BNY

iFlow

MACRO MORNING BRIEFING

**June 28, 2024**

# Gaming Tail Risks In H2 2024

As the first half of 2024 draws to a close, the natural lookback on asset prices suggests some of the best of times – global shares up 10%, US bonds basically flat, USD up 4.5%, oil up 13%, gold up 13%, and the UN FAO food price index up just 1%. What's more, central banks in developed markets have delivered rate cuts, led by the Swiss National Bank and Sweden's Riksbank, then followed by the European Central Bank and the Bank of Canada. Not the Federal Reserve, however.

Divergence of policy stands out but may be more problematic into H2 with growth hopes downbeat. Germany and China remain on the lower end of forecasts and the UK and Japan show nascent signs of growth. The US remains on track for a 'soft landing' as inflation moderates and growth slows but keeps to a 1.5-2.0% range.

Many expect the same trends for returns to hold in H2, albeit moderated by the uncertainties of politics, natural disasters, and geopolitical conflicts. We see investors having a wall of worry to scale with many 5% tail-risk probabilities in play.

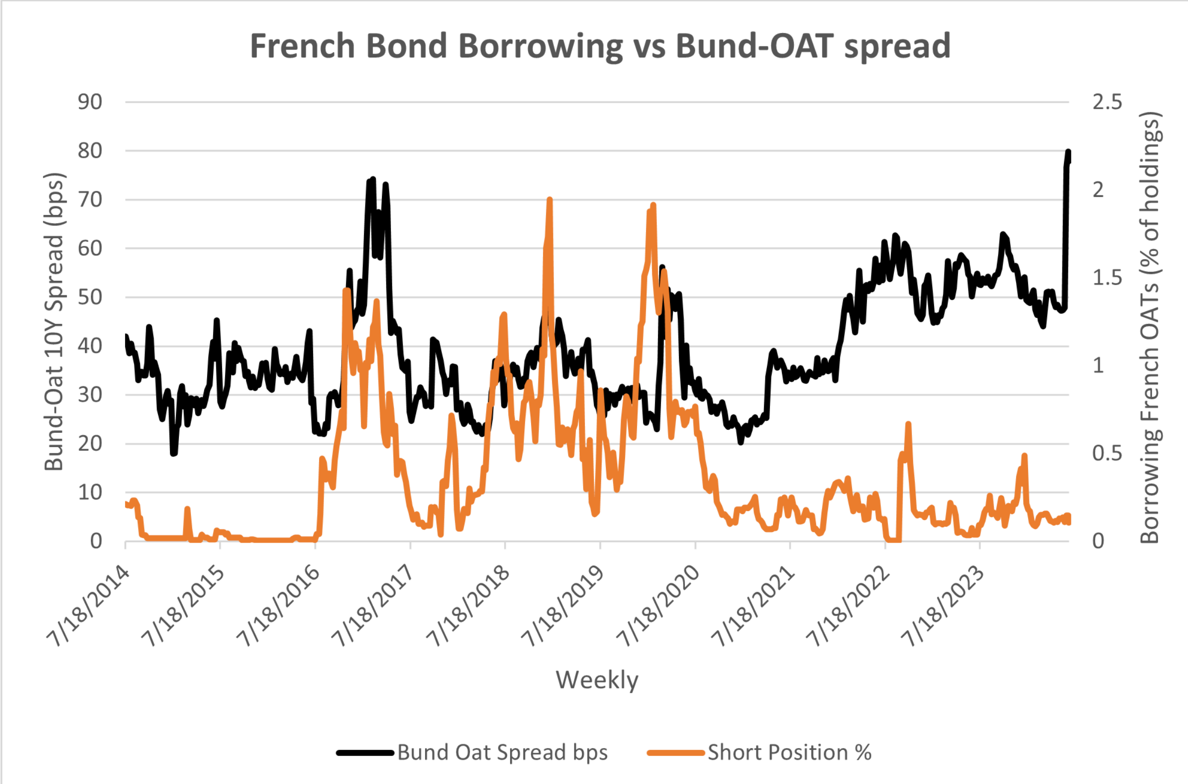
- The wall of worry for H2 starts with politics and elections in **France (June 30 and July 7)** and the **UK (July 4)** – both unplanned. Positioning into these event risks has been reduced but there is a difference between market pricing and positioning, still. As for geopolitical issues, **Iran's presidential election (June 28**) opens the path of policy towards the US/EU and the risks for oil, Israel and Russia. The risk of a run-off seems high given many contenders.
- The **US election has been a talking point** for investors but there is no evidence of any significant pricing for this risk. The short-term reaction to the

first Biden-Trump debate may start this process. Focus in FX markets is on CNH and MXN as barometers for this risk given Trump's focus on China and Mexico in 2016. The reality maybe different in 2024.

