BNY MELLON

iFlow

MACRO MORNING BRIEFING

June 7, 2024

Output Gaps, Currencies And Trade

US economic data reported over the last two weeks have been weaker than expected. The cumulative effect has estimates for Q2 GDP now under 2% from over 3.5% before. The odds priced for a rate cut from the Federal Reserve in September has moved from 45% to 65%. This week brought the expected divergence in policy action by the Bank of Canada and European Central Bank – both cut policy rates by 25bp – with suggestions of further cuts ahead, albeit depending on data.

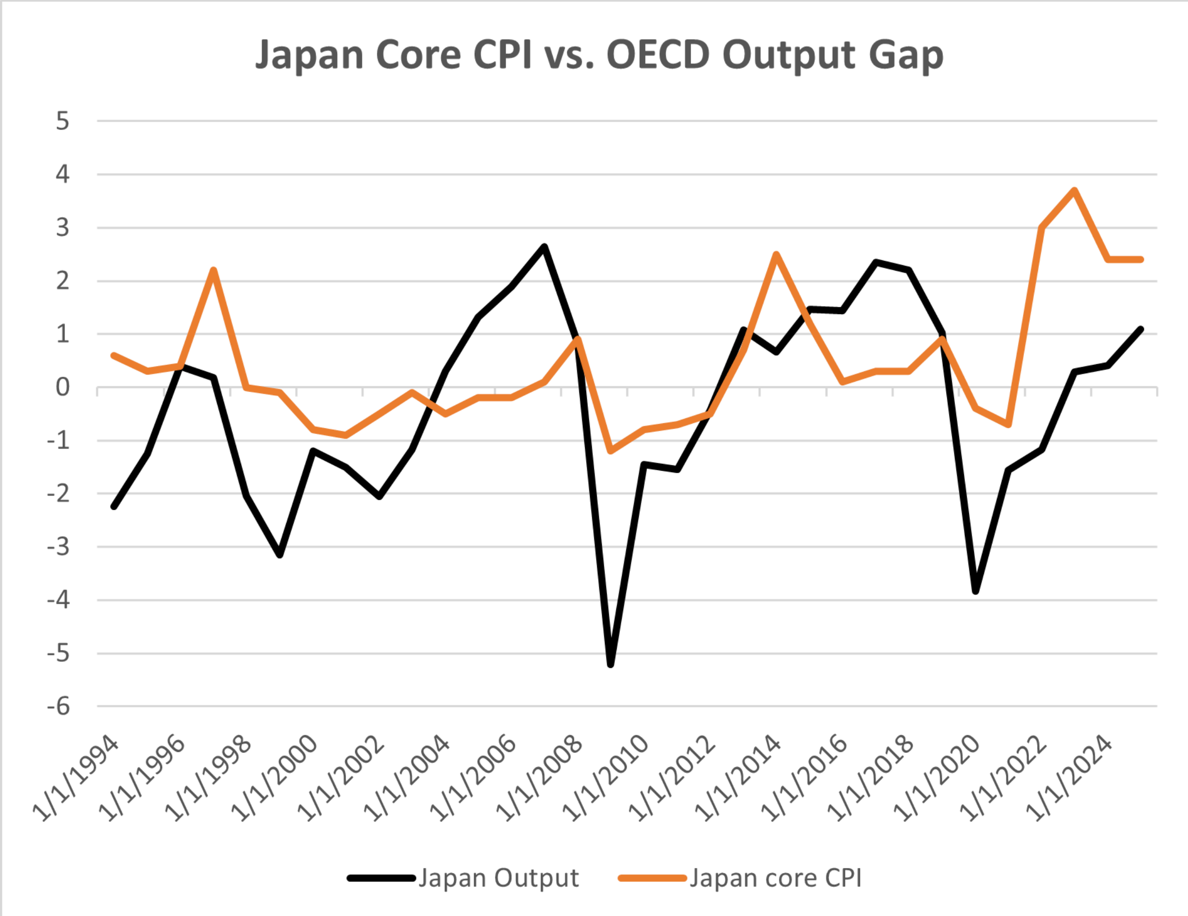
Next week brings the FOMC meeting and the Bank of Japan rate decision. Focus on the Fed's new Summary of Economic Projections will be intense given the spread between 'higher for longer' comments from Fed speakers and the economic slowing shown in recent data. Today's US jobs report is expected to matter significantly, too. While no one expects the Fed to ease next week, the possibility of action in July rests on the US jobs report showing the unemployment rate above 4.2%. That would surprise many given that underlying growth remains above the longer-term average.

