Monthly Report

May 2024

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Introduction – 'Divergence' drives up the dollar

The Fed takes a different route

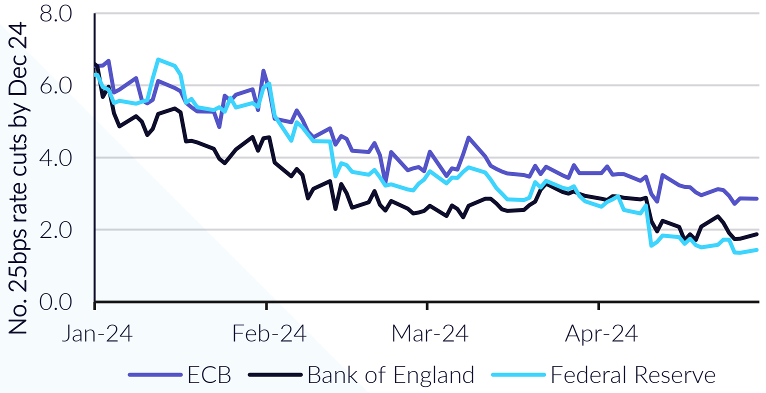
A two-day period largely sums up the story of April. On the 10th, US CPI reaccelerated to its highest in six months, surprising to the upside for the fourth consecutive reading and pushing back market pricing for rate cuts to fewer than two. On the same day, the Bank of Canada put a June cut firmly on the table, while the ECB all but pre-announced one the day after.

Rate cut pricing for central banks across the G10 had been glued to the Fed's trajectory through Q1 but, while its peers continue to gear up for summer rate cuts, US disinflation has now hit a brick wall. As a result, markets have quickly arrived at the conclusion that the first Fed rate cut is likely to arrive significantly later, with September the estimated starting point. This divergence – the immediately favoured buzzword - unshackled US rate spreads and unlocked the dollar's next move higher against the entire G10. This led to some decisive downside breakouts for its peers from the tighter trading ranges of Q1.

Traders in the options markets ramped up implied volatilities as a result, driving a surge in Deutsche Bank's CVIX FX volatility gauge at the quickest pace since late 2022, when UK PM Truss turned the gilt markets upside down and the BoJ was last intervening.

Some new debates surfaced. Might the Fed's next move be a hike, rather than a cut? And with diverging European and US rates, could the euro fall back to parity? Neither are impossible, although those betting on them are in the minority for now.

2024 rate cut bets were trimmed again in April



Too strong?

Another defining theme in FX is the brewing discontent among Asian officials whose currencies have devalued sharply against the bulldozing dollar this year, whacking up the price of imports.

A currency-boosting rate hike in Indonesia, interventions in India and Vietnam, and a three-way press release from the US, South Korea, and Japan were among the responses, with suspected market intervention from Tokyo finally arriving after months of speculation on what it would take for officials to act on their verbal threats.

> *The effects of intervention are naturally short-lived and cannot reverse orderly moves driven by fundamentals, but the constant threat does represent something of a short-term headwind for the dollar's bullish momentum.*

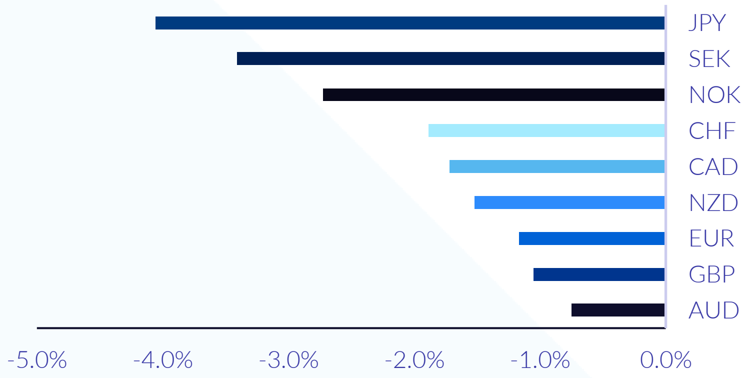
Geopolitics steals some headlines, but markets keep their cool

