BNY MELLON

iFlow

MACRO MORNING BRIEFING

April 8, 2024

Diversifying Exceptionalism

US dollar exceptionalism to be tested in different macro environment

- APAC offers alternatives due to heavy under-positioning
- Static policy expected globally amid Fed caution and firm US data
- Central banks showing limited appetite to deviate from Fed

Q2 policy decisions in play but very few 'live' meetings

Regardless of individual asset allocation preferences, the US employment data reported last Friday will likely keep markets wedded to the exceptionalism narrative around the US and its currency. But while flows may remain heavily focused on the US, cross-asset price action last week suggests that not all will be rosy for risk appetite – a breakdown in correlations is still possible. As we highlighted last Friday, markets are vulnerable to surprise outcomes in policy and data amid positioning volatility and shifting correlations.

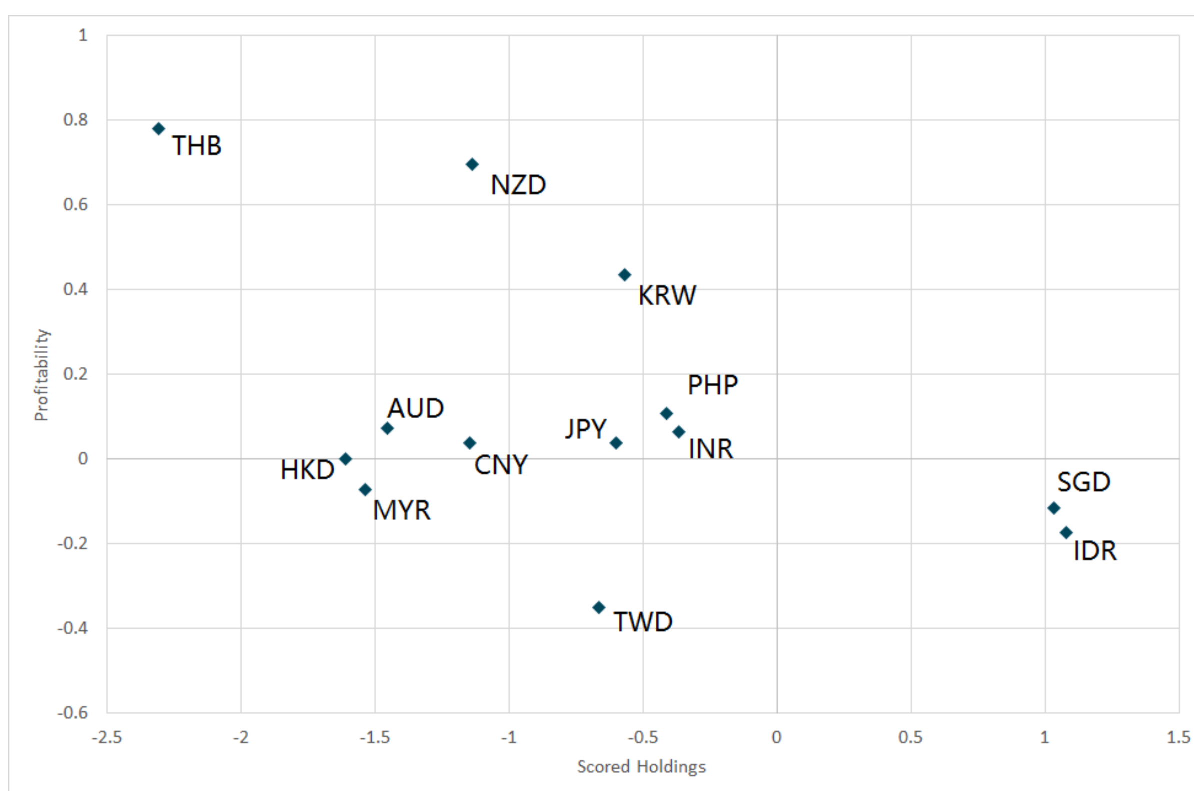
The strong US labour market is a reminder of two-way policy risk, but geopolitics is also moving up the agenda, potentially leading to a rise in 'safety' demand. This would normally simply entail adding to positions in US Treasuries. However, as iFlow has already identified, global investors added to Treasury positioning – across the curve – in Q1. Cross-border investors have been more circumspect, but their overall exposures to US duration have also increased. As such, on a marginal basis, adding to US positions across asset classes seems unlikely offer diversification against additional risk impulse, especially from non-market factors. We thus expect the search for alternative havens to unfold as a theme in Q2.

Conventional reserve assets and currencies aside, positioning and value are additional factors in play. One of the most striking developments we have seen in iFlow over the past quarter is that the currency of almost every developed and emerging economy in Asia is now underheld. The two exceptions are the Singapore dollar and Indonesian rupiah. SGD is a

directional policy operational tool so a structural overheld position is understandable. IDR is arguably the only currency in Asia offering commodity and carry characteristics. In other words, like gold, the market is still looking for protection in real terms.

