Monthly Report

September 2024

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Contents

Introduction – A flashing green light for rate cuts

The beginning of a structural dollar decline, or a rebound ahead?

As confidence continued to grow in the US disinflationary story and the data cemented a switch in focus to the deteriorating labour market, rates markets spent August ratcheting up their expectations for Federal Reserve rate cuts over the next twelve months. That made August a story of broad dollar weakness, with the index falling 2.3% in its worst month so far this year.

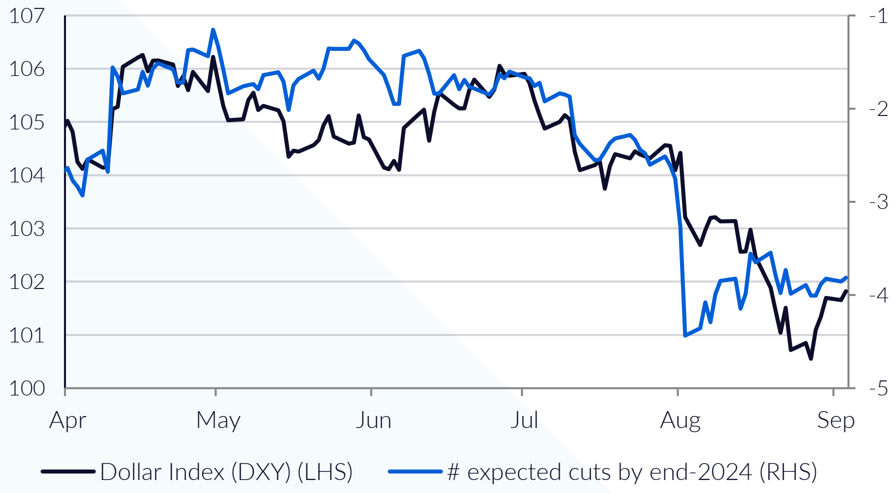
Market positioning has undergone a monumental change over the past few months. Back in June, Fed policymakers were trimming their forecasts to just one cut this year and predicted that unemployment would still be at 4% by year-end. Only two months later, unemployment is already at 4.3% and Powell has formally announced that ‘the time has come’ to cut rates.

While the US economy is still growing at a healthy clip and the soft July jobs number is not necessarily as weak as it seems, the deterioration in the labour market data has come more quickly than most were expecting, and the Fed hit a turning point with a huge dovish pivot that we are not yet seeing to such a degree in its main peers. Markets are now expecting the equivalent of four 25bps rate cuts from the final three meetings of the year. For the dollar’s drop to stick, the Fed will need to deliver on that.

High betas streak ahead

The risk-sensitive G10 stood to benefit the most from these developments in global risk sentiment. US yields fell, but most importantly the extra rate cuts are seen to be coming in the context of a global economic soft landing. The G10 currencies with the highest exposure to measures of market risk sentiment – SEK, NOK, AUD, NZD – all gained significantly.

Rising Fed rate cut bets have driven a decline in the broad dollar



That's despite rate cuts for both top performers - NZD and SEK. In New Zealand, the RBNZ completed a full 180-degree turn from only three months earlier when it was still signalling further hikes, as it cut for the first time in anticipation of a sub-3% CPI print in Q3. And in Sweden, a Riksbank endorsement of market pricing for three further rate cuts failed to sustainably weigh on the krona.

