Monthly Report

October 2024

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Introduction – Soft landing conviction and Chinese stimulus lift FX

Soft landing nirvana

The primary theme of September involved the market raising its conviction in the Federal Reserve delivering a frontloaded cutting cycle that will get ahead of a serious downturn in the US economy. That narrative was supportive of risk assets across financial markets – equities hit fresh highs, risk-sensitive and emerging markets FX rallied, corporate credit spreads tightened, and developed market yields fell. It was naturally a dollar-negative mix, both through the rates channel and through weakened safe haven demand.

Inflation is not completely won everywhere, but there is enough disinflation for rates to be firmly on the way down, and central banks continue to believe that the elusive 'soft landing' is within reach. The Federal Reserve thinks it can stay well ahead of a deterioration in the labour market, and the FOMC calibrated rates 50bps lower as a first step in that direction. Meanwhile, the UK economy is doing just fine for now. For some others, however, there is more urgency, including in Canada, Sweden, and perhaps the ECB. This context has significantly increased the market's sensitivity to the labour market and growth data, while reactivity to inflation prints has diminished for as long as it continues to give a green light for rate cuts.

At the same time, some strong US data, hawkish pushback from Powell, and idiosyncratic weakness elsewhere did put a dampener on the risk rally. The Canadian dollar failed to capitalise at all, thanks largely to tight correlations between expectations for the Fed and the Bank of Canada. And EUR/USD's bearish drivers seemed to multiply, with bleak growth prospects and an accelerated ECB easing cycle cancelling out

EM currencies have rallied this summer

almost all the USD-led gains.

China sentiment rallies

A last-minute addition to the upward drivers for risk appetite involved some big stimulus announcements in China. Leaders finally reached breaking point on the poor post-pandemic economic recovery and shifted efforts from piecemeal actions to enacting the ‘necessary spending’ to hit the 5% target. The measures included a slash to mortgage rates, a liquidity fund for the stock market, a reduction to bank’s reserve requirements, and 2tn yuan in special bond issuance.

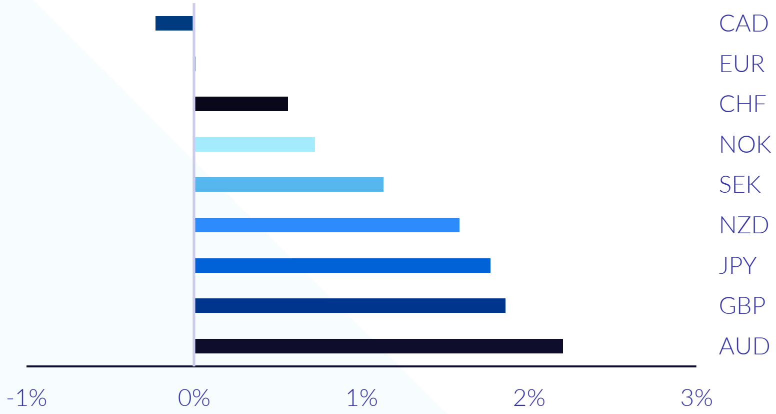
This was great for the yuan, China-linked currencies like AUD and EM Asia, and growth sentiment in general. But, while it is likely to lift the growth figures over the next few years, there is also plenty of scepticism over whether the stimulus can really solve the structural issues of oversupply, weak demand, and ageing demographics. Without results, this sentiment boost will fade.

There are reasons to be cautious

While the mood remains upbeat, there are several key risk events that could shake things up in the final quarter. The dollar is at a fork in the road ahead of the US election, where each candidate’s policy mix represents a profoundly different path for the dollar. In short, a Harris win should trim the greenback’s gains, while a full implementation of Trump’s campaign promises through a full sweep could ramp up pressure on inflation and keep the dollar bid.

However, if you ask the largest financial institutions, as the Bank of England did, the biggest risks are geopolitical. The highest proportion of firms ever sees geopolitics as the predominant threat to financial stability, something that the BoE thinks is not adequately priced into risk assets and could lead to a sharp correction to ‘stretched’ equity markets.

