Monthly Report

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Kyle Chapman
FX Markets Analyst
Ballinger Group

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Introduction – Broadening out

Broadening themes generate volatility

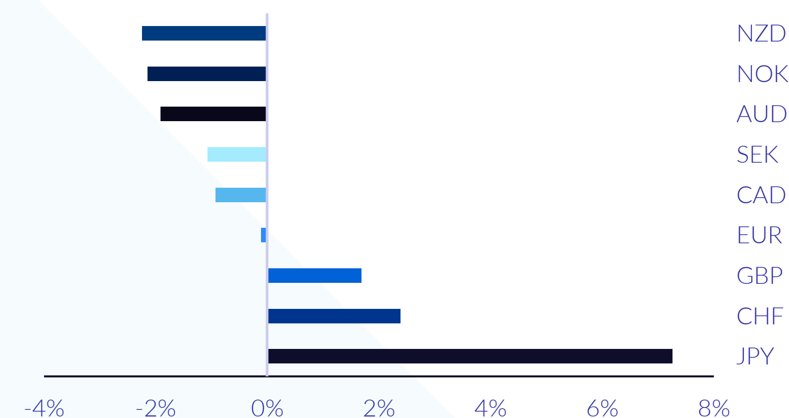
Politics had already begun to compete with rates for traders' attention in June, but the broadening trend in the factors exerting influence on FX kicked up another gear in July. It's adding extra layers of complexity and volatility that lie on top of an underlying story of central banks and interest rates and have at times been increasingly difficult to disentangle.

Politics grows in importance

A surge in US election uncertainty began with a disappointing debate performance by incumbent President Joe Biden, which eventually led to his withdrawal from the race after a three-week period of pressure from other Democrats. Add in an assassination attempt against his opponent, and markets were quickly repositioning themselves for a Trump presidency.

The 'Trump trade' reflected what economists saw as the likely consequences of a second term for the ex-president: deregulation, tax cuts, tariffs, lower immigration, higher inflation, and ultimately, higher rates. This translated into what became a repeatable market reaction that was layered upon Fed-related moves: a steepening of the Treasury curve, and brief rallies in stocks (particularly those related to energy or crypto), gold, and the dollar. The likelihood of a Trump win has since come down dramatically, however, since Kamala Harris' replacement of Biden.

By contrast, UK politics has been a tailwind for sterling. A new era of political stability and a general atmosphere of improved sentiment towards UK assets meant that the pound outperformed against the dollar despite stagnant yield spreads.



Risk and positioning trades favour the low yielders and the havens

Markets were not short of reasons to adjust risk exposure and cover stretched positions. An equity – mainly tech – selloff in the second half of the month, a spike in volatility, cross-asset gyrations driven by US election uncertainty, and the unwind of the carry trade triggered bouts of risk aversion that hit the Nordics (NOK, SEK), the Antipodeans (AUD, NZD), and emerging market currencies particularly hard.

Carry trade dynamics also made the yen and the franc some of the star performers in the G10. Rising bets on both rate *hikes* at the Bank of Japan and rate *cuts* at the Federal Reserve sparked a fall in USD/JPY that heavily squeezed yen shorts. This snowballed into a significant unwind of the carry trade that also lifted its main low-yielding peer, the Swiss franc.

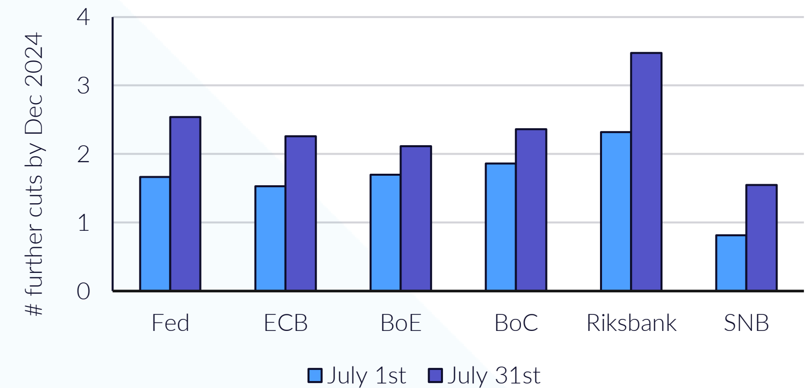
But rates continue to remain central

Rates narratives were still prominent, however, and short-term government bond yields fell at the fastest rate so far this year across most the G10, as traders continued to pile in on bets for interest rate cuts, particularly for the Federal Reserve. Japan is the obvious exception to this rule, with the Bank of Japan hiking for the second time this year.