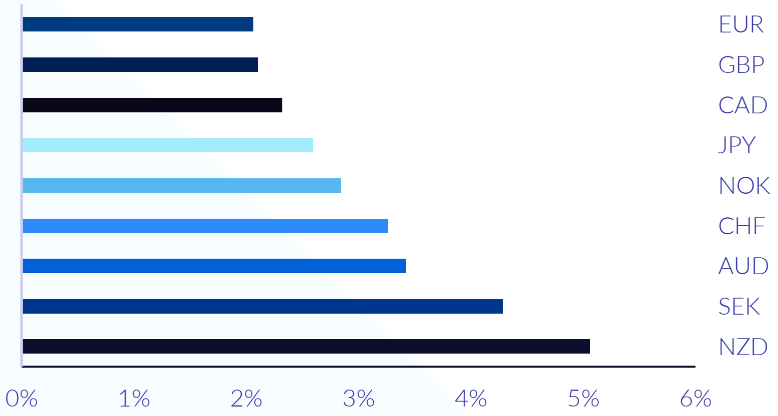
A carry capitulation

It is ironic that a surge in risk assets occurred in a month that also saw a historic spike in the VIX – Wall Street's 'fear gauge' – comparable to Lehman and Covid, alongside a 15-month high in currency volatility and a temporary selloff in equities. The trigger was relatively benign: the combination of a surprisingly hawkish Bank of Japan hike and a weak US non-farm payrolls print. But the vast amount of funds ploughed into the yen-funded carry trade over the past few years had created something of a coiled spring that snapped back once a yen rally rapidly turned these positions loss-making. At its peak, the Japanese yen had gained 12% versus its year-to-date low near 162. The low-yielding Swiss franc also gained some strong momentum on the back of a compression in the yield differential to the US.

A central bank bonanza

Rate cuts are now either well underway or imminent for most central banks, and so far, it has brought the cooling dollar that many had predicted at the beginning of the year. A raft of central bank decisions in September is almost certain to include the first Federal Reserve rate cut of the cycle, alongside further cuts for the Bank of Canada, the ECB, and the Riksbank. The Bank of England is considered much more likely to take a pause, given the marked stickiness in UK inflation, and the Norges Bank and Reserve Bank of Australia still are not ready to land their first cut, although some inflationary progress means that markets have at least now ruled out further hikes for the latter.

G10 August Performance vs USD



FX Reviews

USD

The time has come

The stars aligned for a broad, sustained dollar selloff in August, as a soft US jobs report set in motion both a striking build-up of Fed rate cut bets and a substantial unwind of the yen-funded carry trade.

That's because the Fed now sees victory on inflation and, alongside the market, has switched its primary focus to the economic activity data and the labour market. While there remains a need to be attentive to the upside risks, inflation is broadly considered to be yesterday's problem, now that underlying labour market pressures have eased considerably. CPI came in cooler than expected, at 2.9%, and month-on-month price growth was driven almost exclusively by shelter and auto insurance, both of which are components that lag behind and for which the leading indicators signal that they are likely to come down over time.

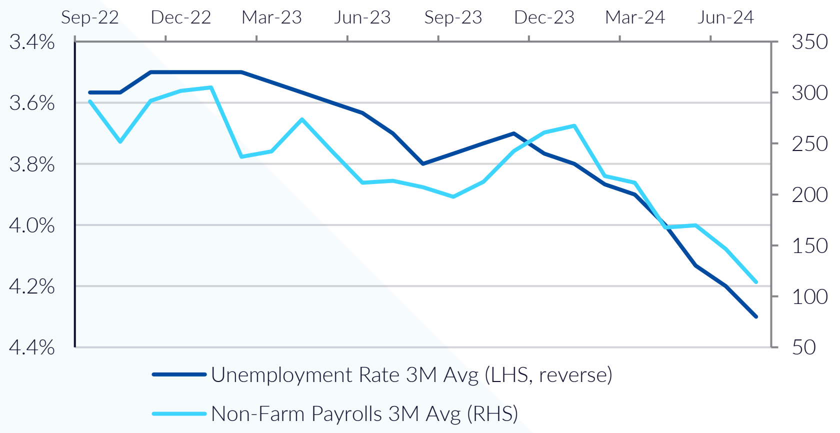
There is a lot of debate surrounding the state of the labour market and the risk of recession. Unemployment has climbed considerably, from 3.4% last year to 4.3% in July, and that has introduced a significant amount of slack in the US economy. But delving deeper, it is labour supply growth through immigration and cooling hiring that are driving the increase, and there are few signs for large layoffs, as would be typical in a recession. The marked cooling in the single 114K July jobs figure was never the apocalyptic warning sign that it was immediately interpreted to be, when at one point markets were pricing in an emergency intermeeting rate cut. It's a data point that is well known for subsequent revisions and was likely warped by Hurricane Beryl disruptions.

