BNY MELLON

iFlow

MACRO MORNING BRIEFING

**March 25, 2024**

# Seeking The Next Surprise

## Two-way policy surprises challenge inflation narrative

- Dispersion in inflation risk growing but drivers remain idiosyncratic
- Financial conditions are supportive but inflation momentum a worry
- Asia allocations looking for second wind post-BoJ

## Successful BoJ and Fed guidance proving the exception

If the outcomes of last week's Federal Reserve and Bank of Japan policy meetings were examples of successful pre-decision guidance through speeches and media reports, markets were clearly unprepared for the surprises thereafter. Developed- and developing-economy central banks surprised in both directions, indicating that global inflation outcomes are far from certain. Market outcomes, however, are asymmetric. We believe each decision should be assessed on its own merits. For example, inflation in Turkey is much different than in Taiwan, and their real interest rates are on different orders of magnitude. However, both economies appear positioned to get stronger inflows up ahead, in which case additional vigilance by policymakers vis-a-vis demand gains will likely be warranted.

While a risk-on tone across asset classes remains despite the injection of policy volatility, we suspect asymmetry could be in play. Dovish surprises are more welcome than the converse, even if the decisions portend concerns over weaker household incomes and corporate earnings due to slowdowns at home and abroad: Swiss equities had their best session of the month after the surprise rate cut by the Swiss National Bank. Easier financial conditions matter greatly. We can see below (exhibit #1) that they have continued to improve over the past few months in the US and Eurozone despite the recent volatility in policy expectations.

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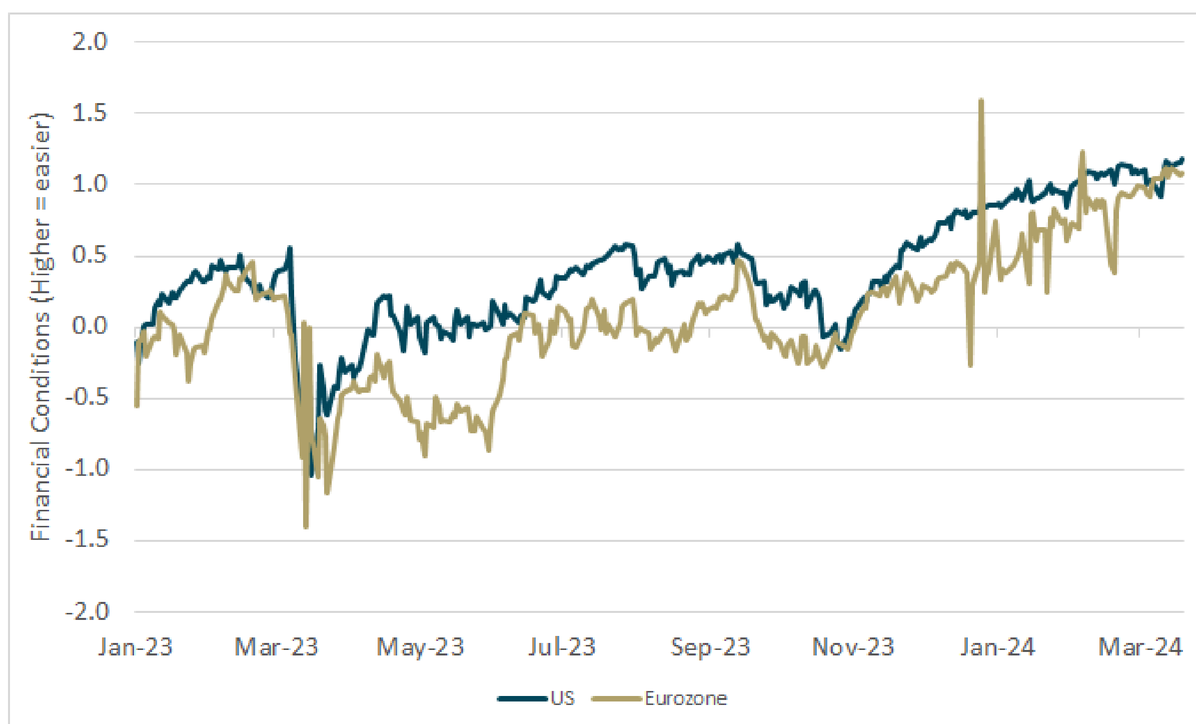
**Exhibit #1: US & Eurozone Financial Conditions**

