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MACRO MORNING BRIEFING

October 21, 2024

Landing in D.C. to No Landing Fears

Fall IMF/WB Meetings to Offer Additional Policy Guidance

- Sticky inflation and household demand a global theme
- Tariff risks underpriced in some key exporter economies
- APAC still underwhelms in reflation stakes

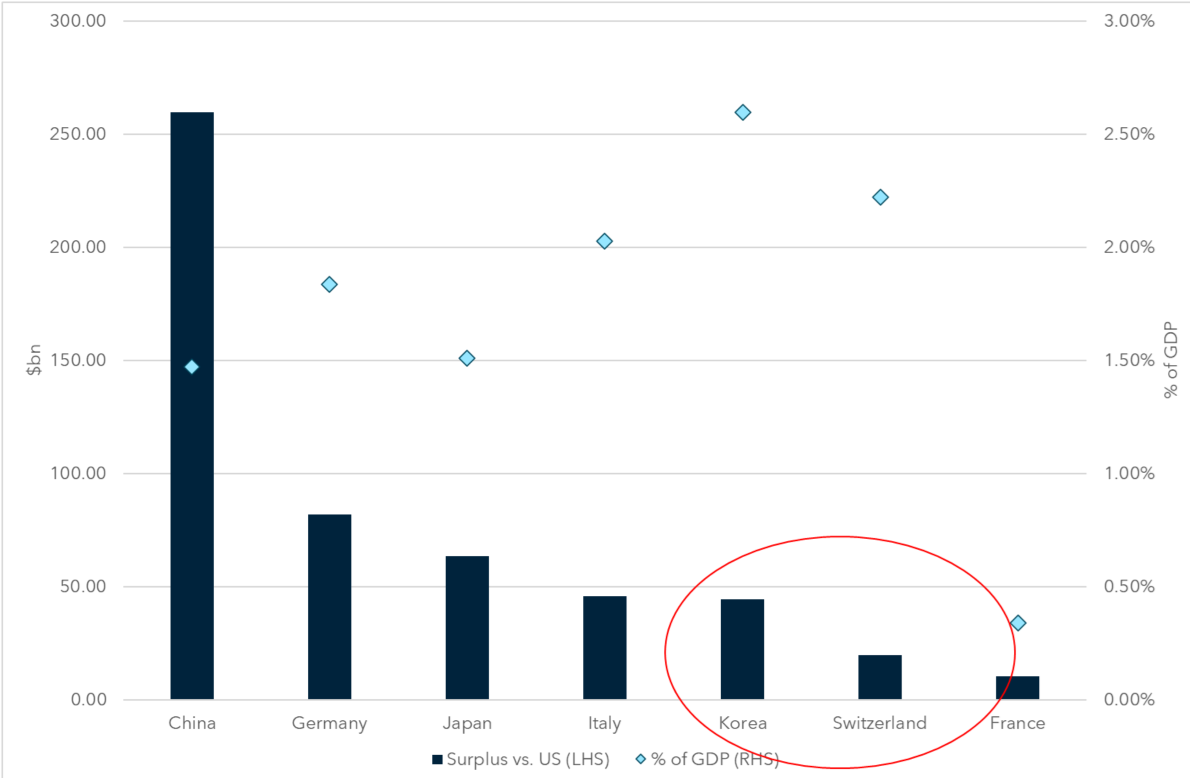
Tariffs and inflation high on the agenda in D.C.

Data and central bank decisions will take a back seat this week, but there will be no shortage of communication and guidance on the monetary front as central bank officials congregate in Washington, D.C. for the annual fall sessions of the International Monetary Fund and the World Bank. Suffice to say, the prevailing mood will be one of confusion, as the monetary policy trajectory globally is proving less clearcut than what was expected barely a month ago. The narrative for a soft landing for the US economy – which the Fed's 50bp cut last month was supposed to help achieve – has changed to the extent that "no-landing" is now being discussed in some quarters, and there are increasing signs that the US is not alone in facing such a scenario.\

Before debating monetary policy, undoubtedly many foreign dignitaries will be asking their US counterparts about the state of the election and policy prospects under different scenarios for the presidency and congress. Tariffs are likely top of mind because of the implications on inflation and supply chains globally. Monetary policy post-pandemic has been disproportionately affected by supply constraints, which are very difficult for policymakers to calibrate, and governments are also struggling to respond in kind as many factors are due to external drivers. The bottom line, however, is that tariffs in a practical context will be seen as imposing real effective rate appreciation on the exporting economy, which may require a commensurate reaction in the currency to serve as an offset. This is why we are already seeing some reaction in the dollar's exchange rate against the Mexican peso and the yen, and we suspect the renminbi would have also reacted more adversely if China's stimulus efforts hadn't come into play in recent weeks. However, we believe that the same risks are somewhat underpriced in the exchange rates of other economies with critical trade exposures to the US, not in absolute terms but rather in relative terms.