The run rate of growth and the run rate of inflation meet paths in output gap models. Running an economy 'hot' spurred by fiscal stimulus and business investment in Artificial Intelligence has been the bedrock of recent 'US exceptionalism'. The drop in US productivity with the slowdown in Q1 reopens debate on whether US outperformance can sustain. The rise in the US trade deficit and the ability of the rest of the world to export their way to growth fills some of the US demand without further inflationary spending to build out new supply to meet ongoing demand.

Comparing the trade deficit and output gap in the US to trade balances and output gaps of Canada, Mexico and Japan is worth considering in light of not only the decisions already made by central bankers but also their likely decisions to come. We see the risk of reversals in CADMXN and MXNJPY in the medium term.

- The US has filled its Covid-induced output gap and now has nearly 1.5% of GDP excess – suggesting any Fed rate cut will have to be based on either inflation meeting target paths or models suggesting this will return to a gap via a recession. The implication for either requires further significant weak US data, say, job creation below 100k per month at a minimum and core PCE below 2.5% y/y. The USD is 10% overvalued using the Fed's broad REER index, adding to the debate that financial conditions are not the same as monetary ones for the decision ahead.
- Mexico assets have seen a significant increase in volatility post-election with the Morena party performing better than any polls suggested. While the new President Claudia Sheinbaum is seen as to the right of outgoing leader AMLO, the fear of super majority control leading to more left-leaning reforms and a reset of the constitution shrinking the size of the lower and upper house remains. The role of the output gap in driving central bank (Banxico) rate cuts will be balanced against the fiscal policy expectations of the new government. MXN remains significantly overvalued (Banxico REER estimates over 30%)
- The Bank of Canada has used output gap analysis in the past to justify rate actions. The cut this week may return focus to this. The OECD sees the output gap in Canada near -0.5%, suggesting that while the cut may help, it's unlikely to fix imbalances in the economy. Further, the wall of mortgage refunding for consumers in coming months will likely require more significant easing to keep current demand intact. The BoC sees CAD near fair value. Most analysts are comfortable with a USDCAD 1.33-1.38 range, but risks remain towards 1.40 should economic data deteriorate with the US slowing.
- The Bank of Japan has been laser-focused on sustainability of the 2% CPI target. Governor Ueda and Board Member Nakamura have both suggested any further tightening will remain slow and cautious. The output gap in Japan has been filled and justifies some action. The wage deals have helped but ongoing CPI over the 2% target leaves the real wage below levels of sustainability. The recent government fiscal spends to help COLA concerns and ahead of the September leadership vote are all in play against the June 14 meeting. We expect the BoJ to end QE and either hike or promise to hike rates further. JPY remains over 40% undervalued and that no longer helps exporters given the imported inflation and consumer pain that follows.