Middle East escalation fears kept traders on edge in April and triggered some wobbles, particularly for the risk-sensitive currencies, but the effects on FX were mostly short-lived, and overall impacts were again limited largely to undulations in gold and oil prices. Markets have grown seemingly comfortable – or numb - with the risky backdrop and few are expecting renewed inflationary risks to materialise. Instead, it was a 4% dip in the S&P 500 and concerns about slowing US economic growth that led the way in risk off moves, denting the likes of NOK and SEK and holding AUD back from taking advantage of rising yields.

'Convergence' may come into play, too

The monetary policy and inflation stories were defined by divergence, but there was some *convergence* to look out for in the growth outlooks. PMI indicators inched up in the UK, eurozone, Australia, Sweden, and Canada, while US business activity softened and GDP slowed sharply in the first quarter. US economic exceptionalism remains intact for now, but cracks are appearing that could erode its advantage.

G10 April Performance vs USD



FX Reviews

USD

Add it to the list

Once again, an unrelenting flow of strong US macroeconomic data added to the list of evidence painting a picture of red-hot inflation and a persistently tight labour market, catapulting the dollar to its fourth consecutive monthly gain. Another blowout non-farm payrolls print at 303K was followed up by a surprisingly sharp reacceleration in US CPI to 3.5%. This was the highest reading since September and hammered home the fact that the sideways inflation trend this year had become too durable to be passed over as just a bump in the road. A colossal jump in the Q1 core PCE deflator - the gauge the Fed actually targets - from 2.0% to 3.7%, and an upside surprise in the Employment Cost Index,m only bolstered the case for US rates to be cut far later than its peers.

As a result, markets dialled down their rate cut bets to just over one this year, beginning in September rather than June, powering the US two-year Treasury yield back above the 5.00% level for the first time since November. As a result, the dollar enjoyed its best week since 2022 as it notched a five-month high.

The Federal Reserve took note and ramped up their cautious commentary. Chair Powell reset his stance, remaining hopeful but dropping his immediate bias to cut in the summer and admitting that recent data had evidently not boosted his confidence. Williams, meanwhile, argued that there is ‘no convincing case’ to cut, while Daly warned that ‘the worst thing to do is act urgently when urgency is not required’.

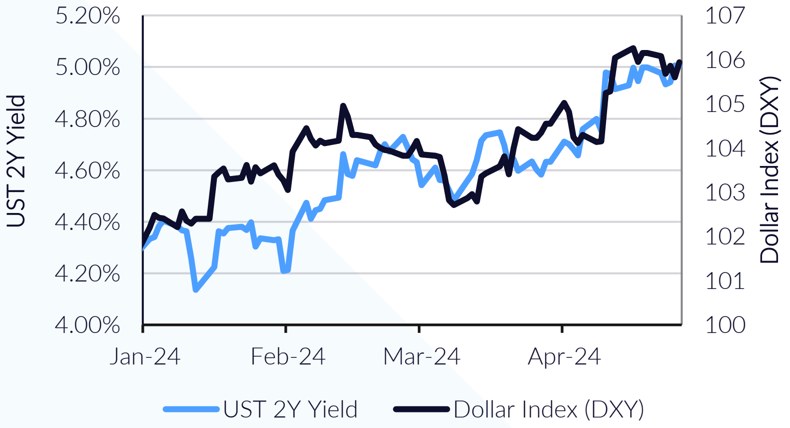
A growing question is whether the data could warrant a further hike as the next move instead, with analysis in the FT suggesting a chance as high as 20% priced into the options market. This would light a fire under the dollar and suggest some longer-term structural strength.

