BNY MELLON

iFlow

MACRO INVESTOR TRENDS

January 2024

2024 KEY RISK THEMES

WHERE ARE US 10Y BONDS GOING?	UKRAINE/ ISRAEL: ONGOING WAR OR PEACE?	ECB EASING WHAT DOES IT MEAN FOR EURUSD?	CHINA GDP GROWTH IN 2024 IS IT 3% OR 5%?	WHERE IS USDJPY GOING IN 2024?
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Special Edition

NAVIGATING 2024 WITH IFLOW

KEY POLICY, POLITICAL AND ECONOMIC RISKS

We see scant room for smooth outcomes in 2024. The risks financial markets face have become bimodal and binary. Investor views, whether bullish or bearish, are deep-seated. iFlow data indicates significant positioning short the US dollar, short equities, and long bonds. Economic data will play a big role in how those various exposures perform.

Highlighted in the panel above are five hot-button issues that have dominated our discussions with investors over the last quarter: Where are Treasury yields going?; What are the risks to financial markets from Russia-Ukraine and Israel-Hamas conflicts?; When does the European Central Bank ease and what does that mean for the euro?; Can China succeed in boosting growth?; When does the Bank of Japan tighten monetary policy and what will that mean for the yen?

We include with our answers to the markets-based questions perspective from iFlow data, as well as views on positioning and where we stand vis-à-vis market consensus.

In addition to the topics highlighted in the panel, we also discuss the Federal Reserve's quantitative tightening and how developments in US politics could affect markets. EU elections add another source of potential risk, so we have included the expertise contributed by a colleague.

Concerns about a US recession for most of 2023 carry into 2024. Potential domestic headwinds for US growth include the lagged effect of the Fed's rate hikes, tighter credit conditions, fiscal policy in a divided Congress and regulations. External factors such as growth in the rest of the world also matter for US growth. Two wars and other potential flashpoints will keep investors on guard for geopolitical risks the world over.

In our view, scarce optimism makes the 'wall of worry' easier to climb. We see upside risk to growth and risk-asset valuations in 2024.

We look forward to helping you navigate through the coming year, and beyond.

10-YEAR TREASURY YIELD AT END-2024: 3.5% OR 5.0%?

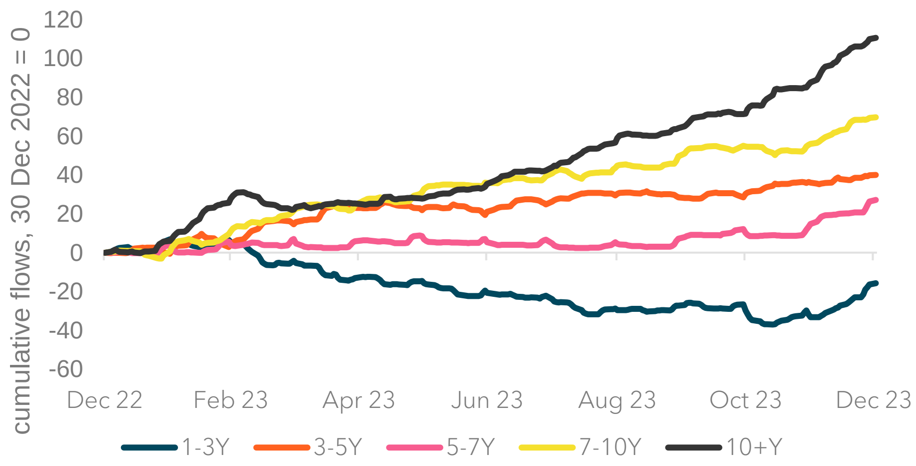
Market Consensus: 4.0%

Our View: 5%, risk of higher; bear and/or bull steepening

- Concerns over coupon supply and stronger-than-expected economic growth to halt rally in Treasury prices and push yields higher
- iFlow: long duration trade ebbs, real money now buying across the curve
- Both bear and bull steepening will un-invert the curve

We think upward pressure on 10y Treasury yields will persist, with a 5% handle likely this year. Although the Federal Reserve appears done with rate hikes, we see supply issues continuing to dominate, along with economic growth staying buoyant. The chart below shows that our investor base had been shunning short maturities in favor of long duration plays until very recently, when market consensus crystalized around early-2024 rate cuts.