While the ECB held steady, the Bank of Canada followed up with a second rate cut, this time with a sense of desperation about the weakness of the Canadian economy that sent the loonie crashing. As the US data turns softer and markets zeroed in on two or three policy moves from the Federal Reserve this year, expectations for late-year rate cuts have converged on a quarterly pace of cuts almost universally, and that means that two further rate cuts are now predicted in the UK, US, and eurozone.

Inflation and interest rates will again be closely watched in August, with central bank decisions in the UK, Australia, New Zealand, and Sweden. The Jackson Hole Symposium also presents an opportunity for US central bankers to give further signals on a September rate cut. Meanwhile, as the US election draws nearer, political developments should also continue to keep political volatility elevated.

Markets are looking for just over two more cuts from most major central banks this year



FX Reviews

USD

The downturn accelerates

The dollar index's 1.7% decline in July, and its temporary dip to a four-month low, were the result of three main factors: (i) softer-than-expected macroeconomic data that plunged the US Economic Surprise Index into deeply negative territory; (ii) the increasing airtime being given to the downside risks to the labour market and growth for Federal Reserve speakers; and (iii) rapid rises in the yen and the franc.

The US labour market has now weakened broadly back to pre-pandemic conditions - in Powell's words - and inflation has returned to a downward trajectory. Job openings were still on track despite an uptick, unemployment claims continue to trend higher, and the three-month moving average of jobs growth was at the lowest in over two years in June, thanks to 111k in downward revisions to previous months in the non-farm payrolls report. Core PCE inflation is now more clearly trending downwards, and the first negative month-on-month print for CPI since January 2023 dragged the annual figure down to 3.0%, from 3.5% in March.

The ISM services PMI was the most damning piece of data, with the indicative rate of expansion falling to a two-year low, and the employment index signalling *falling* employment. But most growth indicators suggested that the US economy is not falling off a cliff just yet. An acceleration in consumer spending lifted Q2 GDP growth to 2.8% and, while rather unsustainable given the deceleration in personal disposable income growth, suggests that a consumer slowdown is likely to be a more gradual process.

The overall picture is supportive of an eventual start to the Fed's rate cut cycle in September, and markets have even priced in a chance that it comes in the form of 50bps if it becomes clear that the Fed is behind the curve.

In fact, the softening in the labour market has made Fed speakers far more attentive to the other side of the dual mandate, and the downside growth risks posed by holding rates too high for too long. Policymakers have pivoted in unison towards rate cut optimism, buoyed by the recent inflationary progress. Ex-NY Fed President Dudley echoed a growing number of big voices calling for a rate cut in July, pointing out that the current state of the US economy is not what's important; rather, it's where it will be in one year's time. He did not get his wishes, as everyone expected, and now his argument would suggest that the decision to hold steady in July may come back to bite the Fed if it is forced to catch up later on.

Some have remained more cautious, however, and suggested that markets have overcooked their bets on rate cuts this year. Governor Waller, for example, acknowledged that recent progress should allow rate cuts this year, but argued that of the many possible scenarios, the one that results in two or three rate cuts this year is not necessarily the most likely.

The election became an increasingly important theme in July and is likely to be a significant driver for the dollar in the coming months as markets adjust their assessments for the winner of the election.

US economic data surprises are skewing to the downside

GBP

UK back in vogue

Sterling managed to surge around 1.6% despite only a marginal improvement in the front-end yield spread. Upside inflation surprises lifted the pound above the 1.30 level for a brief period but rising bets on an August rate cut subsequently dragged UK rates back in line.

