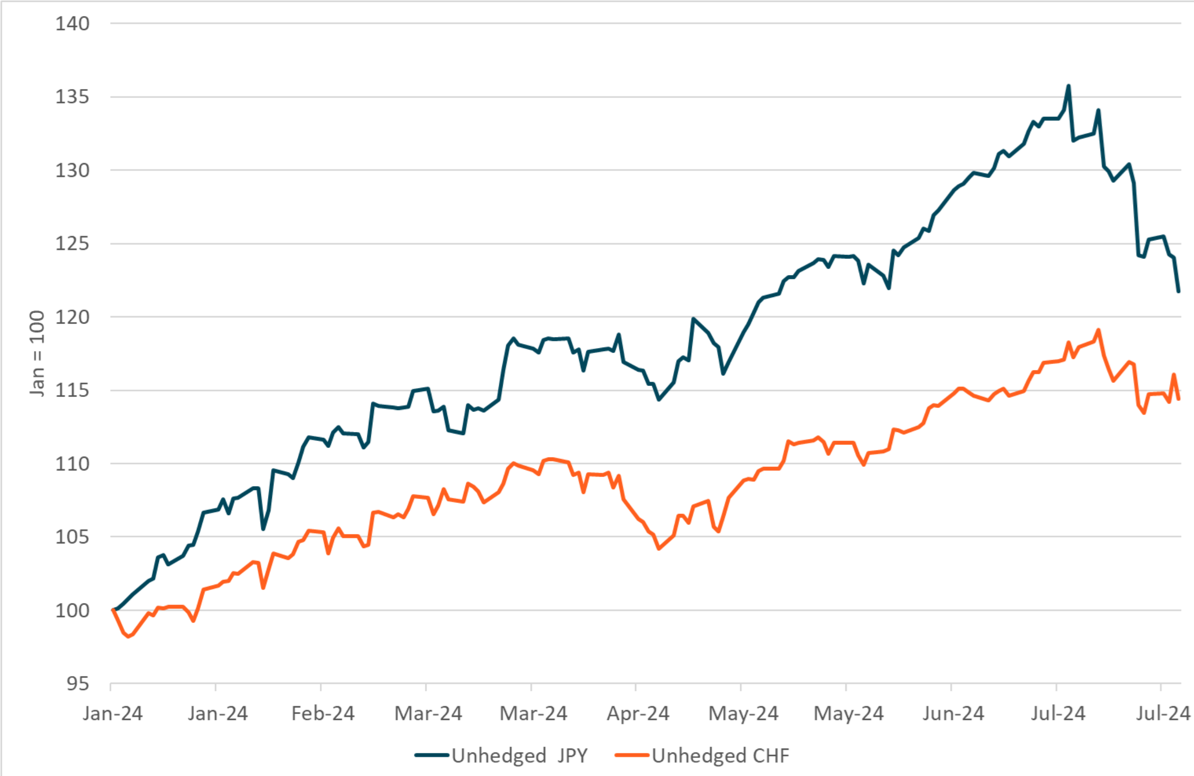
General risk aversion tends to trigger home bias, but there are also specific factors which have supported such flows. Firstly, currency valuations are finally starting to exert a strong impact on price action. Having been frustrated throughout their tightening cycle by SEK's inability to strengthen, SEK is now managing to climb amid mixed data and even a more dovish-than-expected policy trajectory. Yet, it will the CHF and JPY which will take the lead in helping markets track repatriation flows, especially rotation away from the U.S. How much further to go largely depends on the gains made before the investment cycle turned. Be it through outright repatriation or additional hedges, we find that CHF on balance may take the lead in adjustment, or even signal a reversal.

Much of the market focus will remain on U.S. equities after a difficult earnings season. While asset allocators will need to make their own judgement on the U.S. economy, with event and data risk unlikely to improve before year-end, there is a risk of overcompensating for current exposures. Depending on the mandate of the asset allocator, either outright sales will pick up, or hedging of dollar risk will rise as well – to reflect general safe-haven flows but also tight rate differentials. This is particularly relevant for CHF- and JPY-based portfolios because the technical room for maneuver for the Swiss National Bank and the Bank of Japan in interest rates is relatively limited. Unlike other pairs, USD rate differentials against CHF and JPY will largely fall on the USD. Not only will it become cheaper to hedge USD exposures, but the opportunity cost of not doing so is heavily skewed to the upside in the current environment.