Considering that many APAC currencies still enjoy healthy balances of payments (i.e., Asian exporters, and even Australia), even if it is due to severe demand contraction, their 'safety' qualities during times of stress should not be in question. If anything, repatriation flow could adversely affect the US dollar, especially if yields on long-dated bonds face limited upside in a risk-averse environment. While concerns over exposures to China, ongoing JPY weakness and comprehensive yield disadvantages have severely curtailed interest in APAC, we view the extreme under-positioning inconsistent with fundamentals. Add in very attractive valuations, and the region should be the first port of call for diversification flow, in our view.

Exhibit #1: Asia-Pacific Currency Holdings

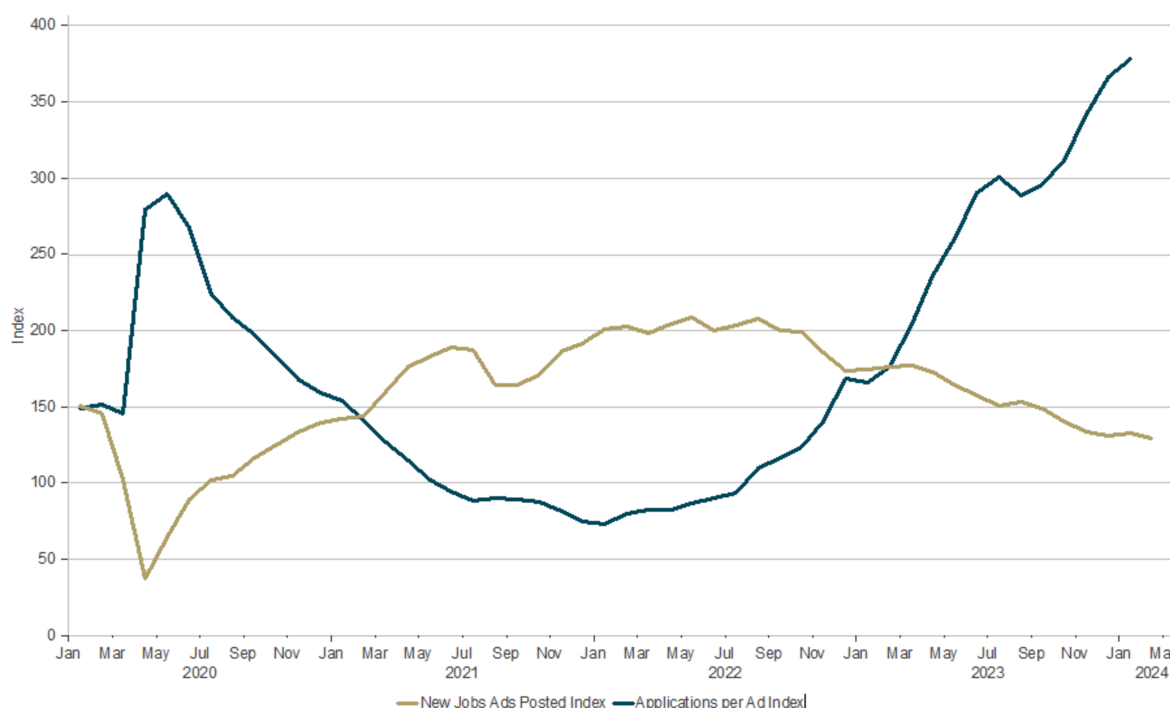


Source: iFlow, BNY Mellon

The Reserve Bank of New Zealand this week kicks off the G10 monetary policy round for Q2. However, it could also set the tone for policy decisions over the coming cycle. Of the eight major central banks deciding on policy in the coming week, we do not expect a single rate cut, even though economic outlooks globally are generally conservative. As expectations for the Federal Reserve have repriced in a less-dovish direction, the previously anticipated room for manoeuvre has not opened up – no central bank can afford any pass-through inflation. Barring structural inflows for reallocation purposes as mentioned above, most central banks will likely choose to wait for the Fed to act before acting themselves.

The RBNZ itself – even in a rare position within G10 of having a policy rate in line with that of the Fed – continues to face domestic obstacles regarding inflation from high aggregate demand arising from population growth. Yet, the NZ labour market is clearly easing (exhibit #2). Higher-frequency data shows job applications per advertisement now well above the highs reached during the throes of the pandemic – this while job ads posted have declined by a third from its peak. These trends will likely be conducive to further downward pressure on wages and contribute to a shift in RBNZ bias in due course. Like its peers, the RBNZ's main frustration remains the pace of the declines and whether they are sustainable. For now, the Swiss National Bank's decision to cut rates ahead of the pack does seem like an outlier, but we stress that its judgement in expecting severe declines in demand-based inflation over the forecast horizon stands at odds with the global policy consensus.