EXHIBIT 1: UST FLOWS BY MATURITY



US BOND FLOWS BY DURATION

SOURCE: BNY MELLON IFLOW

Given our view for higher long-end Treasury yields, we see the curve re-steepening and re-establishing its normal upwards slope. We also see a resumption of bear steepening in 2024 – even with an FOMC that we think will begin cutting rates as early as March. Relatedly, at the short end of the curve, we see 2y yields declining further, adding a bull steepener into the mix, ultimately resulting in an upward-sloping yield curve.

The deciding factors may be actual slowing of the US economy and how the FOMC fares in its quest to get inflation to its 2.0% target.

FEDERAL RESERVE: WHAT HAPPENS WITH THE QT PROGRAM?

Market Consensus: QT tapers by 2H 2023

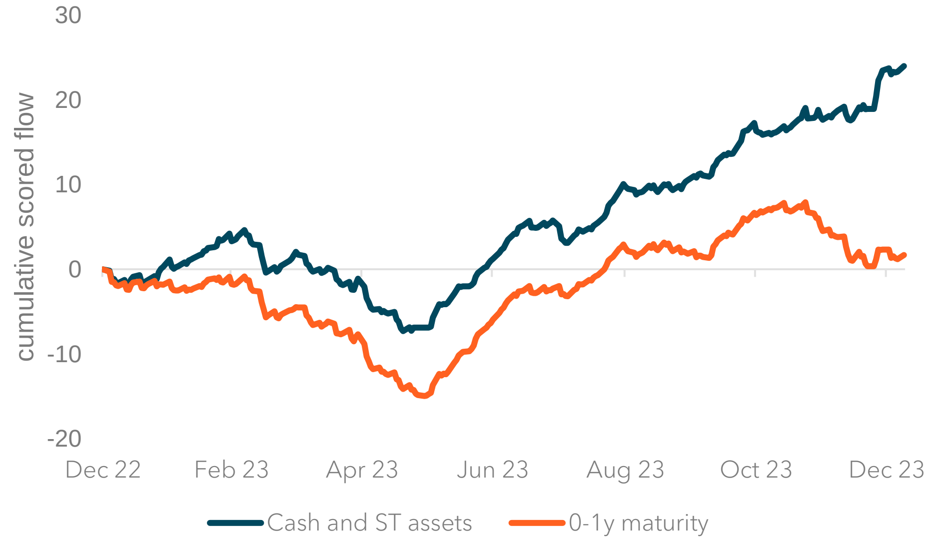
Our View: QT to be reined in; liquidity to become challenging

- We expect the pace of the Fed's QT to slow at some point in H2
- Liquidity will become scarcer as usage of the Fed's RRP continues to decline
- Ructions in repo markets at the end of 2023 suggest that some participants are already approaching reserve scarcity

We initially expected the Federal Reserve's quantitative tightening program to continue apace well into 2024. However, short-lived tempests in money markets at end-November and end-December last year suggested that at least some market participants were approaching liquidity constraints. Reducing the pace of runoff from the Fed's balance sheet unexpectedly appeared in the December FOMC meeting minutes released Jan. 3. The issue was also addressed more directly by Dallas Fed President Logan in a Jan. 6 speech.

Continued shrinkage in the Fed's reverse repo facility (RRP) means that excess liquidity that had been parked there is ebbing, quickly. We see take-up dipping below $500bn by March and below $200bn by May. This could eventually pressure bank reserves, which, now comfortably above $3trn, are widely considered abundant. The Fed won't know at which level below that quantity reserve would become merely "ample" and so require a reduction in the pace of QT. Furthermore, there are distributional considerations. While aggregate reserves are abundant, the distribution of them among banks might be uneven – leading at least some banks to reach their own lowest comfortable level of reserves sooner, so requiring some slowing in the pace of balance sheet runoff.

EXHIBIT 2: SHORT DURATION AND CASH FLOWS



SOURCE: BNY MELLON IFLOW

US POLITICS: WILL DISCORD CONTINUE?

