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MACRO MORNING BRIEFING

August 26, 2024

Jackson Hole: "The Time Has Come"

- Jackson Hole didn't surprise us, but a jumbo hike cannot be ruled out
- August NFP will be the determining factor in the 25 vs. 50 debate
- Canadian dollar strength is more a reflection of recent USD weakness
- iFlow shows little change in cross-border holdings

Jackson Hole Not a Surprise – But Well Received

Fed Chair Powell's Friday speech at the Jackson Hole Economic Symposium didn't venture far from what we expected. He confirmed that rates will start to fall in September ("the time has come for policy to adjust"), which we all more than suspected. He formally stated that "the upside risk to inflation have diminished," but that the "downside risks to employment have increased," which we can see in the data. Relatedly, he affirmed that "we do not seek, nor do we welcome further cooling in the labor market."

Regarding the potential size of the September cut, as well as the pace of cuts thereafter, Powell remained noncommittal, saying "the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks." With these words, he left the door open to a 50bp cut at the September meeting. This was also not unexpected, in our eyes, but the market certainly seemed to welcome the possibility of a jumbo cut, with the dollar weaker almost across the board, equities and bonds both bid. We do think – as we have since August 2 – that by staying agnostic, the September 6 publication of labor market data will be the determining event in the 25 vs. 50-point debate. We currently remain of the view that the smaller of the options is most likely, pending these all-important data.

The market, as seen by examining the SOFR futures curve, suggests a very rapid pace of cuts, down to about 3% (250 basis points!) by the end of 2024. The now

obsolete dots from the June Summary of Economic Projections (SEP) imply a much slower pace of easing. However, the September FOMC – in addition to the first rate cut of whatever size – will provide a new SEP, which we expect to show a median of around 2.5 cuts (to about 4.8%) by year-end, and deeper cuts than expected for 2025. We doubt the dots will line up with current market pricing, though.

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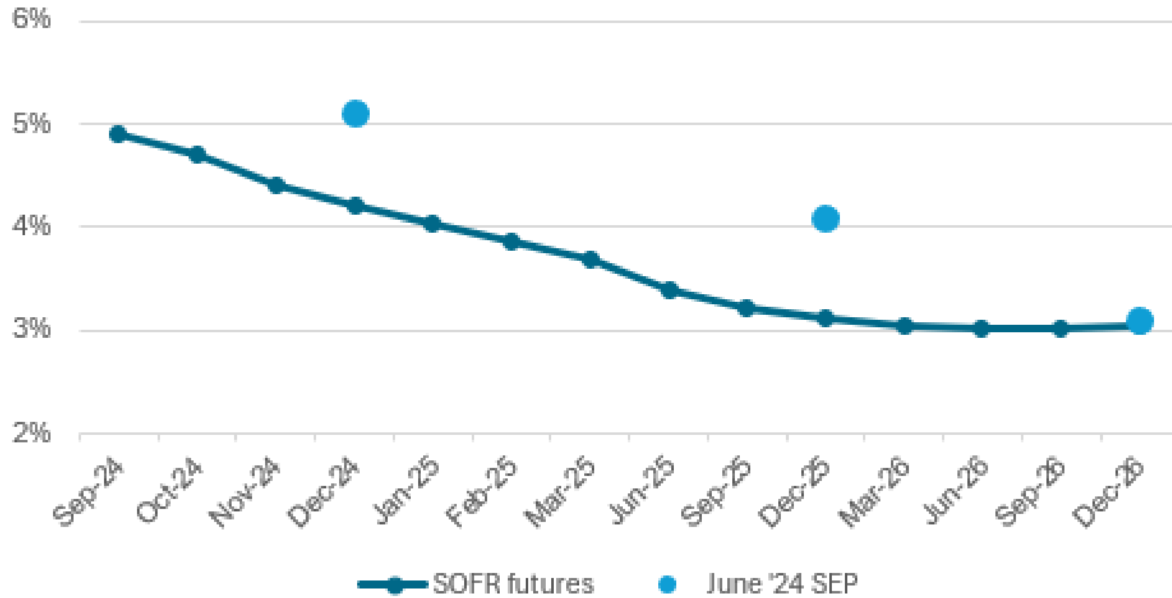
Exhibit #1: Market Way Ahead of the Fed Right Now



Source: BNY Markets, Bloomberg

We think current pricing in the curve almost necessarily assumes a recession over the next 12-15 months, and we're not convinced that is the most likely outcome. We do, however, also believe that Powell's assertion that the Fed doesn't seek further labor market weakness may also be pie in the sky. Unemployment will likely increase – perhaps to as high as or just under 5% – by year-end. But that doesn't have to coincide with a deep output recession – we think growth will slow to something below the commonly estimated 1.8%-2% per year pace.

