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MACRO MORNING BRIEFING

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Giving Pass-Through a Pass

Global transmission dollar and US yield shifts will differ

- Limited reaction in APAC for now despite trade risk
- Europe clearly following individual risks
- Cross-border flows continue to show caution over Treasury securities

Policy requires reassessment, but don't overplay external factors

The impact of the US election result is already being felt in monetary policy circles. The initial steepening of the curves is already a potential headache: inflation premia and term premia have both increased and at the very least, this means that financial conditions have tightened on the margins, which requires an offset. Looking at the front end of central banks' forecast horizons, inflation outlooks may also require some upward adjustments if the dollar's valuations will remain more elevated than previously anticipated, and this is even before details of tariffs are known. Be it outright tariffs or a border adjustment tax, the net result is an imposition of real effective exchange rate increase on external currencies (as export prices rise), and exporters will need to lower their own nominal rates to serve as an offset. However, this also means that for the exporters themselves, the cost of imports may also increase and generate pass-through risk. The extent of future moves will be on a country-by-country basis, with manufacturing exporters likely the hardest hit. However, input-sensitive economies which run trade deficits must also remain vigilant.

Although the dollar rallied strongly against major currencies last week, at least initially, we note that there were major differences in how yield curves responded in individual countries. This means that the transmission from a weaker domestic currency into inflation premia differs between countries, even though trade exposures to the US have similarities. For example, Asia-Pacific currencies weakened materially against the dollar after the results became clear, but China and Japan's yield curves (Exhibit #1), defined by the spread between the 2-year and 10-year government bond yields, have kept in ranges established since September. Markets appear willing to accept that the currencies would be the best vehicle to reflect associated risk premia, but it would not result in any changes in government borrowing costs or even growth trajectories. For APAC economies, the "solution" against a higher dollar and balance of payments adjustments in a non-inflationary manner is often domestic demand suppression. Savings levels in China and Japan mean that external financing is not required, and where import prices create pinch points, domestic demand adjustments through the public and private sector is highly effective. This is the case more broadly across Asia and we note that inflation during the post-pandemic recovery phase was not as problematic as in the rest of the world. Furthermore, if the inflation shock is simply due to pass-through and without other supply-based aspects, price effects are not likely to be persistent. At best, the policy impact will be "above neutral for longer."

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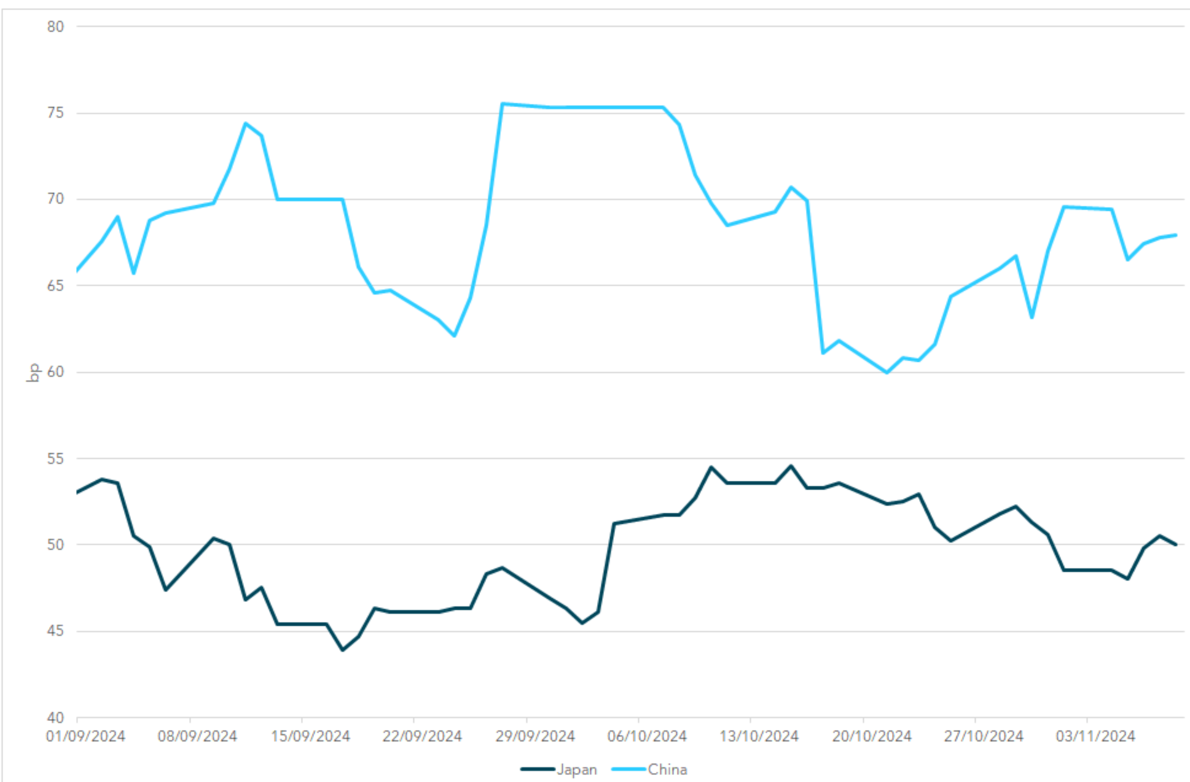
Exhibit #1: 2-10 Curve, China and Japan