Our view: Policy uncertainty and volatility throughout 2024

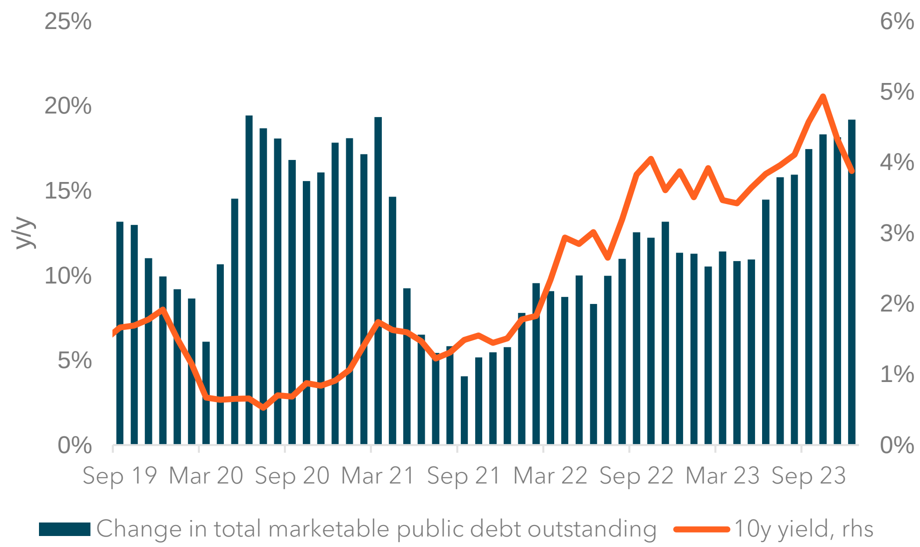
- Congressional setup remains challenging – deep polarization; House Speaker to struggle to maintain any policy momentum
- Government shutdown or not? We think likely. Fiscal policy and funding President Biden's foreign policy priorities sticking points
- Presidential election cycle will prove noisy and outcome close; House and Senate elections also delicately balanced

We think the biggest risk to relatively benign US economic and market outlooks is continued disfunction in Washington, DC. Like his predecessor, the current Speaker of the House faces a risk of ouster over budget plans. Both Democrats and Republicans in leadership positions face primaries as well, so it's hard to say how their platforms might evolve. To us, all this seems to add to the risk of a government shutdown. Significant buying of US debt as per our iFlow data highlights how its reversal could prove problematic. Markets also face potential volatility from presidential primaries as well as from what promises to be a noisy race for the White House in November.

We are concerned that a government shutdown would be seen as credit-negative for the sovereign and result in upward pressure on bond yields. The chart below illustrates the impact of rising government borrowing on the 10y Treasury yield – especially following resolution of the debt-ceiling impasse in late May 2023. We think this relationship will likely hold in 2024.

SOURCE: BNY MELLON IFLOW, US CBO

EXHIBIT 3: PUBLIC DEBT AND BOND YIELDS



UKRAINE, GEOPOLITICAL RISKS – MORE WAR OR PEACE?

Market Consensus: Long and extended conflict with Russia win

Our View: Peace, but it will be tumultuous

- Market consensus: Russia-Ukraine/Israel-Hamas no end soon
- Russia-Ukraine a drag on Europe, emerging markets
- Post-war rebuilds likely mean more debt, inflation risk anew
- Investment flows tell different stories for Saudi Arabia, Egypt

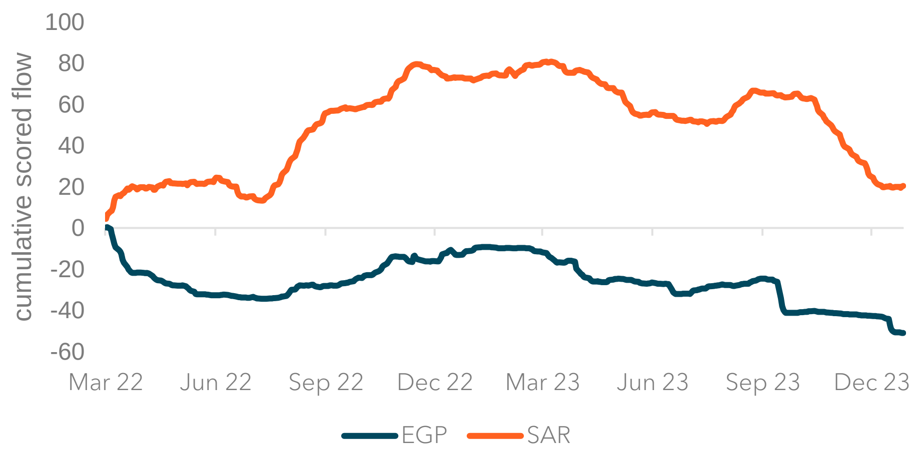
Market views around the war in Ukraine appear to have faded to it being a constant – a drag on Europe and emerging markets. We think the chance of a cessation of hostilities is underpriced. Observers of geopolitics have cited three main ways the war might resolve: Russia's election in March causes President Putin to soften his stance; China/US/Saudi Arabia/UAE/Qatar or other nations broker a peace deal; Russia or Ukraine wins outright. In terms of markets, we think the net result of any peace could be significant in the respect of infrastructure rebuild – and in the debt needed to pay for it. This could result in inflation risks rising again.