But an overcrowded long dollar trade makes it vulnerable to a turn in the data, if it can put near-term cuts back in play this month. Speculators have gone all in on bets that pay off if the greenback appreciates, risking a sharp snapback if these trades need to be covered.

And cracks are appearing in the bottom-up surveys that have only just begun to filter through into the hard data. A falling quits rate and softer hiring signals in the ISM and small business surveys point to an eventual capitulation in the labour market as rate rises bite. Meanwhile, although driven by more volatile components, Q1 GDP growth caught markets off guard as it weakened significantly to 1.6%.

The Fed will be forced to confront the growing pile of hot inflationary data this month. In the near term, a continued dollar rally will require policymakers to follow the markets and trim their expectations for cuts this year, and talk of a hike could add further fuel to this momentum. But the data will dominate in the medium term, as investors try to figure out when inflation will finally hand the Fed an entry point to bring rates down.

Front-end Treasury yields have guided the dollar higher as rate cut bets wane



GBP

Division on Threadneedle Street

If you step back to take stock of the UK data from April, the read is generally quite hawkish. Core inflation remains elevated at 4.2%, and the headline measure landed above expectations at 3.2%. The labour market remains a large source of domestic price pressures, too, with wage growth holding at 5.6% and vacancies still high. And with the technical recession in the rearview mirror and the PMI indicators continuing to improve, the cyclical outlook remains a tentative tailwind for sterling.

But instead of a rally, we got a rapid selloff followed by a recovery as divided Bank of England speakers sowed confusion with two competing narratives.

Bailey and the typically hawkish Ramsden offered the first, more dovish take, suggesting that the risks of inflationary persistence had fallen considerably, and that inflation could fall to the target this quarter and stay there. This initially knocked sterling to a five-month low as markets priced in a first cut in June rather than August. Speculative traders flipped their positioning from net long to net short, switching their bets from a stronger pound to a weaker one at record pace.

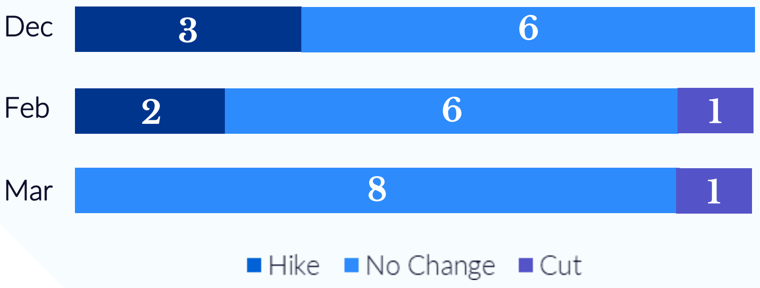
> *The hawks soon followed the doves, however, expressing their concerns that domestic price pressures could persist for longer.*

Haskel pointed to the centrality of the labour market, arguing that the favoured vacancies-to-unemployment ratio is loosening only at a snail's pace. Greene was keen to stress that the idiosyncrasies of the UK economy put it at higher risk of stubborn inflation than in the US, while Pill contended that cuts were 'a way off'.

Which is it, then? Are rate cuts coming this quarter, once falling energy prices kick in and the labour market gives up? Or are we looking at a persistently bumpy last mile that keeps British rates high, as in the US? Traders will spend this month looking for clues on the answer, with particular interest in the Bank of England's official line and forecasts.

Depending on which side of the debate the new forecasts lie, they could either buoy UK yields, or catalyse a more durable move lower as a June rate cut comes back into the picture. The vote split will be critical, too, with the potential that one or two of the voting members join mega-dove Swati Dhingra in calling for a first cut.

Could another cut join the MPC vote split?



EUR

Going it alone

The euro's 1% decline against the dollar came from a de-anchoring of ECB rate expectations from the Federal Reserve. For several months it was primarily the US data that guided market pricing, but while disinflation stalled in the US, it kept on marching in the eurozone. Markets began to wholeheartedly absorb the notion of divergence as Fed bets moved back to the autumn, while the ECB conditionally preannounced that it would go it alone with a cut in June.