Exhibit #2: New Zealand Labour Market



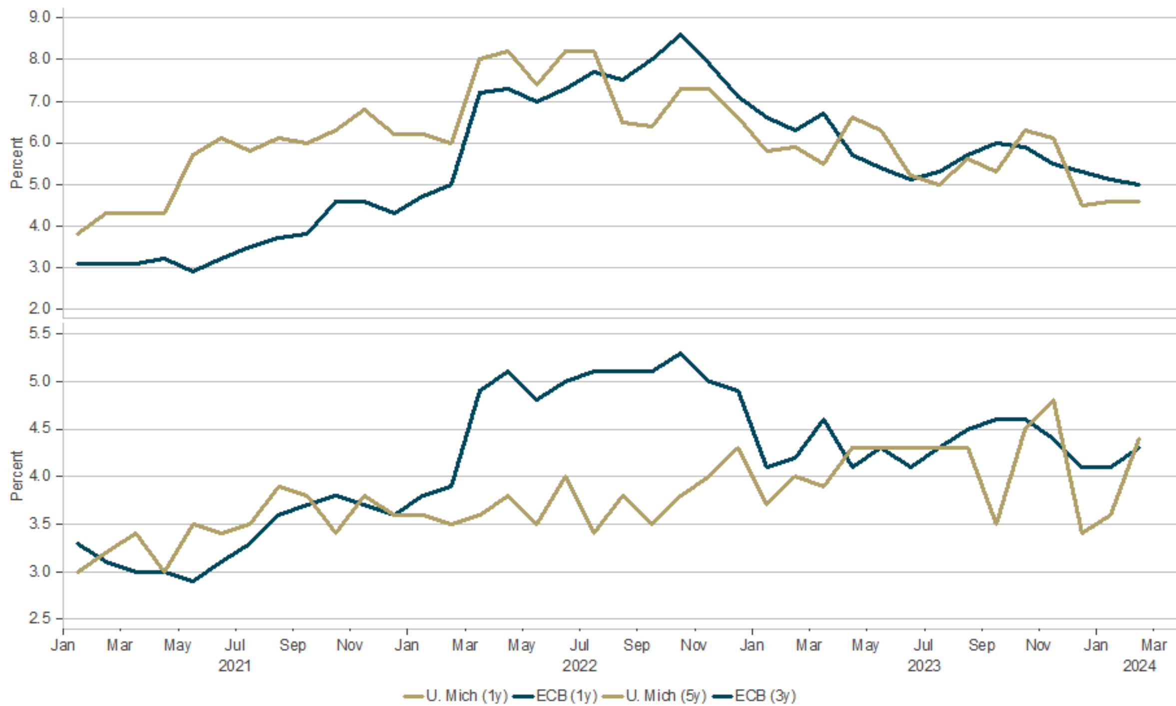
Source: Macrobond

In contrast to the SNB's outlook, exhibit #3 shows the latest inflation expectations surveys on 12-month and longer-term bases for the Eurozone and US. The general trend towards declines remains but traversing the ‘hard yards’ of anchoring inflation expectations to around target levels is proving very difficult. For example, even Eurozone 1y inflation expectations are no lower than where they were at end-Q2 last year. Declines in the US are larger on an absolute basis, but the past few surveys have not pointed to a sustained downtrend. Long-term inflation expectations appear well-anchored in a 3.5%-4.0% range in both economies, but by this measure ‘price stability’ in expectations was already achieved last year.

Household and consumer surveys will differ from official data, so it’s not question of forcing these figures down to 2%, be the target HICP or PCE. However, it is central to central banks’

operational frameworks to anchor inflation expectations to pre-2022 levels, i.e., before global supply shocks generated a wage-price spiral. By this measure, we acknowledge that markets have to contend with ‘higher for longer’, but the first sign of deviation in leading indicators for price surveys will likely generate a shift in policy expectations.

Exhibit #3: Short- And Medium-Term Expectations



Source: Macrobond, BNY Mellon

The European Central Bank's decision this week (dedicated preview on Wednesday) will not come with new guidance via staff economic projections, but inflation surprises have clearly been to the downside of late, even if activity indicators have stabilised. As opposed to in the US, Eurozone data is simply stabilising at very weak levels or ‘contracting less’, especially in core Europe as opposed to the South/Eurozone periphery. This is a very different scenario than US data, which has been surprising to the upside in an expansionary sense.

As such, we find the current convergence in policy expectations between the Fed and ECB difficult to justify, as the degree of futures-implied easing between the June 2024 and June 2025 meetings is almost fully synchronised. This is perhaps another case of central banks unwilling to deviate from the Fed, but synchronisation and perfect correlations are not sustainable. We anticipate a pick-up in co-movements breaking down over Q2, a development which would only add to pressure to seek diversification strategies.

Exhibit #4: Cumulative Easing Expectations Next 12 Months

Source: Bloomberg, BNY Mellon

Disclaimer & Disclosures

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