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iFlow

MACRO MORNING BRIEFING

March 18, 2024

Clarity Elusive Amid Central Bank Bonanza

Focus on potential changes from BoJ and Fed

- BoJ expected to drop NIRP; limited adjustments elsewhere in developed markets
- Domestic inflation keeping Norges Bank and SNB higher for longer
- Crucial week for Latin America as carry interest continues to drop

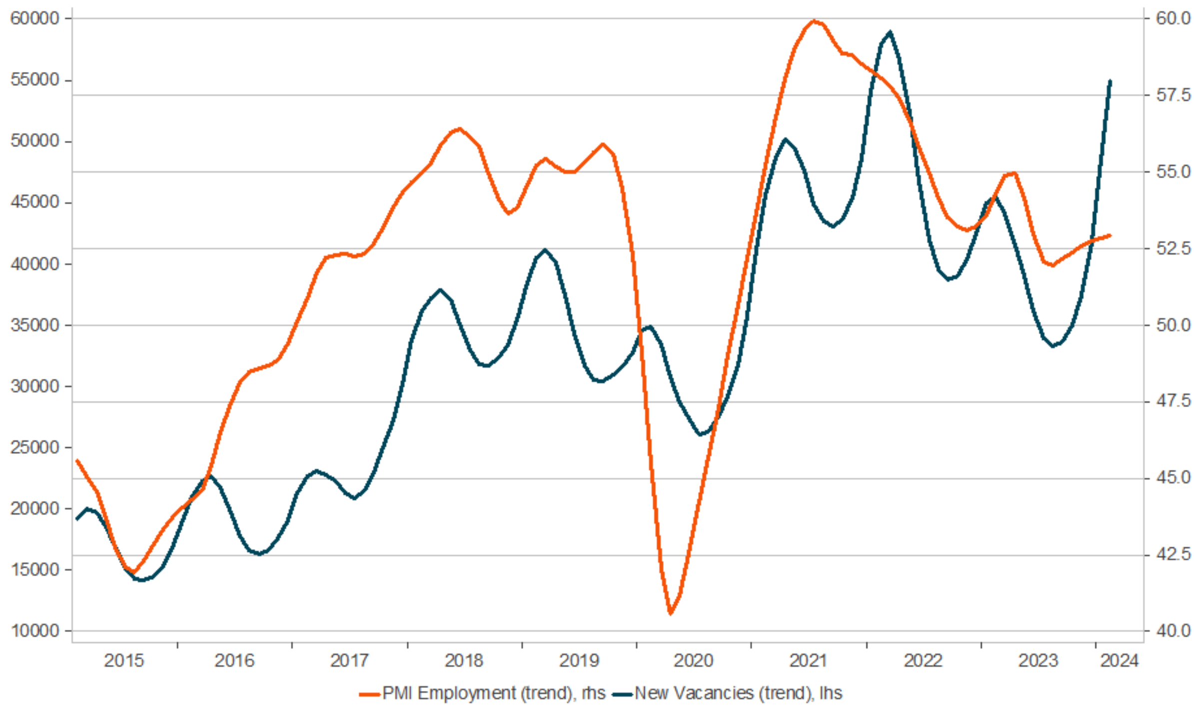
A high bar for any surprise decisions

Over a dozen central bank decisions in key markets are due this week, including from the Federal Reserve. We suspect focus will be on the Bank of Japan, which is expected to announce an exit from Negative Interest Rate Policy (NIRP). However, ample expectations management has left very little scope for surprise. Our custodial flow data shows a softening in JPY purchases over the past week, indicating very limited appetite within markets to hold large, long JPY positions into of the decision. The same probably applies to short USD positions before the FOMC decision. Even though markets' core view for the Fed this year remains that easing will come, little in data has pointed to a more-dovish outcome. We would not rule out the 'dot plot' moving higher from the three cuts indicated in December.

No changes are expected from the main central banks in Europe. Despite data marginally surprising to the downside, we still believe Norges Bank and the Bank of England will not be able to move until H2 this year due to not only the lack of loosening in their respective labour markets, but also resilient demand. For example, there is clear evidence that the UK housing market is starting to re-accelerate (Norway's never softened aggressively in the first place), indicating that household debt-servicing ratios are more than manageable. This would not be possible without supportive nominal and real income growth. Whereas the European Central Bank's recent commentary clearly points to consensus on the Governing Council for rate cuts starting no later than June – as warranted by data, in our view – neither Norges Bank nor the Bank of England have fully confirmed an easing bias for the year.