It was a broad improvement in sentiment towards the UK that appeared to fuel the pound's net gains over the month. Labour's landslide election win surprised nobody, and that meant only a marginal immediate market reaction. Ultimately the boost proved to be more diffuse, as investors woke up to more stable political leadership, and economists welcomed both the prospect of closer ties to the EU and reforms that would put growth at the heart of policy. While time will tell if these pledges are delivered successfully and bring a meaningful long-term boost, sterling is at least benefitting from the relative quiet versus election risks in the US, France, and Germany, for example. Growth was a tailwind, too, with May GDP growth twice as high as expected and the manufacturing sector fuelling a stronger July PMI print.

The UK yield advantage surged temporarily, as services inflation again refused to nudge lower at anywhere near the pace anticipated by the MPC, and at 5.7% prevented CPI inflation from falling below the 2% target. Wage growth came lower but remained elevated, and there were few reliable signs of a loosening labour market to convince the Bank of England that persistence risks would subside.

> *"For a short time, the pricing out of the August rate cut, combined with the political and growth factors, was enough to lift GBP/USD to a two-year high, and above 1.30 for the first time since last summer. Speculators meanwhile built long positions – market bets that sterling will rise – to a record high, according to CFTC data."*

This tapered off, however, as markets progressively upped their estimates for the probability of a rate move in August to above 60%. This likely had more to do with a more global dovish repricing that had driven yields down across the G10, though, because there was very little go on in terms of rhetoric from BoE policymakers.

Perma-hawks Haskel and Mann reminded everyone just how hawkish they are, and Dhingra again called for the rate cuts that she has been voting for all year. Not much was forthcoming from the middle ground, though, beyond some cautious remarks from Pill, and that generated a lot of uncertainty. It was confidence in the forecasts for fading services inflation that policymakers eventually used to justify a cut on the first day of August, and markets are now pricing in a quarterly pace of policy easing going forward.

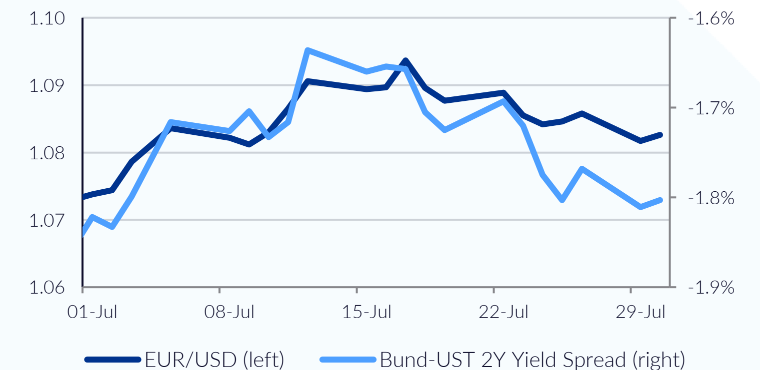
EUR

On pause

July was a month of two halves for the EUR/USD. It touched a four-and-a-half-month high as the US data came in weaker than expected and USD-EUR 2-year yield spreads touched their lowest since mid-Jan, but eventually gave up around half these gains as falling euro yields caught up with the move in the Treasury markets.

Starting with the French election, the three-way gridlock was, on balance, the least-worst case scenario for markets. Admittedly, it makes any attempt at reducing the deficit remarkably difficult to get through the National Assembly, but it also means that neither the far-right nor the far-left can fully implement the tax and spending plans that had spooked markets in June. OAT-Bund spreads have eased somewhat, although the fiscal-related weakness has not fully gone away for the euro and will remain a headwind.

The euro mirrored front-end yields in July



Policymakers switched off the taps for forward guidance at the July monetary policy decision to hold rates, although markets have a high conviction in their bets on two further rate cuts in September and December. Keen not to tie their hands, the ECB swung from almost explicitly promising a rate cut in June to refusing to comment on the potential for another in September.

Learning the lesson from the overpromising ahead of the June cut, the new desire for flexibility comes down to recent upside surprises in services inflation and wage growth, which have served as potent warnings about the likely bumps on the way to 2%. Core inflation – the most important guide for the ECB – unexpectedly rose to 2.9% in June and held there in July. Neither of these materially dented investor confidence in two further cuts this year, however. The key to the pace of cuts going forward will be whether the staff forecasts assess the underlying drivers to be the lagged effects that should fade in line with previous projections, or a more persistent threat.