G10 September Performance vs USD



FX Reviews

USD

Quick off the blocks
Another drop in US yields and a 50bp rate cut knocked the dollar index down another 0.9% in September, as traders priced in a frontloaded Federal Reserve rate cutting cycle.

Ahead of the decision, Bloomberg analysis indicated that traders were more divided on the outcome than they had been since 2007. An uptick in month-on-month core CPI to 0.3% had initially erased expectations for the Fed to kick off with a 50bp cut, but it was soon priced back in at a coin toss, after some articles from well-informed WSJ and FT journalists suddenly suggested there was still an openness to the supersized move at the FOMC.

The eventual 50bp cut came with a significant amount of verbal cushioning and a wholehearted endorsement of the soft landing narrative: that a steady adjustment to rates would fix inflation while preventing he labour market from tipping into a recession. The clearest example of that was in the economic projections, which saw unemployment only rising a touch higher to 4.4% and staying there indefinitely. This arguably goes against conventional economic logic, which suggests that the labour market tends to deteriorate in a non-linear fashion in this situation.

In the statement and the press conference, Powell characterised the unusually large first move as a 'recalibration' afforded to them by the progress on disinflation, which would help to get ahead of further labour market weakness. He was open to more 50bp moves but was keen to stress that it is not necessarily the default pace in future.

There is very little unity among policymakers on the path going forward, however. Goolsbee wants 'many more' rate cuts as a preventative move to shore up the labour market, arguing that it becomes impossible to catch up once the economy tips into recession. Meanwhile, Bostic appeared to disagree, saying that a 'mad dash' is unnecessary. By the end of the month, the data even convinced Powell to push back against market pricing for further 50bp hits, explicitly signalling two more 25bp cuts this year. That came after upward revisions to personal income and the personal savings rates for Q2, which suggested that the consumer may have more left in the tank than previously thought.

Bets on a rapid easing cycle were trimmed slightly as a result, but the market is still pricing in another 65bps by the end of the year, and a return to neutral – now seen as below 3.0% - by the second half of 2025. There is room for a repricing in both the hawkish and dovish directions here, depending primarily on the jobs data.

The Fed's rate path will naturally remain central, but a few things are about to become critical for the dollar over the next quarter. The first is the November election, where most expect inflationary Trump policies would strengthen the dollar in the short term. And the second is the geopolitical situation in the Middle East, where we have already seen flickers of a dollar safe haven bid that would become a lot more pronounced in a wider regional war.

The market-estimated terminal Fed funds rate has shrunk to below 3%

GBP

Pound breaks ground

Sterling hit successive highs in September, pushing through the 1.34 and 1.20 handles on GBP/USD and GBP/EUR for the first time since 2022.

> *It boils down to UK yields pricing in a far more cautious approach to rate cuts from the Bank of England relative to its major peers – the UK simply lacks the privilege of the Fed and the ECB on the inflationary side.*

While the trend is evidently pointing in the right direction, underlying inflation in the UK is yet to deliver the same progress that we have seen in the US and the eurozone. It has always been a step or two behind.

The data last month largely kept this sterling-supportive narrative intact. The 5.6% services figure was hard to ignore, and wage growth ex. bonuses did cool, but only to 5.1% - both remain well clear of levels associated with sustained 2% inflation. The scope for volatility in services inflation is well-known, with categories like restaurants and hotels frequently affected by outliers and the dates used to take the sample, so excluding some of these makes the picture more promising. But that is quite convenient, of course – it needs to translate into genuine progress on the reported figures.

So the underlying trend in domestic price pressures is softer, but it is too slow to match the Fed's pace. Policymakers were widely expected to take a pause in September after first cutting in August, as they did, but what was surprising was just how decisive the decision was. At 8-1, the vote split was virtually unanimous (Dhingra's cut vote can always safely be relied upon), and the policy statement involved further discussion on the still-alive worst-case scenario where inflation has become a more structural issue, rather than one easily squeezed out with current policy restrictiveness. The likes of Greene, Mann, and Bailey were soon separately calling for a 'gradual' and 'steady-as-she-goes' approach.