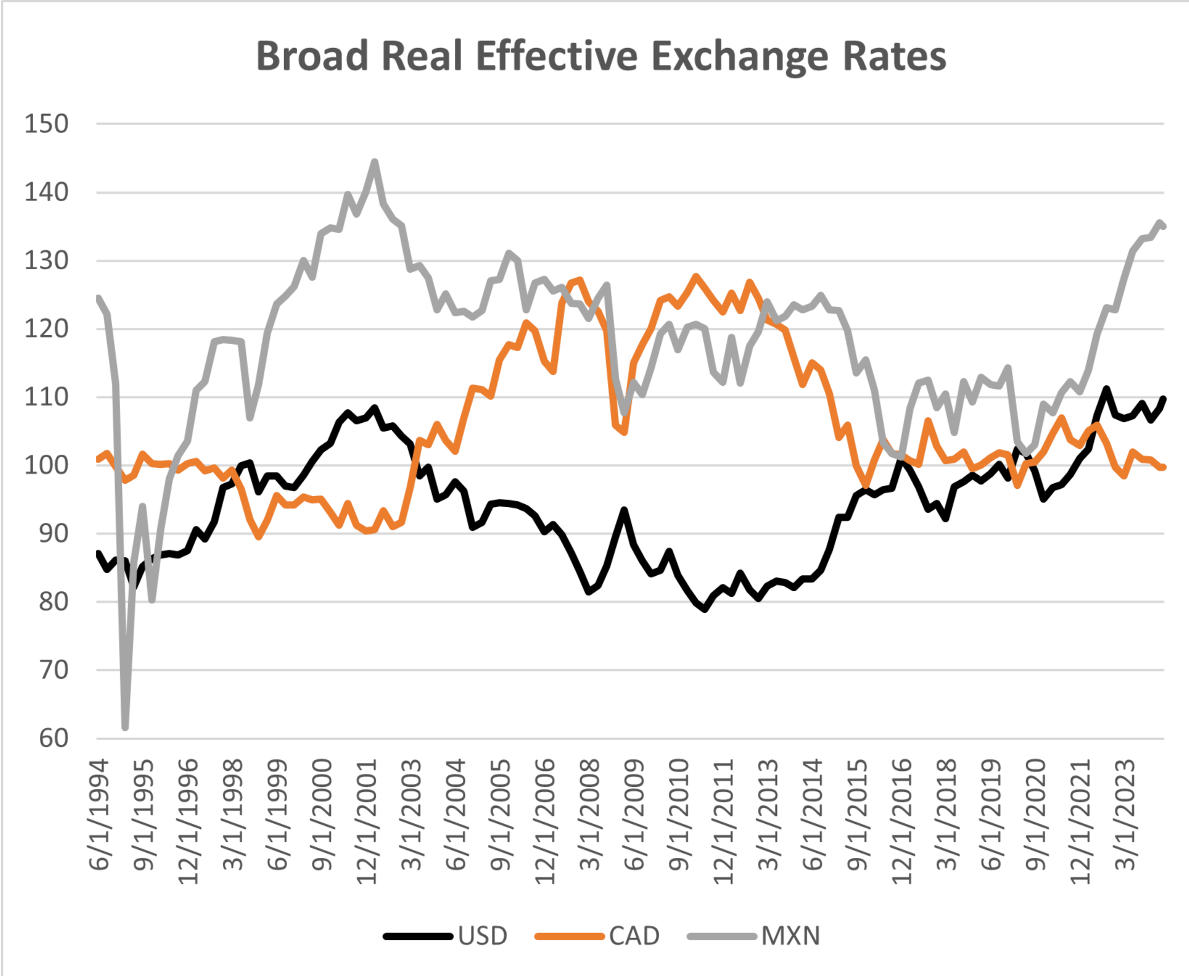
Exhibit #1: Japan Output Gap And CPI

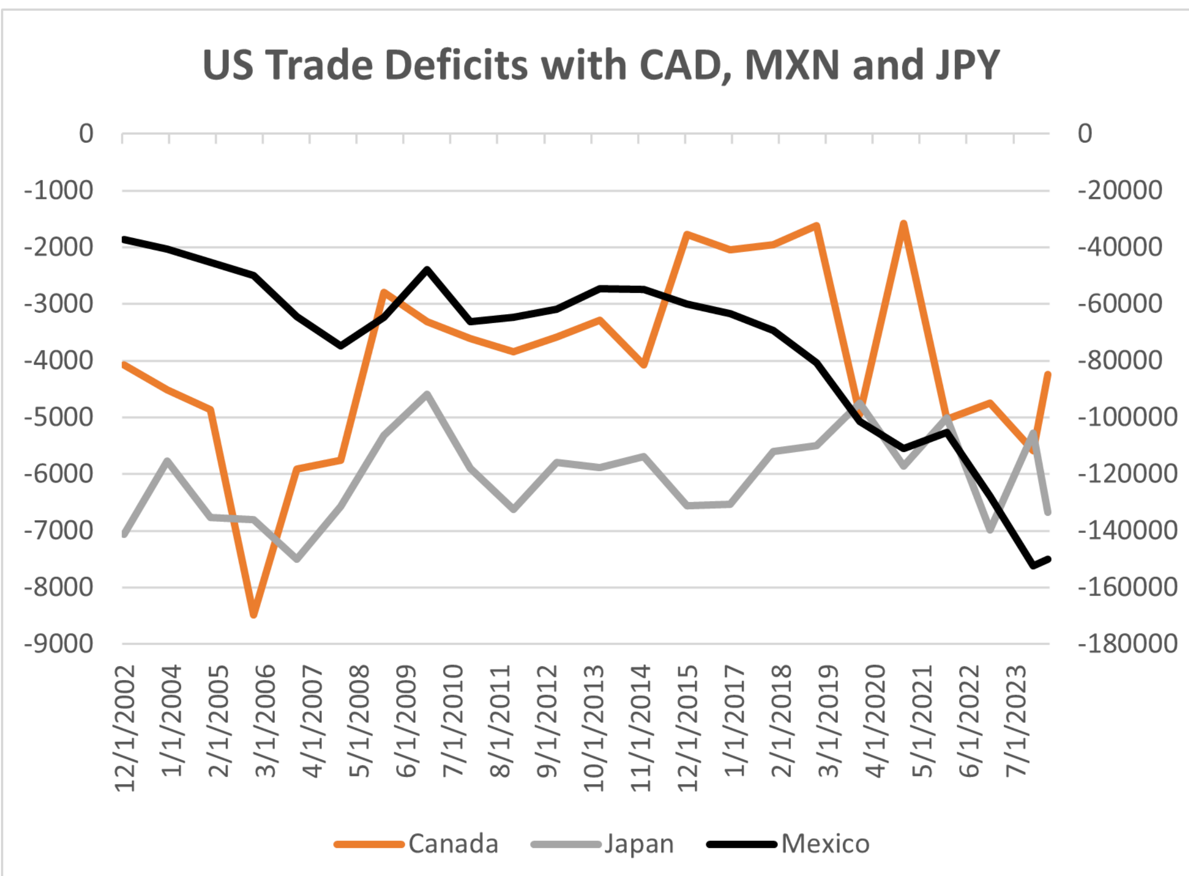


Source: BOJ, Bloomberg, BNY Mellon

The correlation of CPI to the output gap in Japan is notable and adds to the pressure on the BoJ to act to make sure its 2% CPI target remains anchored. The worry about wages vs. inflation are clear in BoJ commentary but the elasticity of trade to FX moves is also important and more problematic. As the BoJ noted in 2022, JPY depreciation has less significance in the last decade in part because of higher-value product and the overseas production ratio. The other important role comes from JPY weakness on income from the balance of payments due to offshore earnings. This is where JPY weakness has helped. This is offset by the third and, most recently, largest effect of JPY depreciation on import price pressures and volatility driving up the risks for the BoJ in losing out on both growth and inflation.

Exhibit #2: FX Value And Trade Elasticity Changed


Broad Real Effective Exchange Rates
150
140
130
120
110
100
90
80
70
60
6/1/1994
9/1/1995
12/1/1996
3/1/1998
6/1/1999
9/1/2000
12/1/2001
3/1/2003
6/1/2004
9/1/2005
12/1/2006
3/1/2008
6/1/2009
9/1/2010
12/1/2011
3/1/2013
6/1/2014
9/1/2015
12/1/2016
3/1/2018
6/1/2019
9/1/2020
12/1/2021
3/1/2023
USD
CAD
MXN

