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By:
Kanika Pasricha
kanika.pasricha@unionbankofindia.bank

Maneesh Gupta
maneesh.gupta@unionbankofindia.bank

- **What can challenge the US Dollar exceptionalism?**
- **Rupee clocks fresh record lows**
- **ECB signalled start of rate cuts in June**
- **Inflation pressures keep rate cuts at bay despite technical recession in UK**
- **End of negative interest rates era in Japan and first-rate hike after 17 years**

Synchronised tightening but unsynchronised easing by central banks likely

Divergence in easing by the central banks after months of synchronised tightening may lead to FX volatility

Forex markets are expected to remain volatile in the time to come. Last few years witnessed synchronised and unprecedented tightening by the major central banks to contain inflation. As central banks are winding up their tightening campaign, central banks' monetary policy easing campaign may not be as synchronised which may lead to volatility going forward. In the US, markets have finally aligned their rate cut expectations with the US Fed, proving the worth of famous saying "don't fight the Fed". At the start of the year, markets were expecting 6 cuts of 25 bps. But now market participants expect less than 3 rate cuts of 25 bps which is even below the Fed's own projections of 3 rate cuts of 25 bps in the latest dot plot. Elsewhere, Japan became the last central bank to call time on its negative interest rate policy as well as its Yield Curve Control program. It raised the rates for the first time after 17 years. Back home, USDINR climbed back to record highs above 83.40 levels with sudden surge in oil prices and repricing of Fed rate cut expectations.

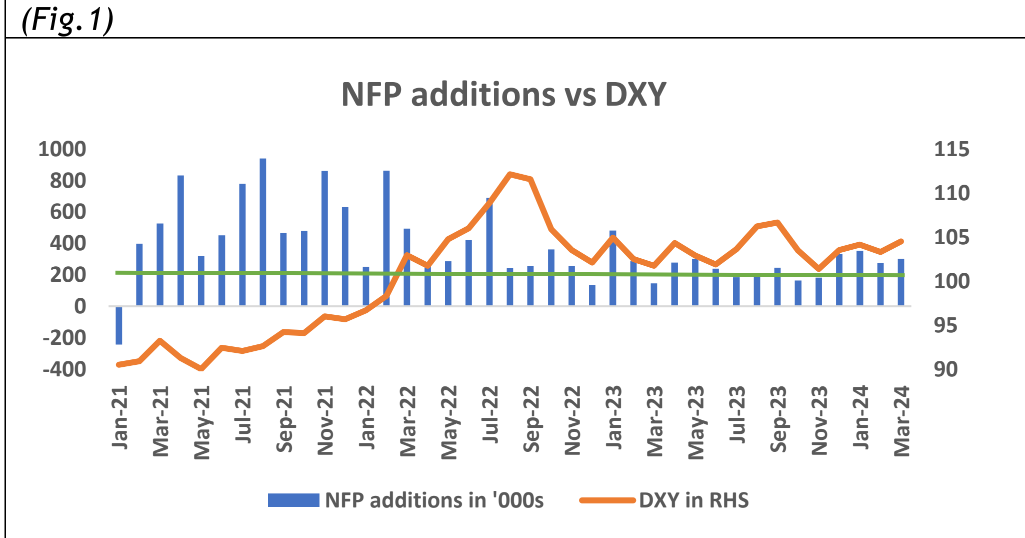
US DOLLAR INDEX ($ - DXY):

What can challenge the US Dollar exceptionalism?

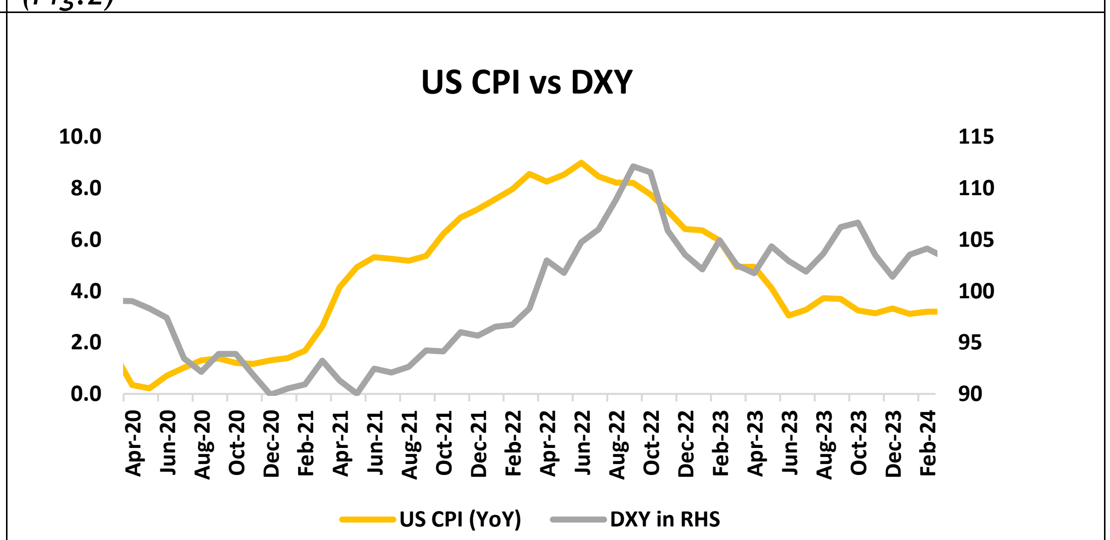
Ongoing US exceptionalism adds to dollar strength

