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MACRO MORNING BRIEFING

November 14, 2024

USD Exceptionalism

- The US dollar has rallied to 2-year highs following the election of Trump. Markets have linked the US gains to trade tariffs and taxes, leading to higher US rates. The rate markets have seen less movement than the USD since the election, begging the question of what really drives the USD.
- The Mexico central bank is priced for a rate cut on Thursday, with 19bp of 25bp of easing priced. The only headwind against more easing is MXN weakness. The currency has dropped 2% since the election, moving from 20.10 to 20.50 with a range of 19.76–20.807.
- US flows since the election have been positive for USD, equities and bonds. Q3 earnings reports have also ended with hopes of lower US corporate taxes from the new Trump administration supporting risk markets.
- The balancing act for US markets rests with the budget plans and how deficit spending and other policy shifts drive corporate profits and investments. The path of the USD depends on asset flows more than rate differentials into 2025.

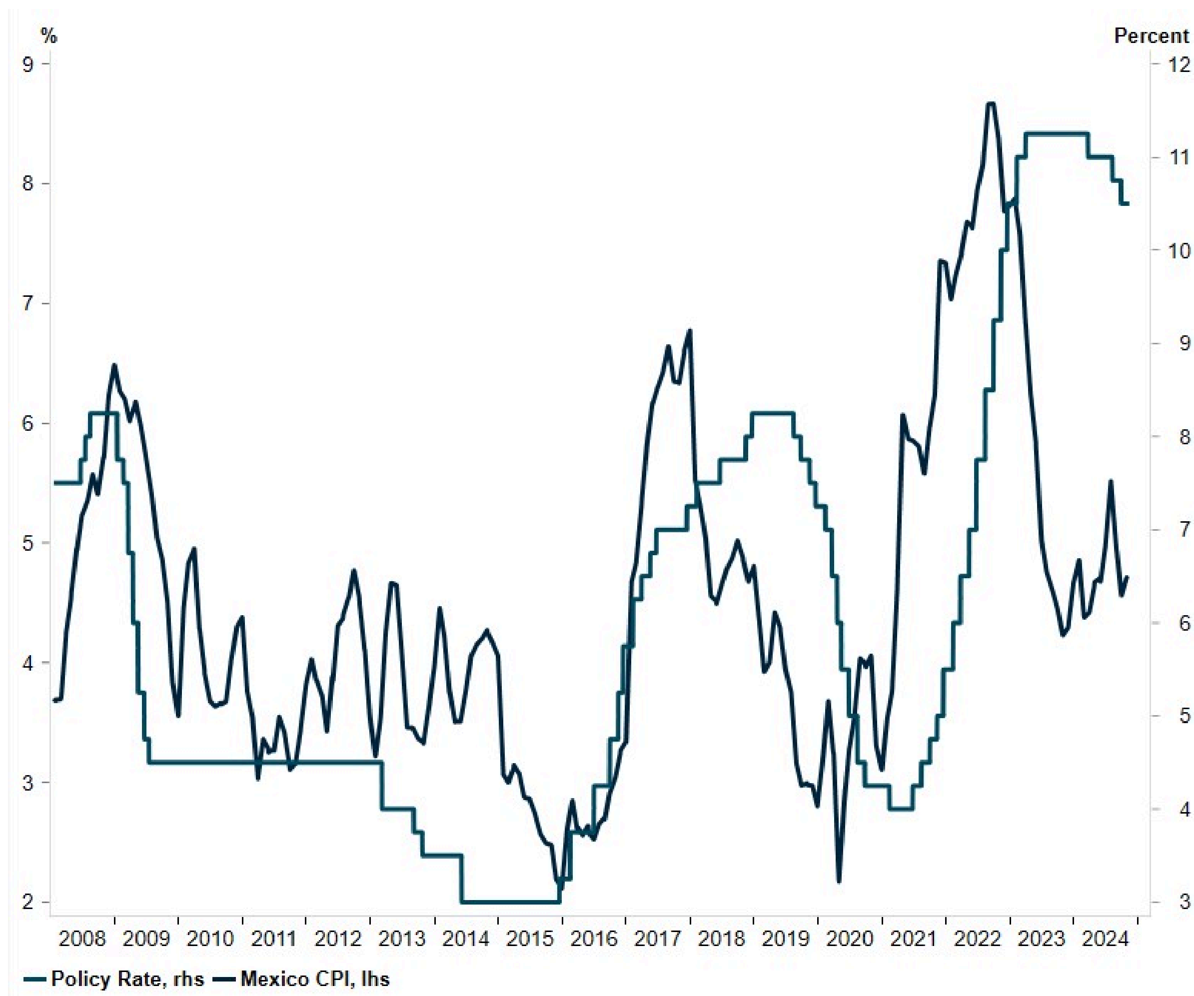
MXN and real rates

Mexico's central bank is widely expected to cut 25bp to 10.25% with the forward guidance expected to keep the easing cycle continuing. The risk for decisions revolves around MXN weakness and market volatility. Against that uncertainty, much of which stems from the US election, the Banxico has kept conditions tight and has seen core CPI decelerating, along with weaker economic growth. Core inflation fell for the 21st month in a row, declining to 3.8% y/y while services inflation fell to 4.98% – the first dip below 5% since August 2022. How the market reacts to a rate cut and the Q4 inflation forecast is now central for MXN. Easing

expectations for December 19 could be confused by further MXN weakness and the risk of the central bank adjusting higher due to seasonal price pressures. As we move into December, meetings between the new Trump team and the Mexican government will be critical. So, too, will the quarterly report from the central bank due on November 27, which will spell out the bank's thinking on pass-through inflation risks from MXN weakness, while the financial stability report on December 11 will touch on the recent volatility.

