BNY

iFlow

MACRO MORNING BRIEFING

August 19, 2024

Normalization in Prices, Not Structures

Fragilities not ignored despite apparent risk recovery

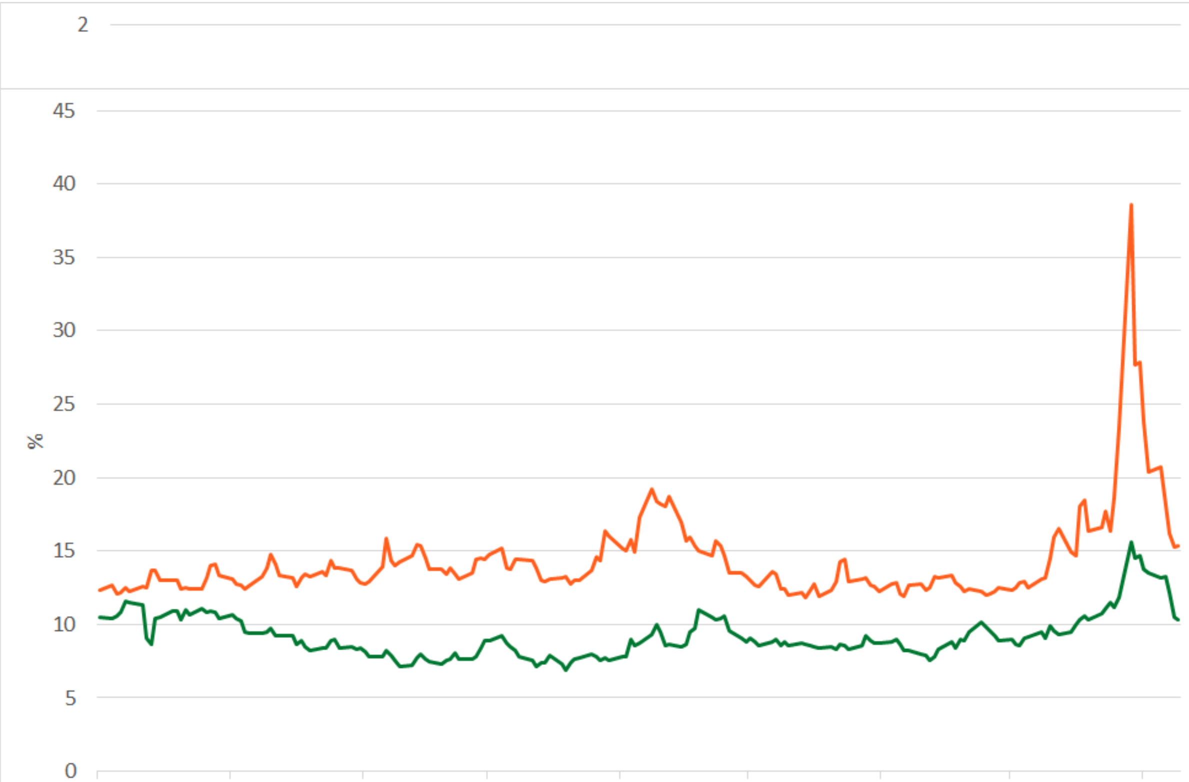
- Financial conditions have not fully mean reverted
- Exchange correlations with assets remain in flux
- Jackson Hole in focus while global central banks keep an eye on idiosyncratic risks
- Riksbank to continue easing as exchange rate risks fall

Volatility gauges not fully discounting renewed turbulence

After a tumultuous two weeks, reassurance is probably the sentiment markets and Fed Chair Powell hope to reciprocate as the market gears up for Jackson Hole. After the volatility seen at the beginning of August, markets are hoping that the monetary policy outlook will conform to data and the soft landing narrative. For their part, policymakers hope that markets simply trust the current data-dependent approach remains sound and leave the policy error narrative to one side, lest markets face a renewal of volatility, which in hindsight appeared to be excessive.

Assuming the week ahead passes without incident amid quieter summer market conditions, policymakers hope that reassurance doesn't lapse into complacency as the status quo ante was not tenable. We highlighted in the market entropy theme in our Q3 Macro Investor Trends Outlook that volatility redistribution can become highly disruptive. To avoid repeat episodes, gradually injecting risk premia into markets, best achieved through increased hedging during the latter stages of the investment cycle, is the most prudent approach in asset allocation. As things stand, we are reassured that while price indices have largely mitigated the losses seen earlier this month, there has been re-pricing in volatility markets across asset classes. Options gauges in equity and FX markets (Exhibit #1) have not and do not seem destined to fully retrace recent moves, which means that net exposures will remain lower compared to a month ago. After all, even if central banks are confident in the soft landing narratives, there are other exogenous risks which arguably have not been accounted for enough in asset allocation throughout the cycle.