Exhibit #1 shows the trade exposures of the US' key trading partners in goods, measured by the trade balance in 2023 and the trade balance as a share of GDP. We exclude Canada and Mexico due to their unique trade relationship with the US, and any adjustments will likely take place within the confines of the USMCA agreement. China's trade surplus with the US is the largest by far in absolute terms and will be the focus of tariffs for any US administration, but we can see that in relative terms, the surplus is below 1.5% of GDP. Similarly, Germany and Japan are the only two other economies with trade surpluses of $50bn or more against the US, but the figures are also smaller relative to the size of their economies. In contrast, Korea and Switzerland have trade surpluses which are well above 2.0% of GDP. Upon decomposition of these surpluses, goods category concentration also becomes an issue. Should the US impose tariffs or border adjustment taxes (mulled but ultimately not implemented during the first Trump administration) on such goods, manufacturing industries of these two economies will be heavily affected. Both countries have also been on the US Treasury department's monitoring list of manipulated currencies in the past and were both removed in the November 2023 iteration.

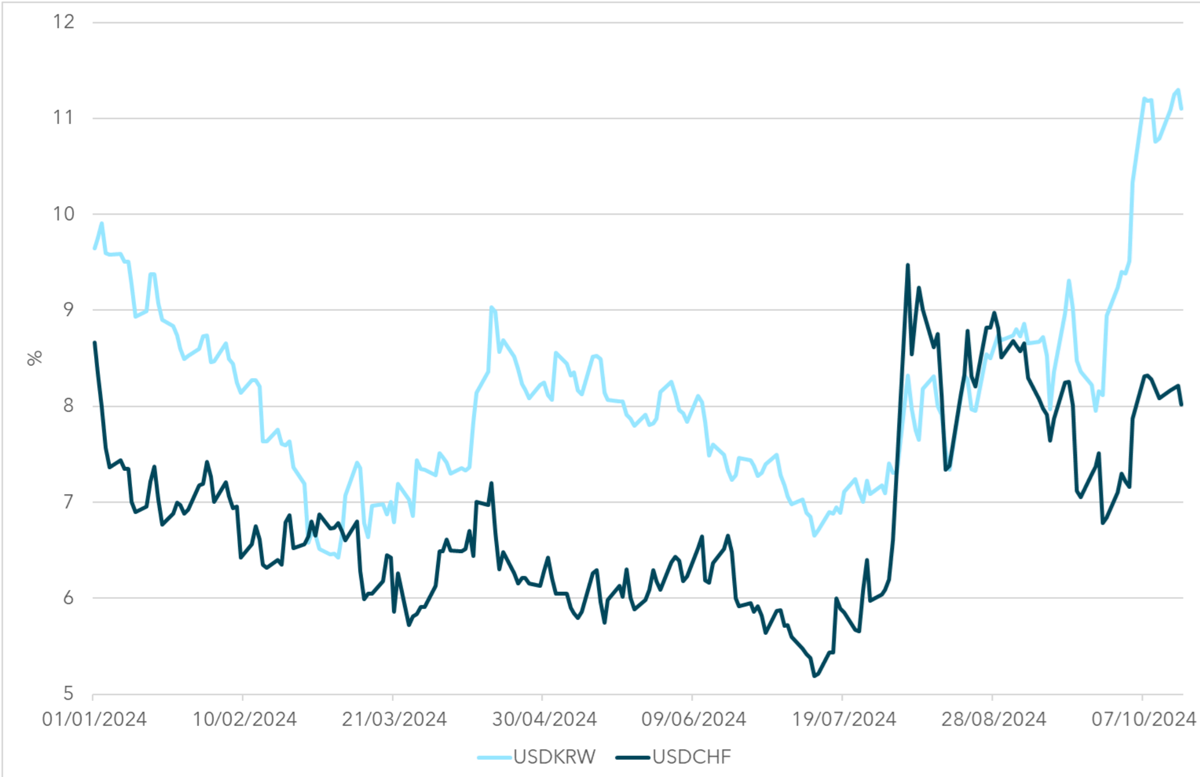
Exhibit #1: Trade Surplus vs. US, Absolute and Relative



Source: Bloomberg, BNY

Border adjustment taxes are particularly problematic as there is an incentive to shift the "value-added" of finished goods to the export destination country. Earlier this year, we highlighted how the Swiss franc was essentially a "pharma currency," as, if the trade surplus in this industry were excluded, Switzerland would be running a trade deficit. In such scenarios, the franc and won both warrant comprehensive de-rating but there is very little sign of this taking place in currency markets at present. Looking at FX options markets for example (Exhibit #2), implied volatility in the franc is lower compared to levels at the beginning of the year. Risk premia are rising in USDKRW, but the move is still not comparable to the likes of USDMXN and USDCNY. We believe there is far more ground to cover if the market is looking for tail hedges against tariff escalation risk.