Exhibit #1: Mexico Has Room to Ease

Mexico Y/Y% CPI vs. Policy Rate

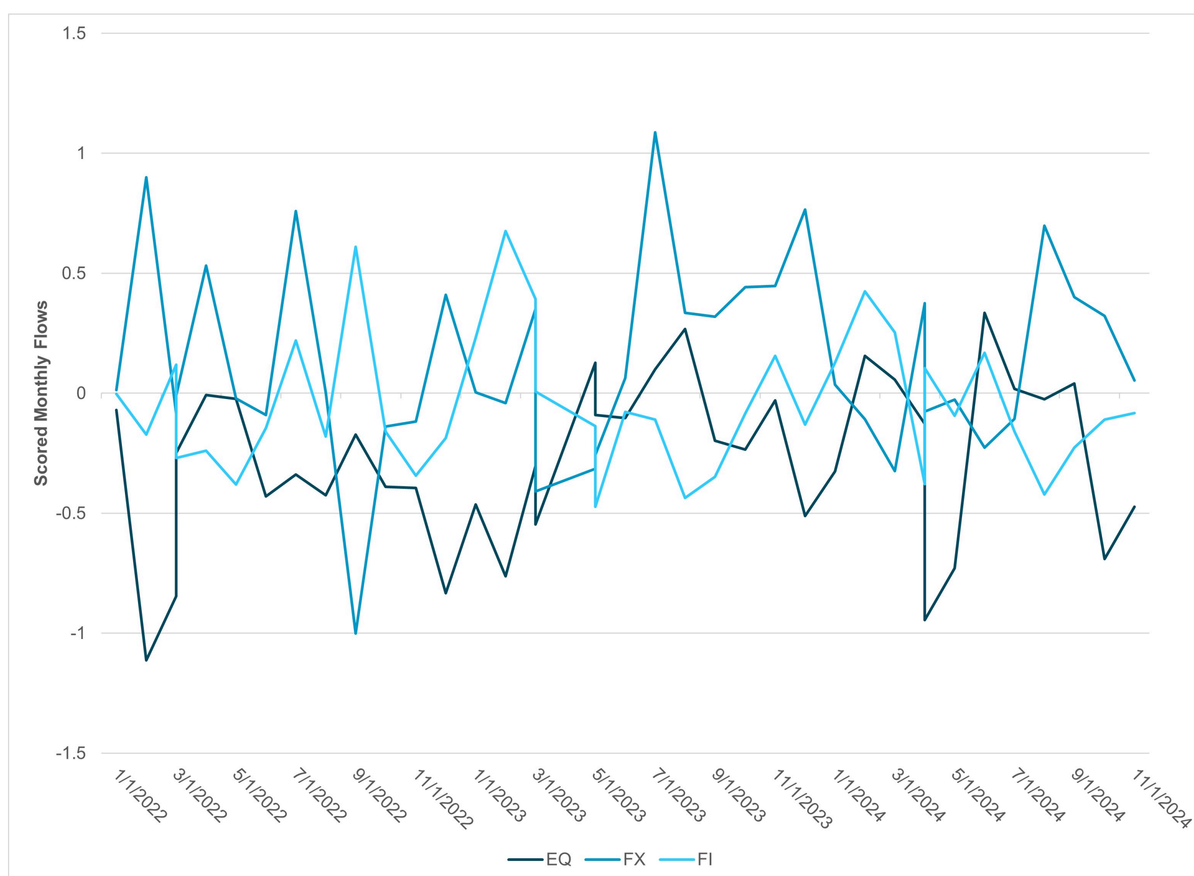


Source: Macrobond, BNY

When we look at the setup for the decision from Mexico's central bank, we can see that flows into bonds and equities have been recovering while the currency has lost ground. However, on a holding basis, MXN remains overheld at 1.5 while the profitability of this holding has fallen from 0.3 in mid-October to -0.75 in mid-November. We expect the long MXN position to continue to unwind and given that carry as a factor in FX remains negative, holding rates will not fix what troubles FX.

Like the US, the Mexico focus is on fiscal stimulus and what that means for 2025 growth and inflation. The new Mexican budget from Finance Minister Ramirez de la O aims to significantly reduce the deficit – including cutting spending by eliminating unnecessary units of state-owned companies. President Sheinbaum has made clear she wants the 2025 budget deficit to be less than 3.5% of GDP. Looking at this plan and the Taylor Rule for Mexico, which suggests the current rate could fall to 7.25%, Banxico has room to remain aggressive in an easing cycle. The 3% risk premium for Mexico rates looks significant and will unwind when the relationship between the US and Mexico trade and the border becomes clearer in Q1 2025.