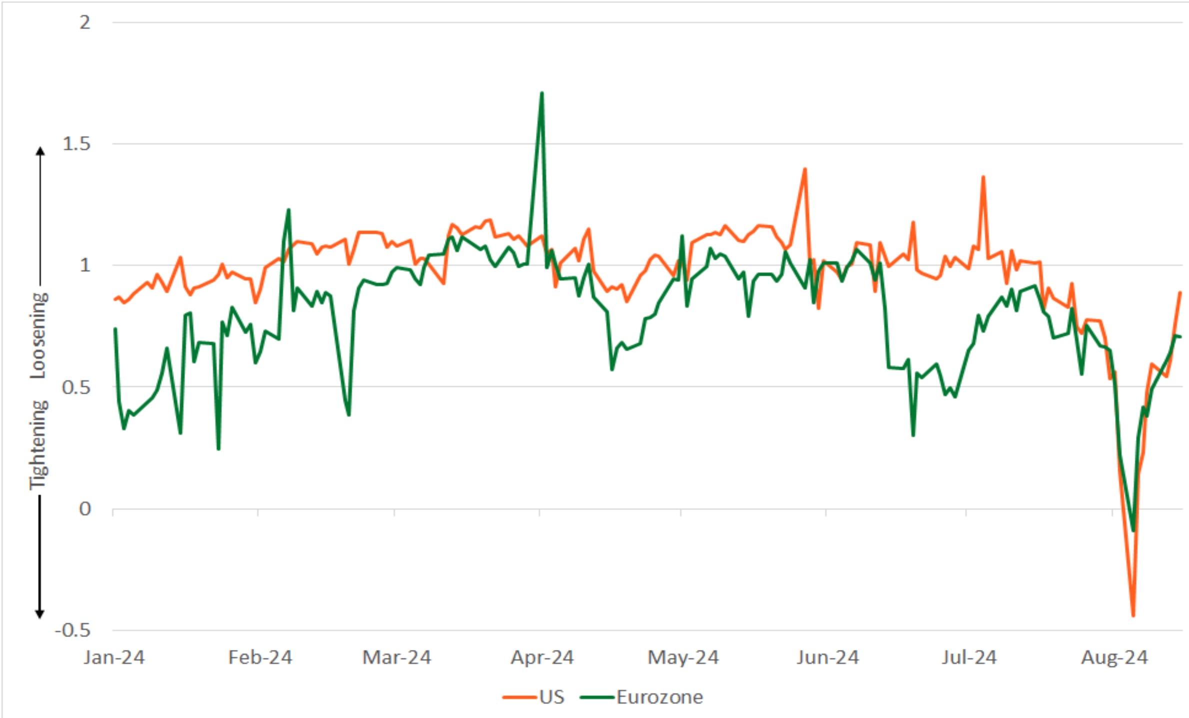
Exhibit #1: Equity vs. FX Volatility Adjustments



Source: Bloomberg, BNY

Another welcome change – from a policy perspective – over the past few weeks is that financial conditions have also not fully mean-reverted (Exhibit #2). Even though very few market observers would say that the Fed or its peers are keeping financial conditions too loose at present, this has been a sticking point in the past when risk sentiment appeared at odds with fundamentals. In theory, the recent recovery in equity markets and lower yields should have contributed to material loosening in financial conditions and this applies globally. As an offset, credit spreads may have closed out August's moves, but the direction of travel of the economy is undeniable and associated risks have been reflected for several months now. We have also highlighted in our custodial flows that corporate debt globally has been the weakest-performing asset class, and we expect this to continue before the cycle reaches an inflection point. Higher cross-asset implied volatility stated above should also limit further loosening in financial conditions.