Thanks to falling US yields, UK gilts now provide the highest yield in the G10, and the spread over US two-year Treasuries has widened from -65bps to more than 30bps in just the last six months.

Politics and growth are likely to be key factors in Q4. The labour market is cooling slowly but remains strong, and the PMI surveys suggest that the UK economy is chugging along at a reasonable pace. However, growth is likely to slow into Q3 and Q4, and that is a view validated by the recent 0.0% GDP m/m prints. Ahead of Labour's first budget in October, Starmer's gloomy economic rhetoric and the prospect of tax hikes have unwound the progress made in the confidence surveys so far this year. However, Labour's strategy is also likely to involve some edits to the fiscal rules to allow for more capital spending and investment, something the IMF and investors have both been calling for.

EUR

ECB to the rescue?

A tough macro environment is keeping a lid on the euro. Cooling inflation lifted the implied probability for an October rate cut from near zero to 90%, the private sector has slipped into contraction, confidence is in a trough, and the drag from politics is worsening. An improving risk environment, rising optimism about China, and a broadly weaker dollar appear to be the only things keeping it above water.

Last month's headwinds were multiple. Starting with growth, the September PMIs saw the eurozone economy diverge further from the UK and the US, falling into contractionary territory for the first time since February, while ZEW economic sentiment for Germany fell to a depressingly low 3.6. The German economic malaise was epitomised by VW's decision to close plants for the first time ever. Ex-ECB head Draghi drew investor attention to the longer-term, structural issues facing the eurozone too, with a damning assessment on the need for investment in productivity growth.

On the inflation side, there is now little doubt that disinflation is at an advanced stage. CPI inflation undershot the consensus quite dramatically in France and Germany, and the entire bloc posted its first sub-2% inflation print since 2021. Energy base effects flattered the headline, admittedly, and core inflation cooled only slightly, but the trajectory remains as evident as ever.

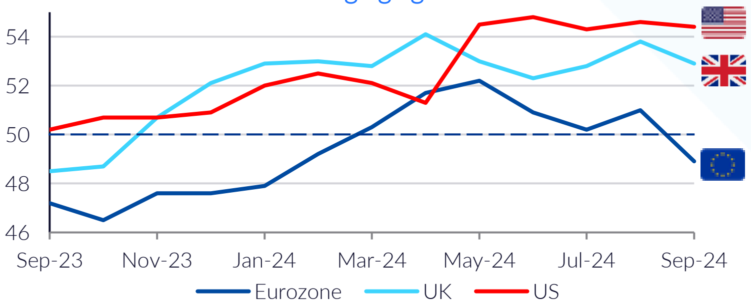
And finally, in the world of politics, confidence in a French budget turnaround has worsened so much that its government debt is beginning to sit within the 'periphery' bracket, with the risk premium on French 10-year government bonds now rivalling Spain's. The rise of the far-right in Germany and Austria are worth watching too.

The ECB kept its inflation forecasts unchanged and continued to steer clear of any specific forward guidance as it cut rates early in the month. Initially, that meant that October was assumed to be a pause, with a quarterly pace of cuts set to continue. While policymaker rhetoric was as noisy as ever, there were some strong views from officials like Kazimir and Simkus, who both agreed that there was very little chance of an October cut.

The data spoke volumes, however, and gave the ECB both the room and the motivation to rescue the eurozone economy. Eventually Lagarde admitted that "the latest developments strengthen our confidence that inflation will return to target in a timely manner" and that "the suppressed level of some survey indicators suggests that the [economic] recovery is facing headwinds'.

That was enough for the market to all but fully pencil in a cut this month, and an accelerated path thereafter. At the same time, inflation swaps are pricing a sustained period of below-2% inflation in 2025.

The eurozone PMIs are diverging again



CHF

SNB frets about the franc

To the SNB's dismay, the Swiss franc squeezed out a fifth successive monthly gain against the dollar. It did marginally break its streak against the euro, however, even as the short-term yield differential moved in the franc's favour and a surge in equities dulled the demand for safe havens.