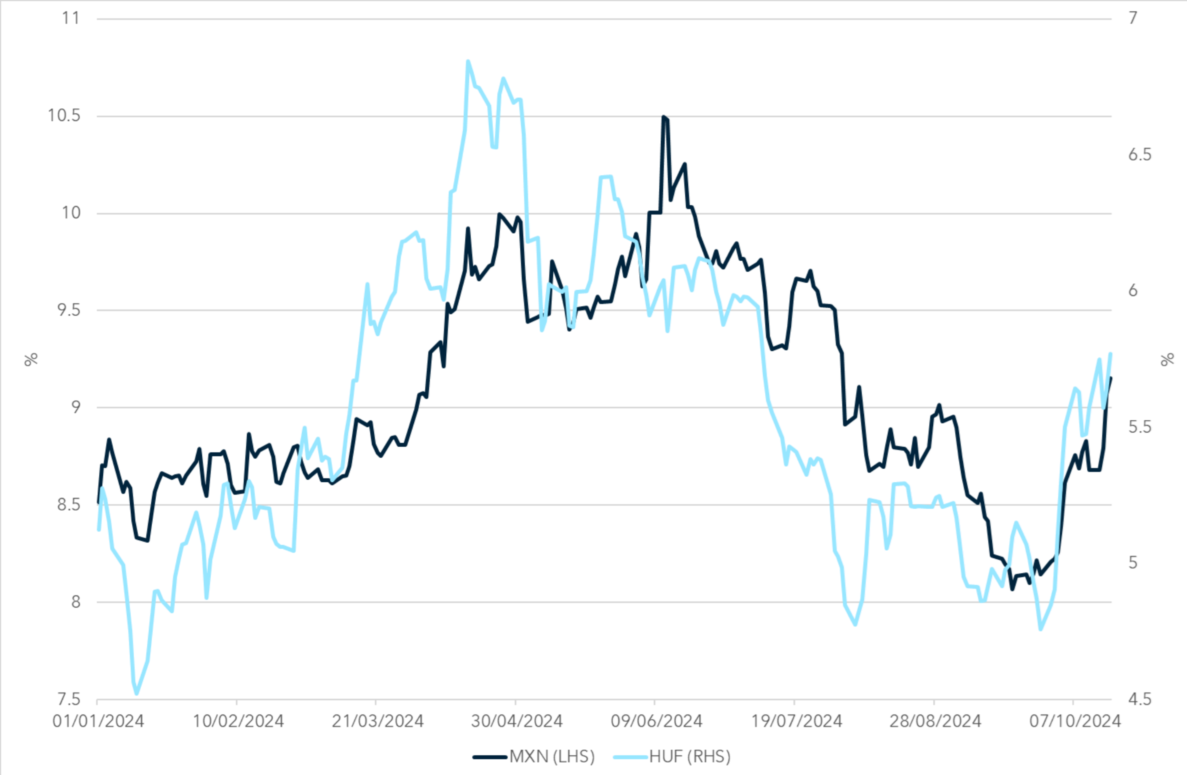
Exhibit #2: CHF and KRW FX Options Pricing



Source: Bloomberg, BNY

Outside of global trade and their supply chains, the other major source of supply-based inflation remains in labour markets and domestic demand. Globally, sticky wages remain a source of concern and there are now signs that robust household demand is starting to impact policy trajectories again, even at this stage of the business cycle. Many central banks have highlighted that terminal rates will be higher compared to pre-crisis levels, but as the central bank of Brazil recently showed, the prospect of returning to rate hikes to manage inflation expectations should not be ruled out either. Furthermore, if the Fed is moving away from aggressive tightening, then the additional risk of pass-through based inflation is no longer negligible. In Europe, the ECB may have opened the door to a pick-up in the pace of easing, but wage risks remain elevated, and President Lagarde last week affirmed the "restrictive" view on policy settings. Meanwhile, in economies where demand was driven by strong fiscal impulse such as Hungary, central banks are also calling time on easing. MNB Deputy Governor Virag last week affirmed that there would be a "sustained pause" in rates. Exhibit #3 shows that forward rates are picking up strongly in Mexico and Hungary. Consequently, the base case for this week's Hungarian central bank decision is for a second hold since the easing cycle began a year ago, but this time it will be more prolonged. As far as inflation is concerned, "no landing" in inflation is now coming back as a material risk in many economies, even if growth remains sluggish.