Exhibit #2: iFlow Mexico



Source: iFlow, BNY

Q3 earnings and the mixed outlook

The Q3 earnings season is almost over, with 93% of companies reporting. Of those, 75% beat EPS estimates – in line with the 10-year average. However, both the aggregate earnings above estimates (4.3%) and aggregate revenues above estimates (1.2%) are below the 5- and 10-year averages. Overall earnings in Q3 were 5.3%, better than the 4.3% at the start of the quarter and the fifth quarter of earnings growth. Revenues rose at a rate of 5.5%, which is

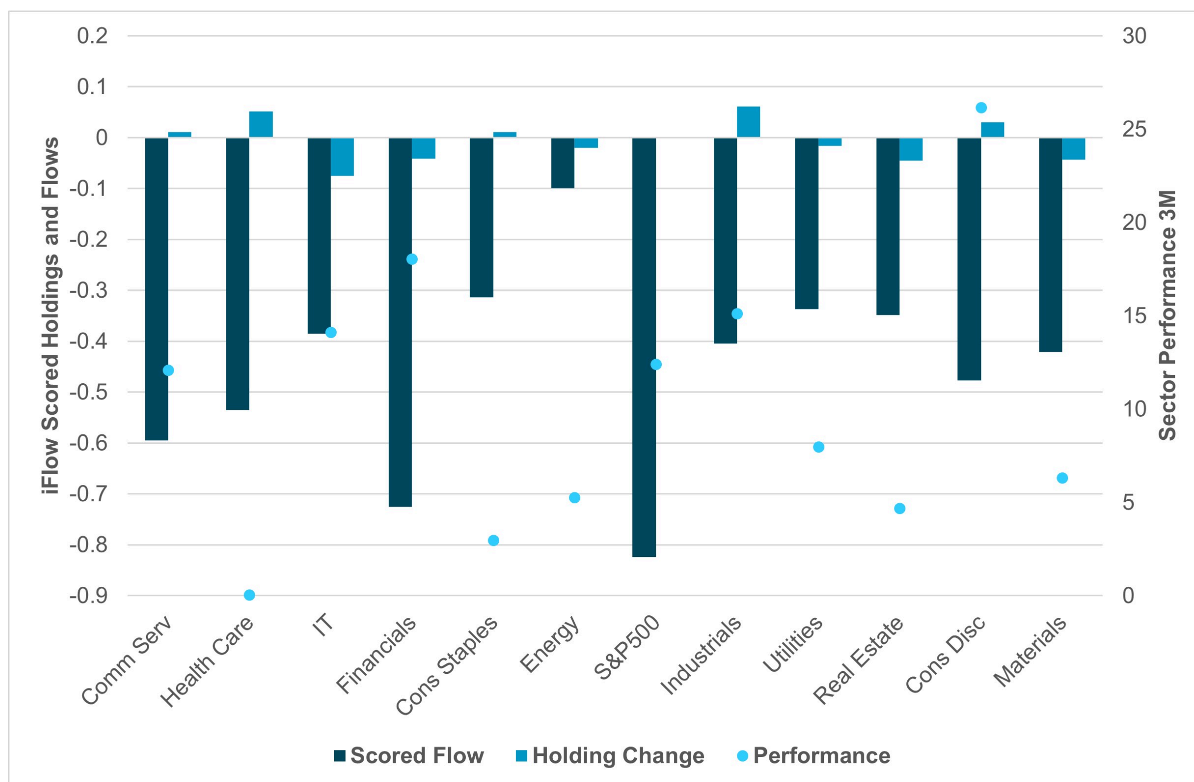
above the 4.7% forecast at the start of the quarter. The EPS outlook is 12.2% in Q4 2024 and 11.9% in Q2 2025. All this boils down into a valuation worry with 12-month current PE at 21.6 and 2024 forward PE 2025 now at 22.2 – both above the historical averages of 19.6 for five years and 18.1 for 10 years. By sector, the best revenues are from IT, Health Care and Communication Services, while Energy continues to be the worst performer.