Exhibit #1 shows the performance of the S&P 500 in JPY and CHF terms this year to the end of July. USDJPY's strong performance throughout the equity bull market has amplified performance. Even though the timings are relatively aligned, JPY's strength in recent weeks on account of Bank of Japan / Ministry of Finance activity and policy steps has already generated a near 15 percentage-point drop in total returns. As JPY strength is a form of tightening for the BoJ, such moves could already impact the forward outlook on BoJ rates. To be clear, we continue to see JPY strengthening based on valuations alone, but this will act as a potential circuit breaker on rates, especially if the Fed proves more dovish up ahead. Combined with the adjustment which has already taken place, additional hedging after such a large move already could be limited.

In contrast, an S&P portfolio in CHF terms has not performed as strongly as the franc has sustained good performance through the year. However, the recent adjustment has not been as pronounced for such portfolios and presents an opportunity for more assertive hedging flows. While the SNB will at least match the Fed's tightening pace and cut toward zero by all accounts, the central bank is unlikely to choose the path set over the past decade to engage in large scale FX intervention and adopt deeply negative rates to limit CHF appreciation. Their conditional inflation forecasts already point to the need to cut to near-zero so there is limited additional capacity to counter such trends in the near term. After all, in real terms the franc is nowhere close to the highs seen during the last cycle.

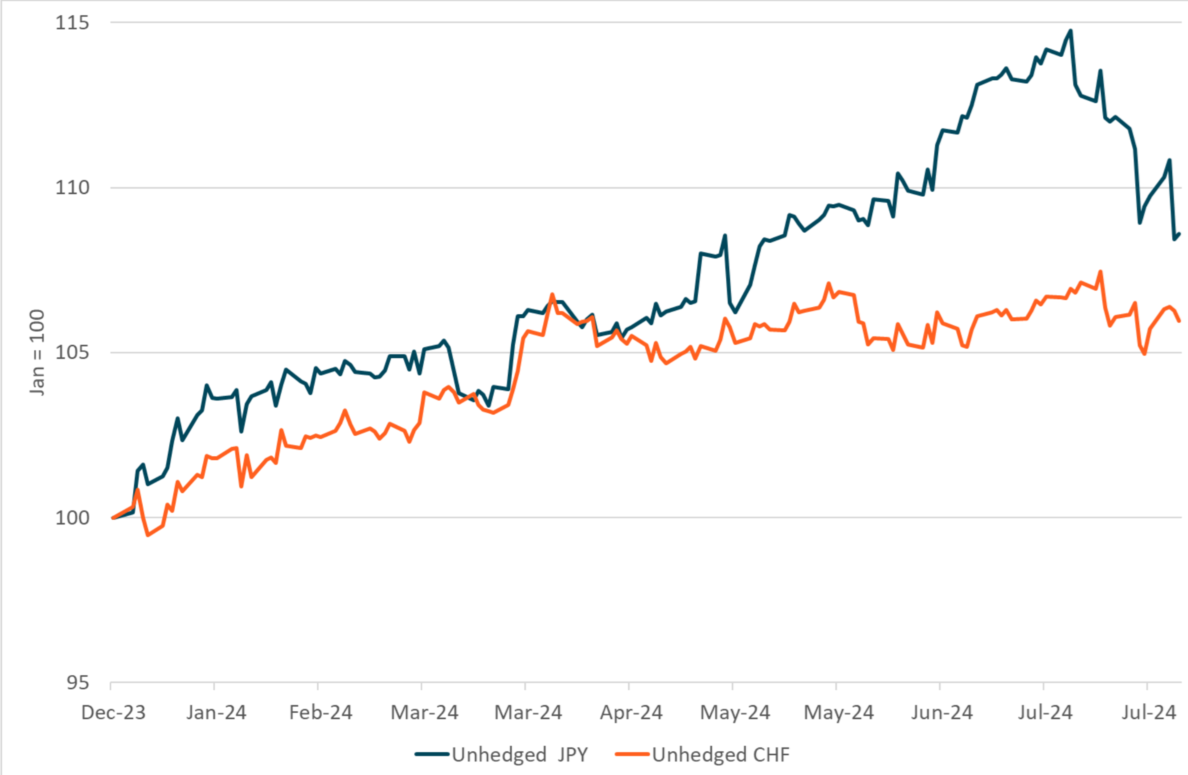
Exhibit #1: S&P 500 performance in JPY, CHF terms