US economic growth is evidently still healthy and running at a >2% pace, but cracks are appearing that suggest that it cannot be sustained indefinitely. Consumer spending growth is running out of fuel and continues to outpace disposable income growth, squeezing personal savings rates to low levels not sustained since just before the GFC. And owing to the long lags with which policy moves filter through to the real economy, the Fed has to act with the *future* state of the economy and the labour market in mind, which tend to deteriorate in a non-linear manner when they begin to shift.

Fed Chair Powell reckons he can cut rates quickly enough to prevent that from taking hold, and he used his speech in Jackson Hole to claim that 'the time has come' to begin cutting rates. A dovish repricing of the US rates curve underpinned the dollar's horror performance in August. A rate cut is now priced at a certainty for September, with a near 30% chance that it comes in the form of a 50bps move. The market implies 100bps cuts in the final three meetings of this year, followed by a consecutive string of cuts that takes the Fed back to neutral, somewhere around 3.00%.

Without a significant disappointment in this month's non-farm payrolls data, 25bps cut will remain the base case. While there is an argument to be made about whether the Fed could, or should, have moved in July, a catch-up 50bps cut would signal panic about the US economy and risk some unnecessary market turmoil. Powell kept the door open, but more cautious commentary from Raphael Bostic, for example, shows that there could be some stiff resistance within the FOMC.

The weakening in the US labour market is accelerating



GBP

A sterling summer

The Bank of England cut rates for the first time in the cycle at the beginning of August, sapping sterling's strength by 1.5% in the first week. Yet it eventually had its best month since November 2023, as it reached its highest levels against the dollar in almost two and a half years.

> *In short, the expectation underpinning sterling's August performance is that the Bank of England is set to cut at a significantly slower pace than the Federal Reserve.*

While labour market nerves in the US have some punting on a rapid string of rate cuts well into next year for the Fed, markets are broadly betting on an unhurried quarterly pace of cuts in the UK, where stickiness in services inflation and a clouded view of jobs dynamics point to a more prudent path. The stark contrast between the central bank bosses' speeches in Jackson Hole encapsulates this well – only an hour after Powell announced that 'the time has come' for rate cuts after 'unmistakable cooling', Bailey called it 'too early to declare victory' and argued that policy will need to 'remain restrictive for sufficiently long … the course will therefore be a steady one'. The BoE is not yet ready for the victory lap that the Fed enjoyed.

The vote to cut rates was tight, at 5-4, and the clear conclusion was that it would only be the beginning of a cautious path of readjustment, rather than being a watershed meeting that would open the floodgates for rapid policy easing. The decision was described more as a tweak to policy restrictiveness, and the overall argument for doing so was not that the intermeeting data had finally tipped the balance, but that confidence in the medium-term forecast for 2% inflation had become sufficient to trim 25bps off Bank Rate. The only forward guidance was that the MPC would move forward neither too quickly nor too slowly.

While we did get some tentative disinflationary progress in the data following the decision, they come with several caveats. Services inflation fell sharply to 5.2%, but the drop was driven by volatile components like airfares and hotels, which are also known to be highly dependent on the day in the month that samples are taken. In the labour market report, ex-bonus wage growth fell to 5.4% and – more shockingly – unemployment contracted sharply from 4.5% to 4.2%. Arguably the biggest lesson learned from that, however, is that the poor response rates for the Labour Force Survey continue to be a significant obstacle clouding the state of the labour market.

Meanwhile, the growth picture remains a tailwind and UK sentiment has retained some good momentum. The British economy grew by 0.7% in Q1 and 0.6% in Q2 and, while likely to slow in the second half of the year, has sharply contracted the growth differential with the US.

EUR

An almost reluctant rally

It almost feels as if the 2.4% rise in EUR/USD in August came *despite* some of the euro's macro fundamentals, having been driven primarily by falling US rates. Take the dollar out of the equation, and it was the worst performing currency in the G10.

