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MACRO MORNING BRIEFING

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Exporters Feeling FX Pinch

Key manufacturing exporters' FX trends look very misaligned

- Inflation slowdown in Germany inconsistent with EUR and DAX performance
- Export prices continue to decline for China and Germany, with limited policy pushback
- Global cycle to remain challenging outside of strategic industries

Negative pass-through risks need to move up policy agendas

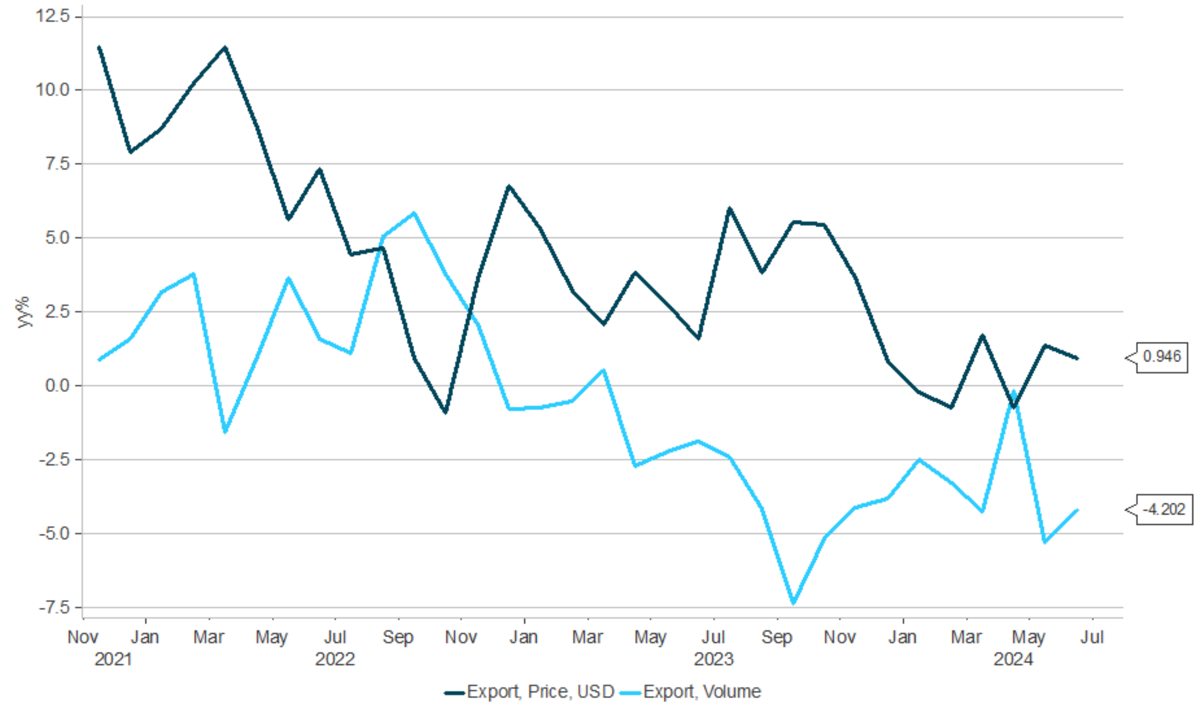
The nonfarm payrolls figure on Friday will undoubtedly be the focus of the week. As risk sentiment ponders the path toward year end, the dollar will also take its cue from adjustments in Fed expectations. The currency has struggled amid the repricing in US rates, but markets globally should not default into the simple assumption that easing is risk-positive and currency negative. The dollar smile may yet reassert itself if the global cycle continues to deteriorate, while central banks should also explore whether currency developments are fully in line with their own mandates. Barring a sudden reversal in the global cycle, the current outlook looks particularly problematic for global manufacturing exporters. This makes recent trends in the EUR and CNY counterintuitive and increases scope for downside data risks as policy season enters full swing from September on.

Last week's German CPI data disappointed heavily to the downside, driven by a sharp decline in energy prices. True to form, the data was glossed over by the ECB's hawks, with Executive Board member Schnabel stating last Friday that "inflation momentum continues to be high," joining several hawkish members who poured cold water on the prospect of substantial rate cuts as priced in by markets. Even considering the dollar's recent travails, euro price action suggests that markets are erring toward the hawkish side in terms of ECB decisions. However, interest rate pricing is pointing to the opposite scenario, while the recent surge in the German DAX index to record highs also points to confidence in much easier financial conditions.

