iFlow
MACRO MORNING BRIEFING

June 21, 2024

Foreign Exchange A Fulcrum For Risk Assets

Economists and policymakers frequently describe foreign exchange markets as shock absorbers for the real economy. In times of war or recession, currency flexibility can have more immediate and powerful impacts than changes in interest rates or fiscal policy. The elasticity of FX markets and their correlations to other markets are part of the expectation that over- or under-valuations correct over time. For many, if issues in the real economy aren't fixed fast enough, markets break.

That fear is manifest in FX markets in the EUR, in stock markets with the outperformance of AI-linked tech, and in bond markets with the inversion of the US curve and other major curves. The time limit for overvaluation working can make for a summer of discontent. USD overvaluation presently, estimated at 15%, has been notable and simply explained by an interest-rate differential in the US's favor. The primacy of rates beating stocks or politics as major focal points changes when shifts in rate policy become a reality, and when growth worries return.

One surprise of the last two weeks was EU elections leading to a snap election in France. USD moving up on this stands out and begs the question: when will the USD correct? The coincident shift lower in US yields puts the correlation of factors into question, as well. For the first time in over a year, FX Carry is significantly negative as a factor. What supplants the higher-for-longer logic supporting the dollar seems likely to become the key worry for FX markets over the summer.

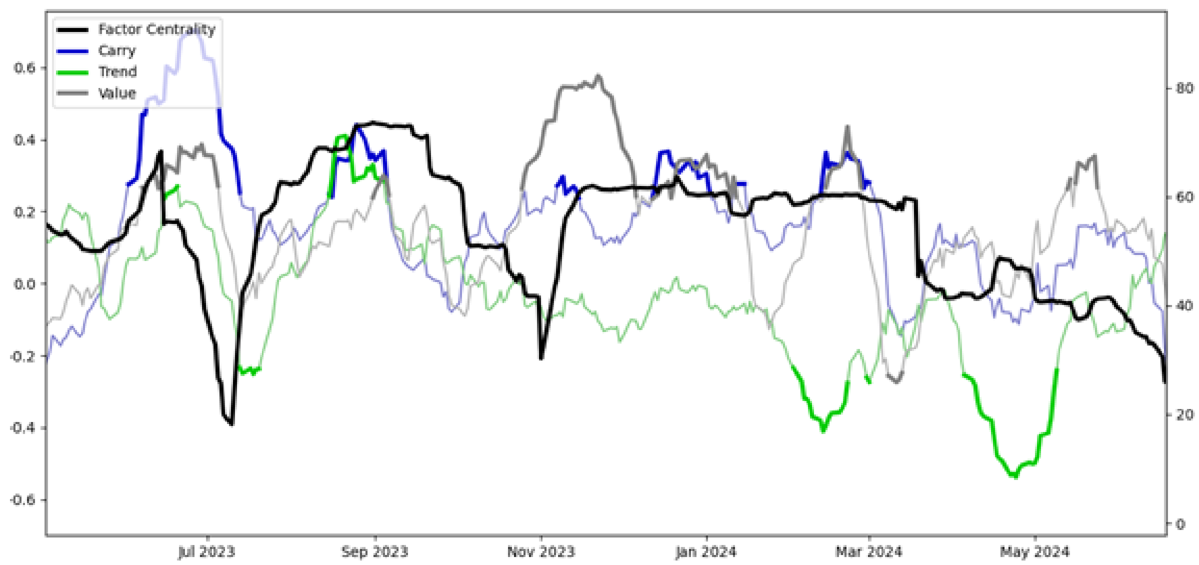
The flow of money into US AI technology stands out as one driver for the dollar. However, the dollar correlates significantly negatively to global equity markets. Further, money flowing into US shares over US bonds correlates negatively. Focus on euro risks dominate discussions into month-end. We make several comparisons that suggest those risks may come to a head.

correlation of bonds to stocks is significantly negative at -0.92. The link of the dollar to all market risks is on the rise even amid unclear drivers.

- **Bond flows last week: outsized buying back of Italy** after a month of outflows. But notable buying in German Bunds too – while EUR volatility jumped. Overall EU equity flows were negative on the week and month.
- **Understanding the difference between our flows and market prices highlights flows vs. holdings risks as carry unwinds**. The overall correlation of EUR to other currencies is modest, with GBP, NOK, SEK, CAD, and SGD the leaders; our flows show SEK has the highest correlation, at 0.32%, while CHF correlation is slightly negative. This makes clear that neither Carry nor Value models are dominant drivers in FX for our investors.

