BALLINGER GROUP

Monthly Report

June 2024

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Introduction – The dollar's fortunes turn as risk bounces

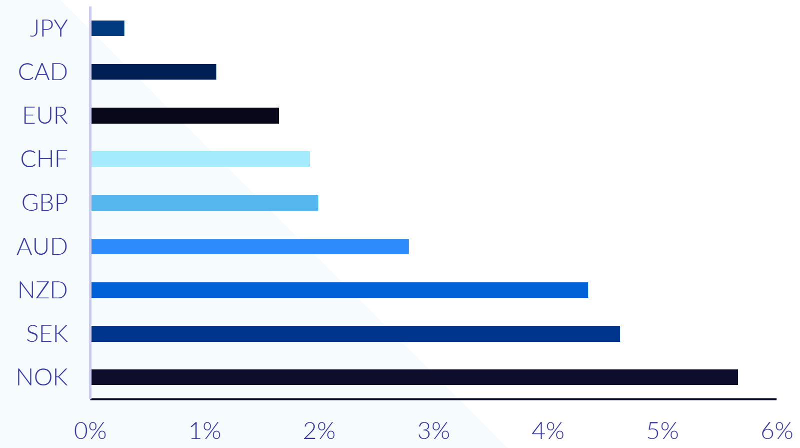
Risk appetite balloons

A turnaround in the US dollar's fortunes was the big story of May, with the rates and risk backdrops finally handing it the first down month of 2024. The hard macroeconomic data began to soften after three months of stagnation and even reacceleration, chipping away at front-end yields and pricing out some of the Fed divergence versus the Bank of England and the ECB.

The risk picture drove much of the G10. Renewed soft landing hopes, record high equities, a subdued VIX, a continued boom in tech, and incoming rate cuts all tempted a rotation of capital into riskier assets. On the graph on the right, G10 FX performance versus the dollar in May is largely stratified by sensitivity to risk, with the safe havens (CHF, JPY) and moderately risk sensitive G10 (GBP, EUR, CAD) comparatively gaining far less against the dollar than the highly risk sensitive, more illiquid currencies: NOK, SEK, NZD, and AUD. US short-term rate differentials moved *against* this best-performing tranche, yet they all made significant gains nonetheless. Weak US Treasury auctions and a brief surge in US yields spooked markets briefly towards the end of the month, but the moves held firm overall.

The Swiss franc was the only one to break the trend here, finally breaking its bearish momentum against the euro and the dollar as inflation resurged and blowout economic growth prompted markets to trim back their bets for rate cuts. The Japanese yen was saved from a net loss only by Tokyo intervention and a dampened dollar, but it was back to business as usual for USD/JPY by the second half of the month as it pushed on back towards 160.

G10 March Performance vs USD

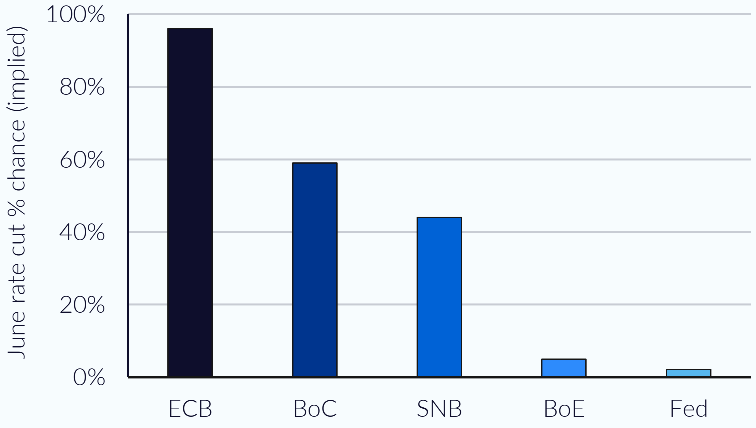


Hot services inflation and a shift in rate cut expectations meant that sterling posted some notable achievements in its first monthly gain against the dollar this year, including at one point its highest level against the euro since August 2022. The euro held firm against its US counterpart, however, with a June rate cut already set in stone and little clarity yet coming about the rate trajectory in the second half of the year.