On the labor market, Powell did point out that rising unemployment has been primarily driven by a rising force rather than elevated layoffs – so far. Yet his very apparent sensitivity to the jobs picture betrays a clear concern about the outlook – and the need to loosen policy now that the inflation mandate looks to be coming into line. The payroll revisions from last week, and the write-down of 818k jobs through

March of 2024 also suggests that full employment is likely lower than the Fed had assumed since COVID. The easing cycle will commence in September with a race between the Fed and the labor market.

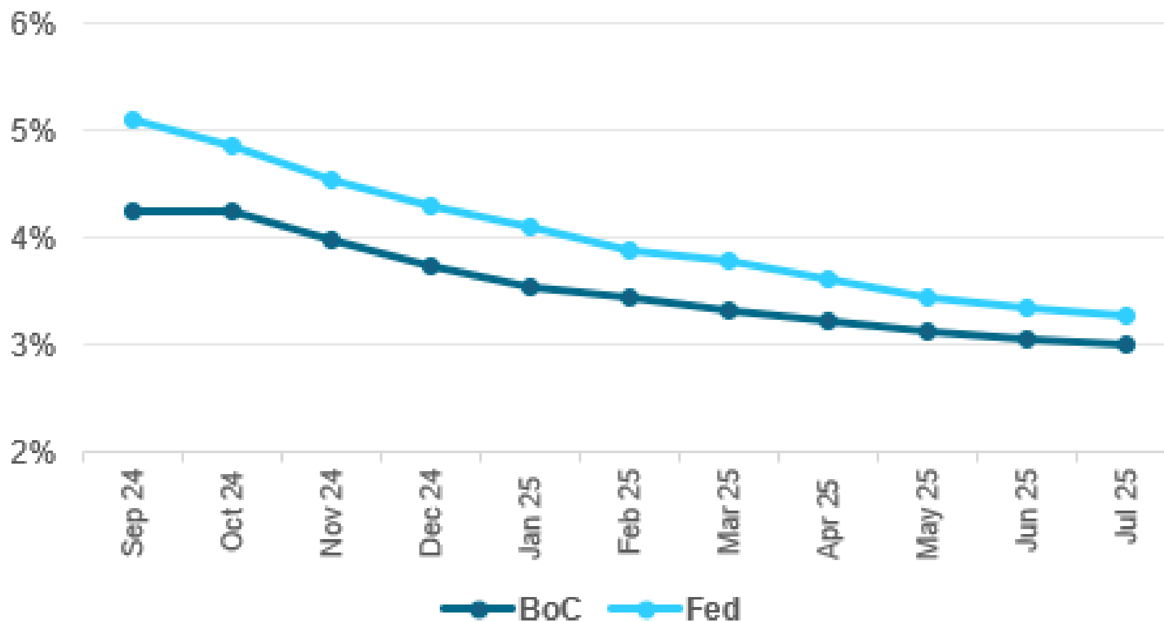
Canadian Dollar – Surprising Strength Reflects USD Weakness

The Canadian dollar seems to be defying gravity. With the economy slowing along with inflation, one would expect the dovish inclinations of the Bank of Canada to be a source of weakness in the currency. Yet the USD/CAD exchange rate has raced from well over 1.38 at the beginning of the month all the way to a low 1.35-handle by last Friday's close.

Undoubtedly this has less to do with Canadian fundamentals and more to do with a weak USD over that period. The DXY dollar index (of which CAD makes up only 9.1%) has been even weaker, down well over 3%, from about 104 to just over 100. The USD has underperformed every G10 currency, although CAD is the lowest outperformer, suggesting CAD weakness against non-dollar crosses is indeed driven by the Canadian outlook – more bearish and more dovish than elsewhere.

Current market pricing for the Fed is quite dovish, even more so after Chair Powell's Jackson Hole appearance. Indeed, it's more dovish than current pricing for the Bank of Canada (see Exhibit #2), at least in the future pace of cuts this year. The market has rates down by over 100bp in the US by the end of this year, but down only 80bp or so for Canada. We think that US rates pricing is too dovish, and BoC pricing may not be dovish enough.