The SNB's 25bp move was an extremely dovish one and clearly geared (unfruitfully) at currency depreciation. The franc's enormous 8% summer rally was blamed for a vast cooling in inflationary pressures over the last quarter, and the bank's inflation projections were again reduced significantly, to 1.2% in 2024 and 0.6% in 2025. While outgoing chairman Jordan saw this as 'within the range of price stability', the franc is evidently generating a lot of downside inflation risk. New chairman Schlegel has kept the door wide open for both negative rates and market intervention, although he stressed that the first tool is their first choice.

That might be because of the scale of intervention required for a material depreciation of the franc, at a time when policy rates are coming down a lot more quickly for its peers and when geopolitical and growth risks threaten to generate spurts of safe-haven strength. The market is pricing in another two rate cuts in its next two meetings, and potentially a third in June next year. All three would take it down to 0.25%, and with officials unable to keep pace with foreign cutting cycles without negative rates, intervention could grow more likely over time.

JPY

Hike hopes recede

The yen's recovery is proving to be bumpy. Its bullish momentum continued through much of September, but receding hawkish hopes meant it could not last. It briefly pierced below the 140 threshold for the first time in a year in the lead-up to the Fed's rate cut, before paring its gains as BoJ Governor Ueda and new PM Ishiba seemed to agree on likelihood that rates stay on hold.

While the BoJ meeting had an optimistic tone, there was little mention of further hikes. Ueda remained confident that consumption would rise and that inflation would be sustained, but he also acknowledged waning upside inflation risks. The market trimmed its expectations accordingly, and now only 5bps in hikes are priced in by mid-2025, down from 24bps.

A continued recent feature of USD/JPY is the higher volatility backdrop. One-week implied volatilities have near tripled since the peak of the quiet earlier this year, and the BoJ's Takata claimed that officials are keeping an eye on this with 'utmost vigilance', although Ueda has also assured that they would not use monetary policy to directly control FX.

Looking forward, it seems like the low hanging fruit has already been picked – the collapse of fast money carry trades and the beginning of the Fed cutting cycle – and the quick gains have already been won. Now, while the consensus is overwhelmingly for the yen to continue strengthening as US rates normalise, the median Bloomberg forecasts point to this being a gradual process, with 140 not hit until 2025 and 130 at least two years later.

SEK

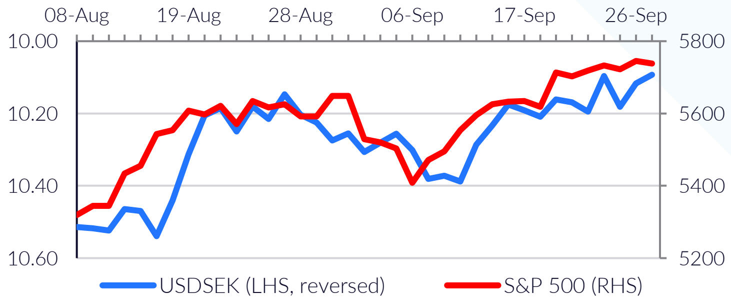
Defying the dovishness

The Riksbank's signals for an intensified rate cutting cycle had little bearing on the krona last month, with global risk dynamics currently a much more impactful driver.

The job is done on inflation – and then some. CPIF is now forecasted at 1.7% in 2024 and 1.6% in 2025, and naturally that has turned the Swedish economy into the Riksbank's primary concern instead. The report suggested that policy needs to lean in a 'more expansionary direction' – something that has rarely been said in recent years – suggesting that rates could be cut to below estimates of neutral policy and into stimulative territory. Two cuts were suggested by the end of the year.

But it was the wider improvement in risk conditions and rising bets for the right kind of Federal Reserve rate cuts (i.e. those that prevent a downturn rather than react to one) that pulled the krona up. Its correlation to the US equity market rose to -0.83 in September.