Source: Bloomberg, BNY

Europe probably does not have the demand levers and from the ECB's point of view, the impact of tariffs on individual countries will also be diverse and complicate policy-setting. For Germany, renewed tariffs on manufacturing exports to the US represent another headache when the sector is arguably facing structural decline, and the country is also effectively without a government. On that individual matter, one of the key events to watch this week is the prospect of a snap election being called. In our view, the earlier the better, especially as upcoming shifts in the US-European relationship requires the full attention of core European Union national government. Chancellor Scholz's original intent to have an election in March 2025, which could push a new German government being formed off until April, is clearly suboptimal in this context.

Tariffs on Eurozone exports will clearly increase pressure on the EUR to depreciate as an offset, and potentially generate higher inflation. However, we believe this is a secondary factor. The next German government will also take a more flexible view on debt issuance. After all, this was the reason behind the current coalition's demise. Even more so than the US election, we believe this is one of the critical reasons behind the steepening in the German bund curve: the 10-year bund yield has risen by 40bp over the past four weeks and the move began well before US election day. It seems that the market was anticipating a fiscal push in Germany, otherwise the damage to the economy arising from the manufacturing downturn could become permanent. In contrast, the gilt curve has been far more stable in recent weeks despite a less-than-effective reaction to the Labour Party's first budget. Unlike the APAC economies, it was anything but a demand suppression story as the budget itself was clearly cast as fiscal easing. Inflation expectations in the UK for the next two years have shifted higher, while the gilt market's extended maturity profile limited the rise in term premia. While there is a case to be made that we should not overplay the dollar's impact on the UK as pass-through is difficult to generate for a services-based economy, developments in the UK and German curves show that domestic conditions ultimately matter far more than external inputs.

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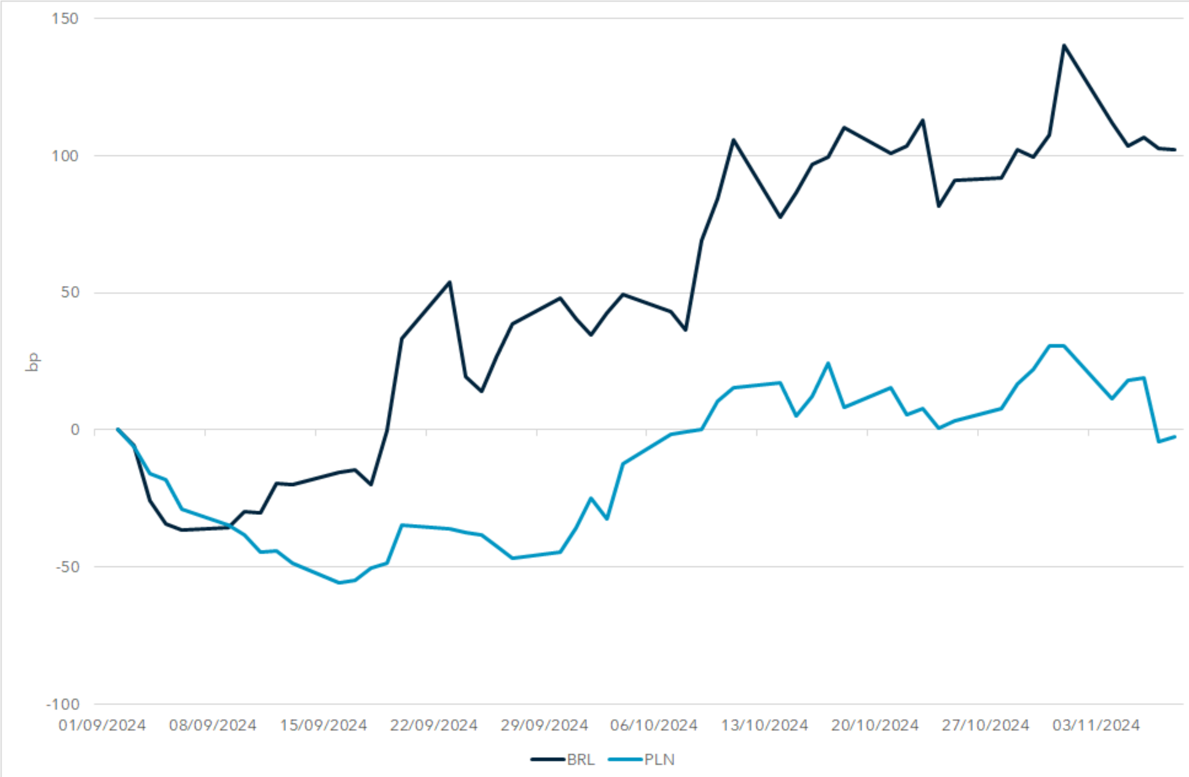
Exhibit #2: 2-10 Curve, Germany and UK