In the Israel-Hamas war markets see risks of a longer conflict, of US entanglement, and of larger regional repercussions. Beyond day-to-day oil moves, markets appear to see clear consequences for Saudi Arabia and Egypt. Saudi oil has replaced Russia's as the go-to source, and the investment money shows in iFlow cumulative investments data. Egypt, however, is being viewed differently given its dependence on Ukraine for grains and its geographical proximity to Gaza/Israel. Outflows from Egypt might have been aggravated by uncertainties heading into the country's election in December. SAR/EGP may be a barometer for "peace risk".

EGYPT VS. SAUDI FX FLOWS POST UKRAINE WAR

SOURCE: BNY MELLON IFLOW

EXHIBIT 4: KEY FRONTIER MARKET FX FLOWS



EUROZONE: ECB EASING & EURUSD?

Market Consensus: EURUSD above 1.10 by end-2024

Our view: EURUSD down to parity before stabilizing

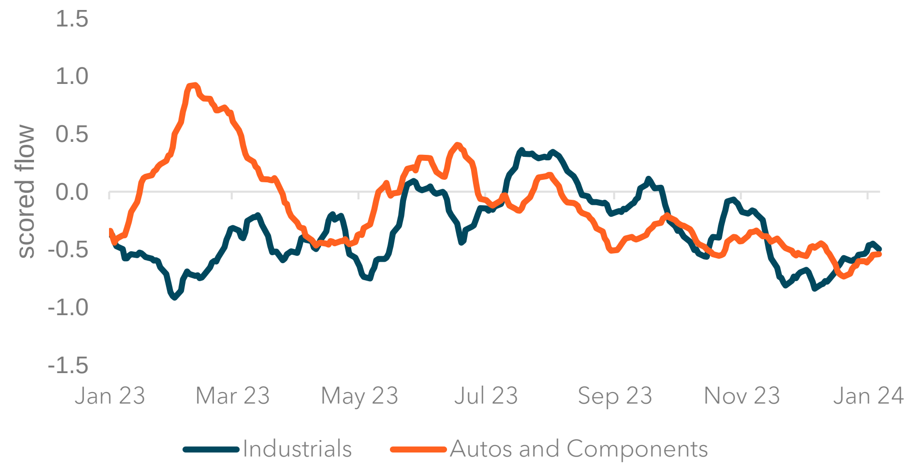
- Eurozone facing structural economic headwinds
- ECB rate cuts to match or even surpass Fed's due to growth concerns
- Euro overvalued; ECB may see it at as a disinflation risk

Market pricing points to the ECB cutting in Q1, though we suspect that the Governing Council may choose to wait until April or just after the Fed moves to give itself some room. However, structural headwinds for the Eurozone, from very weak fiscal impulse to competitiveness losses in the auto sector, likely mean severe growth risks and so require a stronger response.

EU MAJOR ECONOMIES INDUSTRIALS VS AUTOS

SOURCE: BNY MELLON IFLOW

EXHIBIT 5: DEVELOPED EUROPE INDUSTRIAL AND AUTO FLOWS



iFlow indicates that cross-border flows into Industrials, in particular autos and components, deteriorated materially through H2 2023. The rise of China's a battery electric vehicle (BEV) exporter threatens to disrupt global auto markets, which deliver much of Europe's industrial value-add. A growth-damaging trade dispute between the EU and China might loom.

High-frequency data suggests significant labour market deceleration in Eurozone services, adding to problems already in manufacturing. The risk: neither sector can recover in the short and medium term. Fiscal impulse does not look likely given the direction of travel for German and EU politics. The combined growth and disinflation risks could trigger an ECB policy response sharply divergent to the Fed. The ECB may even choose to lean against the euro as an alternative measure to loosen financial conditions.