We believe only interest rate pricing is somewhat aligned with fundamentals and the strength in the EUR is particularly difficult to justify. Our flow data points to strong cross-border interest in the currency and sovereign bonds, pointing to some asset allocation interest away from heavy US exposures. However, US exceptionalism in growth and earnings have been justified over the past cycle. In contrast, the Eurozone economy is becoming increasingly stagflationary and led by public spending, and by ECB members' own admission, with little regard for fiscal sustainability. Furthermore, we are increasingly concerned that the manufacturing and corresponding export sector is being hollowed out. Successive Purchasing Manufacturers' Indices have sounded warnings regarding structural declines in manufacturing output, and we believe the euro's strength is only exacerbating weakness. While each economy will have some degree of specialization, the Eurozone economy has always been exposed to pass-through risk and euro valuations matter for export earnings and competitiveness. This is even more pressing in an environment where industrial policy is becoming paramount, and the Eurozone economy is facing greater competition in industries where it has traditionally enjoyed leadership.

Furthermore, the global cycle has turned and even if the landing is "soft," demand is softening all the same and normally some softening in the exchange rate is required to cushion earnings declines. However, the opposite is happening in the Eurozone: We can see that export volumes are contracting – pointing to real-term declines in external demand and we stress that this has been taking place since end-2022, led by weakness in China. What is striking is that even though the EUR's valuations have generally held up well since 2023, in dollar terms its export price increases have been on the decline, suggesting that price cuts have been taking place to offset the demand losses. This is fully consistent with the worsening outlook highlighted by globally exposed Eurozone companies, yet the ECB continues to focus on the inflation risk arising from services. We do not dispute the need to anchor financial conditions across all economic segments, but the excess focus on the latter risks neglecting a vicious cycle in the manufacturing industry. If public spending does not expand at the same pace up ahead, the drop in national income from other sectors will start to exert itself in price growth. The EUR's strength will contribute strongly to disinflation risk, both from ongoing declines in export levels and outright pass-through disinflation.

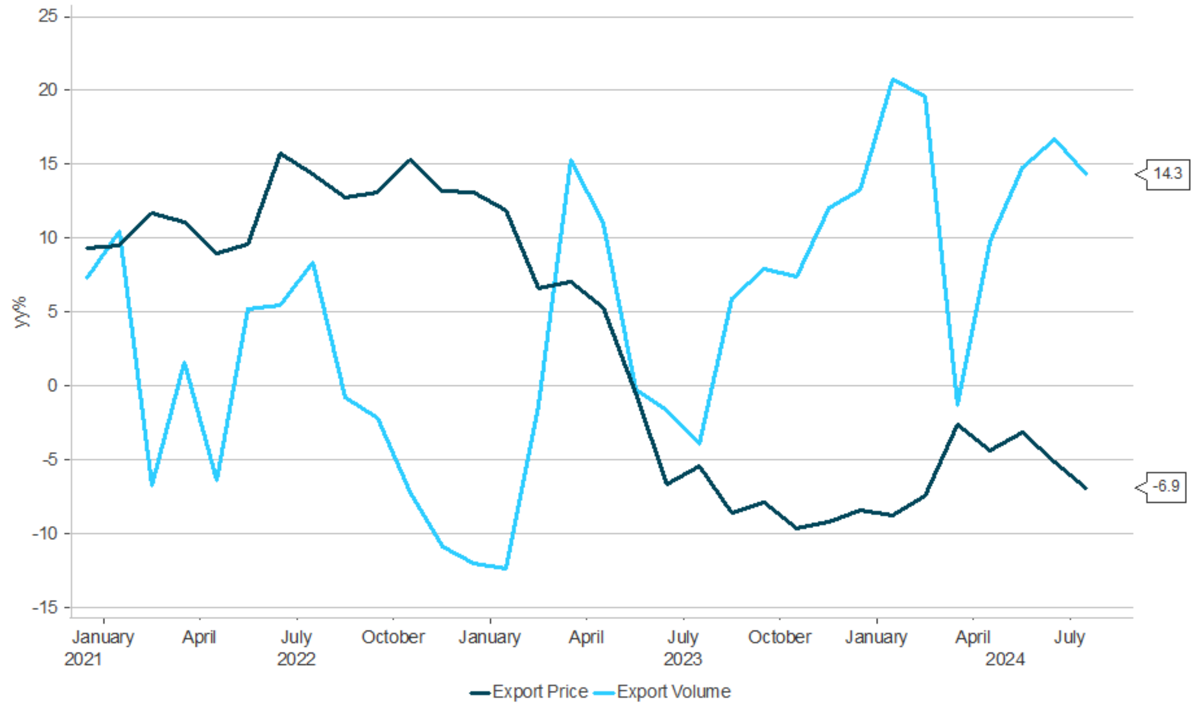
Exhibit #1: Germany Export Prices and Volumes