If anything, Norway's forward-looking employment data (exhibit 1) suggests that wage inflation could rebound. Trend-based high-frequency data for new vacancies is now back at the strongest levels on a nominal basis since 2022, during the post-pandemic reopening labour demand surge. The employment component within the latest PMI data is softer on an absolute basis but expectations are for ongoing expansion. Average monthly earnings remain well over 6% and the gap versus the policy rate is now materially wider compared to a year ago. This begs the question whether policy has been tight enough, though Norges Bank most likely did not anticipate labour markets remaining so strong. With the latest regional reports indicating that Q1 2024 employment plans have been 'revised up slightly' since the previous survey, Norges Bank seems unlikely to change its assessment from the January meeting that "continued high wage growth and the krone depreciation through 2023 will likely restrain disinflation". Coupled with what we think is a good chance of ECB and Fed easing in the coming quarter, NOK depreciation could be the easiest to reverse, but a 'higher for much longer' Norges Bank is a likely necessary condition in the process.

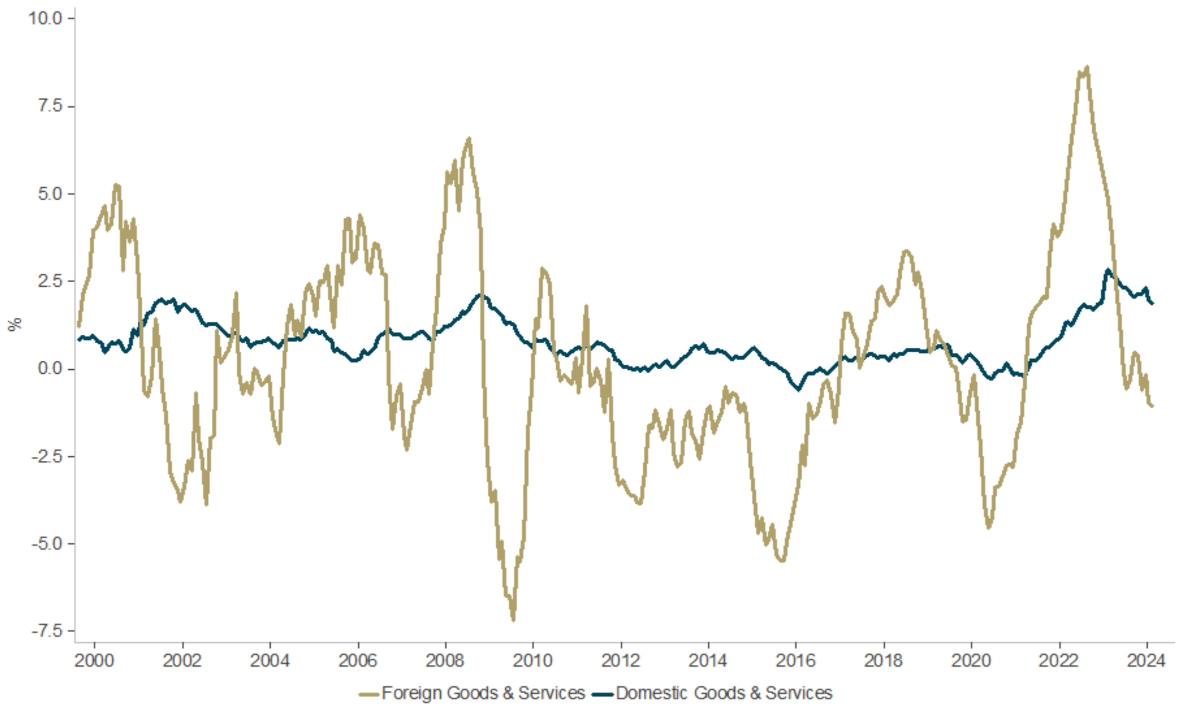
Exhibit #1: Norway Labour Market Expectations



Source: Macrobond, BNY Mellon

As detailed recently, we do not see the Swiss National Bank moving this week, either. We reiterate also that recent market concerns about franc valuations appear overdone. Furthermore, there is no clear evidence that CHF nominal effective exchange rate strength is exerting downward pressure on domestic inflation. Exhibit 2 shows very little moment in domestic goods and services inflation – which remain near two-decade highs despite imported inflation shifting into negative. This stands in sharp contrast to previous policy cycles in which domestic inflation was struggling to stay positive and there was no margin for error for additional disinflation arising from pass-through. There will be other reasons to limit franc appreciation up ahead, but likely requiring a different policy context.