Our FX Factor Centrality index is approaching July 2023 lows – not normal: it's only been here on nine occasions in the last ten years. Factor Centrality measures the spread between the most dominate factor (Carry for the last year) against the next most important one (Value). That it's back to year lows shows lack of investor certainty in FX, and that points to more – not less – hedging of risk exposure into the half-year end. In July 2023, expectations for a soft landing in the US were prevalent, moving from Federal Reserve rate hikes to growth outperformance as key – this is the last time growth mattered to markets. The usual statistical factors driving FX now are mostly neutral. Trend is picking up and Carry is now negative – significantly so, suggesting a larger risk-off mood across markets as Q2 and H1 draw to a close.

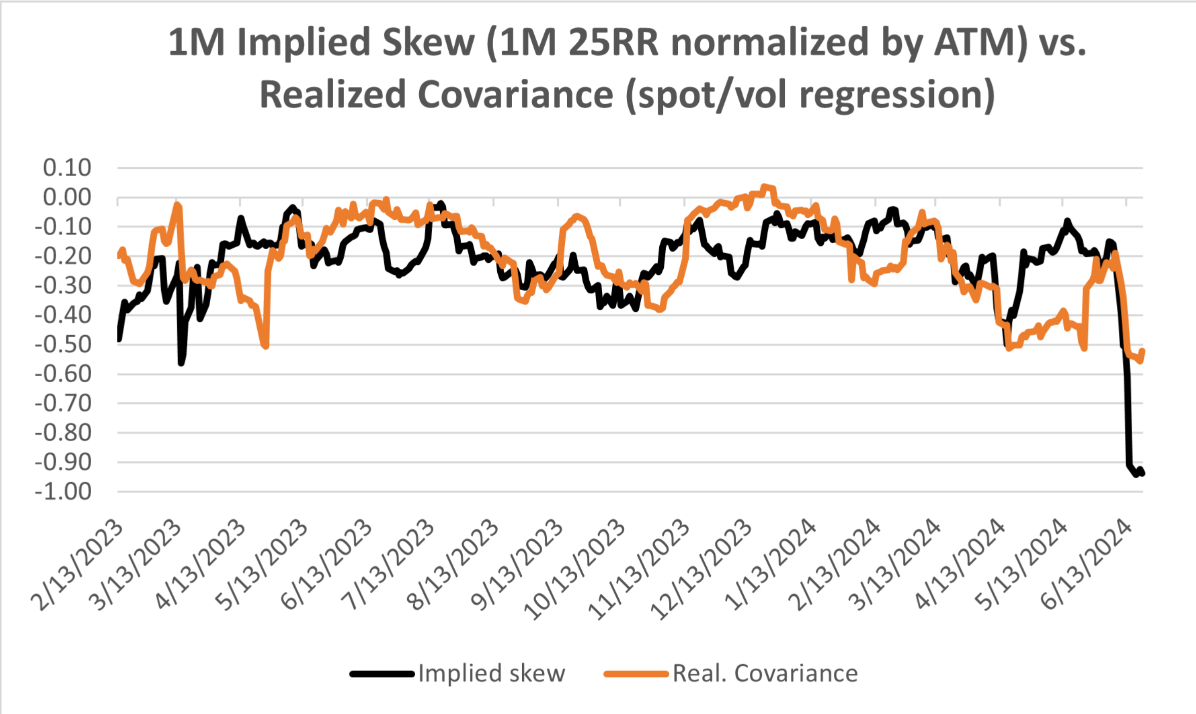
Exhibit #1: FX Factors & iFlow Factor Centrality