While the labour market and wages remain strong, the cyclical outlook is getting noticeably weaker. Q2 growth was higher than forecast at 0.3%, but it was a 0.8% boom in Spain that masked a flagging German economy that returned to marginal economic contraction. The first set of PMIs in Q3 were even poorer than the disappointing end to Q2, and the composite index is now holding on by a thread to the expansionary side of the 50.0 marker at 50.1. Slowing demand growth is one of the factors that should keep ECB policymakers hopeful that 2% in sight, this and could hurt the euro if the economy stops growing, as it did in the middle of last year.

CHF

Low yielders rise

Despite there being very few domestic developments to nudge the franc in July, it strongly outperformed most of its major peers and rose to a four-month high against the dollar. There were two main channels of appreciation working in its favour.

First, while a softer-than-expected 1.3% CPI print for June cemented the case for further rate cuts from the SNB, the two-year yield differential moved over 30bps in the franc's favour against the dollar and over 20bps against the euro, for which a greater number of additional rate cuts were priced in.

Second, a broader unwind of carry trade strategies triggered short-covering and haven bids that significantly eased the selling pressure on the franc. The Swiss currency is commonly borrowed at cheaper interest rates to buy and invest in currencies with higher rates, such as the US dollar or the Mexican peso. The BoJ-led rally in the most popular low-yielding funding currency – the yen (0.1%) – spilled over into the franc (1.25%), and wider market jitters spurred a haven bid as political uncertainty, an equity selloff, and short-squeezing took hold.

The franc was largely externally driven in July and the domestic rates story stayed relatively stable. Low inflation and SNB forecasts for a continued downtrend have markets still betting on a further rate cut in September, and possibly one more in December.

JPY

Relief in Tokyo

July marked a rapid turnaround in the yen's fortunes and its first month of gains this year, rising over 7% as the contrast between the Fed and the BoJ's trajectories sparked an unravelling in the market's 17-year high short positioning and the carry trade.

The yen's rebound began with some fresh intervention from Tokyo, whose new approach involved piggyback on the dollar's post-CPI decline. The MoF knows that it can't turn yen weakness when driven by fundamentals, and it tends to pick times when it thinks it can facilitate a genuine market rally. It saw surging optimism about Fed rate cuts as its opportunity and, as hope then grew that the BoJ would continue hiking at the end of the month, the yen's recovery snowballed into a rapid squeeze on stretched short bets and an unwind of the crowded carry trade, which involves borrowing yen cheaply to buy higher-yielding assets.

Japanese politicians and economists were all but begging the BoJ to follow through and boost the yen, despite continued signs of domestic economic weakness and the frailty of Japan's target inflation achievement. The BoJ delivered, hiking its rate by 15bps and announcing that it would halve its monthly bond purchases by Q1 2026. This took USD/JPY below the 150 mark for the first time since March, with markets betting on a material compression in the enormous rate gap that has pinned the yen to extremely low levels.

SEK

Souring mood

A sharp recovery in the last few days prevented the krona from notching its worst month against the euro so far this year in July, ultimately falling around 2% as disinflation accelerated and risk appetite soured.

The Riksbank's inflation battle is almost won, and it now looks set to cut rates at a healthy pace. After around four months of stable inflation readings in the 2.0-2.5% range, headline CPIF inflation fell far more than expected to 1.3%, and core inflation drifted to within a whisper of the 2% target at 2.3%. There is virtually no question about a further three rate cuts from the Riksbank this year now. Krona weakness is unlikely to be an obstacle in the near-term either, given that it is at stronger now than the levels at which policymakers barely nodded to it when it opted to cut for the first time back in March.

That did not jolt markets too much, however, and it was external dynamics that drove most of the krona's decline. the tech stock selloff, political uncertainty, a carry trade unwind, and a spike in cross-asset volatility bruised both SEK and NOK. The Nordics are some of the most illiquid and risk-sensitive currencies in the G10, and they are therefore often most susceptible to sharp declines when the markets get jittery.

CAD

Macklem to the rescue

A second rate cut, hints at more, and general weakness in the Canadian economy helped the loonie to break an unfortunate six-year record in July, depreciating against its US counterpart for nine consecutive days.