Investors became pretty optimistic about the eurozone economy earlier in the year. It escaped recession when the UK did not in Q4 2023, and the PMIs hinted at a decent recovery when they were suddenly lifting out of 2023's long slump. However, there has been a marked downshift in these rosy expectations over the past few months. Growth returned this year but was still weak in the first half, particularly in Germany where activity contracted by 0.1% in Q2. The confidence surveys are a difficult read – since June, the ZEW index, for example, has erased all the progress made this year. Some of this captured the volatility spike early in the month, but there is growing angst about monetary policy uncertainty, the drag from China, and geopolitical tensions in the Middle East.

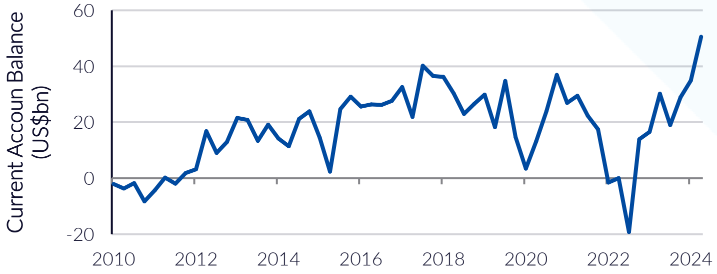
On the one hand, these growth concerns are putting downward pressure on the euro, particularly if they tempt the ECB to start cutting rates more quickly. On the other, cuts should bring some relief, and an economic recovery could bring some good upside. Markets are expecting the ECB to cut either two or three times more before the end of the year. The September rate cut is fully priced, and then there's around a 60% chance that policymakers take a pause in October before going again in December.

Developments in August were broadly supportive of further cuts. Headline inflation fell to 2.2%, core inflation cooled slightly to 2.8%, negotiated wage growth fell to 3.6% in Q2, the cyclical outlook weakened, and the euro appreciated, all of which will put pressure on officials to take the policy rate 25bps lower in the September meeting. Several policymakers have been vocal about endorsing the market's implied rate path, with the likes of Rehn claiming that the steadily increasing growth risks make a solid argument for moving rates into less restrictive territory on their own.

There is one sticking point, however: services inflation. August's uptick to 4.2% was largely pinned down to an Olympics-related flare-up, but there is no shying away from the fact that it has been glued to the 4.0% level for the past ten months now. As a result, Schnabel's argument that 'the pace of policy easing cannot be mechanical' and that 'policy should proceed gradually and cautiously' suggests that a more hawkish camp on the Governing Council could slow the pace of cuts until the cooling in wage growth more evidentlly filters through to core inflation.

In the background, it is worth mentioning that the eurozone current account continues to be a huge tailwind for the euro, with June data released last month showing the biggest surplus on record, having come incredibly far from 2022's energy-led terms-of-trade crisis.

The eurozone current account surplus is at record levels



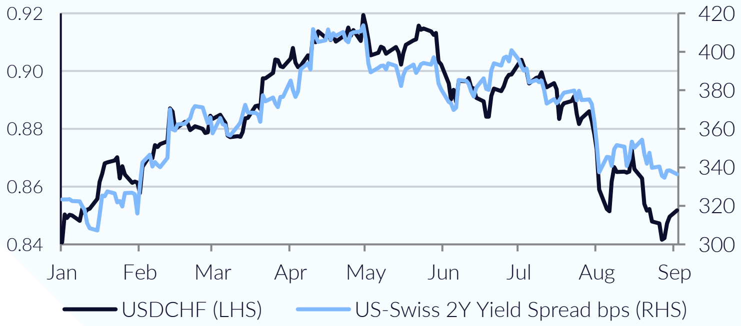
CHF

Yen proxy

With the outlook for the Swiss National Bank holding steady throughout the month, the franc traded as a near-perfect proxy for the carry trade, the yen, and US short-term yields. And that was enough for its best month against the dollar since last year, rising nearly 4% and touching a seven-month high.