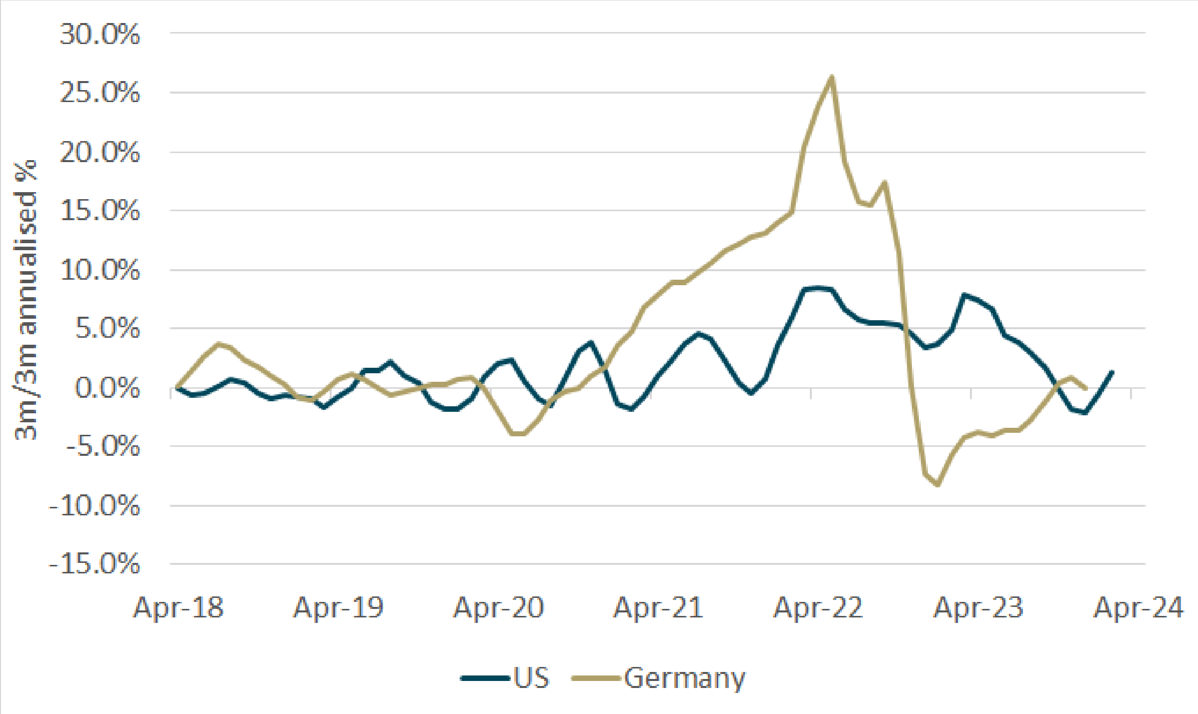



Source: Bloomberg, BNY Mellon

Equity performance has been the core driver of improved financial conditions, but policymakers remain wary of encouraging any excess which would jeopardise their current policy outlook. Some economies have self-adjustment mechanisms. For example, improved positioning in European assets is one of the reasons behind current strength in the euro (the currency is still overheld in iFlow). However, a stronger currency will likely start to exert pressure on export prices, especially if substitutes for an economy's manufactured goods are readily available. The global automotive industry is facing heavy disruption, but considering that the euro has appreciated by 5% against the yuan and 15% against the yen over the past year, there would seem very little margin to increase export prices without losing market share. If this translates into earnings disappointments, financial conditions will react accordingly. The European Central Bank is likely counting on such an adjustment in delaying rate cuts despite a weak export environment.

In contrast, US export prices are rising again compared to Germany's (exhibit #2) despite elevated USD valuations. Without taking a view on the importance of competition and substitution, compared to European or Asian exporters, the global earnings exposure of listed US companies is far lower. So, the Fed might have to consider something remedial were global capital flows into US equities to loosen financial conditions excessively. This could be where the next surprises might arise – and not go down well for risk appetite.