- **JPY intervention risk** and policy shifts by the Bank of Japan in an attempt to thwart currency weakness continue, but investors do not appear to be believers in the currency snapping back as in previous months.
- **Credibility of all central banks** amid policy divergence is a risk as the Fed's higher-for-longer stance has left global growth outlooks vulnerable and FX markets stretched against the dollar. Even Carry as a factor in driving markets has suffered in the last quarter, as concerns over elections and fiscal policy hold more sway than rates in driving money flows.

Regarding France's OAT market, BNY security lending data indicates that short positions were significant in the last election but modest now. This contrasts with the moves in market prices, where the OAT-Bund spread (difference between France and Germany government bond yields) has widened considerably, implying positions have been cut back, but holdings remain neutral not short. The unwinding of France assets, bonds and stocks, reflects the surprise of the snap election. A worry we see for H2 may extend beyond France assets to the country's leadership role in Europe and how the domino effect of any shift plays out in Germany. The risk of a snap election in Germany has risen to 25% for September, as the coalition government frays over the budget deficit. We think markets look too sanguine on France election risks: 55bp of EUR implied option cost for the June 30 and July 7 events is basically just 20bp more than the recent average of daily EUR moves.

**Exhibit #1: OATS And Short Positioning**




Source: Bloomberg, BNY iFlow

**List of 2024 tail-risk worries that started the year and continue into H2**

- **Global Decoupling** – trade war risks and diplomatic alliances failing apart with the US and EU breaking from China and Russia/Iran/North Korea interests. The risk for emerging markets and APAC nations in particular will be in choosing sides when it comes to trade and capital flows.
- **Rising Nationalism and Protectionism** – with rising tariffs on China EVs one example, and the US's IRA another, more nations will likely focus on domestic industrial programs supporting targeted sectors for growth regardless of price.
- **Politics – shifting leadership risks institutional credibility** - and democracy itself. If the French election brings a Le Pen RN victory, many worry about the implications for EU leadership and the entire enterprise. How poorly the UK Tories fare on July 4 puts a spotlight on the role of the opposition and what it means for the private sector with money flight risks.
- **Global debt** – world debt as a percent of GDP is closing in on record levels, e.g., US and UK over 100% of GDP, and China increasing its debt leaves little excess capital for developing markets. The tension of fiscal vs. monetary policy