With no setbacks yet, June is still on. April inflation held steady within a whisper of the target at 2.4%, but the core measure slipped further to 2.7% - the lowest since March 2022. Notably, having long been touted as a significant hurdle to rate cuts, a first downtick in services inflation in five months began to replace normalising energy prices as a primary source of disinflation, solidifying the case for an incoming rate cut.

Given the extent to which policymakers have treated it as a foregone conclusion, the bar for not cutting in June has been raised high. Disappointing wage data, for example, would struggle to suffice as an excuse to stand pat, although concerns here have subsided too, with the bank's proprietary measures heading in the right direction.

That leaves the trajectory from July onwards as the central debate for the euro.

Policymakers are split between a 'pragmatic pace' of follow-up cuts that quickly brings down the level of restriction, and a pause for reflection and a slow, data-dependent glide to more neutral rates. For some market participants, a speedy rate cutting cycle could widen the US rate differential enough to drive the euro back down to parity against the dollar. Whilst it cannot be ruled out, given that we do not have the European energy crisis of late 2022, this would likely require a specific scenario where the ECB cuts dramatically and the Fed pushes its first move into next year.

Some added complexity comes from the uncertainty as to whether the ECB can truly act independently from the Fed, and the debate is equally as split here. Vice President de Guindos sees the exchange rate mechanism as an important channel that could keep a check on rate cuts - diverging too far risks a sliding euro that could reignite imported inflation. Not all are convinced, however, and some make the point that the resulting boost to eurozone exports could be a welcome development.

These themes should continue to dominate in May, and so the final set of CPI figures and incoming wage data will be the biggest events on the calendar. And in terms of growth, markets will also look out for some more emerging cyclical tailwinds for the euro – in the April data, GDP returned to modest growth in Q1, economic optimism surged across multiple survey measures, and the PMI indicators continued to improve.

CHF

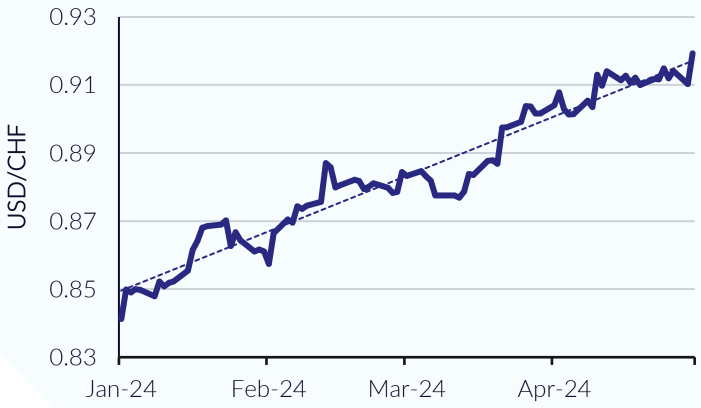
Consistency is key

The Swiss franc's depreciation against the euro finally took a breather, but it continued its absurdly consistent, linear decline against the dollar in April.

The franc's headwinds – the removal of SNB support at artificially strong levels, rapidly falling inflation, and an early start to the cutting cycle – are beginning to lose steam as a source of depreciative pressure against the euro, while the dollar's tailwinds – reaccelerating inflation and delayed Fed rate cuts – are picking up and maintaining the steady momentum in USD/CHF.

Inflation unexpectedly fell again in March to 1.0% and the lowest since September 2021, boosting bets for a second cut in June to nearly 80%. With SNB officials relatively quiet, the next inflation data should be the main event in May.

The franc has depreciated *very* consistently



JPY

Intervention arrives

Tokyo finally followed through on its verbal threats to intervene in the markets and to shore up the yen, and yet it remained the worst performing G10 currency in April as the yawning rate gap to its peers continued to encourage a selloff.