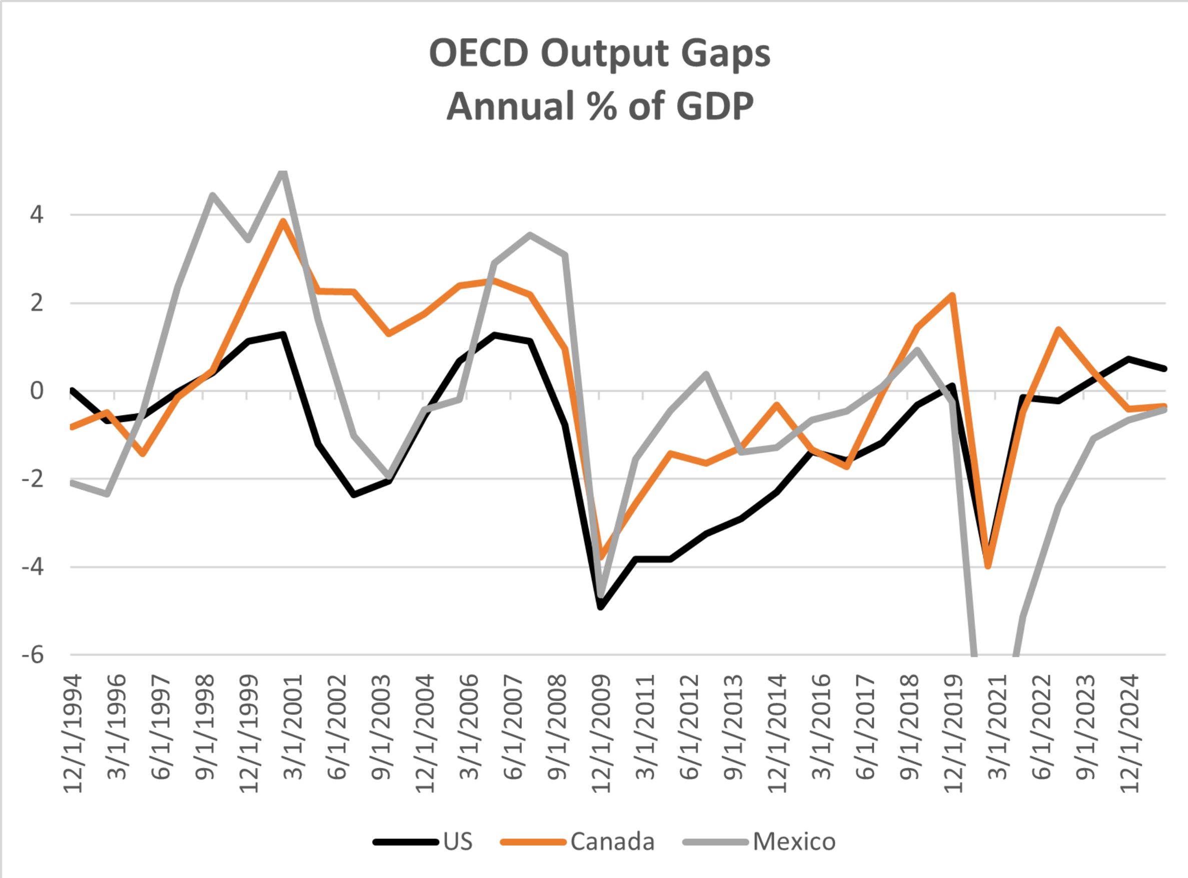

US Trade Deficits with CAD, MXN and JPY
0
-1000
-2000
-3000
-4000
-5000
-6000
-7000
-8000
-9000
0
-20000
-40000
-60000
-80000
-100000
-120000
-140000
-160000
-180000
12/1/2002
1/1/2004
2/1/2005
3/1/2006
4/1/2007
5/1/2008
6/1/2009
7/1/2010
8/1/2011
9/1/2012
10/1/2013
11/1/2014
12/1/2015
1/1/2017
2/1/2018
3/1/2019
4/1/2020
5/1/2021
6/1/2022
7/1/2023
Canada
Japan
Mexico

Source: BOC, BOJ, Banxico, Bloomberg, BNY Mellon

The biggest story for FX markets and risk assets has been in JPY valuation – the role of currency weakness mattering reaches beyond Japan to the entire APAC region, with notable effects on China and Korea. The role of Mexico in this equation should also factor, as the overvaluation of MXN matches JPY weakness. The mismatch accelerated from 2020 and the pandemic. While many attribute the MXN move to the renegotiation of the NAFTA accord into the USMCA, others would note that from 2022, near-shoring and FDI were notable drivers. The acceleration in flows into Mexico is worth noting against the iFlow database, as it highlights the contrast between the excess cash available and the carry trade that the central bank provided and its battle against post-Covid inflation. MXN was the most overheld currency for most of 2023 and has only recently dropped from the top five. The flow of money into Mexico mixed with the government spending to produce significant inflation from 2022 – leaving Banxico policy higher for longer.