Data continued to illustrate the strong impact of high rates on demand and the labour market. Employment growth moved into reverse, the unemployment rate rose again to 6.4%, and May's inflationary uptick was wiped out by an all-around soft June report. The BoC's Business Outlook Survey also again confirmed that demand-driven inflationary pressures are subsiding.

While the macro picture meant that the second consecutive rate cut surprised nobody, it was the extent of the dovish pivot that shocked the rates markets. In June, policymakers had warned that cutting too fast could jeopardise progress made on inflation. In July, they instead warned that inflation might fall too far and drag the bruised economy down with it. GDP growth was admitted to be lagging population growth, and the expanding labour market was said to be generating 'excess supply' that is lowering price pressures. Further cuts were signalled, conditional on the data, and the markets are now pricing in between two and three more by the end of the year.

> *"We need growth to pick up so inflation does not fall too much."*
>
> *- BoC Governor Tiff Macklem*

AUD

Hikes no longer

The Aussie's six-month high never stuck, and it eventually sank 3.5% from those levels as risk-sensitive G10 sold off and traders trimmed bets on a restart to the RBA's hiking cycle.

The data picture skewed dovish enough to cool expectations for rate rises, but not enough to rule them out completely. While employment growth came in strong at 50.2K, quarter-on-quarter core inflation came in cooler than expected at 0.8%. While that increased the likelihood that the RBA could justify holding steady this month, headline year-on-year CPI is still at 3.8% and too little progress is being made. Nevertheless, the data accelerated a downward move for the Aussie that mirrored the risk-off selloffs in the Nordics.

Economic Calendar – August 2024

Alongside four policy decisions, August brings the annual Jackson Hole Symposium, when the world's central bankers converge on Wyoming.

Date	Time (CET)	Currency	**Event**	Previous
Thu 1st	13:00pm	GBP	Bank of England Monetary Policy Decision	5.25%
Fri 2nd	8:30am	CHF	CPI y/y	1.3%
Fri 2nd	2:30pm	USD	Non-Farm Payrolls m/m	206K
Tue 6th	6:30am	AUD	Reserve Bank of Australia Policy Decision	4.35%
Fri 9th	2:30pm	CAD	Employment Change m/m	-1.4K
Tue 13th	3:30am	AUD	Wage Price Index q/q	0.8%
Tue 13th	8:00am	GBP	Claimant Count Change Average Earnings Index 3m/y	32.3K 5.7%
Tue 13th	2:30pm	USD	PPI m/m	0.2%
Wed 14th	4:00am	NZD	Reserve Bank of New Zealand Policy Decision	5.50%
Wed 14th	8:00am	GBP	CPI y/y	2.0%
Wed 14th	2:30pm	USD	CPI y/y	3.0%
Thu 15th	3:30am	AUD	Employment Change m/m	50.2K
Thu 15th	8:00am	GBP	GDP m/m Prelim GDP q/q	0.4% 0.6%
Thu 15th	2:30pm	USD	Retail Sales m/m	0.7%
Fri 16th	8:00am	GBP	Retail Sales m/m	-1.2%
Mon 19th	9:30am	SEK	Riksbank Monetary Policy Decision	3.75%
Tue 20th	2:30pm	CAD	CPI y/y	2.7%
Thu 22nd	10:00am	EUR	Flash Manufacturing PMI Flash Services PMI	45.6 51.9
Thu 22nd	10:30am	GBP	Flash Manufacturing PMI Flash Services PMI	51.8 52.4
Thu 22nd	3:45pm	USD	Flash Manufacturing PMI Flash Services PMI	49.5 56.0
22nd - 24th	All day	All	Jackson Hole Symposium	
Wed 28th	3:30am	AUD	CPI y/y	3.8%
Fri 30th	11:00am	EUR	Eurozone CPI y/y	2.6%
Fri 30th	2:30pm	CAD	GDP m/m	0.2%
Fri 30th	2:30pm	USD	Core PCE Price Index m/m	0.2%

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Group Headquarters:
65 Curzon Street, Mayfair, London, W1J 8PE

T: +44 (0) 20 3869 1800

Malta
Fino Buildings, Level 3, Trip I-Imdina, Zone 4,
Central Business District, Birkirkara, CBD 4010, Malta

T: +356 2033 0130

E: info@ballinger.group

T: ballinger.group