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MACRO MORNING BRIEFING

November 18, 2024

Differentiation Amid the Dollar Surge

Opportunities emerging after comprehensive FX outflows

- EURUSD back to a rate differential story and will stay heavy
- EM FX selling led by APAC, especially high-yielders and overheld names
- EM central bank decisions this week a chance for a strong response

After the sales, G10 and EM FX can start to diverge

After a week of political introspection, finally the market is able to revisit fundamentals in driving asset classes. It would be remiss of markets to forget that towards the end of October, the main source of macro volatility pertained to whether the September 50bp rate cut by the Fed was consistent with price stability in the US. Since then, even without making reflationary assumptions about the incoming administration, US data do give some credence to a "no-landing" scenario. While the prospect of expansionary fiscal policy up ahead continues to support our view that steepening risk can only grow in the US curve, FX markets – especially in G10 – will now have to contend with the risk of comprehensive policy divergence as well. Furthermore, if the inexorable rise of deglobalisation means that strong US demand is no longer in a position to benefit other economies, growth and rate divergence could be much more pronounced and persistent compared to previous cycles. In other words, the global economy could splinter into different cycles, with the dollar no longer subject to conventional valuation adjustments.

We are already seeing such divergence coming through in front-end rates. Exhibit #1 shows that trend changes in March 2025 futures for the fed fund rates and the Eurozone front-end rates have fully diverged. Markets are now visiting the prospect of a 50bp rate cut by the Governing Council in December and the cycle will continue well into next year. It is once

again unclear which side of 4% the Fed's terminal rates will fall on. As we highlighted last week, the risk is that the structural changes necessary in Germany and the rest of the Eurozone will take far longer to plan, let alone implement. The pace of EURUSD's decline – which is consistent with the sharp adjustment in rate differentials – is looking somewhat extreme. However, fundamental re-rating of the global economy is taking place. Even though our data show that cross-border holdings of the euro are at extremes, indicating high levels of hedging, which is a function of rate differentials, this will only limit the pace of selling and EURUSD's decline. If fair value estimates adjust in the dollar's favour, this will take place through the nominal as much as inflation differentials, especially if supply-based inflation persistence remains an issue globally.

Source: Bloomberg, BNY

Our client flow data indicate that EURUSD is facing the strongest level of near-term selling (monthly smoothed basis) since the energy crisis of 2022 and is not even far off the severity of liquidation seen during the Eurozone sovereign debt crisis over a decade ago. Even with the evident deterioration in Eurozone fundamentals, repricing in the dollar is the much bigger driver. The moves in EURUSD have been orderly, without any sense of financial stability risk, which was much more relevant in 2011–2012 and even in 2022. Furthermore, the impact of