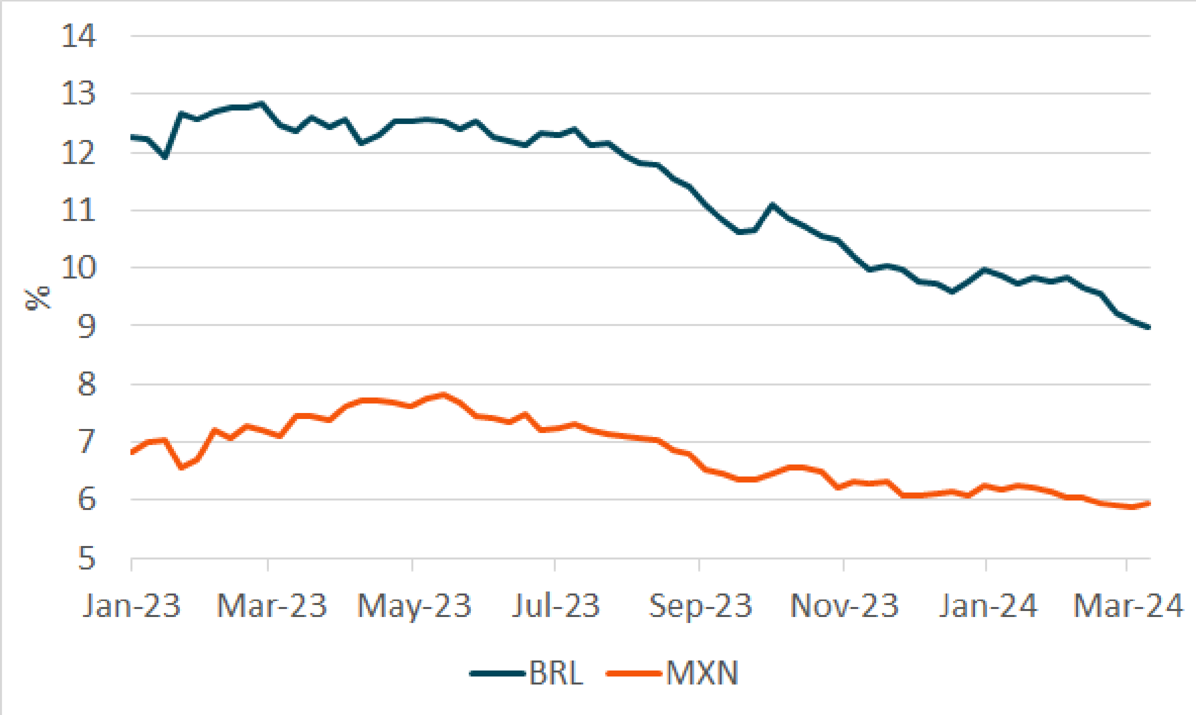
Exhibit #2: Swiss Domestic vs. Foreign Inflation



Source: Macrobond, BNY Mellon

This week will also bring another test of market perceptions of risk:reward in EM carry trades, especially in Latin America. Policy rates in Brazil and Colombia are likely to be lowered further, barring any material hawkish surprise from the Fed. Central banks across LatAm have fully shifted their biases and we see an outside chance that Banxico could also commence easing. If the Fed had been able to move commensurately and thereby reduce US dollar strength, the compression in rate spreads (exhibit 3) between LatAm economies and the US would have likely prevented disorderly unwinding in carry and continue to support duration in the region. Real rates in LatAm remain high but dollar equivalents have not dropped as much as anticipated at the start of 2024. Implied yield differentials between Brazil and the US have dropped to single digits for the first time in the recent cycle, testing the market's expectations of compensation for Brazil fiscal and inflation premia.