Source: Bloomberg, BNY

The larger portfolio flows for global savings pools will be in U.S. fixed income markets. We have highlighted in recent months that cross-border investors have not shown any concern over U.S. duration despite impending fiscal risks, and shifts in the curve have largely justified such steps. Based on current expectations, duration will continue to perform so any drawdown in U.S. fixed income portfolios for cross-border investors will likely come from the currency. This means the propensity to hedge out dollar exposures will be far higher among fixed income portfolios compared to equity peers. Similarly, year-to-date it is CHF-based investors who have seen far more stable performance, and the risk of further drawdowns is stronger as U.S. yields continue to struggle. In contrast, JPY-based investors have already seen a material FX-driven move in their U.S. fixed income portfolios so the utility in expending an additional 4-5% annualized to hedge exposures is more limited. The bottom line is to increase hedging before the FX valuation adjustment in any portfolio, and we believe markets continue to underappreciate the risk of a much stronger CHF in the process as the SNB acts much more cautiously.

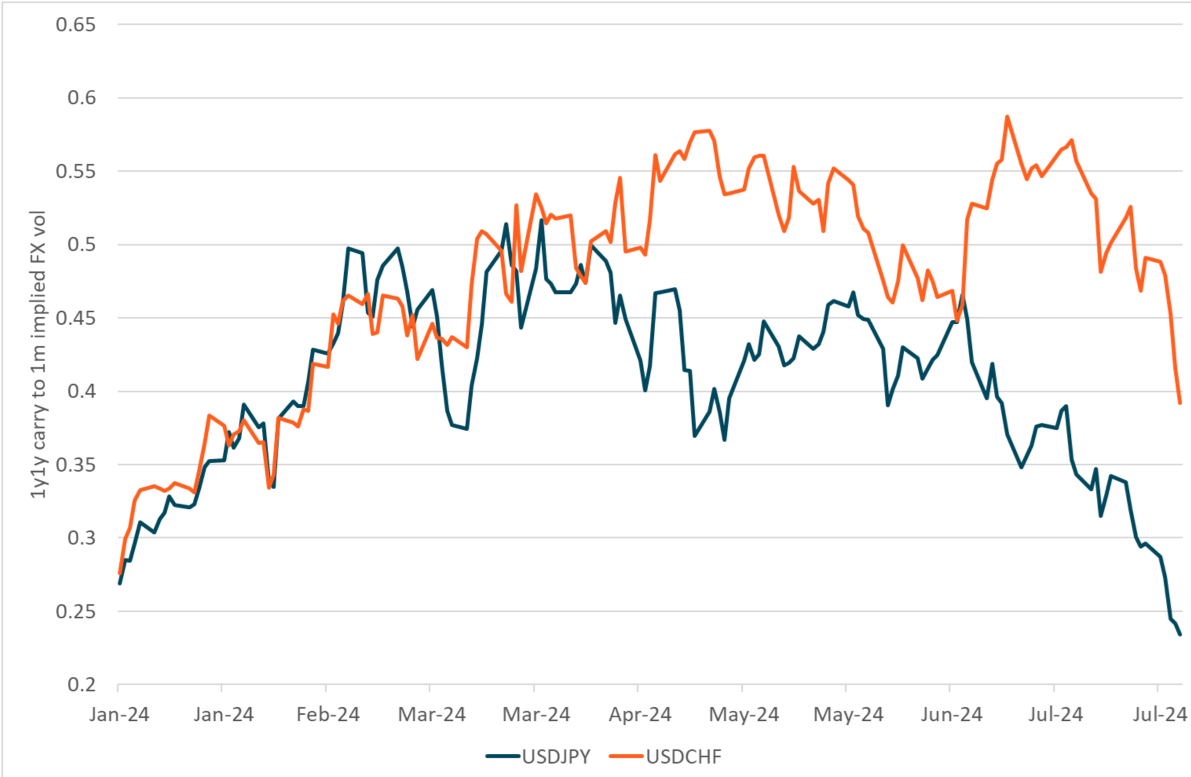
Exhibit #2: Bloomberg U.S. aggregate in JPY and CHF terms



Source: Bloomberg, BNY

Another measure which reflects the lack of risk-aversion or relatively lower hedging demand in CHF is by looking at forward rate differentials relative to FX implied volatility (Exhibit #3), also known as the carry-to-volatility ratio. On this measure, USDJPY hedging demand has already picked up sharply due to the move in volatility introduced by JPY price action. As a result, JPY's carry-to-volatility ratio has fallen by more than half from the highs in Q1 and is now below levels at the beginning of the year when the market was still comfortable owning the carry trade. In contrast, while USDCHF is also facing performance headwinds, its carry-to-volatility ratio is only one-third lower, and it does not appear that there will be any additional safety demand coming through in CHF from Eurozone issues. While it is unlikely USDCHF will match USDJPY by this measure, the lack of alignment also suggests that more CHF purchases could come through as a general hedge. If realized, the SNB will need to cut to zero earlier than anticipated and likely bring down USDCHF's CTV in any case.