More to join the rate cut club

> *Sweden followed Switzerland in May by cutting rates for the first time this cycle, while the ECB and potentially the Bank of Canada are set to join the club in June. For the UK, US, Norway, and particularly Australia and New Zealand, inflation figures are not yet giving policymakers the confidence to go the same way.*

The markets see the ECB and BoC cutting in June



The first rate cuts are just the beginning, however, and the inflation data and central bank decisions will continue to dominate FX once again in June.

The timing of the first Fed cut and how far Europe and Canada will diverge from this remain the key question for rates. And on the risk side, the risk-sensitive G10 will rely on sustained strength in equities, cooling geopolitical tensions, and continued economic recovery.

Election volatility is also firmly on the radar and should begin to ramp up as we approach key votes in the EU, UK, US, and elsewhere - polls in South Africa and Mexico have already triggered some big moves. The snap election in the UK is likely to amplify the peaks and troughs but not to steer the pound's direction over rate differentials, although prospects for a closer UK-EU relationship could be a boost. Meanwhile in the US, the poll and policy impact of the first criminal conviction of a former president is not yet clear for the elections across the Atlantic, but should spice up the race to November.

FX Reviews

USD

Data puts the brakes on the dollar rally

For the dollar, May was principally a reversal of the take-off in the US yield advantage that sent it to year-to-date highs in April. It notched its first monthly decline in five. The sticky-inflation, higher-for-longer rates narrative remains the backbone of the greenback's 3% rally this year, but a moderate cooling in the hard macroeconomic data largely quashed the debate about further hikes, and helped markets to become tentatively more optimistic about the Fed's ability to cut rates.

A dovish Fed took the first swing at the greenback when, despite a first quarter stall in disinflation, Powell kept his eye firmly on rate cuts this year and put a high bar on a rate hike, arguing that 'persuasive evidence' would be required. The overall message was that it would take longer than expected to bring inflation down to target, and the minutes later revealed more hawkish undertones, but most importantly, the market's worst fears were soothed.

Softer signals from the on-the-ground surveys then finally began to filter through into the hard labour market data. Job openings fell to a three-year low, turnover fell to pre-pandemic levels, and non-farm payrolls weakened just the perfect amount for markets to gain belief in a timely US soft landing. The weak Q1 GDP figure was knocked further in its second revision, too, to 1.3% annualised.

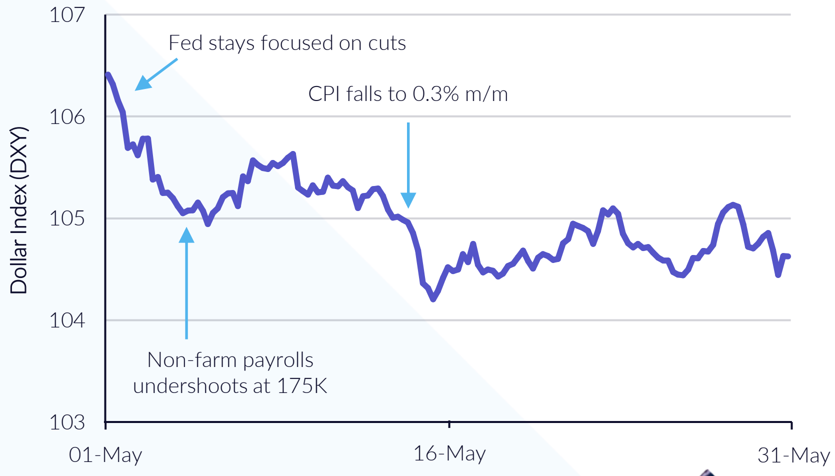
In the CPI report, month-on-month inflation then surprised on the downside for the first time since October, easing slightly from 0.4% to 0.3%. The moderation was small but unexpected, and the directional change was enough of a positive sign for rate cut optimism to rebound.

Once the dust had settled, however, some caution did creep back in. One month of softer data does not make a trend, and big adjustments to market pricing from a single minor CPI miss risks overinterpreting slight variations in the data - not all the data was on the Fed's side. 'Supercore' inflation, which excludes goods and housing and is closely watched at the Fed, remains elevated at 4.9%, and business activity expanded as the quickest pace for two years in May. Fed officials were quick to remind markets that further data would be required to confirm the trend, and that there is more work to do.