**Exhibit #2: US & Germany Export Price Trends**

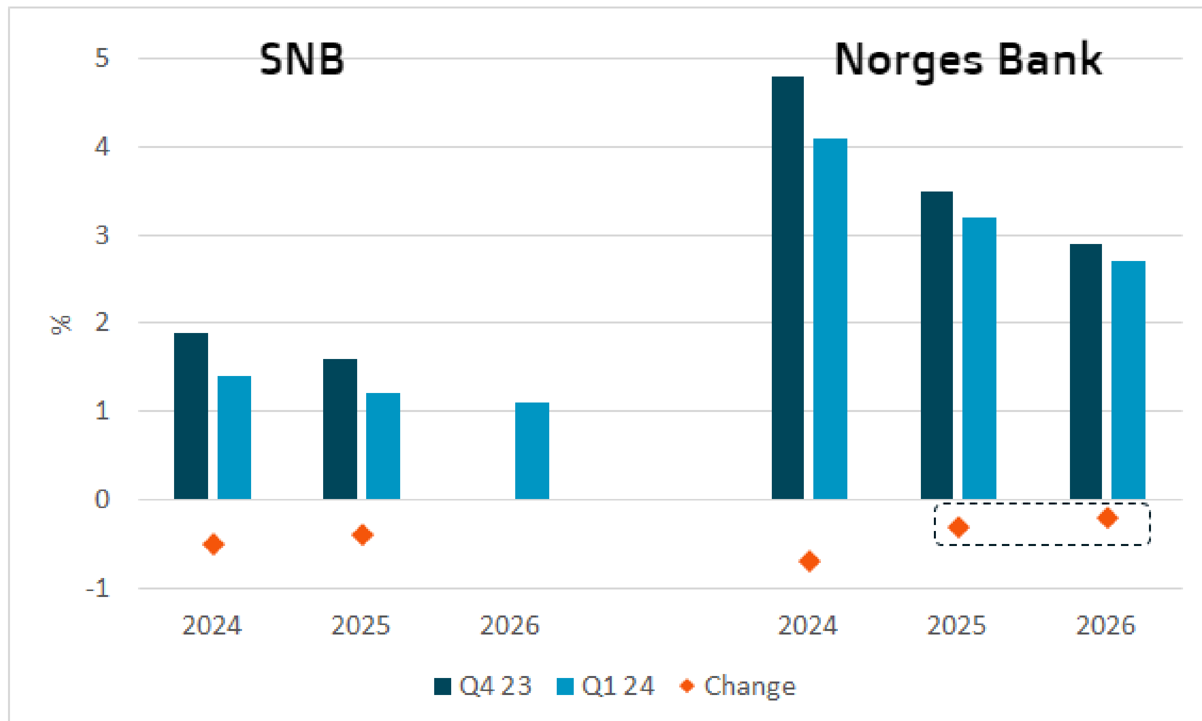


Source: Macrobond, BNY Mellon; PCL = Prime Central London

For smaller economies still heavily exposed to global conditions, we suspect that there will be caution over the global demand environment. Whether that can translate into weaker domestic conditions is a different story, however. For example, the SNB clearly took the view that with international prices already contracting and domestic prices showing some downward momentum, the price vs. expectations cycle will start to turn negative. The “lower second-round effects” conclusion meant that downward revisions to inflation applied to the entire forecast horizon, to the extent that inflation would be barely above 1.0% even with lower policy rates – implying that additional easing will be needed (full SNB press release). This could be the direction of travel for the Riksbank this week, though officials might appreciate even half the currency buffer for inflation that the SNB's currency possesses.

In contrast, while Norway’s downward inflation revision for 2024 was far larger than the Swiss equivalent (exhibit #3), reversions thereafter were far more moderate – to the extent that inflation, both CPI and CPI-ATE, is expected to remain above target in 2027 (Q1 2024 Monetary Policy Report). This is because Norges Bank has chosen not to extrapolate the current declines in prices into lower second-round effects, especially through wages. Compared to the Q4 2023 Monetary Policy Report, wage estimates have barely changed through the entire forecast horizon, thereby inhibiting the central bank from pushing for greater downside risk to inflation. Similarly, even though the Bank of England’s vote split was more dovish and the path is clear for rate cuts over the next quarter or so, the Monetary Policy Committee also warned that the recent drop in services inflation was “accounted for largely by weakness in non-labour rather than labour costs” (MPC Minutes, section 29). The bottom line is that globally, wage disinflation remains frustratingly elusive for central bankers.