Exhibit #2: Financial Conditions and FX Correlations

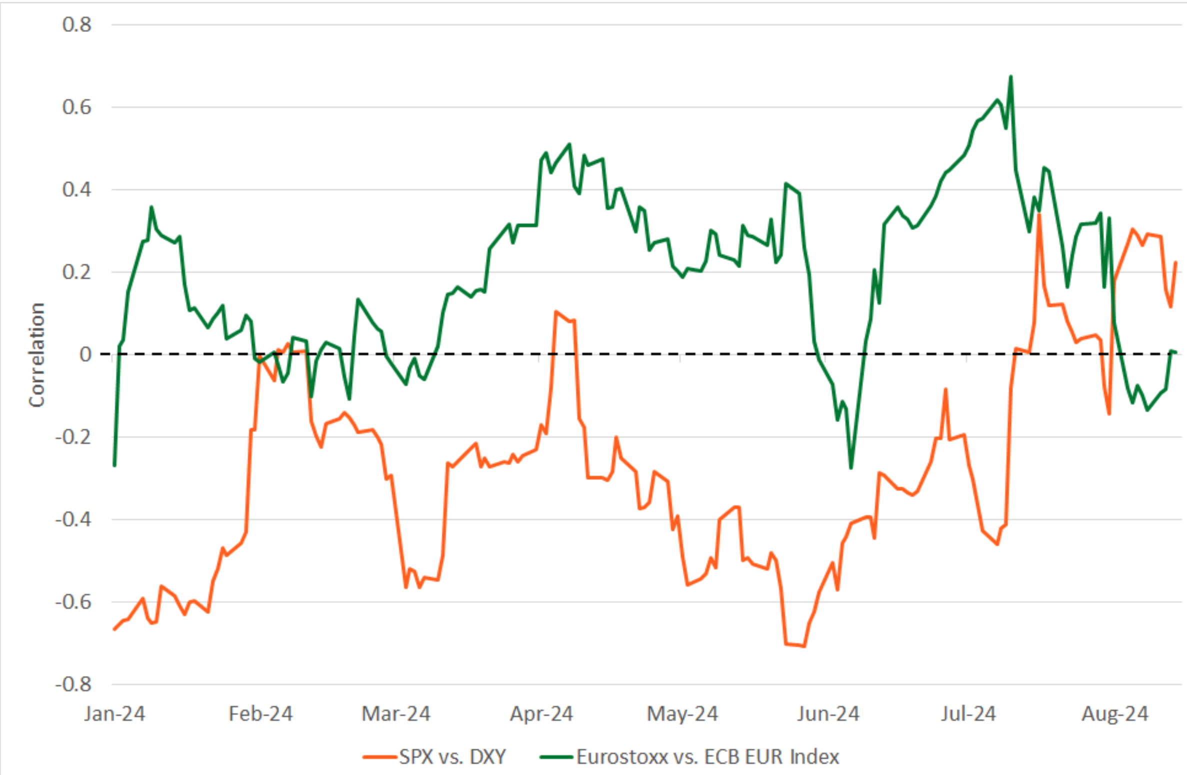


Source: Bloomberg, BNY

Currencies also represent a major factor in financial conditions, but the contribution varies sharply between economies. Normally, export-driven economies or equity indices with strong levels of overseas earnings exposures necessitate a strong impact of exchange rate performance on financial conditions. Normally, this is most relevant for European and Asian economies, whereas the US's relative self-sufficiency and low share of global trade to gross domestic product has rendered the dollar relatively neutral to financial conditions.

However, throughout the year the opposite has been true: the SPX's returns have been negatively correlated to the dollar until the past few weeks (Exhibit #3), whereas the opposite has been true for the relationship between European equities and the euro. Normally we would expect the dollar to be neutral for US stocks rather than adversely affecting returns. This suggests that valuations have approached extremes and the risk of weaker FX profit translation for US firms is stronger even with a relatively lower international earnings component. For Europe, the export and manufacturing sector has not assumed its conventional role as the main growth driver as the sector has been contracting now for the better part of two years, so it is understandable if the currency is no longer a marginal factor for earnings. As the European Central Bank has highlighted, domestic demand and services is now driving inflation and wage growth, and until recently ECB expectations have been elevated relative to Fed expectations and kept the EUR overvalued. The volatility of the past two weeks, however, has generated a material shift in the dollar's correlation to positive. This belies the dollar's normal performance as a safe haven currency which benefits when global markets struggle. In hindsight, this is a reflection of the degree of unhedged positioning by international investors in the US, across all asset classes due to the US exceptionalism narrative. This marks another market structure change which is particularly relevant for capital flows.