The flows into sectors have been modest, with Health Care, Consumer Discretionary and Industrials all seeing modest inflows, while Real Estate, IT and Financials have seen outflows. This contrasts with the performance for Health Care and Materials, where the flows have been notably negative compared to shifts in holdings, highlighting this market capital point. Also notable is that S&P 500 outflows are significant.

Exhibit #3: The Disconnect between Q3 Earnings and Flows

Past 3M S&P 500 Sectors

Flows/Holdings/Performance



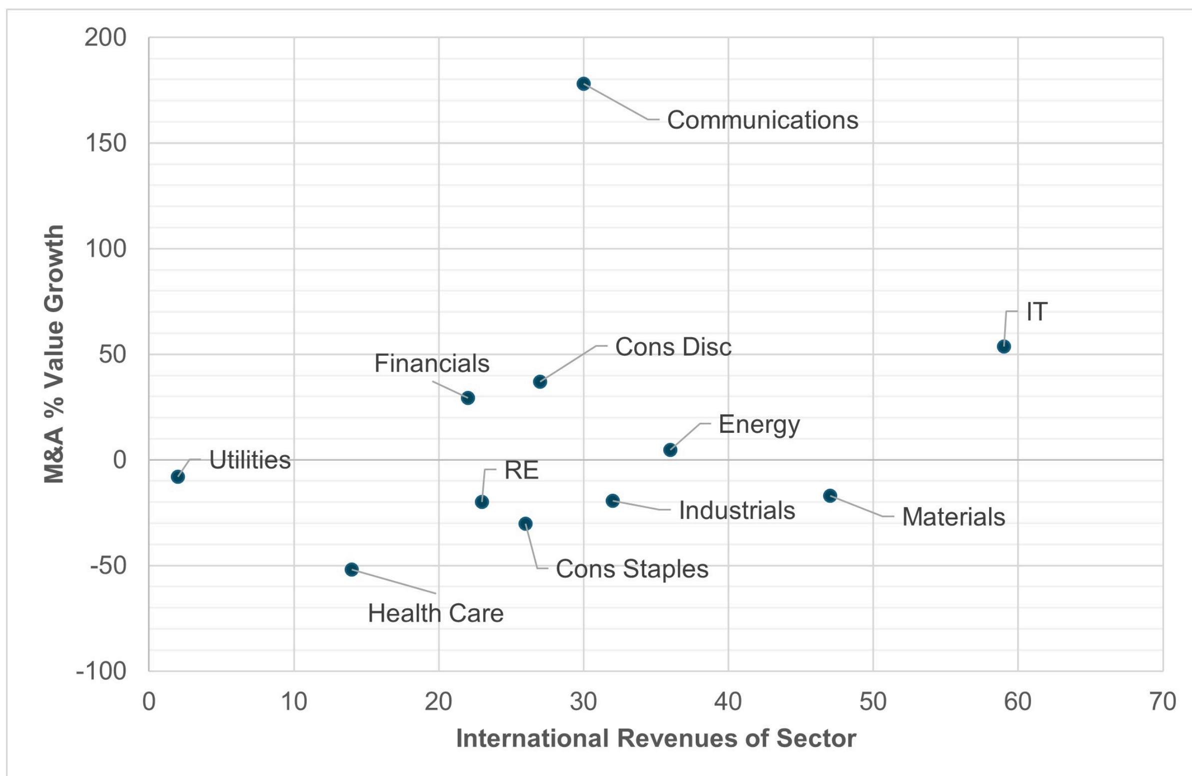
Source iFlow, Bloomberg, BNY

All of this gets to the question of which sectors have the most Trump trade risk and reward. The sectors most exposed to international rather than domestic sales caught tariffs hurting their returns, along with the recent USD rally making their sales less important to the bottom line. Then there is the power of M&A and how tariffs will increase vertical interests in sectors,

