February 16, 2024

FX Volatility, Growth And Inflation

G10 FX implied volatility is near decade lows despite the shock reactions to US CPI on Tuesday. Our FX Trend factor is near multi-year lows. The two are linked.

- The elasticity of FX rates to economic shocks has been part of the power of floating currency rates since the inception of the post-gold-standard US dollar in the 1970s. This ability to move FX to adjust for shocks has stiffened and changed over the last 50 years. Monetary policy is doing more of the work.
- The US CPI release this week shocked markets and proved to be a wake-up call for FX, fixed income, and stock markets. The responses were outsized in relation to the data surprise. We have evidence of this from the reaction post-US retail sales data on Thursday. Sticky inflation and less growth than expected are the key takeaways from the US data this week.
- The role of growth or inflation in driving all asset prices is in balance for the year-ahead. However, discovering which is more dominant to the investment thesis will be crucial for volatility-adjusted returns.

Markets have unwound 80bp of easing in the US and that has driven 10y+ US bond yields higher, while lifting the US dollar to yearly highs. Fixed income markets have been chasing a US “duration” trade since the October FOMC meeting and the pivot to high-for-longer, rather than “higher”, rates. The USD short position in markets has also been part of the thesis as FOMC easing was assumed to be coincident with easing from the ECB, BoE, et al. Given this setup, G10 FX markets were content to wait out the risks in data. The drop in trading volumes and volatility has been notable. The setup for bond markets in February according to our iFlow positioning was similar – only selling of old corporate issues to buy higher-coupon new ones at auction, while owning the long end of rates was seen as the “safe bet.” The net result: both FX and fixed income markets saw a significant one-day move on

Tuesday. But that just has not lasted with the market still clinging to an FOMC easing bias, still thinking that the volatility of markets last year has passed.