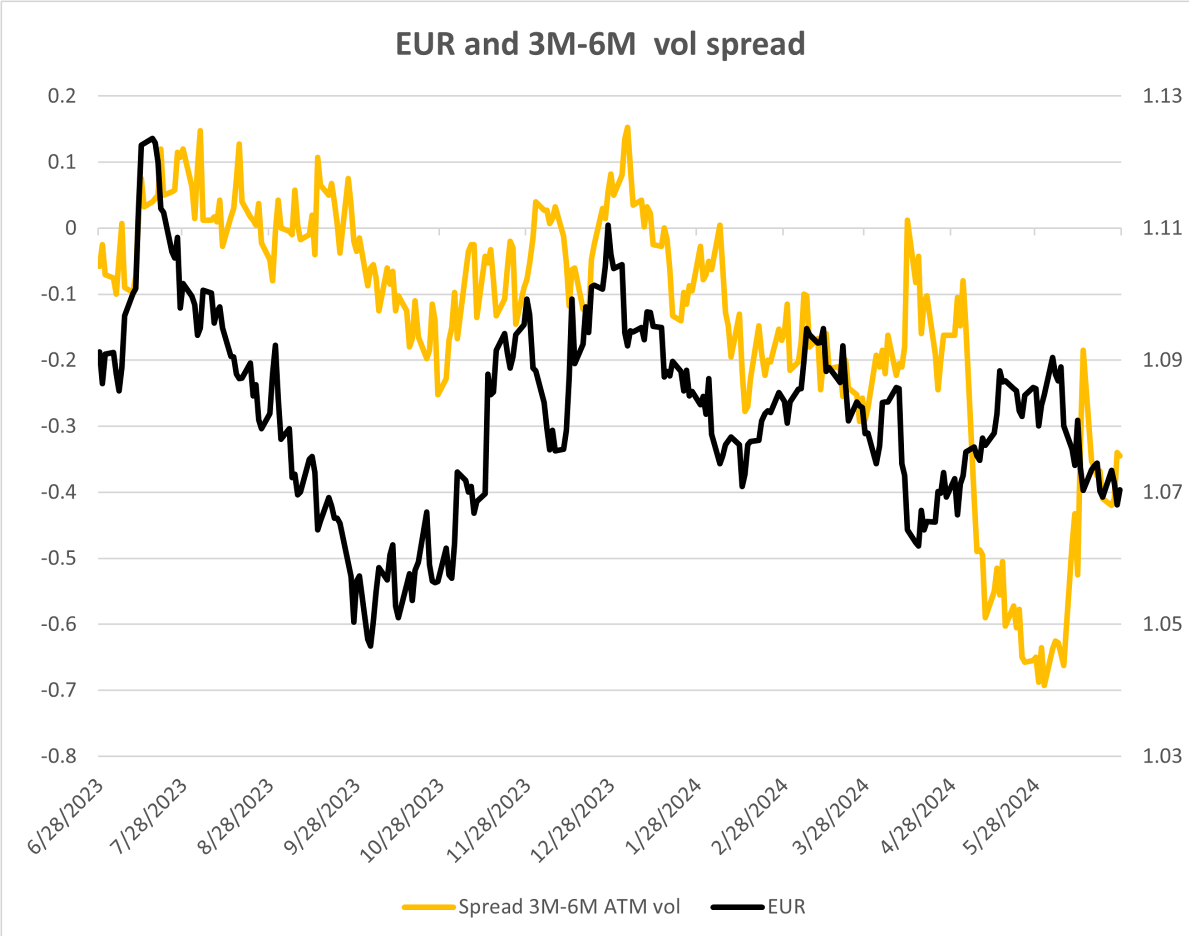
puts independent central bank policy into the risk arena risk as it mixes with unconventional politics.

- **Rising immigration issues** – even with labor market tightness in many developed markets. Cost-of-living issues are further strained by new demand for housing and social safety nets like healthcare and education. This is clearly an issue for the US, and features in the election, but is also important in France, the UK, Canada, and Australia.

While the above issues are different, the problem of pricing probabilities into markets starts with positioning and conditionality. The political risks for the US in November have a role in all of the other risks. Similarly, debt, immigration, protectionism, and geopolitical alliances are all interconnected. The unconditional probability of any of the above worries leading to a crisis event is low – perhaps 5%. But should any happen, they may bring all the others into play. This is the problem for H2 – interconnected risks happening fast and all at once.

How markets price such a scenario shows up in the future implied option volatility with spikes around known events like Nov. 5. The chart of implied volatility of the EUR into the US vote can be shown by comparing the 3M vs. 6M at-the-money EURUSD implied volatility. The move in EUR implied volatility looks more about the surprise of the French election than the US one.