EU POLITICS: ELECTIONS & RESETS ON THE AGENDA

Consensus: Extremes of left and right gain at expense of centerists

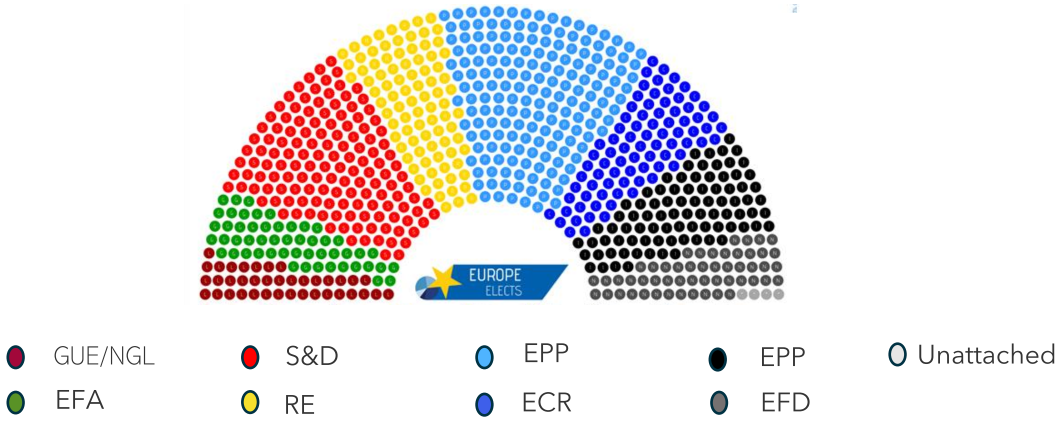
- EU Parliament elections June 6-9 will reset the legislative agenda, including new Commissioners and Parliamentarians
- Current polling points to a tight majority for Ursula von der Leyen's 2019 electoral coalition
- Expectations have centrist, Green parties to lose votes; conservative ECR group and far-right to be the main winners

SET PROJECTIONS FOR EU PARLIMENT

SOURCE: BNY MELLON IFLOW, EU COMMISSION

CONTRIBUTOR:BEN POTT, GOVERNMENT RELATIONS

EXHIBIT 6: SEAT PROJECTION FOR EUROPEAN PARLIAMENT



From a financial services perspective, the most contentious files have been agreed with Basel 3.1 (CRD 6/CRR 3), MiFID II review, and the AIFMD review getting the green light from negotiators in 2023. Though leaving it late, the EU's corporate sustainability due diligence directive (CS3D) was also agreed in December and, with technical trilogues ongoing, is expected to be voted through in April.

The big political topic of early 2024 will be the EU's position towards Ukraine. After EU leaders voted to start EU accession talks with Ukraine in mid-December, the remaining key sticking point is the EU's €50bn financial package to support Ukraine's military. Hungary recently vetoed the financing package, which will again be on the agenda at the Feb. 1 EU leader's meeting. The key risk is that Hungary's veto effectively paralyses EU decision-making on Ukraine.

Heading into the June elections, particular focus will be on the larger member states, specifically Germany, France, Spain and Poland. Given the large size of their EU Parliamentary delegations, a significant strengthening of the far-right ahead of the elections could have implications for the final composition of the EU Parliament. Current polling still suggests a majority for the centrist parties, namely the EPP (center-right), socialists (center-left) and Renew (centrist, liberal) – but also a significant strengthening of support for the conservative, Eurosceptic right (ECR) and far-right (ID). The key risk to watch for is if populist parties can block decision-making. For now, the base case assumes a majority for the centrist parties.

USDJPY AT END-2024: 100 OR 200?

Market Consensus: Weaker JPY amid Bank of Japan status quo

Our view: 100, but not ruling out test of 150 again first

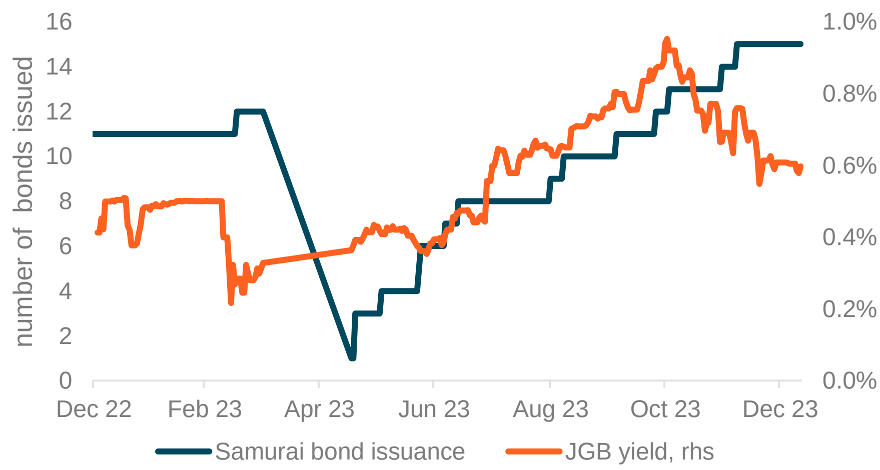
- Market consensus sees more yen weakness as the BoJ stays soft on inflation and continues to monetize Japan debt
- Most see BoJ only lifting its policy rate zero by March 30 and reluctantly ending yield curve control – but remaining behind the inflation curve, thereby keeping policy accommodative
- Our view: BoJ ends both negative rates and YCC in early 2024, skewing USDJPY risks to 100, not 200, by end-2024 as JGB yields rise and Japan investors shift to a "home bias"
- Potential unwinding of JPY-funded global carry trades is not fully priced – could be a notable risk into 2024