Lack Of Momentum, Tight Ranges Drive FX Volatility Lower

FX G10 Vol and iFlow Trend

FX 1M G10 vol

9
8.5
8
7.5
7
6.5
6

iFlow FX Trend

0.5
0.4
0.3
0.2
0.1
0
-0.1
-0.2
-0.3
-0.4
-0.5

8/15/2023 9/15/2023 10/15/2023 11/15/2023 12/15/2023 1/15/2024

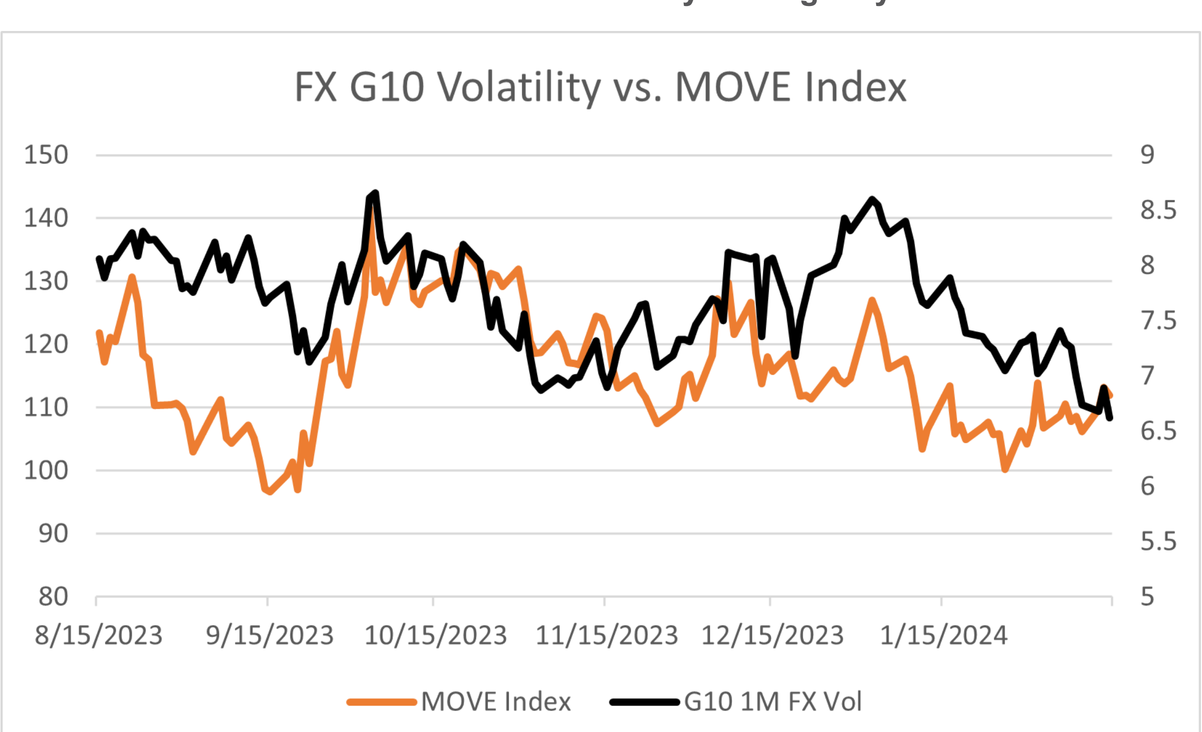
Axis Title

G10 1M FX Vol
Iflow Trend

Source: Bloomberg, BNY Mellon

The correlation of fixed income and FX 1-month volatility to the lack of momentum trading stands out over the last month. The drops in both FX and fixed income reflected the tight range trading of markets. But all that changed this week with the split between the fixed income MOVE index, which measures implied volatility across duration, and G10 FX volatility indexes showing up. Whether this break in correlation lasts will be a critical driver for the rest of the month, if not into the March FOMC meeting. The rise in the MOVE index after the October FOMC meeting stands out. The split of FX to fixed income now may be similar.

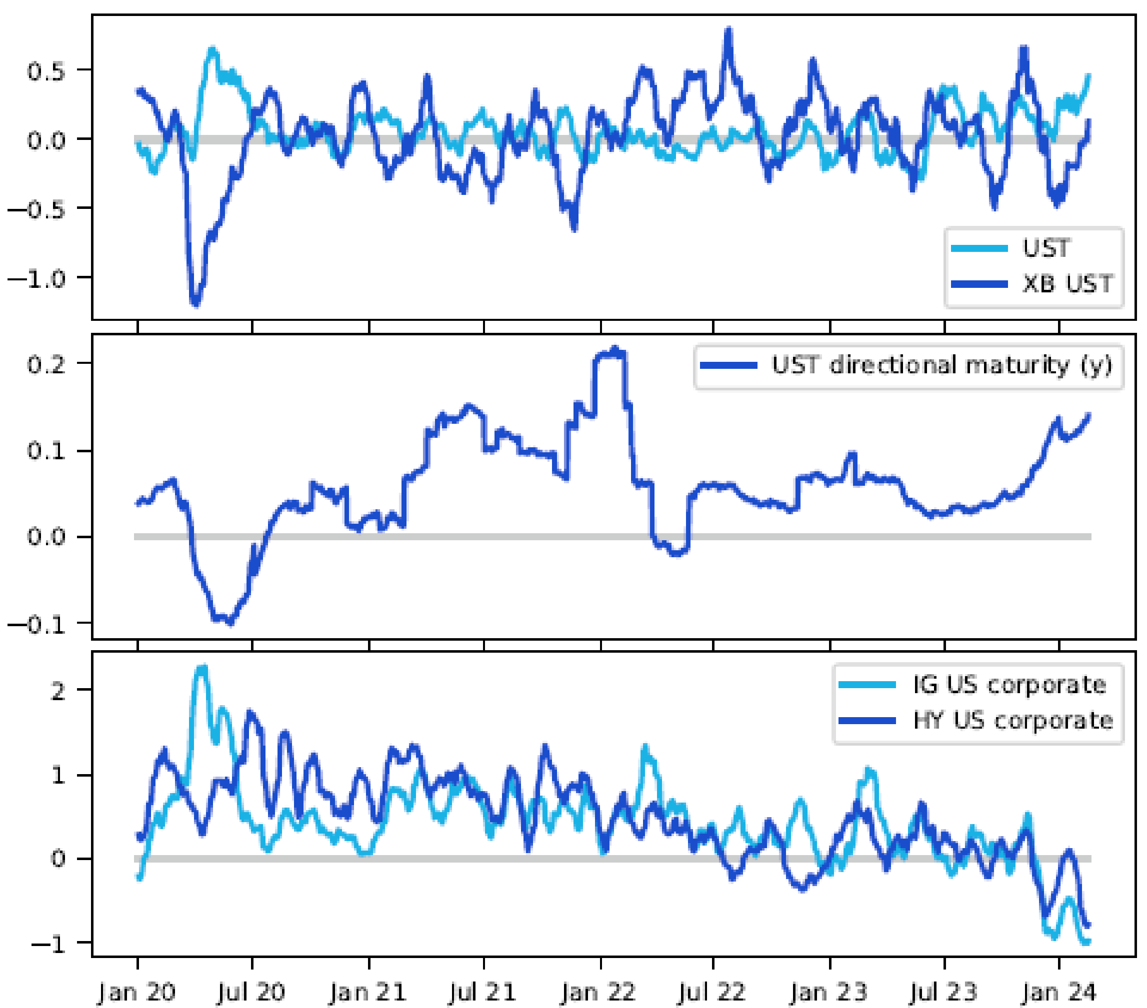
FX & Fixed Income Volatility Parting Ways



Source: Bloomberg, BNY Mellon

Our iFlow data shows real money investors over the last week continuing to buy bonds, particularly longer duration. This is not just a domestic story but also a global one for the US. The fact that the data didn't change the fixed income bias stands out. The selling of corporate paper regardless of rating also has been notable, but that too has stalled as a trend. Fixed income markets are in a different place than FX.