That said, the net impact was a contraction in the rate differentials versus the euro and the pound, and a weaker dollar. In the coming months, the underlying drivers are likely to remain stable until the election truly comes into play. That means continued emphasis on the inflation and labour market data, and whether these build on the softer indicators from May and open a path towards rate cuts this autumn, or if they return to giving the Fed a policy headache. Policy is assumed to be restrictive, but a continued stall in inflation, strong growth, and rallying equity markets could put discussions about rate hikes back on the table.

The rate decision on the 12th is the headline for June, where we'll get a fresh set of economic projections and a new 'dot-plot' of where officials expect interest rates to go this year. For now, markets are pricing in less than half of the three pencilled in back in the March meeting.

The dollar had its first down month of the year in May



GBP

Fewer than the Fed?

Despite a slow start and a dent from a dovish Bank of England, reignited concerns about sticky services inflation helped sterling to its best month of the year in May. It touched a two-month high versus the dollar, a 21-month high versus the euro, and a 16-year high against the yen.

As suggested that he might last month, Deputy Governor Ramsden dissented from the pack and joined Dhingra in calling for a rate cut, marking another step in the vote split towards policy easing, this time to 7-2 in favour of a hold. Although keen to emphasise the importance of the data, Governor Bailey said that second-round, more persistent effects were abating more quickly than expected, and seemed open to a rate cut at the June meeting. Read between the lines on the inflation projections, which forecast an eventual overshoot below 2% based on the market-implied rate path, and too few cuts appear to be priced into financial markets according to the BoE.

June bets were swiped away as soon as they had been ramped up, however, falling from a near certainty early in the month to a <5% probability as GDP, wage growth, and CPI all landed higher than expected. UK economic growth eclipsed even the US in Q1, expanding by a surprise 0.6%. Inflation fell significantly from 3.2% to 2.3%, but this was less than the consensus had hoped. A lower energy price cap flipped goods prices into deflation, but services inflation fell only slightly to 5.9%.

The market quickly sided with the more hawkish rate-setters on the MPC, swapping a June first cut for September or November, and pricing in fewer cuts than even the Federal Reserve.

> *"The risk now is that this severe rates adjustment could unwind relatively rapidly if services inflation gets back on track, or if policymakers lean towards rate cuts anyway. The May CPI report arrives the day before the June rate decision, and an at-target print could make it remarkably difficult to communicate to the public holding rates steady. As policymakers have argued, rates can be cut whilst keeping monetary policy restrictive."*

A snap election in July is big news for sterling, too, although it is likely to be more impactful through elevated volatilities rather than for the pound's direction. A vast and stable lead for Labour in the polls has taken out much of the uncertainty over the outcome, and markets will more likely be keeping their eyes on Labour's campaign pledges, which will be constrained by the limited fiscal headroom. The UK-EU relationship will be of particular interest because of the 'Brexit premium' - the prospect of closer trading ties to the bloc could unwind some of the deep discount priced into sterling and sterling-denominated assets that was embedded after the referendum in 2016.

EUR

June set in stone

Well-anchored expectations in the short-term have left foreign developments to steer the euro lately, and a weaker dollar gave it the best month of the year so far. A policy move this week is all but set in stone, with the ECB set to join the SNB and the Riksbank in cutting rates for the first time this cycle. Above all else, policymakers are likely to ease policy now because they said that they would, with countless optimistic speeches and a soft pledge in April putting a very high bar for a data surprise to steer them off the track.

To hold steady now would create a credibility issue. Fortunately, most of the inflation data has continued to cooperate and the move seems appropriate, although wage growth – once the make-or-break decider that needed to cool off before rates could be cut – ticked higher to 4.7%. Curiously, an ECB blog was quick to explain why, after emphasising the importance of a slowdown for many months, one-off factors and wage catch-ups have made it important not to overinterpret higher figures.

Given the lack of uncertainty regarding the outcome, it's the trajectory in the second half of the year that is the dominant concern for the euro. Policymakers are somewhat split on the pace of policy normalisation. While the likes of Villeroy see significant room for further cuts and a likely straight-line trajectory, most foresee a data-dependent, meeting-by-meeting approach that is more careful and does not risk a strong divergence to the Federal Reserve that does big damage to the euro.