Our iFlow data shows real money investors not short yen, modestly long instead, even amid underweight holdings of JGBs and the TOPIX. The issues we see for USDJPY revolve around both monetary and fiscal policy. We think the risk of a reversal in prevailing JPY weakness is less about the Federal Reserve's rate policy and more about the Bank of Japan's inevitable shift to tighter policy. How this plays out matters, as 2023 brought several unsustainable forces. One for instance was new foreign issuance of yen-denominated debt, which in essence banks on both a weaker yen and lower yen rates for longer. This so-called Samurai issuance should be more about the rise in 10y JGB yields but instead has risen in lockstep – and is now on pace to break pre-pandemic issuance levels. As the BoJ shifts policy, this debt will need to be hedged, adding to downside pressure on USDJPY.

SAMURAI BOND ISSUANCE AND JGB YIELDS

SOURCE: BNY MELLON, BLOOMBERG

EXHIBIT 8: SAMURAI BOND ISSUANCE VS. JGB YIELDS



CHINA GDP IN 2024: 3% OR 5%?

Market consensus: 4.5% or lower

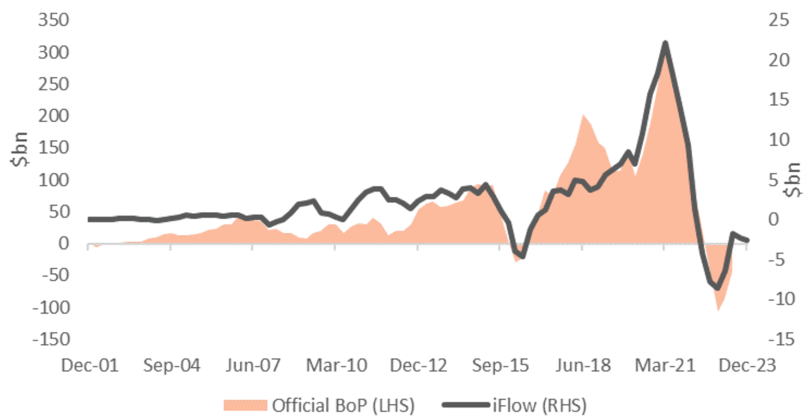
Our view: At least 5%, and surprisingly strong capital inflows

- Fiscal stimulus announced in October shows growth remains a priority
- China's central bank will need to use its balance sheet more, with TLTRO/QE-like instruments, e.g., pledged supplementary lending (PSL)
- Equities to rally on boost from fiscal expansion and tech – investors are underweight China; sovereign bond flow already recovering strongly

CHINA OFFICIAL PORTFOLIO FLOWS AND IFLOW PROXY

SOURCE: BNY MELLON IFLOW, CHINA NBS

EXHIBIT 7: CHINA OFFICIAL PORTFOLIO FLOWS VS. IFLOW



Despite its late arrival, the year-end deficit expansion should be able to lift 2023 growth to 5%. We do not see this baseline target changing in 2024, especially if the deficit target is lifted to well above 3% of GDP. Coupled with the multiplier effect and the lack of additional real-estate stress, we still see growth closer to 5% in 2024. Generating more sustainable growth, even at a lower level, does not require the level of constant intervention seen in 2023.

We acknowledge that household demand in China remains subdued, and that there is still much reluctance to reorient fiscal resources there – the last round of material household tax cuts was in 2019. Until clear signs of rebalancing emerge, asset allocation flows will likely be tentative. However, iFlow indicates that global investors are already coming from a very underweight position, as index-inclusion flows since 2018 have been fully liquidated. Our data show China government bonds the strongest-performing Emerging Market sovereign debt market in December.

Notwithstanding geopolitical and regulatory risks, the combination of growth stabilization, new high value-added industrial champions and ongoing policy support suggests strong upside in capital inflows this year.

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