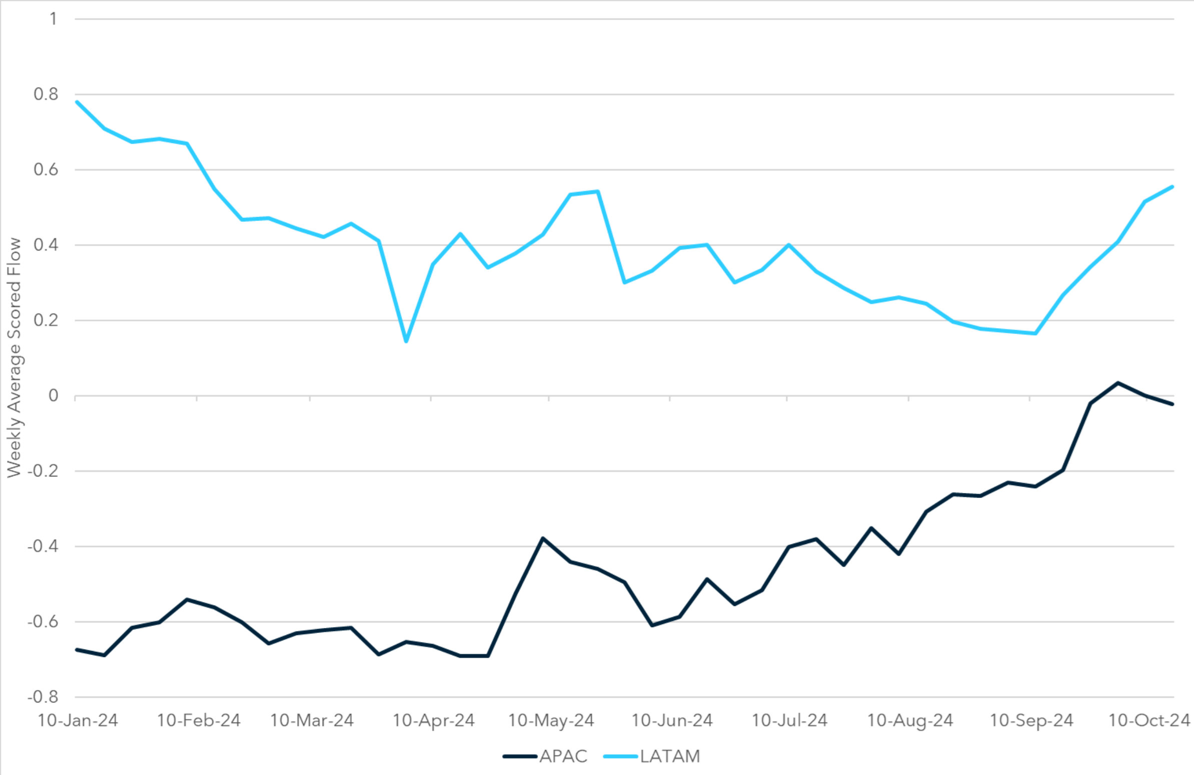
Exhibit #3: MXN, HUF 1y1y Forward Swap Rates



Source: Bloomberg, BNY

The only region where markets are less concerned about upside rate surprises is APAC. Markets will continue to focus on China, where the People's Bank of China, Ministry of Finance and other "relevant organs" of economic policy are continuing to release and execute policy measures in support of the economy. However, price pressures remain a concern and for now it appears the wider region is not counting on Chinese demand to generate a recovery in demand and prices towards year-end. Fiscal and labour dynamics are different compared to Latin America and there is less supply-based inflation impulse as a result, but as the Bank of Thailand's surprise cut last week shows, the bias of policy remains towards getting ahead of weakening in growth. Falling Chinese rates in aid of stimulus measures and lack of CNY strength will continue to anchor policy settings in the region, so the APAC FX's funding status versus higher yields in Latin America and Central and Eastern Europe will remain intact.

Exhibit #4: iFlow APAC & LatAm FX Holdings



Source: BNY

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Please direct questions or comments to: iFlow@BNY.com

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