particularly those that face trade – namely Industrials and Materials. Over the last 30 years, the key sectors for M&A have been in Financials, Health Care, Retail and Industrials.

Exhibit #4: M&A vs. International Exposure

S&P 500 Sectors H1 2024

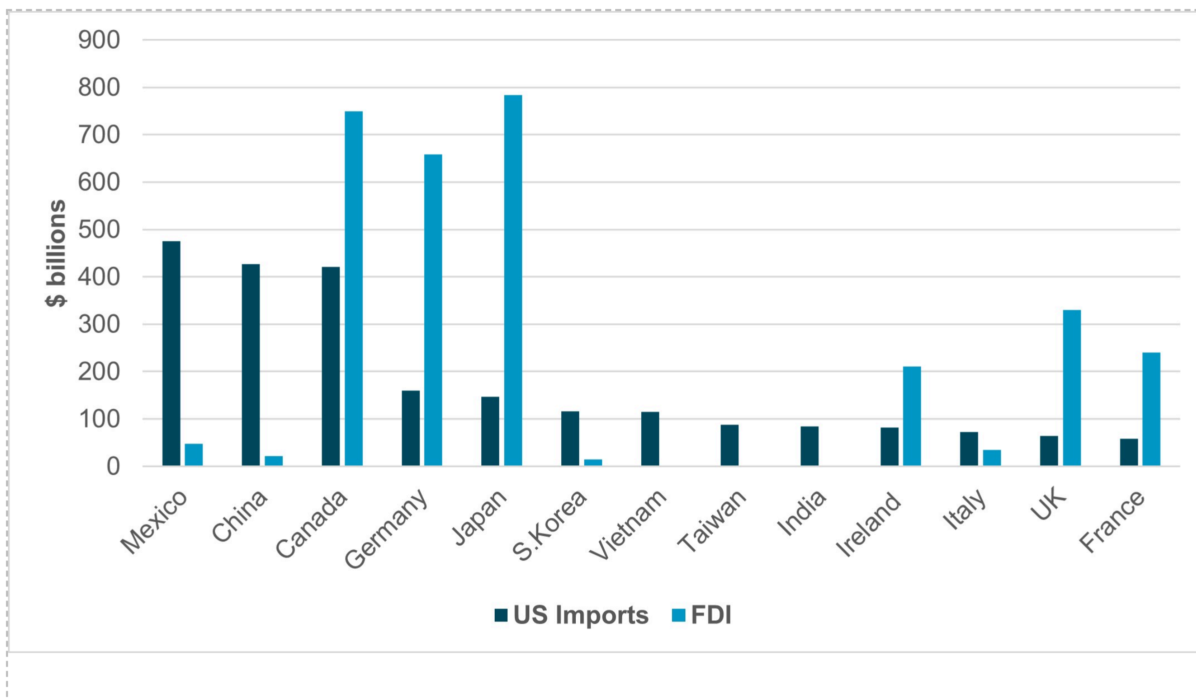


Source: iFlow, PwC, FactSet, BNY

The nations that are most likely to invest in the US are different from the ones that export to the US – Mexico and China are tiny FDI investors while France, the UK and Ireland are big investors and modest trading partners. The alliances of the US apart from trade also make a difference and could be part of Trump 2.0 decisions on trade policy and investments. Deregulation and lower taxes could lead to a separate set of investors from abroad.

