BNY MELLON
iFlow
MACRO MORNING BRIEFING

April 19, 2024

Global Elections And FX Volatility

How upcoming elections (many across the globe) play out is a hot topic in markets – and a big unknown for the quarter- and year-ahead. This is on top of already-dominating geopolitical risk related to two wars with hard-to-foresee outcomes. What does seem knowable, however, is the uncertainty of electorates across the world, which, along with less trust in polling, renders election outcomes less obvious and capable of bringing more volatility. FX has a role to play in absorbing the shocks of geopolitics and politics. The most-recent example: +/- 3% moves for Israel's shekel following the events of last weekend. We believe markets' focus in the weeks ahead is likely to continue to shift from evaluating the risks around monetary policies to gauging the risks related to elections and the ongoing fog of war.

- US and UK election risks show in longer-dated FX option vols but are hard to pinpoint given other factors driving uncertainty and hedging demand. The 1y GBP ATM vol is now 7.75% compared to an 8.5% average in Q2-Q3 2023.
- Flows into emerging markets so far this year have been more about rates than election risks. Factor Centrality (explained here) is dominated by expectations around the Federal Reserve's rate path.
- The impact of South Korea's shock election outcome on KRW has been hard to distinguish from the influences of the moves in US yields linked to shifting Fed views, and from the Bank of Korea shifting to a dovish policy view.

Election-related risks over the next quarter are likely to rise – markets know these events are coming and are capable of pricing such risks, i.e., liquid. The problem for many investors, however, starts with dissecting which factors are dominant, along with when election results might shift policy outcomes. Further, knowing an event risk doesn’t evenly show up across all assets at the same time – so hedging in FX may not be the most efficient tool for some election surprises.