**Exhibit #3: Target Inflation Forecast Adjustments**




Source: Schweizerische Nationalbank, Norges Bank, BNY Mellon

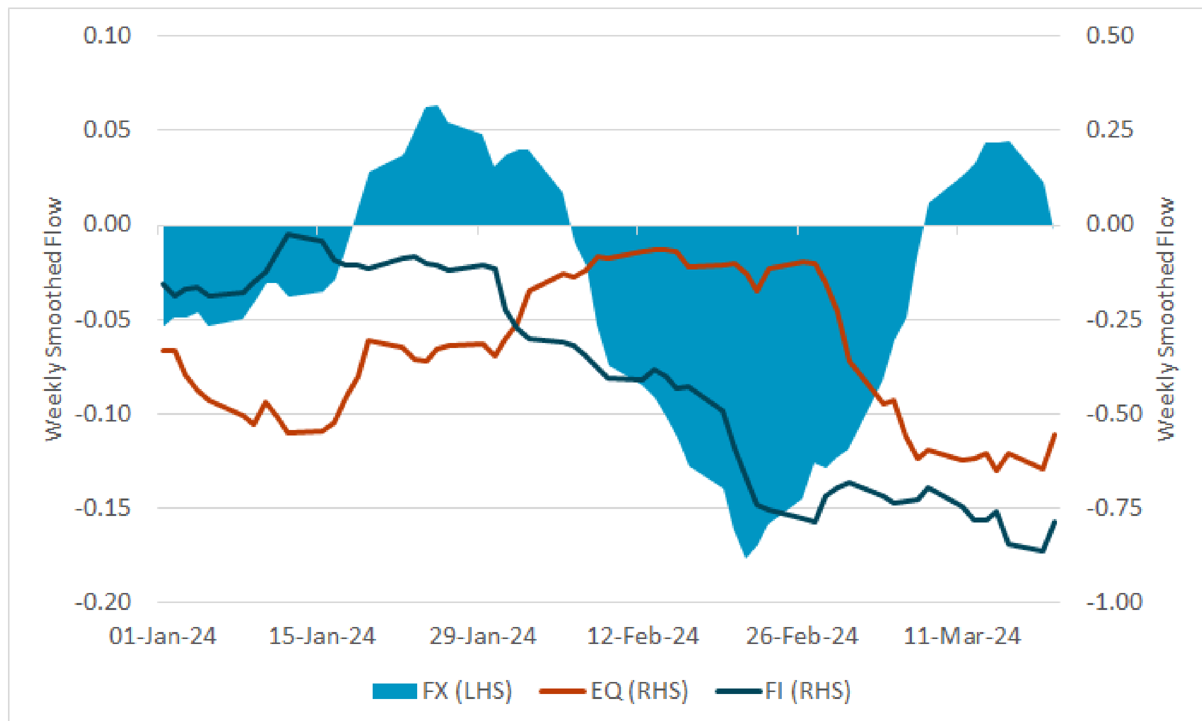
We previously highlighted (see here) how BoJ policy normalisation could create additional policy space in Asia. The surprise rate hike in Taiwan was clearly attributed to local concerns over inflation, and undoubtedly the large amounts of global investment flows into semiconductors are contributing to a demand boost in the country. Terms-of-trade improvements will help manage inflation as a natural adjustment, but the BoJ move has given peers the option of providing an additional push – exercised in Taipei's case. Although the immediate aftermath of the BoJ decision brought further yen weakness, the direction of travel for financial conditions in Japan has shifted. Even through keeping policy differentials stable, much of Asia will likely be able to tolerate a combination of higher rates and currencies to help keep real rates higher to manage inflation.

This opens the prospect of renewed interest in local fixed income markets. Now that Latin America is moving in the opposite direction, on a risk-adjusted basis APAC assets could be a destination for rotation flow due alignment in various factors. First and foremost, currency valuations are attractive and additional strength will help anchor inflation and real rates. Secondly, the global investment push in the region seems only set to continue, and on a diversified basis. In addition to the traditional flows into high value-added manufacturing in the Asian Tiger economies, there is renewed interest in structural financial account allocations to India, as well as FDI into Indonesia's battery-industry, underpinned by nickel reserves. Emerging and even frontier markets in ASEAN will also benefit from productivity advantages. China's growth trajectory remains the main source of uncertainty, and this has been well-reflected in asset allocation in Q1. Rather than rely on flows into China to 'stop-in' allocations into wider APAC, roles have reversed – broader allocations into the rest of the

region could also help support flows into China as well due to its market depth.

We see some signs of a pick-up already (exhibit #4). All APAC asset classes we track in iFlow had material under-allocations in February, but currency interest started to recover in March – and now both equity and fixed income flows shows of rebounding from a very low base. On a mean-reversion basis, we would have expected favourable adjustments in any case, but the BoJ decision can in our view serve as a catalyst for increased rotation.

**Exhibit #4: APAC Multi-Asset Flows**




Source: BNY Mellon

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