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MACRO MORNING BRIEFING

September 16, 2024

Fed Leads Way, in Most Cases

Fed to set the tone for much of the world but divergence exists

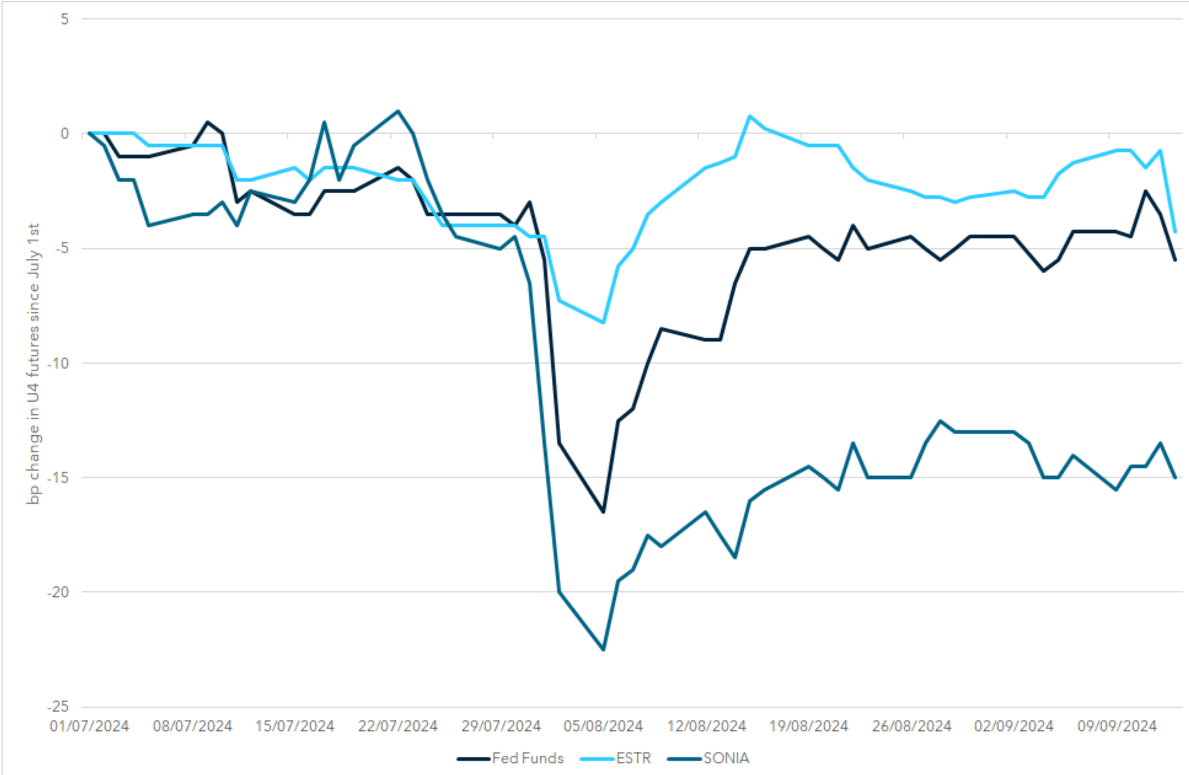
- Norges may not cut until next year, Copom expected to hike
- EM central banks not letting up on real rates focus
- Equity preference clear in EM asset allocation

FOMC counterparts cautious as global financial conditions loosen

A common adage has it that "when the US sneezes, the world catches a cold." The monetary policy corollary to that statement could be "when the FOMC turns dovish, global central banks should cut rates." As the only suspense on Wednesday is whether the FOMC cuts by 25bp or 50bp, under normal circumstances its peers should be moving ahead with easing, hoping to stimulate their economies with lower rates and ensuring that their own currencies don't strengthen too much against the dollar lest exports be jeopardized.

It is true that across the world, easing cycles have been in place since last year. However, even if the FOMC proves more dovish than expected (either based on this meeting or its trajectory), it is no longer certain that its peers will simply passively follow its lead. Last week's European Central Bank (ECB) decision is a case in point: by all accounts the ECB's bias is to remain restrictive, even hawkish. Frankfurt clearly has been unable to shake the notion of "hawkish cuts." Similarly, the Bank of England is also expected to remain relatively cautious in its decision this week. We can see that since July movements in rate expectations for the September decision have been relatively subdued. For any economy with strong trading and exposure to the US, policy synchronization is clearly not the default option. This speaks to the view that most economies are now adjusting to supply-driven inflation and central banks are attuned to the idiosyncrasies of their own labor markets.