Exhibit #2: CAD vs. USD Pricing Diverges – But Not by Much



Source: BNY Markets, Bloomberg

By the middle of next year, market pricing for both central banks gets tighter, but the point remains that expectations for a more dovish Fed (with respect to the pace of cuts) than the BoC have helped keep USD/CAD lower than we might have expected. But what if – as we suspect – the anticipated pace and depth of US rate cuts is revised lower and slower? We would expect both the broad USD and the USD/CAD cross to rise.

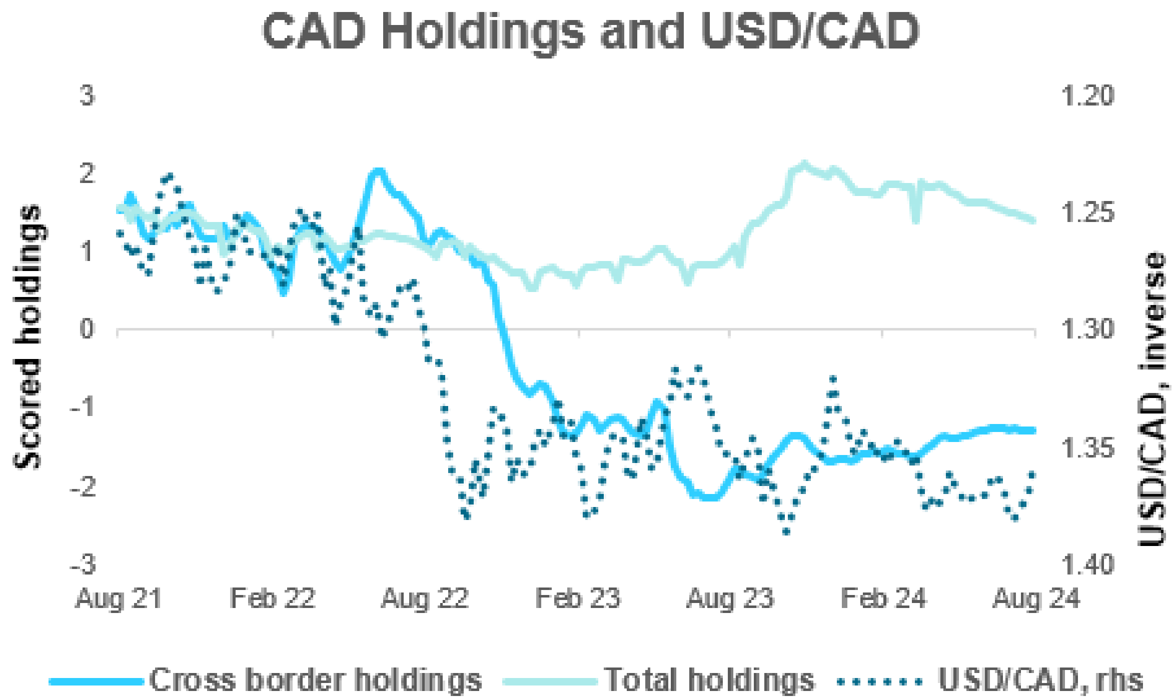
iFlow shows that real money holdings of CAD are quite stable. As we have pointed out in the past, loonie holdings feature a structural long – local Canadian investors buying overseas (mainly US) assets and hedging back to CAD, making them register as overweights. However, cross-border investors (primarily US-based) remain structurally short. As we can see from Exhibit #3, a big change in cross-border overweights to underweights in late-2022 coincided with a significant depreciation of USD/CAD from 1.25 to nearly 1.39 over that period.

These cross-border holdings have remained generally steady and low ever since, and it's remarkable that USD/CAD ranges have held pretty steady between 1.32 and 1.39 for most of that period – and they have generally been even narrower than those two extremes.

CAD's seemingly surprising strength at the moment is less about positioning, and

more about a weaker USD since midsummer. As rates get back to a place where we think they ought to be (i.e., less dovish than at present), this period of USD weakness will eventually wane, CAD rates expectations should reflect a more dovish profile and USD/CAD should move higher toward the top of its range.

Exhibit #3: Structural Longs But Cross-Border Shorts



Source: BNY Markets, Bloomberg

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Please direct questions or comments to: iFlow@BNY.com

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