The risk we see for investors in post-election Mexico lies in how government spending and trade policy shifts might change. But this may have to wait for the US election in November for further clarification of Mexico and trade policy, particularly related to Chinese goods being reassembled in Mexico and sold to the region.

Exhibit #3: Output Gaps Useful For Measuring Policy Risks



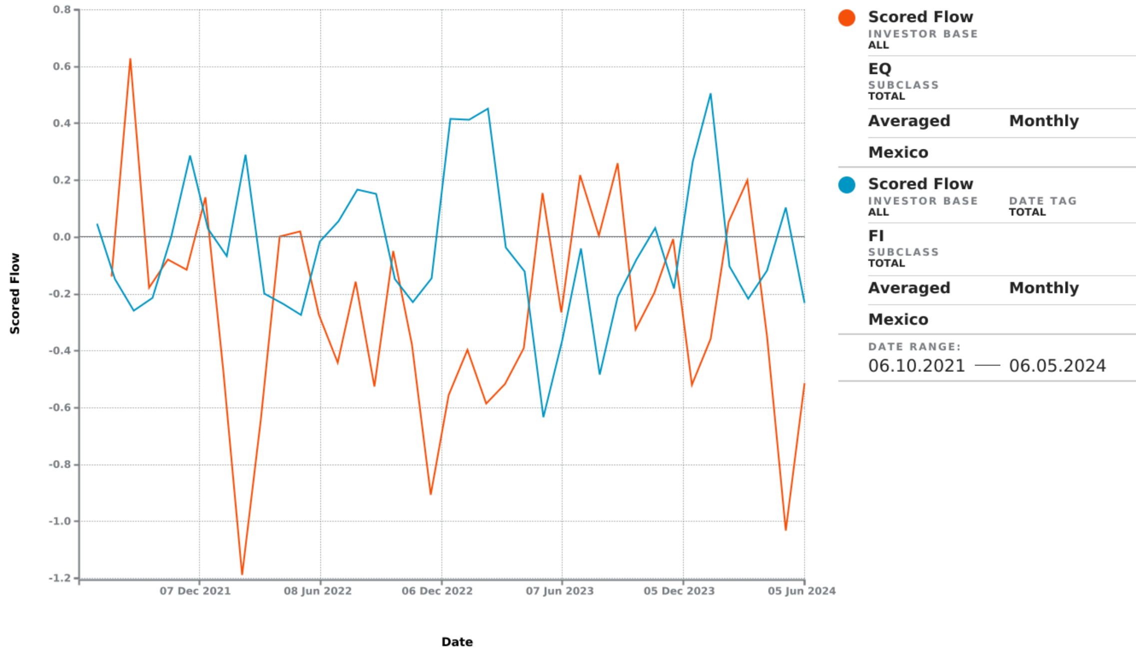
Source: OECD, Bloomberg, BNY Mellon

Bottom Line: Output gaps of the US, Canada and Mexico help explain the policy of central banks in the trading bloc, but not the currency or investment flows. 'US exceptionalism' requires US growth to remain at 1.8% or higher. The OECD sees that in 2024 but not so clearly in 2025. The role of the carry trade and the unwind risk into 2025 is linked, as the role of Japan and inflation will change the way investors there look at the North American opportunity set.

We think higher rates in Japan, less certain growth in Mexico, the US and Canada, along with rate spreads narrowing, point to increased risk of a MXNJPY reversal in the medium term. Banxico's reluctance to cut faster may shift – even with post-election volatility in MXN – given the output gaps in the country and the risk of a larger slowdown should money flows from FDI and trade stall.

Exhibit #4: Mexico Assets Were Sold Into The Election

EQ & FI Scored Flow



Source: BNY Mellon, WM/Refinitiv

Source: iflow, BNY Mellon

Disclaimer & Disclosures

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

Bob Savage
HEAD OF MARKETS STRATEGY AND INSIGHTS

CONTACT BOB

Can't see the email? View online

This message was sent from an unmonitored email box. Please do not reply to this message.