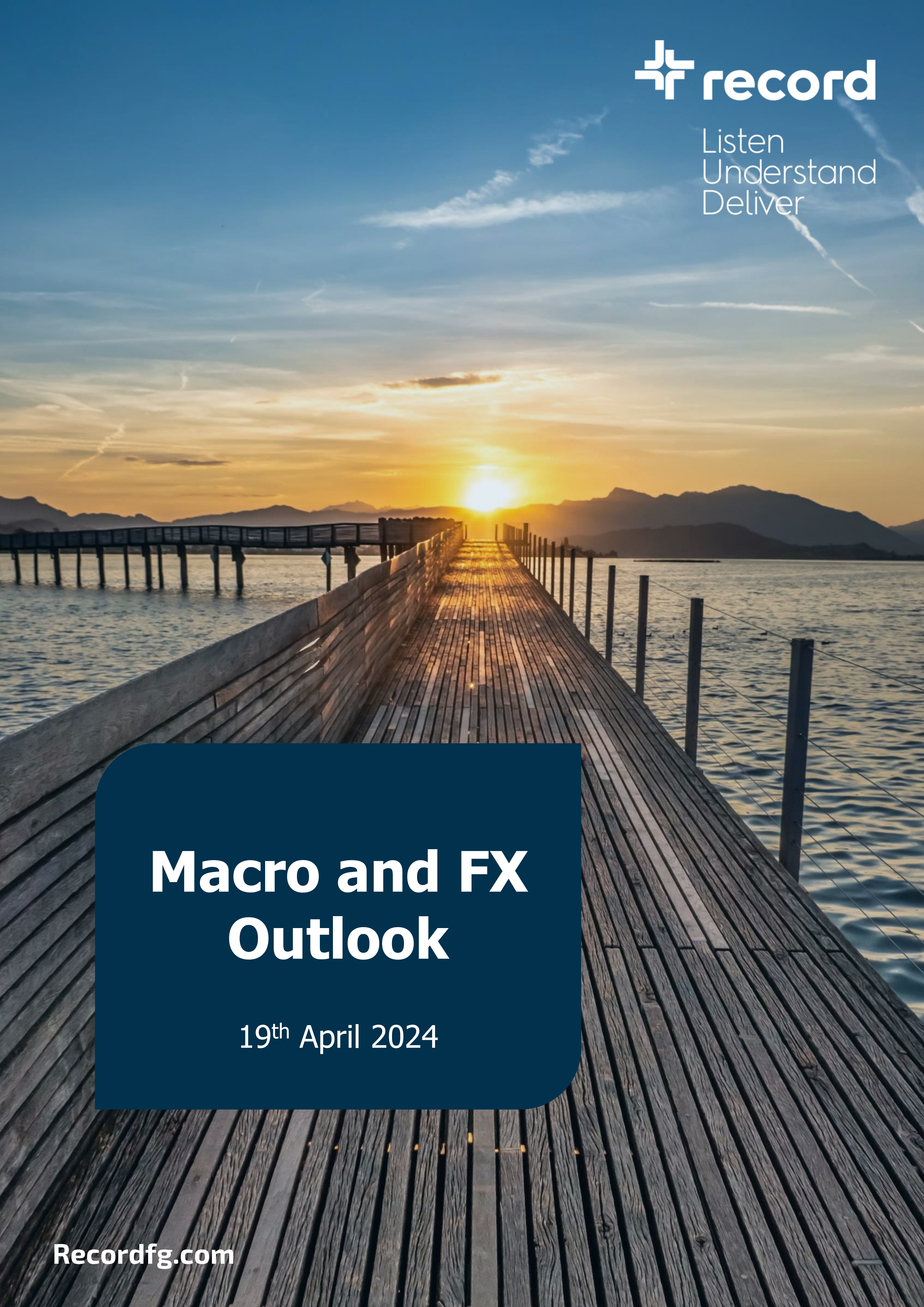

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Macro and FX Outlook

19th April 2024

Recordfg.com

1 Inflation and Currency Volatility

Recent slowing of the disinflation process presents a final hurdle for rate cuts

Central banks remain highly attentive to ongoing inflation risks, and although disinflation has been slow, it has generally been a smooth and somewhat successful endeavor. Most Developed Market central banks are now approaching the target rate, however, a recent slowing of the disinflation process for core inflation presents