**Exhibit #2: EUR And US Election Risk**




Source: Bloomberg, BNY

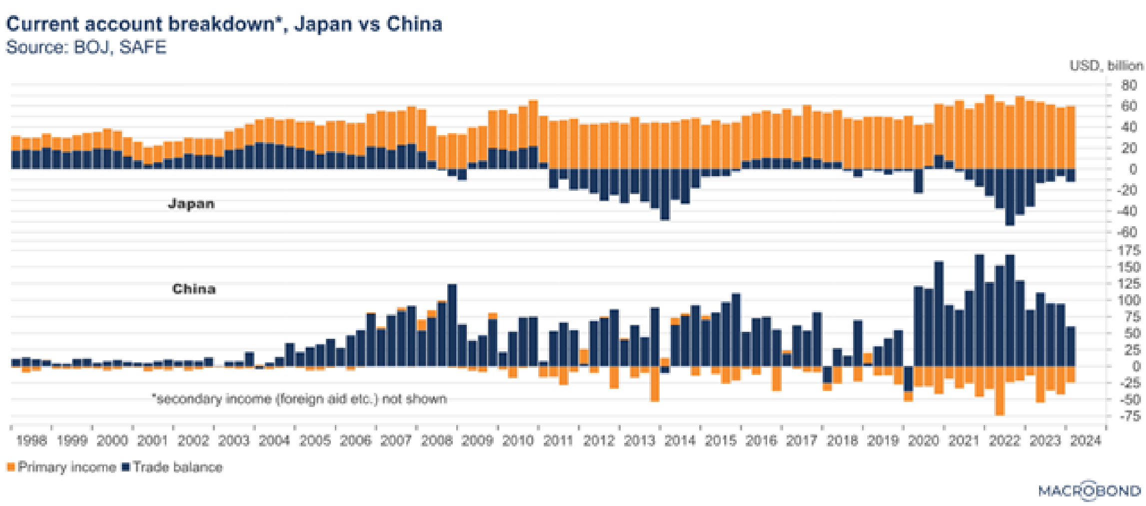
The roles of the yen and yuan in FX adds another considerable risk for markets in summer, as the weakness of Japan's currency continues to be outsized. Consensus estimates for JPY undervaluation: 25% or more. The impact of this on China, South Korea, Indonesia and others in APAC stands out and drives central banks to push for rate hikes or sticky rates, along with FX intervention to cap import inflation risks. The problem for Japan is that a weaker JPY isn't helping the trade balance. Further, trade gains for China and the region from weak currencies open the door for US and EU reactions. e.g., arguments about currency manipulation. Politics and FX are likely to be part of the US election fears and could lead to further volatility.

At home, JPY weakness has shown up in Prime Minister Kishida's unpopularity and ongoing government spending to offset cost-of-living frictions. The role of investments abroad and their returns make clear that JPY flows since 2012 are more connected to how the rest of the world performs in rates and growth than just Japan. Investments abroad arguably look better with a weaker JPY. The risk of slower growth in China and Germany, and potentially the US, may be the only way for JPY corrections to materialize. For the world, JPY and intervention risks will endure until the BoJ meeting on July 31. China's role in the APAC FX narrative can't be ignored, either. The role of trade surpluses in keeping China's current accounts positive look difficult to sustain and could leave CNY weakness less problematic.

**Bottom Line:** There are plenty of risks for investors into the second half of 2024, but the trend factors across markets have been significant and offset those worries in June. We enter Q3 with many of the same themes as in Q2 – watching economic data for a US slowdown sufficient to spur a Fed rate cut, waiting for election results to determine fiscal policy and geopolitical risks, and searching for offsets to ongoing concentration risks in equities as AI and technology transform the world.

---

**Exhibit #3: Japan & China Current Accounts Drive FX**




Source:BOJ, Bloomberg, BNY

## Disclaimer & Disclosures

---

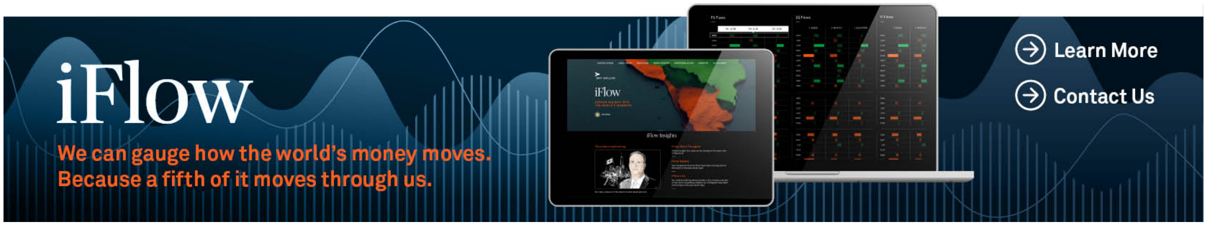
**Please direct questions or comments to:** iFlow@BNYMellon.com

---

**Bob Savage**
HEAD OF MARKETS STRATEGY AND INSIGHTS

CONTACT BOB

---






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