Exhibit #3: Brazil, Mexico Implied Rate Differential vs. US

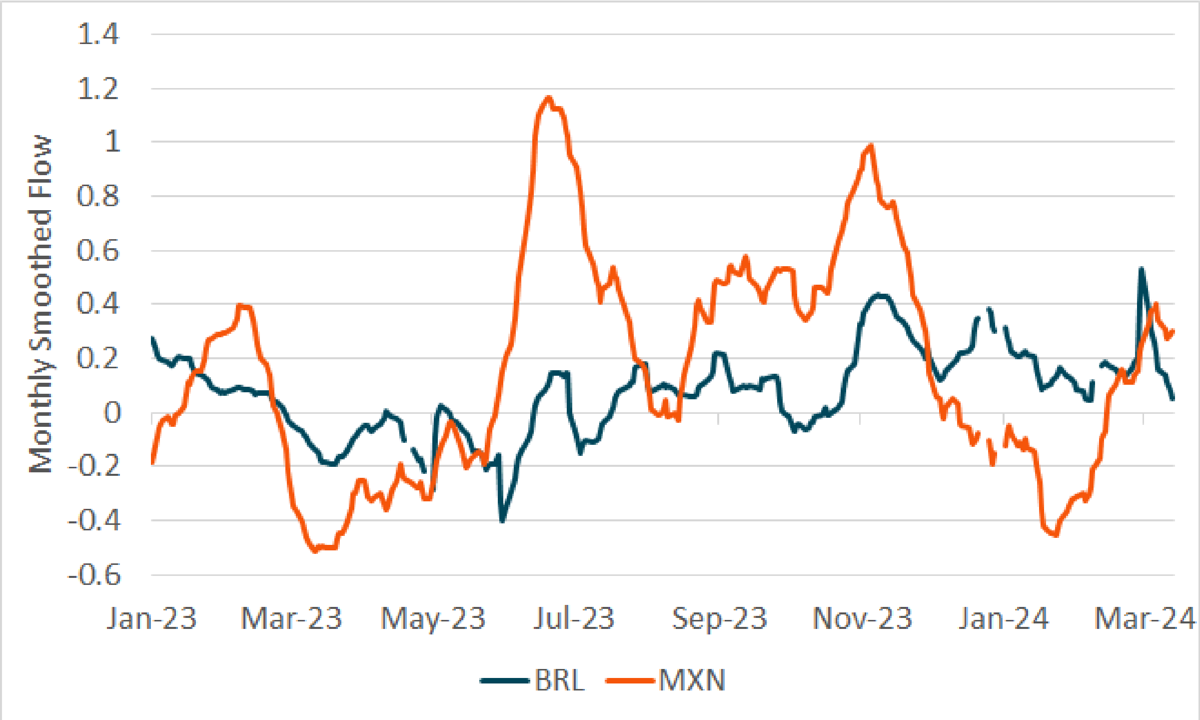


Source: Bloomberg, BNY Mellon, based on 1m forwards in USDBRL (NDF) and USDMXN

Consequently, the carry trade, which was dominated by Latin American and Central and Eastern European currencies last year, is beginning to fade. Although iFlow Carry enjoyed another period of positive statistical significance earlier this year, the high-yielding leaders, such as TRY and ZAR, are not benchmark currencies in a position to receive strong flows. More recently we have observed strong demand in frontier markets, notably Egypt, Nigeria and Argentina. Flows into BRL and MXN both struggled around the turn of the year (exhibit 4). Colombia's central bank decision will also be crucial in determining how existing long COP positions fare – hitherto a profitable carry trade due to BanRep's late start to easing.

After a light recovery in towards the end of February, the general global carry complex is reversing again, according to iFlow. Despite weakening economic activity in these economies, the risk of not maintaining a healthy real-rate buffer on absolute and relative bases carries strong pass-through risk; manifestation of that could undermine the hard-won credibility achieved over the past 18 months. There is some additional room to ease over the next quarter, but depending on subsequent Fed outcomes, emerging markets outside Asia-Pacific will likely slow or even pause easing. We believe this is one of the reasons why fixed income flows into EM have underperformed – and may continue to in the near term.

Exhibit #4: BRL, MXN Flows



Source: BNY Mellon iFlow

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