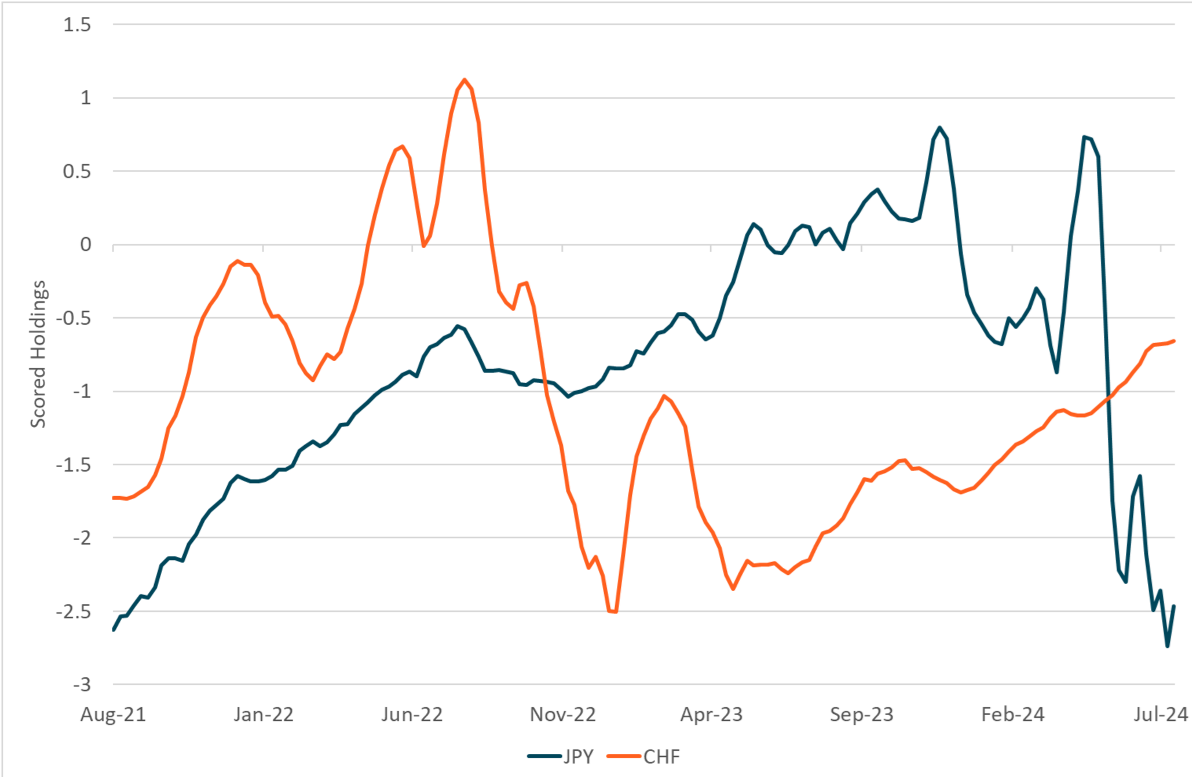
Exhibit #3: Carry to vol ratios, USDJPY and USDCHF



Source: Bloomberg, BNY

Unsurprisingly, in iFlow both CHF and JPY are underheld. This is normal behavior for cross border clients who would normally remain underheld a traditional funding currency due to rate differentials. However, CHF underheld positions have been consistently fallen over the past few months, whereas JPY has also found a floor and will face purchase flows up ahead. Such transactions would reflect the buying back of CHF- and JPY-funded positions in a manner consistent with risk aversion, but we are cautious on the notion of the market turning outright long both currencies. Especially for CHF, this was only achieved in 2022 when the SNB was seen as an early mover and briefly more hawkish than the ECB. The current cycle is different, and we would see CHF moving toward overheld as a signal that relevant hedges have reached a saturation point.

Exhibit #4: Holdings change, JPY and CHF



Source: BNY

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