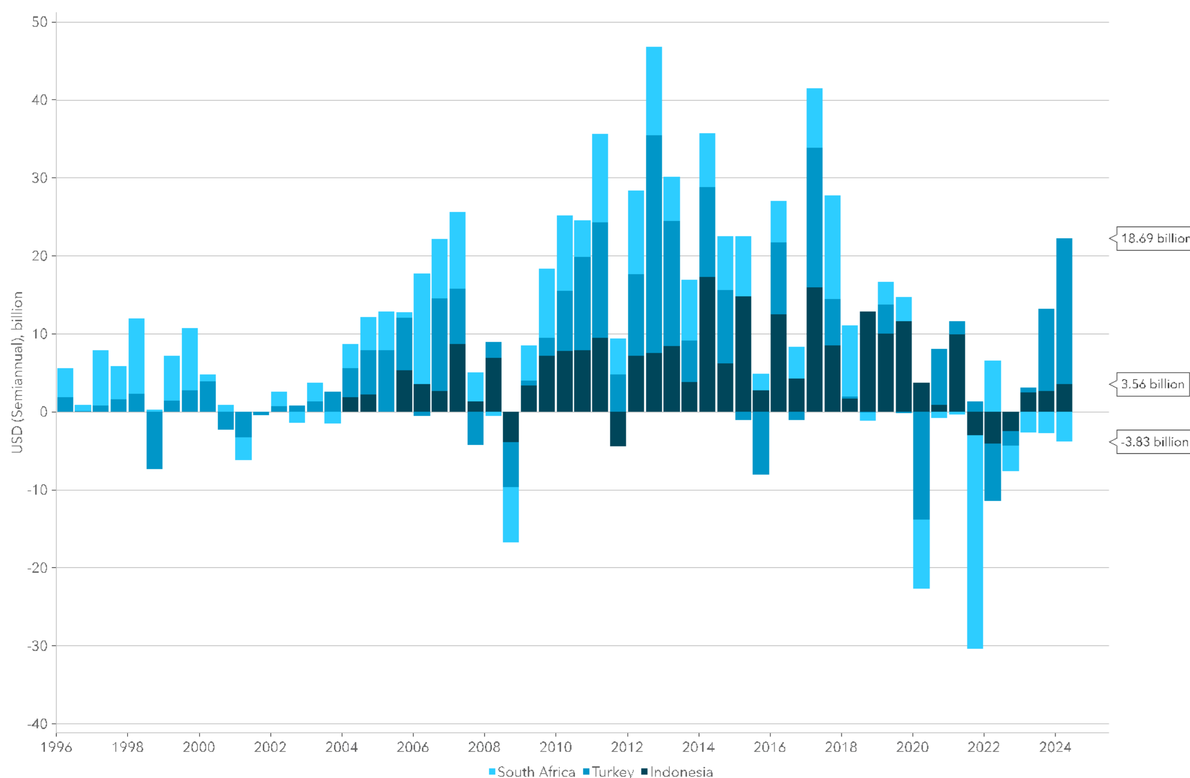
the dollar's repricing and Fed expectations is even more evident in EM markets. Exhibit #2 shows similar weekly smoothed flow for emerging market currencies in the Asia-Pacific, Latin America and Eastern Europe, the Middle East and Africa, which have all deteriorated severely. It is most pronounced in Asia-Pacific, understandably, as the region will be most affected by a rise in US tariffs on manufactured goods. Furthermore, as the CNY and JPY also occupy significant weightings in regional real effective exchange rate baskets, even if some currencies are in a better position to withstand dollar strength, the gains in USDCNY and USDJPY would also mandate an offset lest financial conditions suddenly tighten due to nominal and real effective exchange rate gains. This has been particularly relevant for the IDR and INR, which have faced heavy sales over the past week, as iFlow data show, and more importantly the liquidation is taking place from overheld positions due to their more attractive yields.

Source: BNY

Consequently, Bank Indonesia's (BI) policy decision this week, along with that of the South African Reserve Bank (SARB) and Central Bank of Türkiye (TCMB) will be a test of how forcefully emerging market central banks will respond to a new dollar reality. BI has displayed solid policy credibility in defence of the currency throughout the year and is widely expected

to hold rates. TCMB’s real rate buffer is barely positive, and it will need to retain high nominal rates, while the SARB is one of the few large EM central banks still in a position to cut rates. BI and TCMB are particularly exposed to the downside on rates and the currency due to the strong levels of foreign portfolio investment over the last two years (Exhibit #3). Hard-won policy credibility has underpinned these flows, and we expect them to be resilient, but room for manoeuvre has narrowed severely due to the dollar’s surge and is unlikely to reopen up ahead if the US economy is to “run hot,” as the bar for dollar real rates has risen again. Even if US asset markets struggle to make further headway due to US financial conditions tightening, associated risk aversion will not benefit high-carry EM currencies as the dollar smile will exert itself in the form of safety flows.