Exhibit #1: EM & G10 Election Calendar To June 30

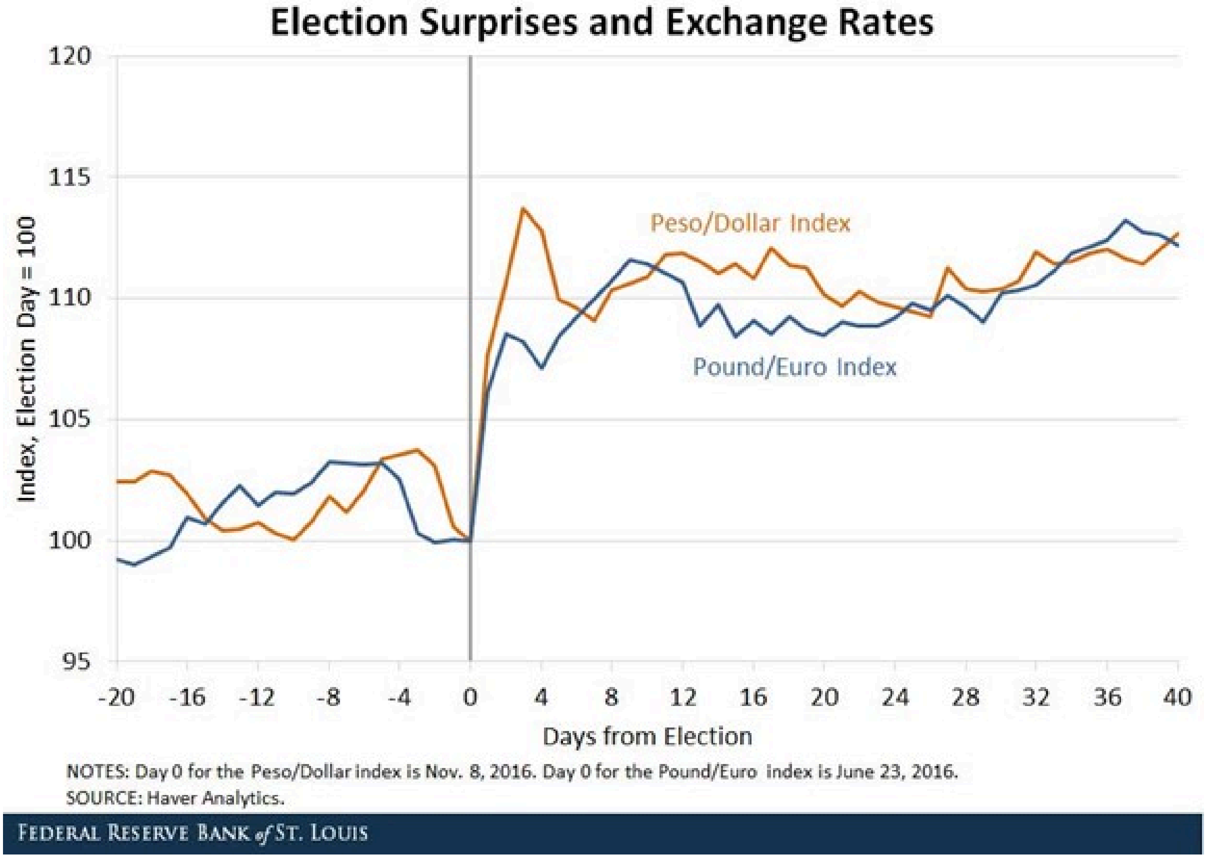
Election Calendar EM and G10 markets

- Croatia – April 17 – National Assembly
- **India** – April 19-June 2 – National Assembly
- Ecuador – April 21 - Referendum
- Lithuania – May 12 – Referendum and Presidential Elecction
- **South Africa** – May 29 – National Assembly and Presidential Election (ANC risks)
- Iceland – June 1 – Presidential Election
- **Mexico** – June 2 – General Election
- **European Union**– June 6 – Parliament
- Ireland – June 7 – Referendum
- Belgium – June 9 – Chamber of Representatives

Source: BNY Mellon

There are known unknowns in elections and unknown unknowns in wars. Markets highlighted the difference between the two on Friday April 12 and Monday April 15. The need for certainty matters in valuing stocks and bonds. Evaluating the cost of money starts with the assumption of the return of capital, then it's onto calculating risks around the return on capital. The difference between politics and geopolitics is at play against economic data and the vagaries of monetary policy, and all that against many elections in the months ahead. One problem with elections is that not all predicted outcomes pan out. For example, the UK's Brexit vote and the US election in 2016 had impacts on GBP, CNY and MXN. Known unknowns of elections can still surprise and was the case in 2016 – worth 10% to FX markets.

Exhibit #2: Will MXN Or GBP Repeat History?