Source: Bloomberg, BNY

Another currency which also recently managed to hit the year's highs, and fully against monetary policy pricing and guidance, is the renminbi. Transactional aspects relating to the dollar's decline aside, we believe price action is arguably even harder to justify, as in contrast to the ECB, the People's Bank of China has repeatedly committed to further easing, with Governor Pan stating last Thursday that the central bank would "study more policies to boost [the] economy." Furthermore, the PBoC has been open in acknowledging deflation risks, and monetary policy requires lower real rates. Allowing the currency to strengthen to the year's highs runs counter to both priorities. Finally, as much as China's increasing prowess in high value-added goods in addition to traditional segments is now generating concern globally, Beijing must also consider whether this is truly delivering income improvements as well. Volumes have unsurprisingly surged, but prices even in dollar terms have been in annualized contraction for nearly 18 months. Similar to the situation in Germany, this makes tolerance of a stronger currency even more difficult to justify.

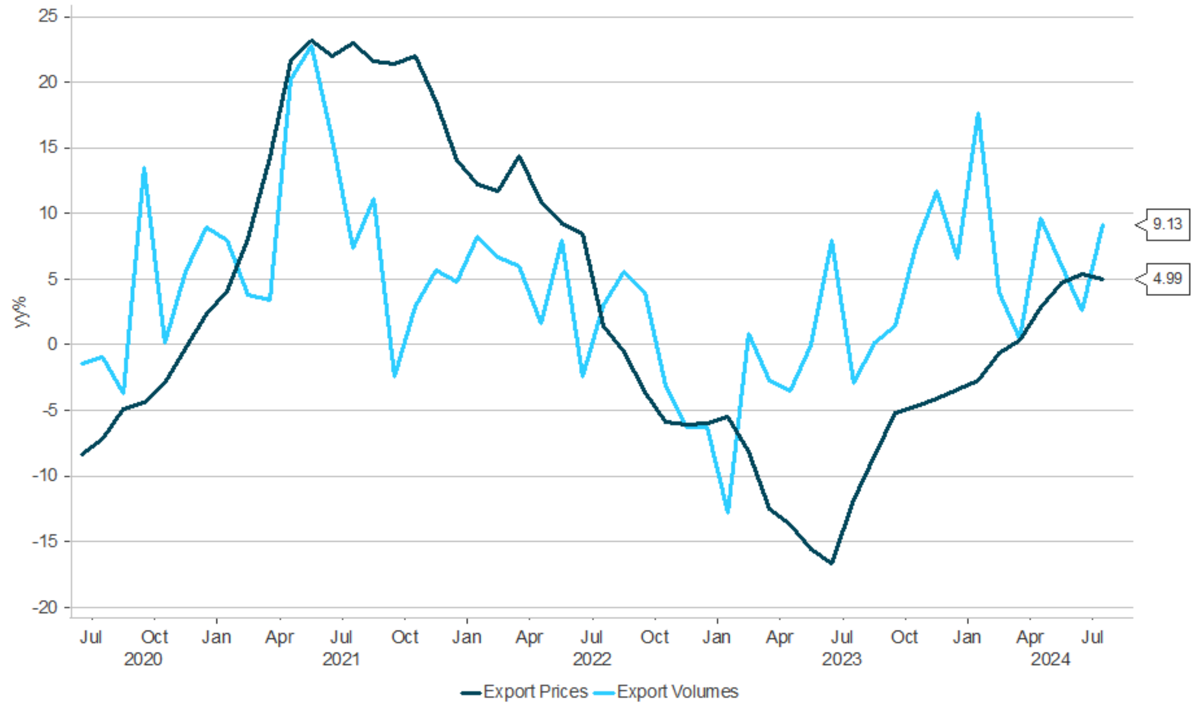
Exhibit #2: China Export Prices and Volumes



Source: Bloomberg, BNY

Not all exporters are in a difficult spot. Last week we highlighted Korea's budget has set out fiscal consolidation. Also, in contrast to Germany, arguably this is possible because other sectors of the economy are performing well. We have documented inflows into Korea's equity market by international investors but as opposed to flows into Eurozone equivalents, the fundamental case is strong. Export prices in dollar terms and export volumes are both generating strong growth. It is helpful that semiconductor demand is going to remain inelastic for the foreseeable future, but the gains to national income are evident, though how the proceeds are distributed in a manner which maximizes growth will be a separate issue.