a final hurdle. Monetary policy makers have been gaining the confidence to begin cutting rates before inflation comes fully into balance, however a reacceleration of inflation rates risks delaying that process further.

In the next six months currency moves will continue to be driven by the path of disinflation via size and speed of rate cuts.

Once cutting cycles are underway, speculation is likely to shift towards adjustments in the terminal destination of policy rates.

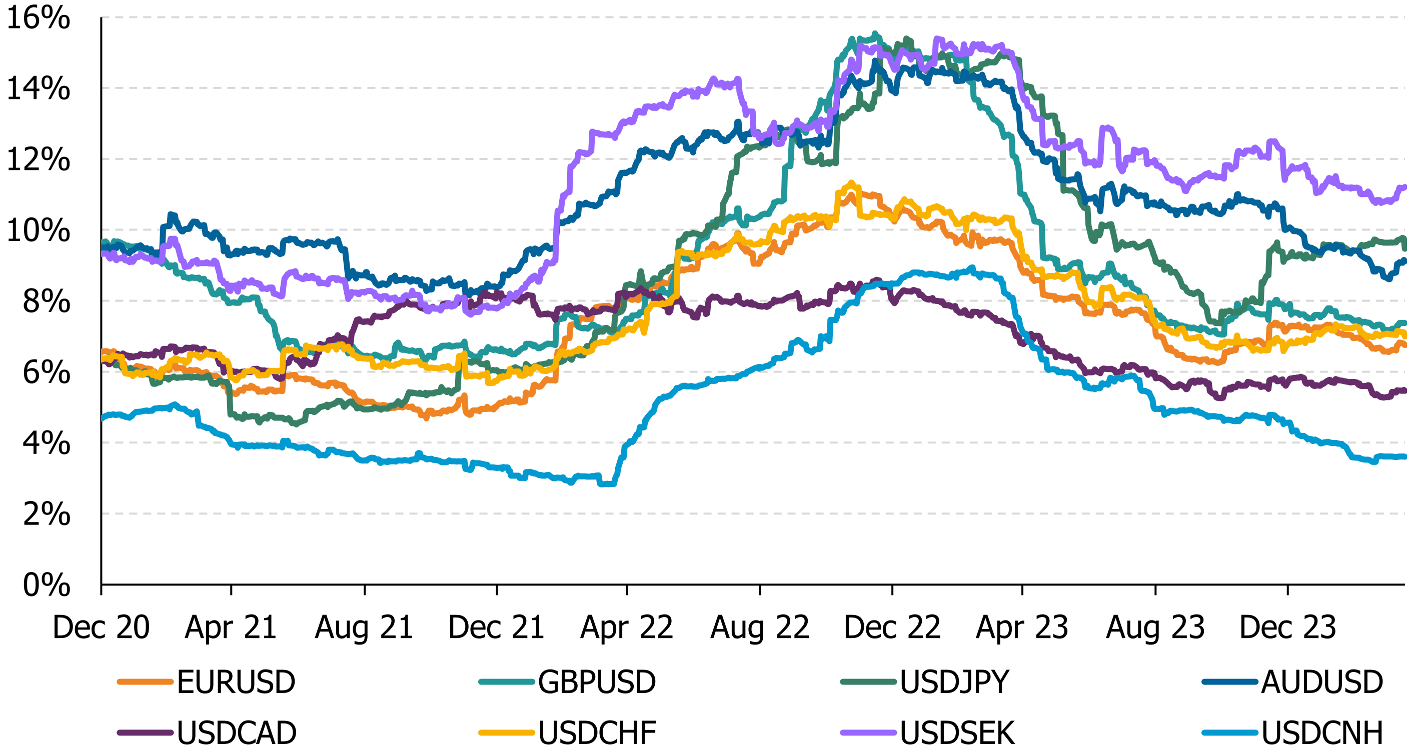
Currency volatility is declining despite the presence of disruptive factors