Markets were well accustomed to the somewhat hollow warnings about the preparedness of Japanese authorities to step in and buy yen, but as it pushed through key boundaries, these were ramped with a trilateral joint statement including commitments to 'consult closely' with Korean and US officials on currency movements, amounting to tacit US approval for intervention.

After the Bank of Japan's guidance on future hikes were too subtle for the market's liking, the weakening accelerated and USD/JPY hit 160 in the next session, at which point the yen jumped to 155 in what looked like three waves of intervention, later confirmed by accounts data that suggested a $30-40bn spend.

Tokyo cannot turn the tide if the yen's fundamentals continue to worsen – half of the intervention impact was wiped out within two days – but it can make traders nervier and slow the decline, with most expecting a series of interventions to follow. And while markets have priced in a hike or two from the BoJ this year, it's ultimately only a contraction in US rates that can durably lift the yen from its 34-year trough.

AUD

Questioning the cuts

Despite risk-off headwinds and a softened Chinese yuan, the Aussie dollar stood out from the crowd, inching lower only against the US dollar as stubborn inflation in the first quarter led many to question whether the Reserve Bank of Australia would cut rates at all this year.

The employment data was generally mixed – the Australian economy lost 6.6K jobs on the back of a blowout 116.5K increase the previous month, while unemployment ticked up only slightly to 3.8% after a huge drop in the previous month. CPI inflation, meanwhile, beat expectations on a quarterly and yearly basis, both for the headline and trimmed measures. The quarter-on-quarter price increase surged from 0.6% to 1.0%, underpinned by still stubborn services inflation.

This triggered a hawkish repricing of the RBA rates profile, which included the pricing out of rate cuts this year and even a non-negligible 35% probability that rates are higher by the December meeting. To stage a solid rally, however, the pro-cyclical Aussie will need relief from the downward pressure from the equity market and geopolitical tensions.

CAD

Door’s open for June

At its lowest in April, a dovish backtrack at the Bank of Canada and another broad-based decline across inflation measures pushed the Canadian dollar to within a whisper of a two-decade low.

The macroeconomic data was damningly dovish, with *all* the headline data printing lower than expected. Payroll growth went into reverse, losing 2.2K jobs in the month of March alongside a surge in unemployment from 5.8% to 6.1%. The combination of a loosening labour market and a downward turn in inflation from previous month forced the BoC to pivot more dovish after a surprisingly hawkish statement in March. Macklem was keen not to tie themselves into a June cut, however, but admitted that it was ‘within the realm of possibilities’, acknowledging that the data was heading in the right direction and asking only for more of the same to gain the necessary confidence to initiate rate cuts.

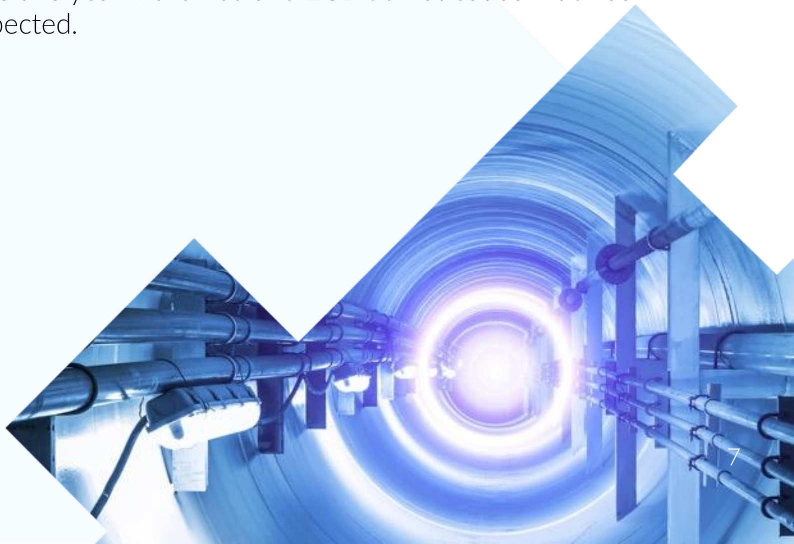
More of the same is what he then got – the following week saw a sticky headline print but a broad cooling across all the core inflation measures, most of which are now within the 1-3% tolerance band. The swap markets have a cut at the next meeting in June pencilled in at a coin flip probability, with two priced in before the end of the year.