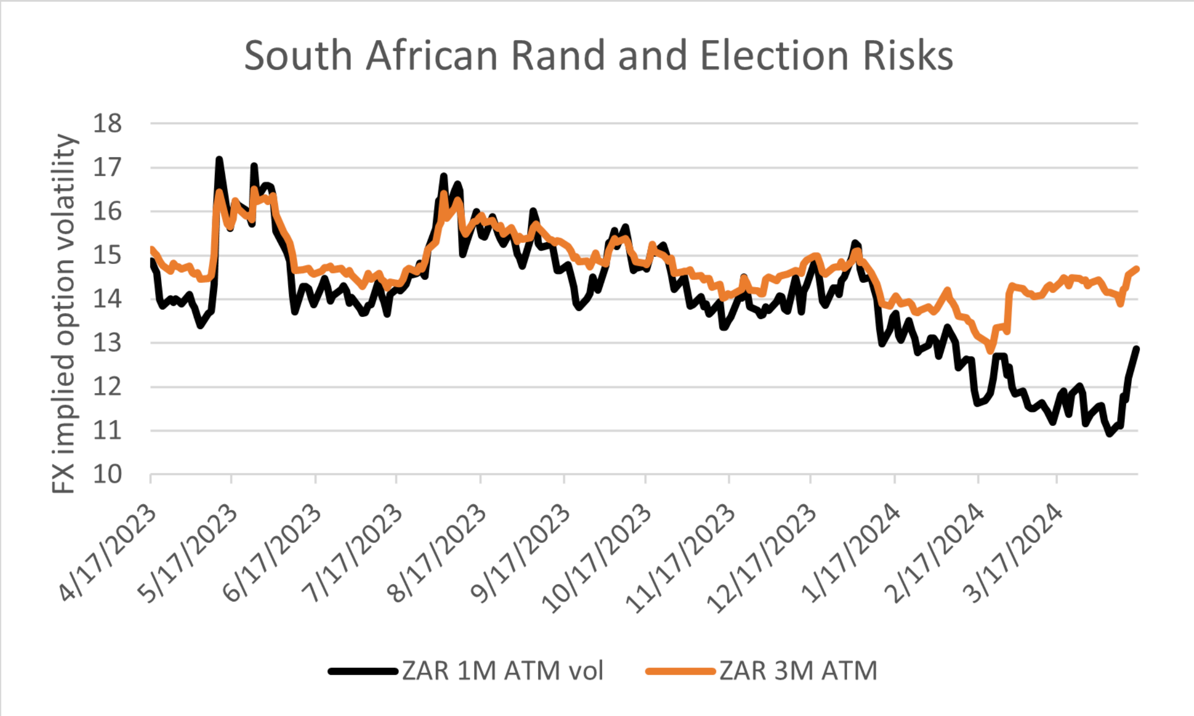


Source: St. Louis Fed, BNY Mellon

The US election in November and the dollar are intertwined with concerns about fiscal and foreign policy shifts linked to the value of the dollar. However, pricing-in the risk of such uncertainty is harder to measure. The rise of FX option vols from March to now is a sharp reversal from the steady decline to 2019 lows, and 2014-like levels as well. The reversals then were sharp: 6%+ moves in six months. The implication: the 1.5% rise on the Israel-Iran escalation seems not yet finished. Whether we have the same experience now is the debate wrapped around wars and elections. Also notable is flattening of vol curves across EM and G10 currencies in the last month. That makes much of the analysis of FX markets and election risks more complicated, as the shape of future volatility is not always event dependent.

Implied FX option volatility around elections is one interesting example of how politics spook markets. South Africa's May 29 election was called at the end of February, and as you can see (exhibit #3) from the spread of 1-month vs. 3-month options, the risk of the election has been about 2% since announced. The election is expected to be different for the African National Congress this time – given the surprising turnouts at campaign rallies for “Wrecking Ball” ex-president Jacob Zuma and his MK party. The risk for the ANC would seem that they must govern in a coalition government. ZAR reflects this prospect and more given the ongoing fragility of South Africa's power grid and geopolitical leanings toward Russia over the EU/US axis. What has seemed clear from the start of April is that the risk of the election has gone up – but the move up in all risk thanks to the Iran/Israel events has narrowed the overall election impact. The effect of real shocks in driving up volatility comes from other asset classes – particularly shocks in rates and stocks.

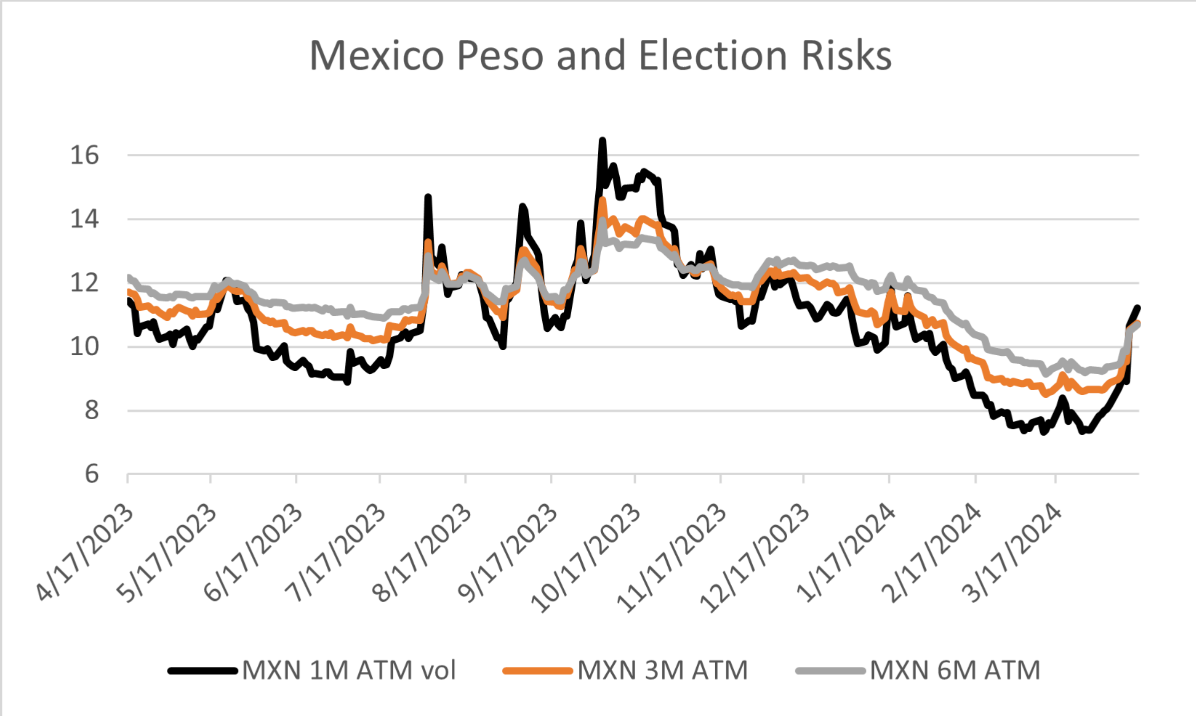
Exhibit #3: ZAR 1m-3m FX Options And Election Risk