Successes in tackling inflation, the stability of current interest rates, and attendant expectations of lower global rates are contributing to a decline in currency volatility. **In some cases, market-implied volatility is close to pre-pandemic lows**, and may also reflect market optimism about a potential soft landing in the US economy, coupled with a revival in activity elsewhere that is contingent on a synchronized easing of monetary policies.

There are some exceptions, including the recent depreciation of the Swiss franc following its unexpected rate cut in March, the yen's continued slide despite threats of intervention, and more recent volatility in high-yielding EM currencies.

Remarkably, **low volatility prevailed despite emerging geopolitical tensions and climbing oil prices**, which typically stir financial markets but have had minimal supply impact so far on the assumption that effects are localized. Should such factors begin to influence central bank decisions more prominently (e.g. via the inflation outlook), we would expect increased currency volatility.

120-day Rolling Realised Volatility (Annualised)



Source: Record, WM/Reuters. Date range: December 31, 2020 to April 17, 2024.

2 US Dollar Outlook

US dollar remains strong despite facing opposing forces

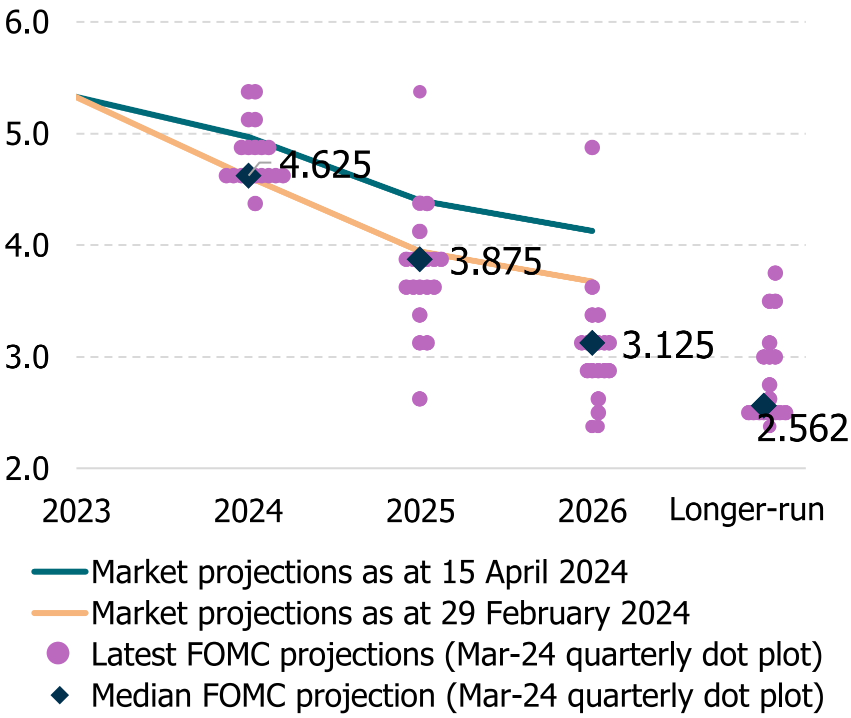
Despite positive sentiment in risk markets, **the US dollar has remained strong, caught in a tug of war** with the widely anticipated Fed easing cycle and positive risk sentiment on one side, and ongoing economic exceptionalism that supports "higher for longer" pricing of interest rates on the other.

We remain of the view that the outlook for the US dollar depends on the balance between global risk sentiment and the relative economic performance of the US.