Markets are positioned for the latter and the number of rate cuts by year-end have shrunk to just over two, suggesting a once-per-quarter cadence that aligns each cut with a set of fresh macroeconomic projections. A 'hawkish cut' that stresses caution is a probable outcome this week, and a higher-than-expected 2.6% CPI inflation print in May could tempt a nod to holding steady in July.

The ECB's eventual rate path will primarily come down to a couple of factors. The first is naturally how the inflation and labour market data evolves. For example, wage growth was played down last month but could become a bigger concern if it continues to rise and put upward pressure on services inflation. The second is the Fed, to which the ECB is inextricably linked, even if it diverges somewhat significantly. Holzmann calls it the 'gorilla in the room', and at some point the negative effect of divergence on the euro could come into play.

The one factor unlikely to weigh on policymakers is the growth outlook, with the eurozone economy returning to growth in Q1 and the PMI surveys continuing to climb into expansionary territory. Consumers are regaining purchasing power through pay growth and confidence is surging – the ZEW economic sentiment index rose to the highest in two years in May. This improving picture and steady convergence with the US has shielded the euro from much of the rates-induced weakness that many were expecting and could remain a tailwind into 2025.

CHF

The decline halts

After four consecutive months of decline against both the euro and the dollar, the franc's fall grinded to a halt in May, buoyed by a rebound in inflation and bumper growth.

Having fallen 7% from the 13-year high at which it entered the year, the franc now seems to have adjusted to a more appropriate equilibrium level following the unwind of the SNB's intervention efforts at the end of 2023. With the structural headwinds fading, an upside beat on CPI inflation for April handed it a leg up, which jumped from 1.0% to 1.4% and trimmed the prospects for rate cuts in the remaining three meetings this year.

The biggest one-day rally came right at the end of the month, however, as the Swiss economy unexpectedly posted its best quarterly growth since Q1 2022 at 0.5%, driven by a boost to consumption and investment. Not even one full cut is now expected over the next year, and the market-implied probability for June has slumped from around 80% to 44%.

The franc's depreciation stalled in May

JPY

Business as usual

Normal service resumed as soon as intervention was over for the yen, which returned to its steady decline as traders bought each dip in USD/JPY and continued to sell the Japanese currency in search for yield elsewhere. Intervention has certainly had a temporary effect, and we're still below the 160 mark that initially triggered action from Tokyo, but the momentum remains firmly in the direction of yen weakness.

So far, Tokyo has failed to time intervention at USD/JPY's natural peak, as it did in 2022. While BoJ policymakers have tried their best to engineer one with forward guidance and talk of a series of further hikes later in the year, markets are not fully biting, and gains made in Japanese yields have so far failed to shore up the yen. As of yet, there is no guarantee that inflationary progress will be sustained, and rate hikes risk taking a hit to already anaemic consumer demand. There is far greater risk in hiking rates for the sake of the yen and returning to deflation, rather than staying patient and treading carefully.

Ultimately, the gulf in rates persists, and the small recovery in the yield differential has not been enough to turn the depreciative tide. Further intervention this month cannot be ruled out, although if it continues to be ineffective then Tokyo may begin to lack the political will – authorities have already begun turning focus towards the current account's role in yen weakness.

SEK

Risk boost offsets a cut

Boosted by a significant improvement in the risk backdrop, the Swedish krona had a surprisingly strong month given that it joined the SNB in cutting its key rate by 25bps, to 3.75%.

The Riksbank had already pencilled in a cut for May or June, but many were caught by surprise when it came at the earlier opportunity. One of the primary concerns was that the weak krona would make policymakers hesitant to knock it down further. In the end, however, it only received a small nod in the policy statement, and the bleak growth outlook emerged as the primary motivator for getting a move on.

The focus now switches to the pace of easing this year. Governor Thedeen has since ruled out another cut in June, but guidance was relatively explicit about an extra two cuts in the second half of the year. At 2.3%, the April CPIF figure was lower than forecasts and continues to hover around the Riksbank's target, suggesting some significant room for further cuts down the line, particularly if the krona continues to benefit from risk-on capital flows. Traders are only looking for one, however, and this opens the Swedish currency to some downside risk if the economic outlook continues to motivate policymakers to cut.