Inflation printed as expected at 1.3%, endorsing the call for two more rate cuts this year, and there was little domestic newsflow of note beyond that. That meant that it tracked its main low-yielding peer – the Japanese yen – very closely for most of August, rallying strongly at the beginning as the yen surged. While much of these gains were shed by mid-month, rising bets on US rate cuts then took it back towards its highest point this year. Some have argued that the franc has overshot levels justified by short-term yield spreads, and it could be at risk of some tempering without further fuel, or if the SNB decides the franc is too strong for its liking and turns to FX intervention to buoy inflation.

USD/CHF has very closely tracked yield spreads



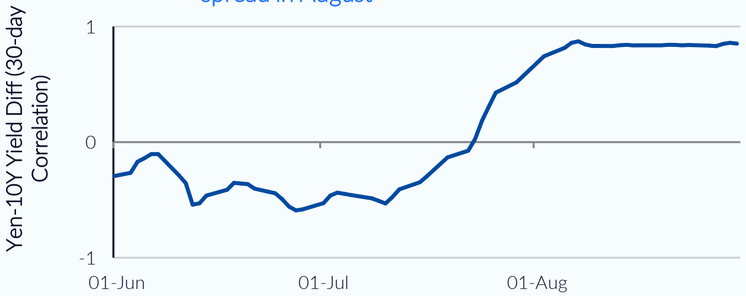
JPY

Macro fundamentals retake the wheel

August saw USD/JPY reconnect to its main macro driver of the last few years: the 10-year US-Japan yield differential (30-day correlation illustrated in the graph below). After a surprise BoJ hike and weak US payrolls, the imminent prospect of a rapid shrinking of that differential triggered a sharp yen rally, leading to the squeezing out much of the excess weakness created by the carry trade. The yen peaked at a seven-month high at 142.

The carry trade broadly involves selling cheaply borrowed yen to buy high-yielding assets and profiting from the difference. When popular, it adds a significant amount of selling pressure. But it is only profitable in periods of low volatility, and quickly becomes loss-making when the yen rallies, and its momentum snowballed as speculators covered their losing trades. CFTC data showed that net short-term positioning for yen – i.e. which direction that speculative traders are betting on – flipped from extremely short historically (poised for further weakness) to long for the first time in four years (betting on appreciation).

The yen regained its strong correlation to the 10Y yield spread in August



SEK

Risk backdrop dominates

Domestic rate developments seemed to matter little again for the krona in August, and instead it outperformed on an improvement in wider risk conditions despite a dovish Riksbank.

Investor risk appetite has really dominated compared to yield differentials as a driver for the Nordics this year, and the impending prospect that widespread policy easing will boost the global economic story more than offset the increasingly dovish picture in Sweden. The rates story could begin to take on increased importance, however, with it unclear how much more there is to gain from the soft-landing story.

The CPIF release further confirmed that there is little excess inflationary pressure to speak of in the Swedish economy, with core inflation falling further to 2.2%. Some more softness was to be found in the Q2 GDP growth figure which, although eventually revised to only a 0.3% contraction rather than 0.8%, underlined the extent of the urgency to bring rates down and stimulate spending.

As a result, the market upped its cut bets and at one point pencilled in the equivalent of more than five 25bp moves in the final three meetings of the year, before being tempered to around three. The Riksbank cut again to 3.50% and all but endorsed market pricing with explicit guidance of two or three more moves this year.

CAD

Flattered by its neighbour

The Federal Reserve easing trade turned the tide for loonie in August, with USD/CAD shedding nearly 3% in a slow and steady decline as the 2-year yield spread shrank to its lowest in 3.5 months.

While the domestic data flow was predictably quite weak, none of it really changed the economic narrative. The Bank of Canada has its head down in rate cutting mode, and policymakers are well aware of the negative employment growth, sluggish GDP figures, and the strong disinflationary trend. Rapid immigration continues to create slack through labour supply growth, and it is the only thing keeping GDP on an upward trajectory right now.

While there have been a few wobbles in the inflation data in recent months, it was back on course across the BoC's core measures in July, which all now sit well within the 1-3% target range. The market is predicting another four cuts at the next four meetings, and then an extra two by mid-2025 as policymakers switch to a quarterly pace.