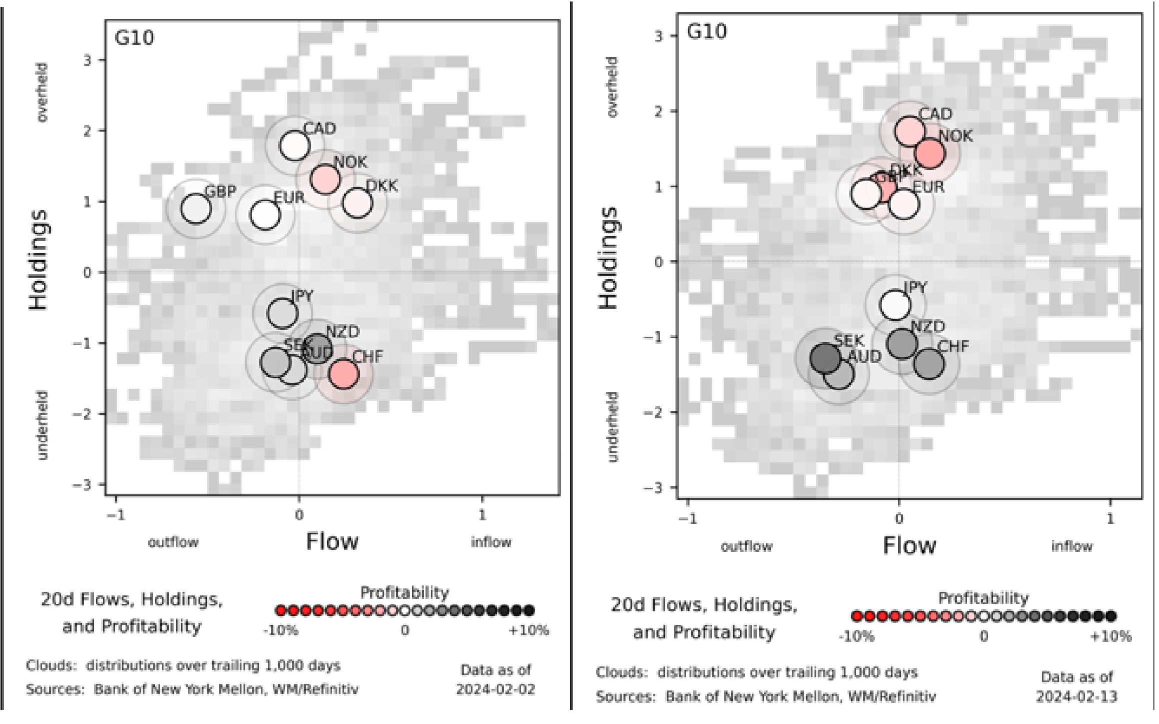
US Bond Buying Both Domestic And Cross-Border