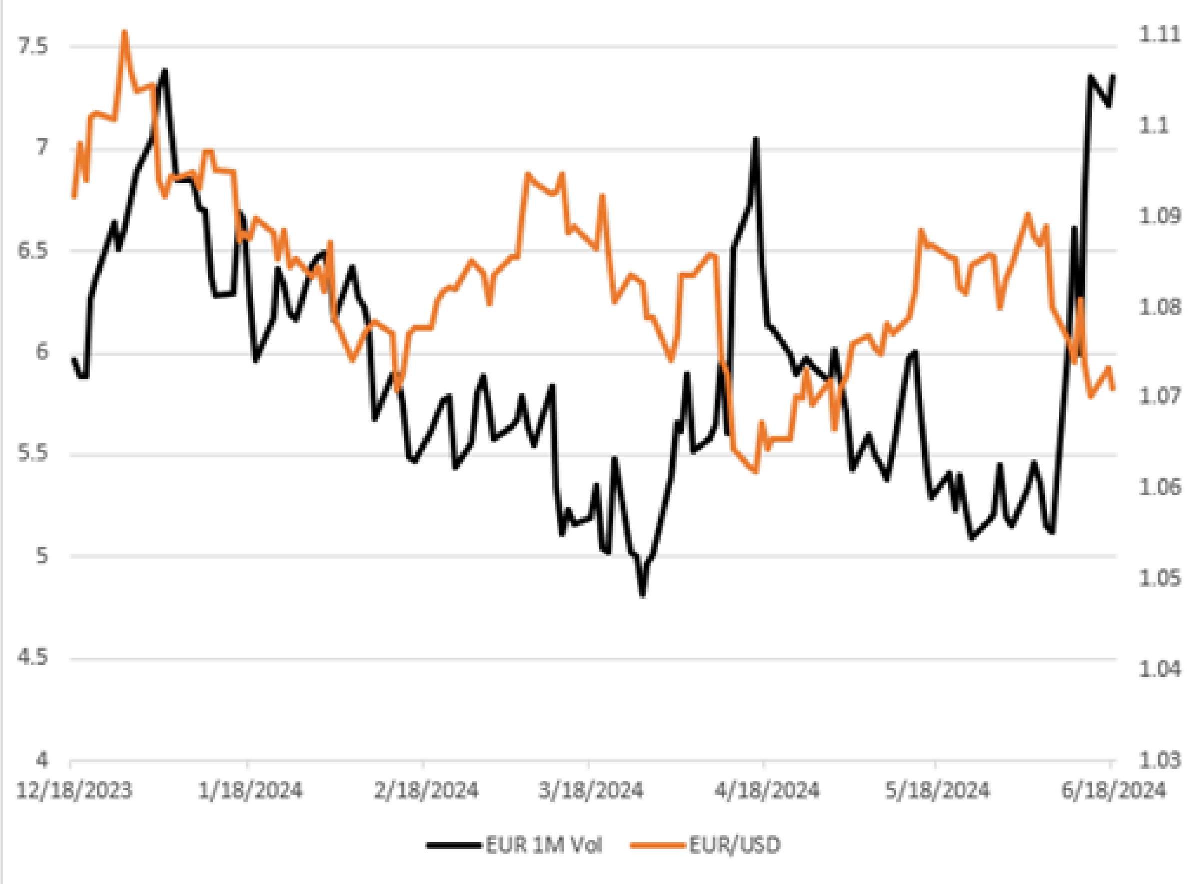


the last two weeks. Generally speaking, EUR is viewed as the only viable alternative to USD in central bank reserves. The role of Europe across markets matters given the sizes of its population, its bond and stock markets, and its savings. The EURUSD drop from 1.09 to 1.06 has made the skew of options markets a key factor, with the correlation of the FX spot price to implied volatility rising.

The fear of larger EUR moves lower links to the French election opening medium-term risks of a Le Pen government driving fiscal deficits to a debt-crisis breaking point, to the retreat of France from EU leadership roles, and to more nationalistic, anti-immigration, higher tariff policy mixes that hurt growth and productivity. Further, the role of France stepping back from Europe, rather than being one of its leaders, begs the question: what other country can make up for the weaker German role given the fractured coalition of Chancellor Scholz? Politics as a driver for EUR has risen dramatically and led to fatter tail risks priced into EUR options.

Exhibit #2: EUR & Options Betray Downside Fears

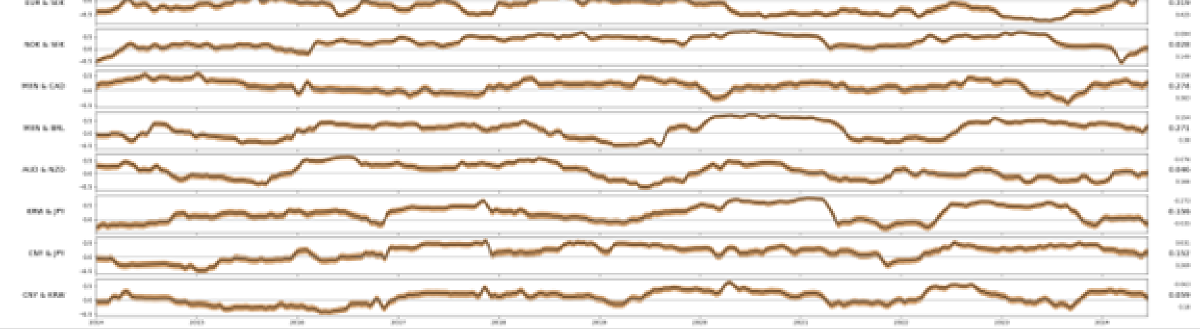




Source: Bloomberg, BNY

Given the rise of equities over bonds in returns in H1, investors argue that FX models should reflect Growth or Value factors over rates or politics. The rise of cross-currency trading to sidestep the USD but hedge other risks inherent to the Eurozone or other regions has been notable. We have seen increased volumes and interest in relative-value trades like AUDNZD or NOKSEK. The correlation of our flows to actual price correlations shows that the power of such tactics has not been working; only SEK has been rising as a counter-currency vs. EUR and NOK.