SEK has closely followed the equity market



CAD

Follow the Fed

The Canadian dollar has so far proven to be least able to capitalise on the weakness in its US counterpart over the summer. In fact, it was the only G10 currency to weaken against the greenback in September. Much of that is down to the interconnectedness between the two economies, and correlations in pricing between the Federal Reserve and the Bank of Canada.

The story in Canada is broadly unchanged from last month. CPI inflation is back to 2.0% – or 1.2% if you exclude mortgage interest costs – and jobs growth, while positive this time, disappointed on expectations and came alongside a rise in the unemployment rate to 6.6%. As the BoC themselves have admitted, there is 'little evidence' of broad-based price pressures, suggesting that policymakers need to bring rates down relatively quickly to prevent any further economic weakness. Luckily, there is certainly the room to do so.

Unlike the Fed, which opted for 50bps, the BoC stuck to 25bps in September. But expectations for the two have been closely correlated, and the Fed move has seen rates markets increase the implied probability for an emboldened BoC to do the same in October to 50%. Governor Macklem did not rule out an accelerated pace of easing in September, and the market appears to think that the Fed's precedent might give a 50bp move much more attention, especially now that inflationary pressures have subsided so significantly.

AUD

Baby steps

A fresh US dollar decline and a steadfastly hawkish Reserve Bank of Australia lifted the Aussie dollar to a year-to-date high in September. A boost to the yuan and commodity prices also helped the closely-linked AUD on the back of China's announcement for its biggest post-pandemic package of stimulus measures.

Despite a dip in the headline inflation rate to 2.7%, elevated core inflation meant that RBA rate-setters opted to continue their pushback against market pricing for rate cuts this year, with Langcake pointing to Q2 next year as a likely starting point. The special-case BoJ aside, the RBA remains among the most hawkish central banks in the G10, alongside the Norges Bank. That said, although there was some mention of further hikes remaining on the table, it is no longer being explicitly discussed in the meetings – this small step towards a dovish pivot dampened the Aussie's gains.

Economic Calendar – October 2024

The upcoming US election, geopolitical risks, and continued rates volatility are set to take centre stage in October.

Date	Time (CET)	Currency	**Event**	Previous
Tue 1st	4:00pm	USD	JOLTS Job Openings	7.67M
Fri 4th	2:30pm	USD	Non-Farm Payrolls m/m	142K
Thu 10th	2:30pm	USD	CPI y/y	2.5%
Fri 6th	8:00am	GBP	GDP m/m	0.0%
Fri 6th	2:30pm	CAD	Employment Change m/m	22.1K
Fri 6th	2:30pm	USD	PPI m/m	0.2%
Tue 15th	8:00am	GBP	Claimant Count Change Average Earnings Index 3m/y	23.7K 4.0%
Tue 15th	2:30pm	CAD	CPI y/y	2.0%
Wed 16th	8:00am	GBP	CPI y/y	2.2%
Thu 17th	**2:15pm**	**EUR**	**ECB Policy Decision**	**3.50%**
Thu 17th	3:30am	AUD	Employment Change m/m	47.5K
Thu 17th	2:30pm	USD	Retail Sales m/m	0.1%
Fri 18th	8:00am	GBP	Retail Sales m/m	1.0%
Wed 23rd	**3:45pm**	**CAD**	**Bank of Canada Policy Decision**	**4.25%**
Thu 24th	10:00am	EUR	Flash Manufacturing PMI Flash Services PMI	44.8 50.5
Thu 24th	10:30am	GBP	Flash Manufacturing PMI Flash Services PMI	51.5 52.8
Thu 24th	3:45pm	USD	Flash Manufacturing PMI Flash Services PMI	47.0 55.4
Fri 25th	2:30pm	CAD	Retail Sales m/m	0.9%
Tue 29th	4:00pm	USD	JOLTS Job Openings	7.67M
Wed 30th	1:30pm	USD	Advance Q2 GDP q/q	2.9%
Thu 31st	2:30pm	CAD	GDP m/m	0.0%
Thu 31st	2:30pm	USD	Core PCE Price Index m/m	0.1%
Thu 31st	2:30pm	USD	Employment Cost Index q/q	0.9%

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