Exhibit #5: Trump Trade Policy May Clash with FDI

Largest US Trading and Investing Nations

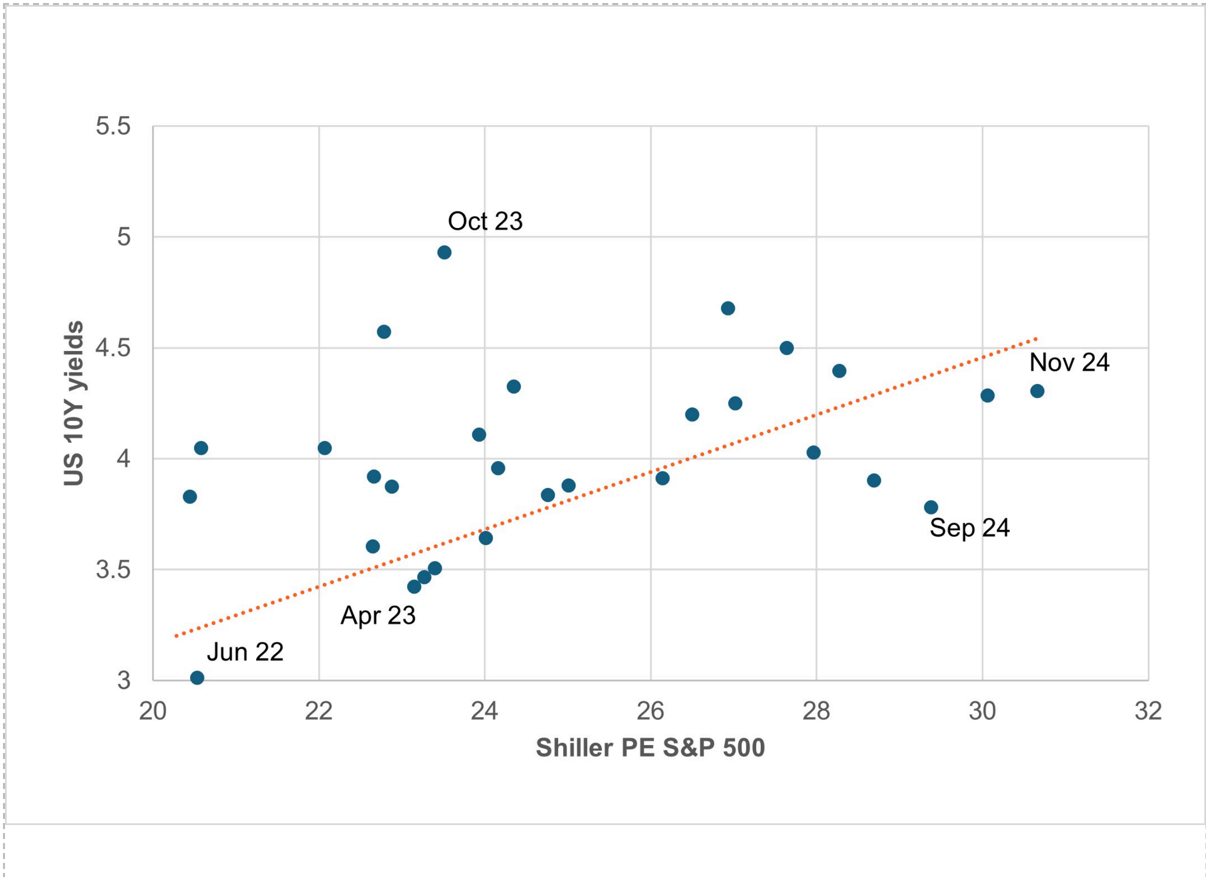


Source: iFlow, Bloomberg, BNY

The other constraint on equity markets is the level of rates. In October 2023, the market had 10-year yields near 5% and at that level, equities suffered. Similarly, when bond yields touched 3.60% in September 2024, equities were underheld. There is a level of bonds to stock valuation that has worked over the post-pandemic period when inflation was on the downturn. What is not clear is whether this relationship can hold if inflation rises. Markets look overvalued on the Shiller PE metric – the historical long-term average is 17 and we are now at 30.6 for the S&P 500. Similarly, 10-year bond yields over the same period of 150 years have a 3.81% average yield. We have long-tail risks ahead but the trend line for now suggests this rally in stocks will merely lead to higher bond yields as well – 4.75% is the new 4% for the next six months.

Bottom Line: Before the election, USD exceptionalism was led by CNY and MXN. After the election, EUR has led with the surprise collapse of the German coalition and the call for a February election. The role of equities and USD clearly matters. How other central banks decide on rates and view their FX rate is a key part of USD exceptionalism. The current trajectory of rates and stocks leaves little room for error and USD holdings may become a barometer of risk across markets.

Exhibit #6: Rates and PE Valuations – Outliers Matter



Source: iFlow, Bloomberg, BNY

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

Bob Savage
HEAD OF MARKETS STRATEGY AND INSIGHTS

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