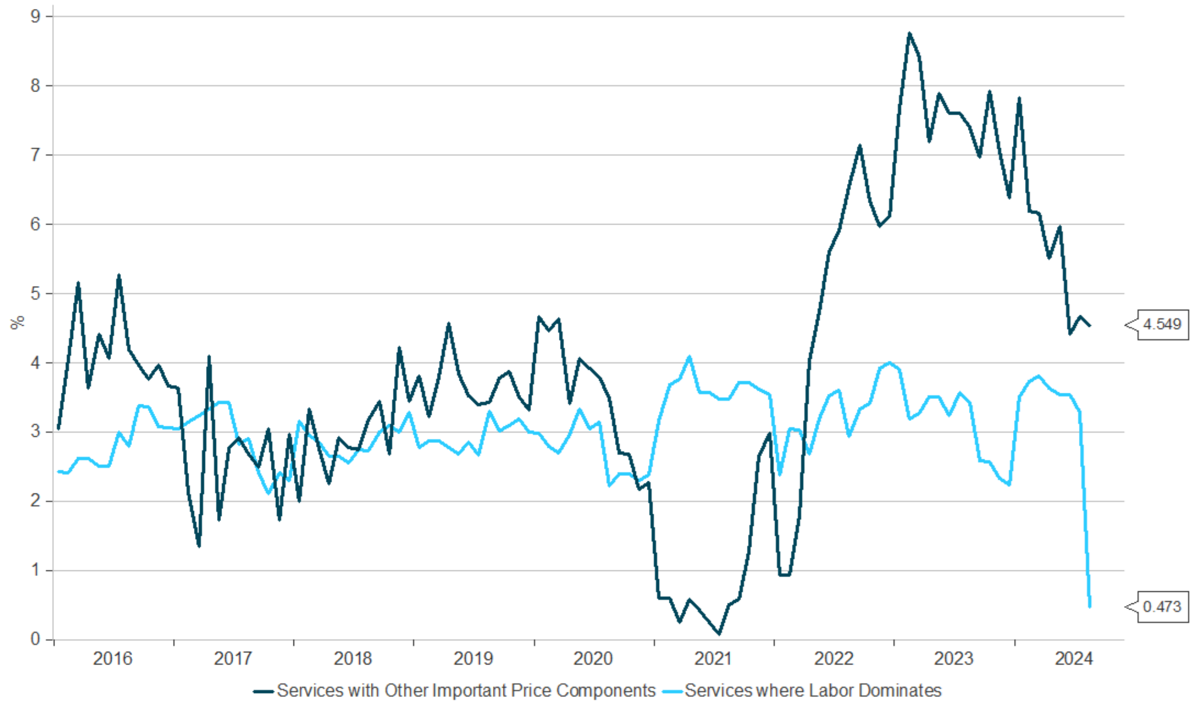
Exhibit #1: Sep 2024 Fed Fund Futures Change



Source: Bloomberg, BNY

For example, Norges Bank is expected to remain on hold this week, even though the Norwegian economy faces pressure from all sides. Its major trading partners have all begun to cut rates and there is severe downside risk to oil prices. However, the market is not even sure whether rates will fall at all in Norway this year. Inflation remains above target and the currency's decline now poses upside risks to inflation. Even with Norway's unique foreign exchange mechanisms in place, pass-through inflation is too great a risk, as we have seen in neighboring Sweden. The timing is rather unfortunate as there are very clear signs that services inflation is now coming off sharply, especially in the wage and labor market-related components. On the other hand, although renewed inflation risk does delay the policy path, it is arguably easier to manage than supply issues, especially with regard to the labor market, which is well beyond the purview of a central bank. We believe the krone valuations are very attractive at current levels and will likely perform strongly on the crosses. Even if oil prices decline, the likely adjustment in the central bank's foreign exchange transactions will provide a natural buffer for the currency. The system is well understood by FX markets and highly credible, which stands in contrast to the uncertainty over the Riksbank's approach to currency weakness and associated inflation risks during the tightening cycle, which we believe ultimately kept the krone undervalued for longer and to a greater extent than warranted.