Exhibit #3: Equity Correlations to FX

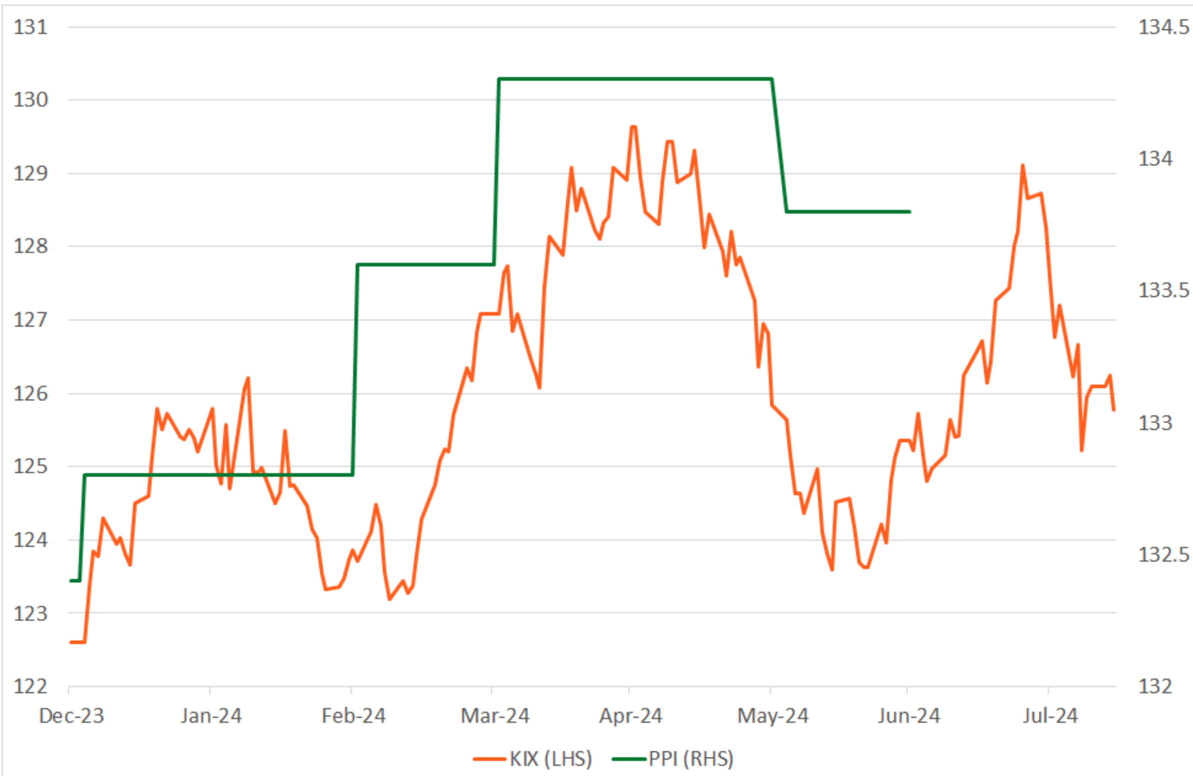


Source: BNY

Finally, while Jackson Hole is the main policy event this week, several APAC central banks will make policy decisions. While all will acknowledge recent global volatility, there are major differences in current performance between economies in the region, and policy outlooks will reflect the dispersion. In many respects, the ability of the region to continue reducing growth exposure to cyclical and secular changes in the Chinese and US economies represents a shift compared to previous cycles. We believe that positioning – especially in equities – remains very light relative to fundamentals, but as flows leave the US iFlow has indicated a material pick-up in rotation into EM APAC equities (ex-China) away from fixed income, suggesting that valuations are strongly supportive, especially for dollar-based investors.

We also take note of tomorrow's Riksbank's decision, where another 25bp is expected as Swedish financial conditions continue diverging materially from the Eurozone's. In strong contrast to the decision from neighboring Norges Bank, which attributed its hawkish stance to weakness in the currency and potential pass-through risk. The Riksbank has arguably been even more concerned about the situation during its own policy cycle but chose never to act forcefully and allowed valuations to take their course. SEK has ultimately ceased falling even amid an easing cycle as the market is now warming toward owning funding currencies as risk appetite wanes, perhaps justifying their initial approach. Vigilance is still needed, but as household demand is clearly waning and inflation is on course to fall below target across all indices, the case for consecutive cuts up ahead is strong and exchange rate developments (Exhibit #4) – volatility aside – should no longer play a dominant policy role.

Exhibit #4: Swedish PPI vs. Riksbank KIX*



Source: Bloomberg, BNY; KIX is the Riksbank's traded-weighted effective exchange rate index, a higher KIX denotes a weaker SEK

Disclaimer & Disclosures

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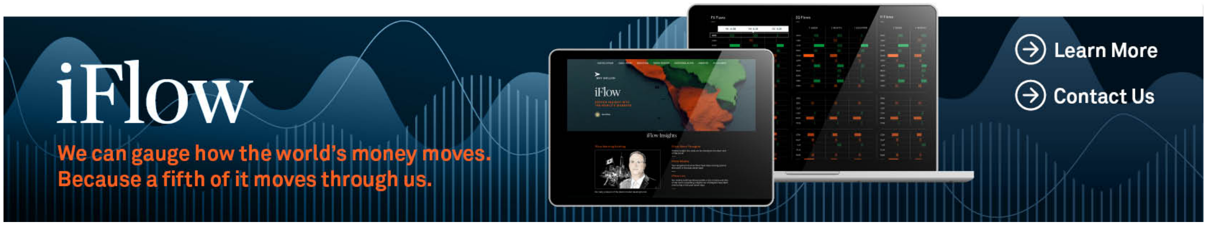

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