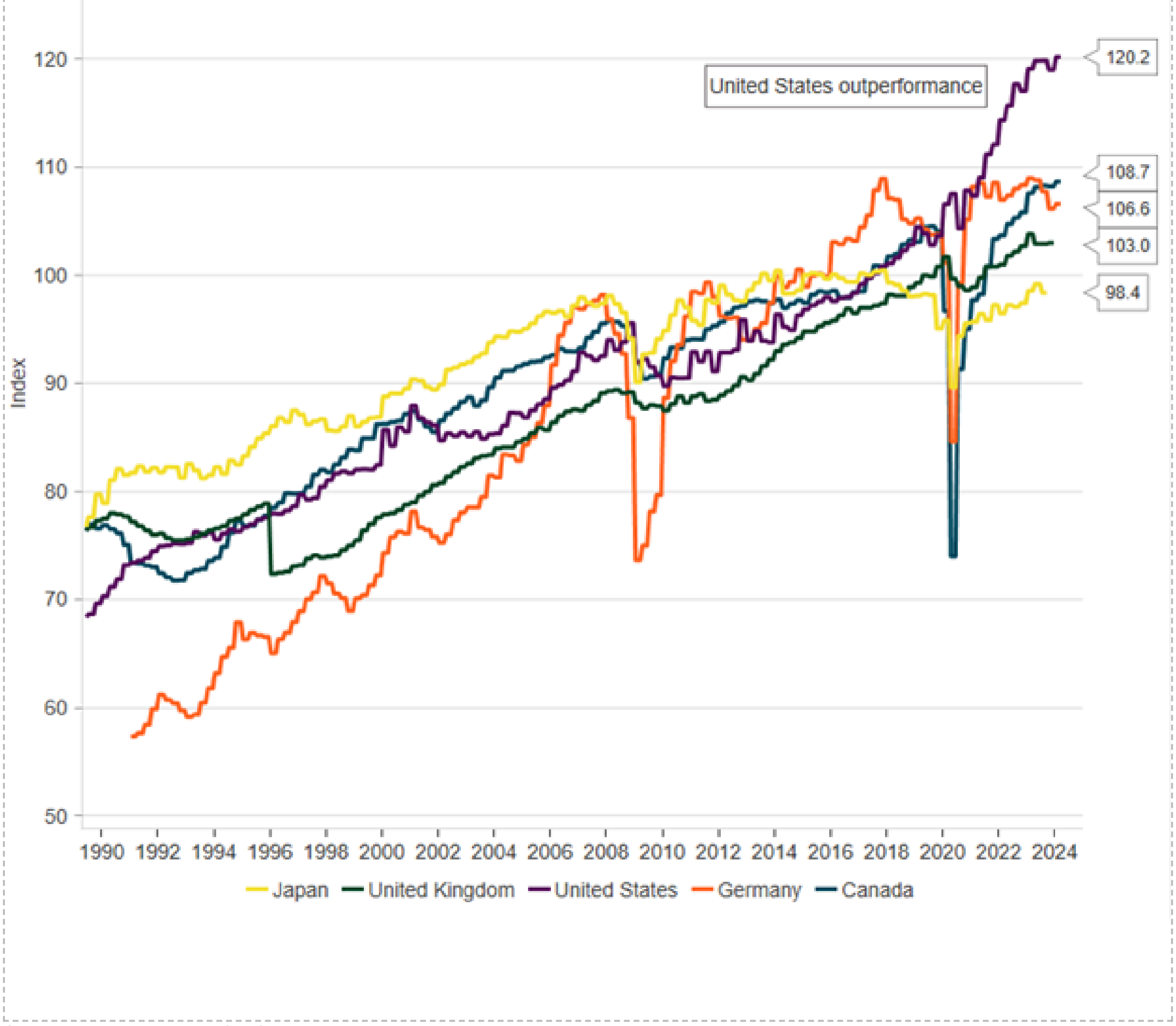
Exhibit #3: iFlow FX Correlation Matrix For RV Trades



Source: iFlow, BNY

Clarity on what will matter to markets in the next quarter rests on factors outside of Carry, Trend or Value. This leaves growth the logical next measure for USD performance. We think US growth in Q2 and beyond will become the main driver in FX. The narrative of money flowing into AI investments and tech to drive productivity and growth in the US over the rest of the developed markets stands out. To many, the risk for FX has become a derivative of Nvidia shares' direction. This may be too simplistic, but the power of investments to drive growth and outperformance for a quarter or two looks normal in the context of market history.