Source: Bloomberg, BNY

Looking beyond the US' core trading partners, we note that there were signs for several weeks that central banks were starting to shift gears away from an easing path. Despite the multitude of rate cuts in G10 last week, there were hawkish outcomes such the RBA decision and the 50bp hike in Brazil. In Europe, despite the weakness in neighbouring Germany, the Polish Central Bank's decision was more akin to the Bank of England outcome, where domestic labour market tightness and sustained fiscal impulse has largely ended the easing cycle. The direct and indirect inflation risks from the US election are also secondary in this respect, though we acknowledge Poland could be disproportionately affected by geopolitical shifts as the incoming US administration's foreign policy may materially adjust from the status quo. Forward rates in both BRL and PLN softened last week as current policy remains restrictive, and there is little impact from FX movements arising from last week's events.

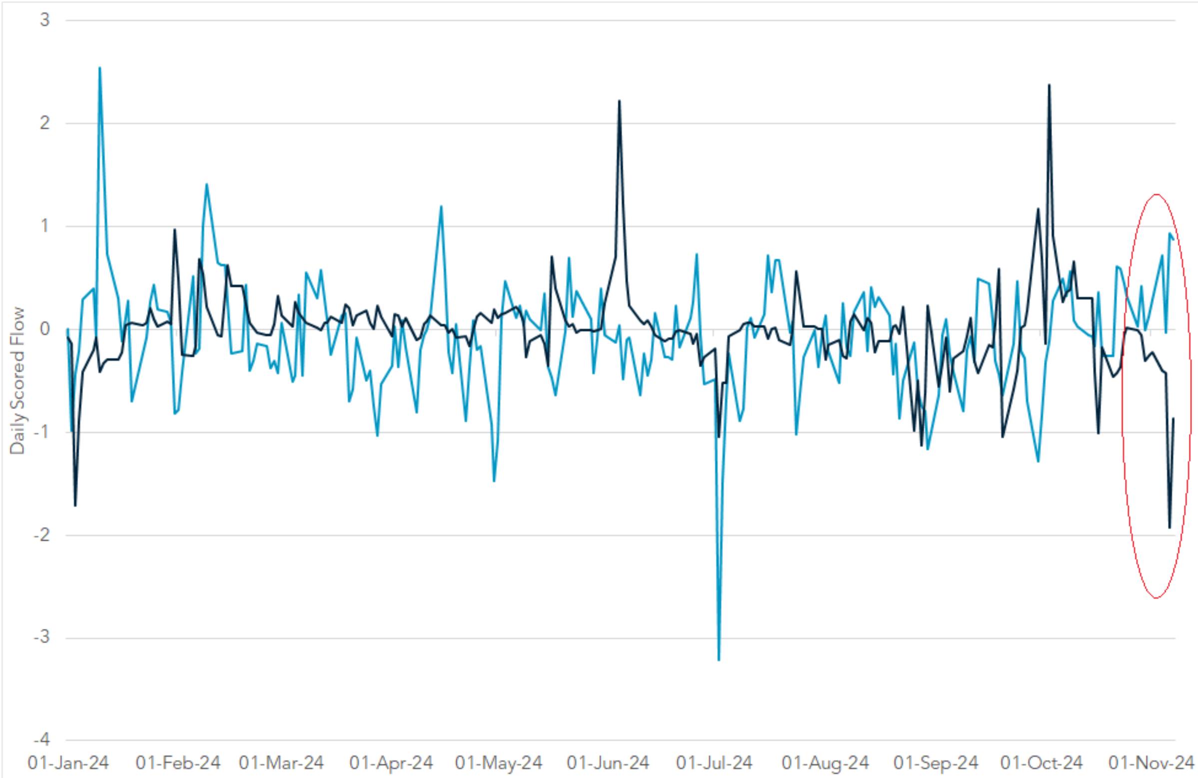
Exhibit #3: BRL and PLN Forward Swaps



Source: Bloomberg, BNY

For the US itself, the direction of travel for fiscal policy will be at the centre of scrutiny and in our view, a crucial contributor to macro volatility over the coming years. Domestic and international perception of term premia will differ. Even though we note that international investors have shown little interest in structurally shifting their current holdings away from US Treasury securities, there is no guarantee that future surpluses will be recycled into these securities. Furthermore, if the US succeeds in reducing foreign surpluses – which is doubtful – then there won't be fresh liquidity to direct into the Treasury market. Our flows last week indicate a material rise in foreign liquidation of long-dated US Treasurys. However, the USD was also net bought cross-border investors, though this could be a sign the unwinding of hedges as well. US Treasury securities aside, "US exceptionalism" has had a good week in asset-market terms, but maintaining such preference in an age of ever-rising trade and financial decoupling will prove a bigger challenge.

Exhibit #4: Cross-Border USD and UST Flow



Source: Bloomberg, BNY

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