Source: iFlow, BNY Mellon

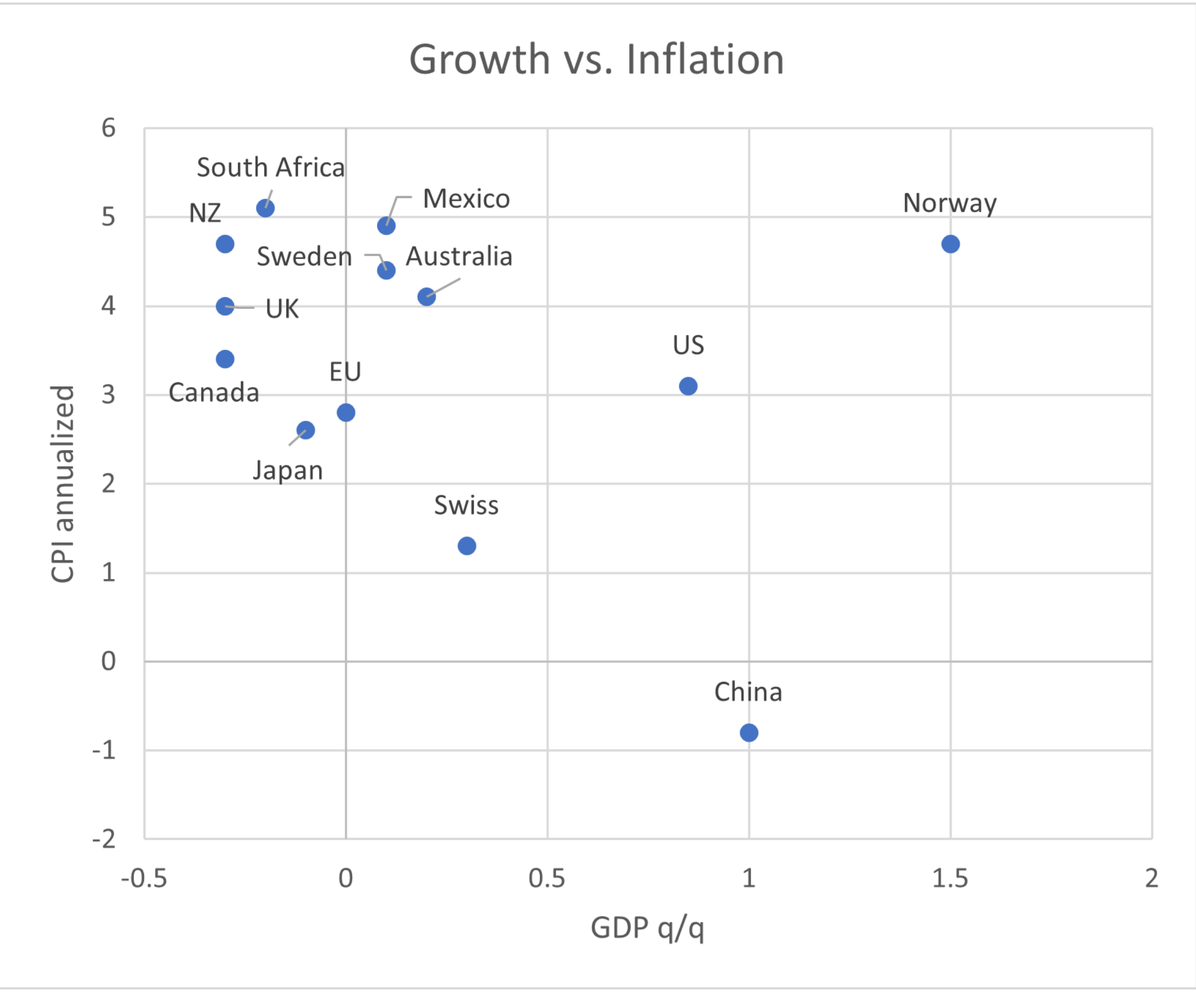
In FX, iFlow holdings of CAD, NOK and EUR stand out as long, and seeing investors add to positioning as the noise of CPI did not shift positioning as much as drive down profitability. The post-data risk for FX markets is intermixed with the shift in the debate at the FOMC from when to ease to what is the neutral rate. Sticky services inflation in the US and elsewhere requires new work on the part of central bankers to consider interest-rate policy against wages. How the G10 holdings and positions

chart shifted in February shows that positions have not really changed much despite the data surprises and the moves in front-end fixed income. The takeaway in FX so far this month is more about profitability shifting than any position washout. The technical pressure to shift out of losing positions has not yet mattered.



Source: iFlow, BNY Mellon

Growth in most of the world in Q4 2023 was flat to negative, so sparking growth or escaping a recession is not about FX weakness leading to more exports to the US or others that are growing. The post-pandemic recovery in global trade was interrupted by two wars, leaving FX elasticity wanting as a policy tool. Markets are clearly more focused on growth and carry over anything else in FX. The deflation in China stands out, but so too does the tame inflation story in Japan, Europe and Switzerland. Japan with negative rates is the anomaly, and even that did not stop a technical recession. Clearly, the ECB and SNB are most likely to be the central banks to act on monetary policy shifts lower.



Source: Bloomberg, BNY Mellon

Bottom Line:

Markets are struggling to find a theme beyond US exceptionalism. The need for the FOMC to ease looks quite different despite some cracks in the data, e.g., rising continuing jobless claims and weak retail sales. Markets are likely to look on policy paths and real rates as key investment guideposts in the weeks ahead. Inflation is still too high in most of the world, leaving those nations that can ease more likely to see growth, equity inflows and currency gains. For volatility, data and the central bank decisions around it seem the only drivers of risk. We appear to have fallen into event-driven hedging, rather than any shock repricing of global markets.

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

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