Exhibit #4: G5 Labor Productivity

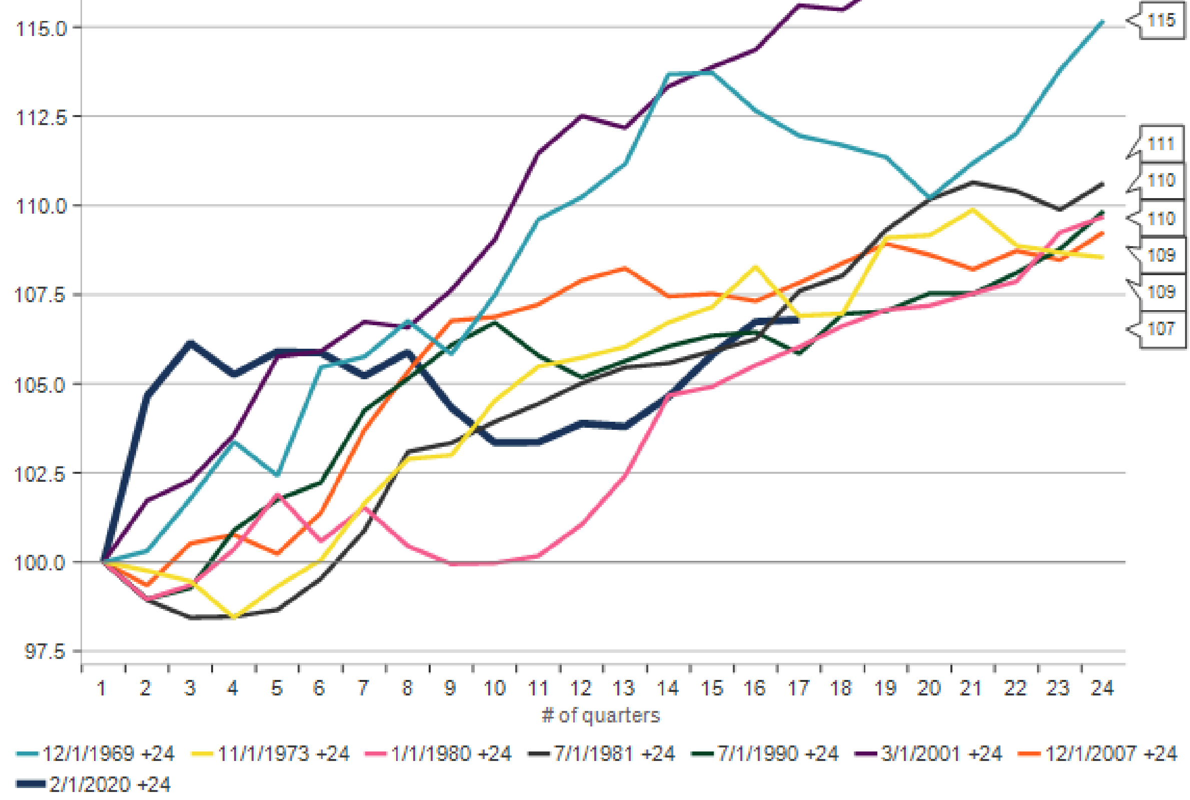


Source: Macrobond, OECD, BNY

Bottom Line: For those harboring doubts about markets sustaining AI hype – look back at the productivity of the US as it recovers from a recession. The pandemic effect was fast, and it has only been in the last year that 'US exceptionalism' from AI and data center growth linked to the IRA (and other government policies to push onshoring) that the US productivity rise looks different. Optimists will see US election risks already priced and the US's investment paying off in 2025. Pessimists will see messy politics, larger government deficits and the risk of a US slowdown below 1.5% (GDP) toppling the dollar. The ability of the US to outperform in such growth contests looks more important for the USD exceptionalism trade than anything else right now.

USD holdings per iFlow are nearing neutral. That means any data surprises – to either the upside or downside – will matter over the hot summer ahead.

Exhibit #5: History Of US Productivity Recovery After A Recession



Source: Macrobond, BLS, BNY

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