However, there were some positives for the loonie. The 0.4% month-on-month rise in CPI is worth keeping an eye on, for example. Core retail sales defied expectations for a -0.2% decline, instead rising by 0.3%. Unemployment also slipped back to 6.4% from 6.5%, although that must be put in the context of a rise from 5.0% early last year. But with jobs growth in reverse and inflation back on track more quickly than expected, it's difficult to argue that CAD's rally had much to do with Canada itself.

AUD

Cutting bias returns

The Aussie was one of the hardest hit by the volatility spike and equity selloff in the first week of August, briefly touching an 8-month low in the chaos. That soon flipped to a 7-month high, however, even as markets switched back to a cutting bias for the RBA, with the Aussie catching tailwinds from a rising yuan and improving risk conditions.

Cooling wage growth, rising unemployment, and another downward move in inflation to 3.5% all helped to cement the switch from a bias in the market's year-end expectations from higher to lower rates compared the current 4.35% benchmark. A rate cut by December is priced at around 30%, but that's something that RBA Governor Bullock has explicitly disagreed with. The RBA remains quite hawkish, and the lagged start to its cutting cycle should continue to keep AUD buoyed.

Economic Calendar – September 2024

There are eight G10 central bank decisions in September, with the Federal Reserve set to deliver a long-awaited first rate cut on the 18th.

Date	Time (CET)	Currency	**Event**	Previous
Tue 3rd	8:30am	CHF	CPI y/y	1.3%
Wed 4th	**3:45pm**	**CAD**	**Bank of Canada Policy Decision**	**4.50%**
Wed 4th	4:00pm	USD	JOLTS Job Openings	8.18M
Fri 6th	2:30pm	CAD	Employment Change m/m	-2.8K
Fri 6th	2:30pm	USD	Non-Farm Payrolls m/m	114K
Tue 10th	8:00am	GBP	Claimant Count Change Average Earnings Index 3m/y	135K 4.5%
Wed 11th	8:00am	GBP	GDP m/m	0.0%
Wed 11th	2:30pm	USD	CPI y/y	2.9%
Thu 12th	**2:15pm**	**EUR**	**ECB Policy Decision**	**3.75%**
Thu 12th	2:30pm	USD	PPI m/m	0.1%
Tue 17th	2:30pm	CAD	CPI y/y	2.5%
Tue 17th	2:30pm	USD	Retail Sales m/m	1.0%
Wed 18th	8:00am	GBP	CPI y/y	2.2%
Wed 18th	**8:00pm**	**USD**	**Federal Reserve Policy Decision**	**5.25-5.50%**
Thu 19th	3:30am	AUD	Employment Change m/m	58.2K
Thu 19th	**10:00am**	**NOK**	**Norges Bank Policy Decision**	**4.50%**
Thu 19th	**1:00pm**	**GBP**	**Bank of England Policy Decision**	**5.00%**
Fri 20th	**6:30am**	**JPY**	**Bank of Japan Policy Decision**	**0.25%**
Fri 20th	8:00am	GBP	Retail Sales m/m	0.5%
Mon 23rd	10:00am	EUR	Flash Manufacturing PMI Flash Services PMI	45.6 53.3
Mon 23rd	10:30am	GBP	Flash Manufacturing PMI Flash Services PMI	52.5 53.3
Mon 23rd	3:45pm	USD	Flash Manufacturing PMI Flash Services PMI	48.0 55.2
Tues 24th	**9:30am**	**SEK**	**Riksbank Monetary Policy Decision**	**3.50%**
Tue 24th	**6:30am**	**AUD**	**Reserve Bank of Australia Policy Decision**	**4.35%**
Wed 25th	3:30am	AUD	CPI y/y	3.8%
Thu 26th	9:30am	CHF	Swiss National Bank Policy Decision	1.25%
Fri 27th	2:30pm	CAD	GDP m/m	0.0%
Fri 27th	2:30pm	USD	Core PCE Price Index m/m	0.2%

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