Source: Bloomberg, BNY Mellon

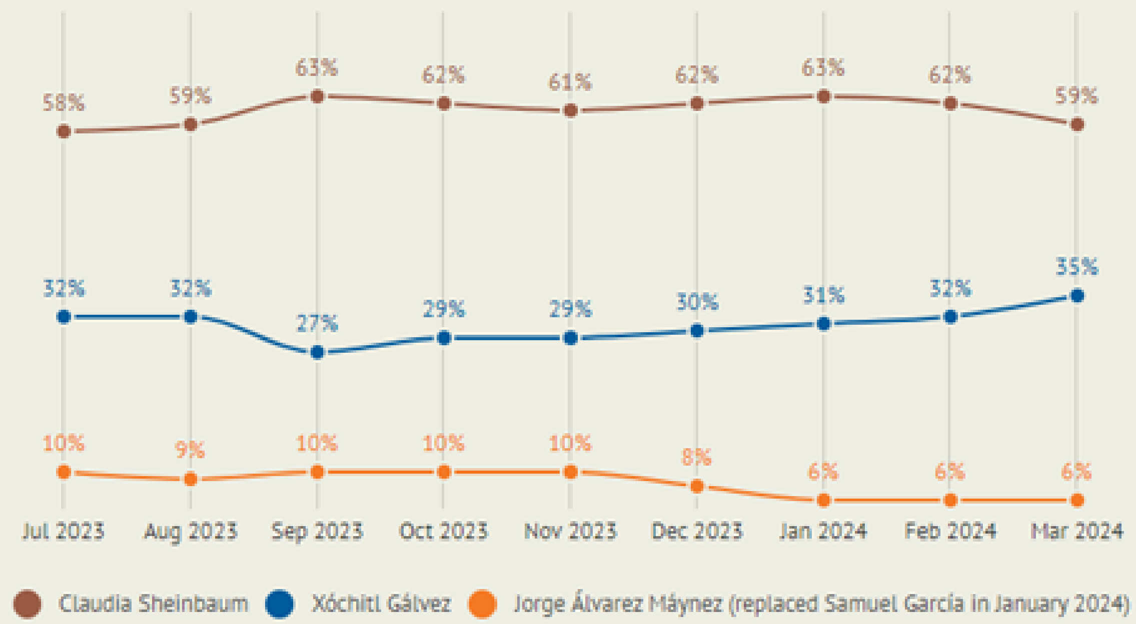
In contrast to South Africa, Mexico's June 2 election was not much focus for risk until February, and since April has had no apparent impact. The leading candidates have been known for the last six months but the risk of the vote in FX options only shows up in late February to March, the latter when polls showed Sheinbaum's margin ahead of Galvez dropping below 30%. The contrast of MXN behavior into Mexico's election vs. the experience of the US 2016 election surprise remains a risk factor. It also keeps risks around the Nov. 5 US election significant.

Exhibit #4: MXN Reflects US Rates More Than Voter Angst



Oraculus

Oraculus aggregates polling support for the candidates of the two party alliances as well as for the MC. Below we see that aggregated polling starting in July 2023, shortly after the two main alliances defined pre-candidates. The aggregated numbers are adjusted to not show undecideds or blank/null votes and represent information on the Oraculus site as of April 9, 2024.



Source: Oraculus, BNY Mellon

Bottom Line: FX options are being used by traders across asset classes for risk reduction – with elections one factor in a world concerned about both unknown and known shocks. Elections in South Africa, India and Mexico are all in focus but only

South Africa has a real premium for uncertainty at the ballot box. Markets are likely to continue to look for more hedges given the poor start to Q2 for risk overall.

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

Bob Savage

HEAD OF MARKETS STRATEGY AND INSIGHTS

CONTACT BOB