Exhibit #3: Semiannual Change in Portfolio Liabilities

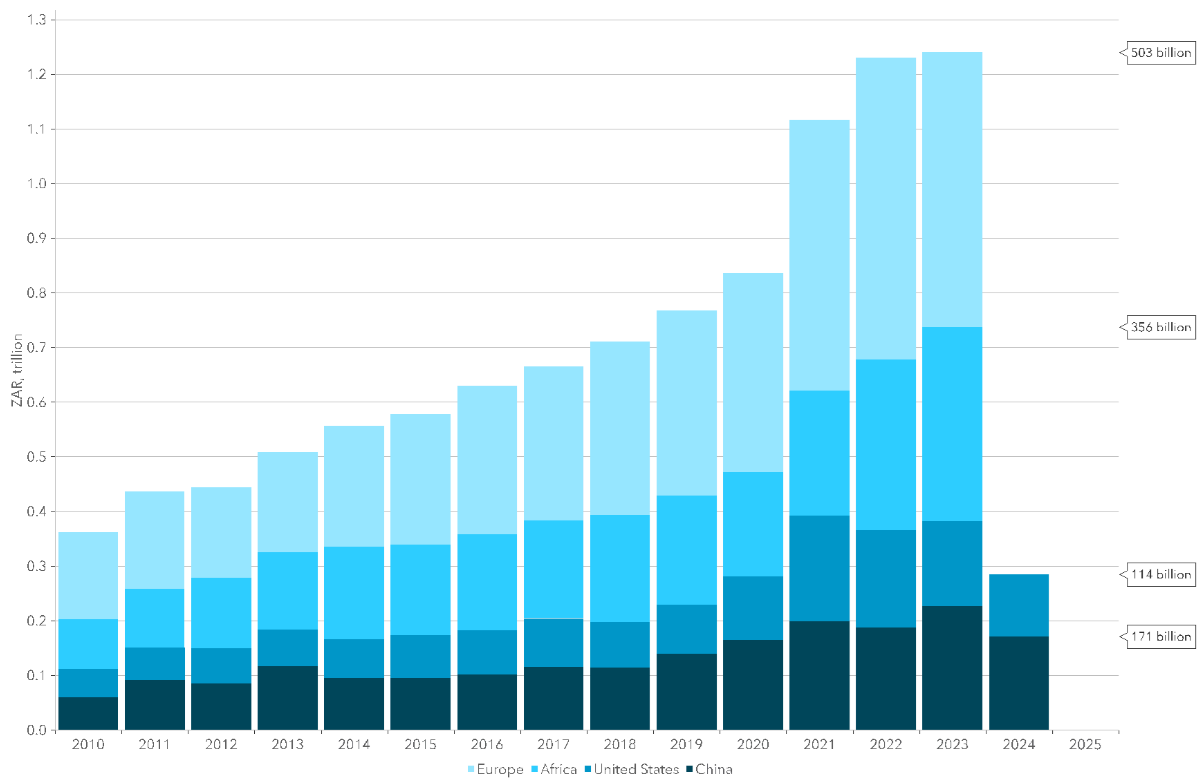


Source: Macrobond, BNY

In such an environment there is a case for SARB to maintain caution ahead of rate cuts, and the October inflation figure to be released before its policy decision will play into the outlook. As markets have likely overcome the first wave of comprehensive liquidation from EM FX, differentiation will start to emerge. Liquid currencies with good real rates and a low US growth/export beta will be in the best position to limit losses or even to benefit outright if prior positioning is light. ZAR ticks all these boxes as the currency remains underheld. Exhibit #3 shows that that portfolio flows have yet to turn around, even though risk premia in government bonds have fallen substantially since general elections in May. The economy

may benefit from exposures to China's stimulus efforts, but more importantly the strong presence of trade with the rest of Africa (Exhibit #4) acts as a substantial point of diversification away from the world's largest economies, which are about to face a period of tumult in their individual trade relationships and growth. The bottom line is that much like the euro, emerging market assets have comprehensively repriced to reflect a new dollar environment, and there is little incentive for now to stand in front of such moves. However, unlike the euro and other G10 currencies, there is greater scope for medium-term recovery and rotational inflows, providing that monetary and fiscal credibility remains, and growth is increasingly diversified towards domestic investment and trade outside the major economies.

Exhibit #4: South Africa Export Distribution



Source: Macrobond, BNY

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