Exhibit #2: Services Inflation in Norway

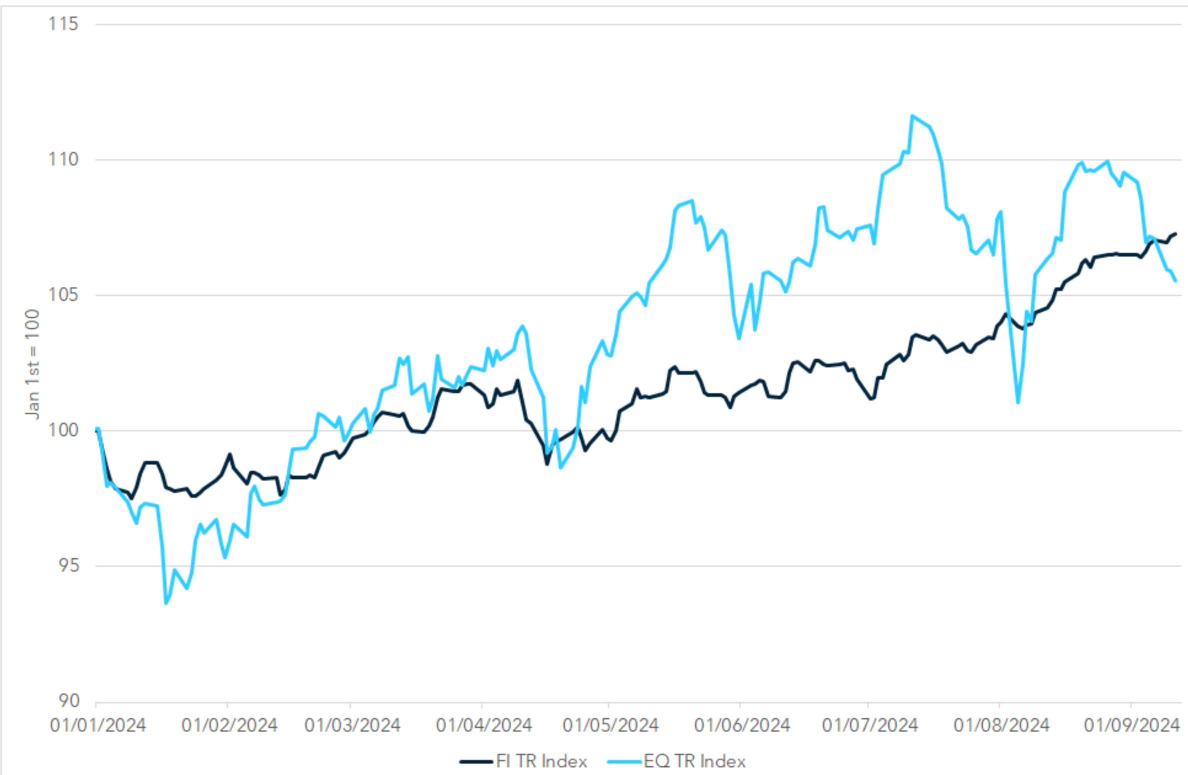


Source: Macrobond, BNY

It will also be a very busy week for emerging market central banks, including economies with a very important role in carry-based asset allocation. In another example of policy divergence away from the Fed, the Brazilian central bank is expected to reverse easing rates and hike back to 10.75%. Even though commodity-based economies remain highly exposed to terms of trade affecting financial conditions, the labor market and household resilience have also been a major theme over the past two years in these economies. Given the relatively lower fiscal impulse seen in Latin America during the pandemic, these new drivers underscore the economic rebalancing in these economies away from exports. Relative to initial assumptions, the Monetary Policy Committee (Copom) has already ended easing early, and it is imperative to maintain resilient real rates. Unlike currencies in other regions, Latin America has been under pressure against the dollar even as FOMC easing expectations have strengthened. Not unlike the situation in Norway, limiting pass-through risk is essential until supply side issues, especially pertaining to the labor market, normalize. The problem for emerging markets is that the bar for real rates is extremely high.

South Africa and Indonesia are in a better position to cut rates, but the focus on real rates is just as strong. Bank Indonesia (BI) needed to hike this year to manage imported inflation risks from a weaker currency, so any immediate rate cuts cannot even be construed as moving toward a full-fledged easing cycle yet. Meanwhile, the South African Reserve Bank is expected to cut rates for the first time since their policy apex was reached in June 2023, but any fears over excessively loose financial conditions up ahead have been met with a renewed commitment to lowering the inflation target. This means that real rates will stay high not through keeping nominal rates high, which is the convention in emerging markets. For example, the Turkish Central Bank is expected to keep rates on hold at 50% this week, but real rates are about neutral. For now, a healthy real rate buffer remains in place relative to the dollar in Brazil, Indonesia and South Africa. If the dollar is expected to face further valuations adjustments against such names, the risk-reward is very high to encourage further asset rotation into these markets. The state of the global economic cycle does not support renewed carry positions, and we believe they are well owned already through the currency and fixed income. Consequently, moving into emerging market equities on a very selective basis offers far better risk-reward, especially in economies where policy credibility remains sound.