SEK

A cautious cut?

The Swedish crown suffered another torrid month as global risk appetite cooled off and inflation fell much more sharply than expected. The year-on-year Riksbank-preferred CPIF figure slipped dramatically to 2.2%, defying forecasts for a rebound to 2.6%.

After the Riksbank pre-announced a May or June cut in March, the data makes May look like an obvious choice, but policymaker concerns about easing too quickly and reigniting both domestic demand and the inflationary effects of a weakened crown have markets fully pricing a cut by June, with only a 50/50 chance it arrives this month. Caution is the name of the game for rate-setters – Jansson even argued that a weak currency could be the biggest threat to cuts this year if the Fed and ECB do not cut as much as expected.



Economic Calendar – May 2024

Six G10 central banks make their latest decisions in May in the US, Norway, Australia, Sweden, the UK, and New Zealand, plus a fresh set of inflation and growth figures for investors looking to fine-tune their expectations.

Date	Time (CET)	Currency	**Event**	Previous
Wed 1st	4:00pm	USD	JOLTS Job openings	8.76M
Wed 1st	8:00pm	USD	Federal Reserve Monetary Policy Decision	5.25-5.50%
Thu 2nd	8:30am	CHF	CPI y/y	1.0%
Fri 3rd	10:00am	NOK	Norges Bank Rate Decision	4.50%
Fri 3rd	2:30pm	USD	Non-Farm Payrolls	303K
Tue 7th	5:30am	AUD	RBA Rate Statement	4.35%
Tues 7th	9:30am	SEK	Riksbank Rate Decision	4.00%
Thu 9th	1:00pm	GBP	Bank of England Monetary Policy Decision	5.25%
Fri 10th	8:00am	NOK	CPI y/y	3.9%
Fri 10th	8:00am	GBP	GDP m/m	0.1%
Fri 10th	2:30pm	CAD	Employment Change	-2.2K
Tues 14th	8:00am	GBP	Claimant Count Change m/m Wage Growth 3m/y	10.9K 5.6%
Tues 14th	2:30pm	USD	PPI m/m Retail Sales m/m	0.2% 0.7%
Wed 15th	8:00am	SEK	CPIF y/y	2.2%
Wed 15th	2:30pm	USD	CPI y/y	0.7%
Thu 16th	3:30am	AUD	Employment Change	-6.6K
Tue 21st	2:30pm	CAD	CPI y/y	2.9%
Wed 22nd	4:00am	NZD	RBNZ Rate Statement	5.50%
Wed 22nd	8:00am	GBP	CPI y/y	3.2%
Thu 23rd	10:00am	EUR	Flash Manufacturing PMI Flash Services PMI	45.6 52.9
Thu 23rd	10:30am	GBP	Flash Manufacturing PMI Flash Services PMI	48.7 54.9
Thu 23rd	3:45pm	USD	Flash Manufacturing PMI Flash Services PMI	49.9 50.9
Fri 24th	8:00am	GBP	Retail Sales m/m	0.0%
Fri 24th	2:30pm	CAD	Retail Sales m/m	-0.1%
Wed 29th	3:30am	AUD	CPI y/y	3.5%
Fri 31st	11:00am	EUR	CPI y/y	2.4%
Fri 31st	2:30pm	USD	Core PCE m/m	0.3%
Fri 31st	2:30pm	CAD	GDP m/m	0.2%

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