CAD

The BoC gets what it wants

Although a weaker dollar pulled USD/CAD away from the six-month highs notched in April, another month of softer inflation data and a growing correlation to the US data saw Canadian dollar fall on the crosses.

The data painted a mixed picture overall, but it was enough to put a June cut on the table. Employment growth blew expectations away with a 90.4K print – the highest since February 2023 – but the underlying signs continued to show a weakening in demand. It came on the back of a contraction in March, a significant proportion was down to part-time hires, and rapid population growth continues to flatter the aggregate figures.

Inflation, meanwhile, gave the BoC exactly what it asked for, with a fresh 'broad-based deceleration' that dragged all the bank's CPI variants into the 1-3% tolerance range for the first time in several years. It is becoming increasingly difficult for the BoC to overlook the case for rate cuts, as the Canadian economy has seen sustained disinflation for four months in a row now. Markets are looking for a 60% probability that a first rate cut comes this month.

Much of the loonie's fate is now in the hands of the Fed. Although divergence is unavoidable over the summer, Governor Macklem's reluctance to turn dovish so far indicates that he always had one eye firmly on the Fed, and he has admitted that there is a limit to divergence, although this is some way off for now.

AUD

An inflation headache

The hawkish picture and a boost to risk continue to buoy the Aussie dollar. Inflation again refused to abate in last month's data – it jumped up to 3.6% in April – and it's unclear that RBA policy is sufficiently restrictive.

Weaker jobs data provided a flicker of hope for policymakers, with the 38.5K gain driven entirely by part-time hiring, but the pricing out of further hikes was short-lived. The jury is still out on whether another will come before the end of the year. While the RBA minutes revealed that a hike was discussed, there was a desire not to excessively fiddle with the policy rate. The fourth straight policy pause did not include a reinstation of a hiking bias as some had expected, sticking with the line on not 'ruling anything in or out'.

Economic Calendar – June 2024

The G10 sees seven central bank meetings in June, and rate cuts could come from the ECB and Bank of Canada.

Date	Time (CET)	Currency	**Event**	Previous
Tues 4th	4:00pm	USD	JOLTS Job openings	8.49M
Wed 5th	**3:45pm**	**CAD**	**Bank of Canada Monetary Policy Decision**	**5.00%**
Thu 6th	**2:15pm**	**EUR**	**ECB Monetary Policy Decision**	**4.00%**
Fri 7th	2:30pm	CAD	Employment Change m/m	+90.4K
Fri 7th	2:30pm	USD	Non-Farm Payrolls m/m	175K
Tue 11th	8:00am	GBP	Claimant Count Change m/m Wage Growth 3m/y	8.9K 5.7%
Wed 12th	8:00am	GBP	GDP m/m	0.4%
Wed 12th	2:30pm	USD	CPI y/y	3.4%
Wed 12th	**8:00pm**	**USD**	**Federal Reserve Monetary Policy Decision**	**5.25-5.50%**
Thu 13th	2:30pm	USD	PPI m/m	0.5%
Fri 14th	**5:00am**	**JPY**	**Bank of Japan Monetary Policy Decision**	**0.0-0.1%**
Tues 18th	**6:30am**	**AUD**	**Reserve Bank of Australia Monetary Policy Decision**	**4.35%**
Tues 18th	2:30pm	USD	Retail Sales m/m	0.0%
Wed 19th	8:00am	GBP	CPI y/y	2.3%
Thu 20th	**9:30am**	**CHF**	**Swiss National Bank Monetary Policy Decision**	**1.50%**
Thu 20th	10:00am	EUR	Flash Manufacturing PMI Flash Services PMI	47.4 53.3
Thu 20th	10:30am	GBP	Flash Manufacturing PMI Flash Services PMI	51.3 52.9
Thu 20th	**1:00pm**	**GBP**	**Bank of England Monetary Policy Decision**	**5.25%**
Fri 21st	8:00am	GBP	Retail Sales m/m	-2.3%
Fri 21st	3:45pm	USD	Flash Manufacturing PMI Flash Services PMI	50.9 52.9
Tue 25th	2:30pm	CAD	CPI y/y	2.7%
Wed 26th	3:30am	AUD	CPI y/y	3.5%
Fri 28th	2:30pm	CAD	GDP m/m	0.0%
Fri 28th	2:30pm	USD	Core PCE y/y	0.2%

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