Many developed economies have been in or are close to a technical recession; if synchronized easing cycles lead to a resurgence in non-US growth, and if "risk-on" sentiment strengthens due to lower interest rates, then there could be a pathway to a weaker US dollar. This is especially likely against currencies where the US yield advantage is most significant, such as the Japanese yen and Swiss franc.

Conversely, persistent services inflation in the US and ongoing large fiscal deficits — despite growing fiscal risks — may delay the Federal Reserve's normalization efforts and subsequently strengthen the US dollar. Currently, **market expectations of US policy rates sit above the FOMC's own projections**, suggesting a slightly higher bar for near-term US dollar strength.

Target federal fund rate projections vs. FOMC dot plot



Source: Record. Bloomberg. Data as at April 15, 2024.

3 China Outlook

Many challenges still lie ahead for the Chinese Economy

For much of Europe the Chinese economy is highly influential in so far as it helps inform the cyclical growth outlook. The Chinese economy still faces various obstacles, including **fragile house prices, stringent regulatory measures, and high debt levels**.

However, the government's policy response is constrained;

Fiscal Policy Constraints:

- Debt sustainability
- Real Estate excesses

Monetary Policy Constraints:

- Bank profitability
- Currency stability
- Renminbi internationalization

Consequently, **elevated real interest rates are likely to exert a dampening effect on economic activity in China**. Slower Chinese growth as well as competition from within China, e.g. in the automotive sector, will continue to drive part of the outlook for European currencies.

As for the renminbi itself, the PBoC will seek to moderate FX weakness in a US dollar strength setting (via the fixing and to "prevent currency overshooting") but its actions **could be more measured now if the trade-weighted value of the renminbi rises too much,** given broader deflation and export pressures.

4 Emerging Markets

Diverging economic fundamentals driving a mixed outlook in Emerging Markets

Central banks in **Emerging Markets are now approaching cutting cycles more cautiously**, given the pricing out of US rate cuts, and the risk rising oil prices poses to the final leg of disinflation. Those countries with **higher growth potential seem better positioned to manage higher inflation and currency volatility.**

Eastern European economies have a smaller growth cushion, which might lead to higher currency volatility if their central banks need to implement more growth-supportive policies.

In Latin America, currencies generally offer an attractive carry profile, although the varying speeds of rate cuts are affecting their relative performance.

South-East Asia stands out, especially India, Indonesia and Thailand, as these economies also appear to be benefitting from increased protectionism trends and friend-reshoring.

If recent depreciation pressure persists in relation to geopolitical risks and uncertainty around the number of Fed rate cuts, EM central banks will need to deploy verbal intervention, dig deeper into FX reserves, and potentially review their monetary policy paths to support currency values. Additionally, this year we may see increased uncertainty due to **elections in India, Mexico, South Africa, and Romania**.

5 Geopolitical Challenges

Middle East

The onset of conflict between Israel and Hamas has introduced new challenges to the global economy, **supporting oil prices and raising concerns about further supply chain disruptions**, especially as Houthi militants, backed by Iran, targeted commercial vessels in the Red Sea. The first direct attack on Israel by Iran was another major escalation. So far, the currency impact has been limited mostly to Emerging Markets via risk sentiment channels and the unwinding of popular carry positions. Further escalation could support safe-haven currencies such as the Swiss franc, US dollar, and Japanese yen, subject to their relative dependence on oil imports.

United States

After an unsuccessful summer offensive by Ukraine, signs of war weariness are apparent in the West and among US lawmakers, and this may indirectly raise the risk of a strategic clash in the Taiwan strait.

Meanwhile, ahead of the US election in November, investors have started to assess the **potential impact of a shift towards Republican policies on industry and international relations**, including trade and tariffs and a potentially more confrontational stance towards the Federal Reserve. Escalatory outcomes on most of these fronts (except monetary policy independence) are on balance more likely to benefit the US dollar through its relatively recent acquisition of **energy independence, and growing efforts to shore up its supply chains.**

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