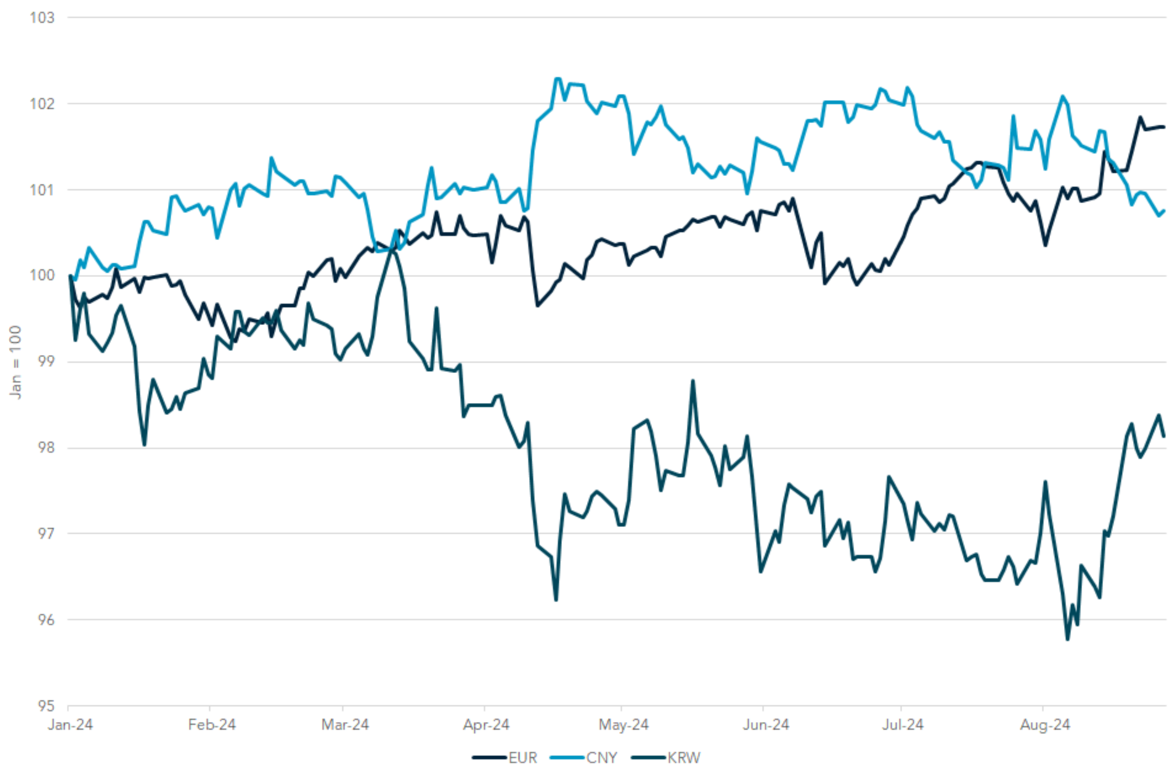
Exhibit #3: Korea Export Prices and Volumes



Source: Macrobond, BNY

Even if Korean exports have to worry less about price competition, the fact that the KRW has been relatively weak in NEER terms (Exhibit #4) is clearly helpful. In contrast, the EUR's NEER has hit year-to-date highs, and we suspect that only appreciation in the JPY and EUR relative to the dollar has managed to limit the increase in CNY in NEER terms. No large economy has foreign exchange as its direct point of policy transmission, but this doesn't mean that price and economic sensitivity can be fully discounted. We believe pushing back against currency strength on the dollar leg will become a core policy pillar for the ECB and PBoC up ahead, especially if the risks to the greenback from Fed adjustments are increasingly skewed to the downside.

Exhibit #4: Year-to-Date NEER Performance



Source: Macrobond, BNY

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