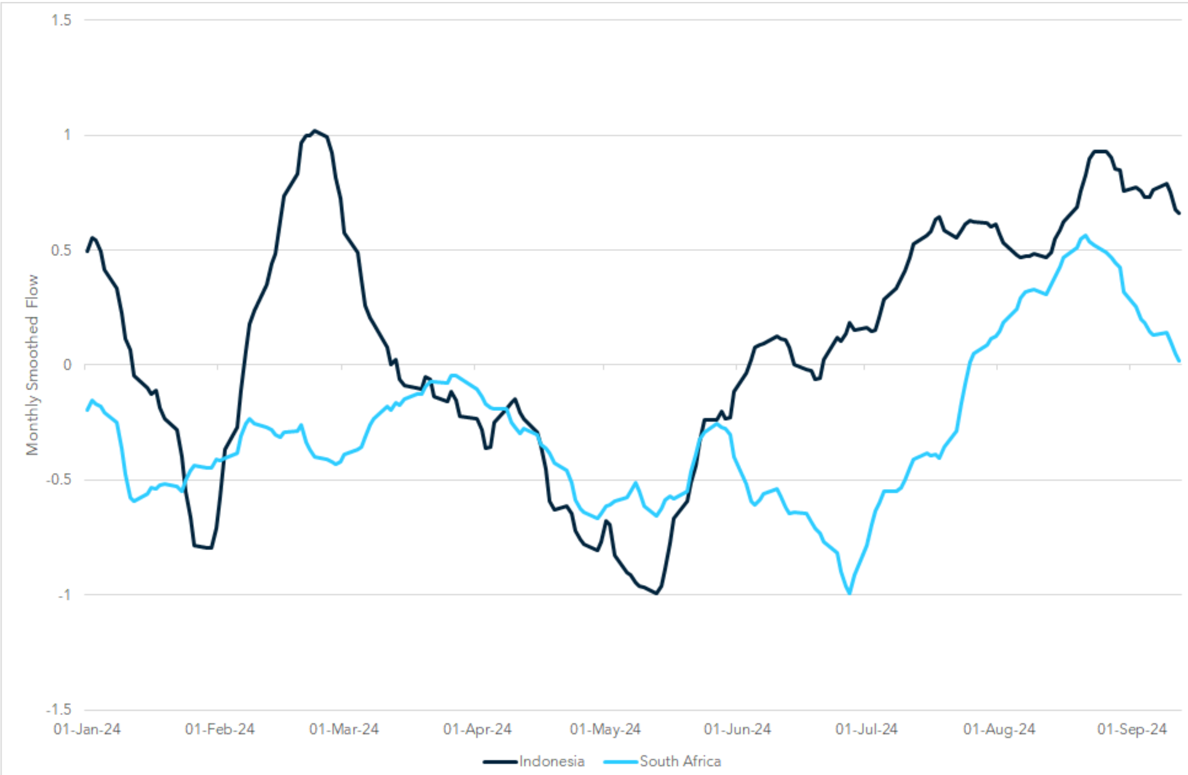
Exhibit #3: Total Return Indices Year-to-Date



Source: Bloomberg, MSCI, BNY

Since Q2 this year, EM equity total return indices have been materially outperforming fixed income equivalents, only to be derailed by the volatility in August (Exhibit #3), from which the asset class has struggled to recover. We also acknowledge that even though its role in the benchmark has diminished somewhat, the ongoing underperformance of China's economy and its stock market is also having an effect. This is not to say that fixed income will perform poorly, but equities is clearly the under-allocated asset class within emerging markets. Furthermore, given the comments by China's leadership last week, it remains difficult to discount a very strong year-end growth surge to hit the full-year growth target. Even though we believe any form of stimulus should favor household cashflow rather than commodity-intensive investment growth, markets will reflexively move into commodity exporters to China. Indonesia and South Africa remain core beneficiaries of Chinese demand, and it appears some tactical positioning in local equity markets is already taking place (Exhibit #4).

Exhibit #4: EM iFlow Equity Flows



Source: BNY

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