Dollar showed remarkable strength in the last 2 years with unprecedented rate hikes by the Fed, boosting broad-based dollar strength. Dollar index rose as markets finally aligned their expectations with the Fed's dot-plot (3 cuts of 25 bps each) in 2024 as against earlier market's expectations of 6 rate cuts at the start of this year with start of easing from March meeting itself. In fact, some section of markets now expects less than 3 cuts of 25 bps and expectations of June cut slipped down to below 50%. Post FOMC, Dollar weakened to lows of 103.20 as Fed retained the forecast of 3 rate cuts. However, dollar retraced losses and then rose again to 105 levels with focus on the hawkish details of the FOMC decision and data points along with robust labour market releases (NFP, ADP, JOLTS) helped boost Dollar and pared the rate cut bets especially for June. We expect that dollar's exceptionalism will last until markets become convinced that rate cuts are near.

Nonfarm Payrolls addition holding above 200K level (Fig.1)



US CPI inflation cooled but showing its sticky nature (Fig.2)



Source: Cogencis, UBI Research

US economy remains robust

Is there a rush for rate cuts with the economy holding strong?

Dollar strengthened on the back of positive US economic data surprises especially for growth and labour market indicators. Private payroll additions (NFP) remained above the critical 300k threshold in March (at 303K vs est. 214K). Also, average hourly earnings growth on annual basis for the Mar'24 eased but remained above the Fed's inflation goal of 2%. On MoM basis wage growth witnessed uptrend and came in at 0.3% in March vs upwardly revised 0.2% in Feb. Unemployment rate remained below 4% in the last 26 months in a row and it is the first time it is happening since late 60s. This trend will be on close watch going forward.

US GDP growth remained strong with Q4'2023 print clocking 3.2% y/y. This shows that despite tighter financing conditions, economic growth remains strong. Meanwhile a soft landing for US economy is expected this year with other indicators such as ISM Manufacturing PMI also coming back again in the expansionary territory for the first time in 18 months. Strong growth data points are again weighing on the markets with traders trimming their expectations of rate cuts by the Fed in 2024.

Inflation proving to be sticky

Disinflation underway yet 2% target still far away

While disinflation is underway, pace of disinflation is slow to return to 2% target. PCE, the most watched inflation metric by the Fed, inched up to 2.5% in Feb'24 from 2.4% in Jan'24, moving further away from the 2% target. More importantly, Core PCE based inflation came in line with the market's expectations at 2.8% in March which is showing improvement in price pressure but sticky nature of inflation. Recent upward revisions in the Core PCE inflation for 2024 from 2.4% to 2.6% in the Fed's own dot-plot also shows that inflation will likely be stubborn going forward.

Higher for how much longer?

Connecting the dots

In the March meeting, Fed's dot-plot showed that the members' median expectations of rate cuts remained unchanged at 3 cuts of 25 bps each, similar to the projections made in December dot-plot. Markets were anticipating that Fed members may revise their dots up and pare down the rate cuts to two cuts of 25 bps each later in the year. Out of 19 Fed voting members, 10 members expect 3 or more cuts and 9 expect 2 or lesser cuts so median projection of 3 rate cuts was a close one. This implies that any unfavorable inflation may pare the expected Fed's rate cuts this year.

Apart from Fed funds rate projections, Fed also revised its 2024 inflation (core PCE based inflation higher to 2.6% from 2.4%), 2024 unemployment rate (lower to 4.0% from 4.1%) and 2024 GDP growth forecast (higher to 2.1% from 1.4%). Higher GDP growth rate expectations for 2024 with unemployment rate also remaining low is indicating that the economy may manage soft landing. Higher inflation projections in conjunction with maintaining 3 rate cuts of 25 bps in 2024 imply that the Fed may not wait for inflation to reach 2% target and may start cutting rates much earlier.

Apart from that, Fed Chair Powell mentioned that there was some discussion regarding tapering of the QT program and that it would be appropriate to slow the balance sheet runoff however no decision in this regard has been made. FOMC minutes due to be released on 10th April 2024 will be watched for any other details regarding the same.

What can challenge dollar supremacy?

We expect Dollar to weaken from Q3-2024 on start of rate cut cycle by FOMC

In the coming months, the key theme in FX markets remains with respect to how long the USD exceptionalism will persist. Despite dovish Fed, we have seen continued gains in Dollar as other central banks viz Swiss National Bank (SNB), BoE have turned out to be more dovish. In the coming months, with consensus emerging with respect to first rate cut by the Fed in June/July along with start of QT taper, we see a shift in Dollar trends with weakness probably gaining ground.

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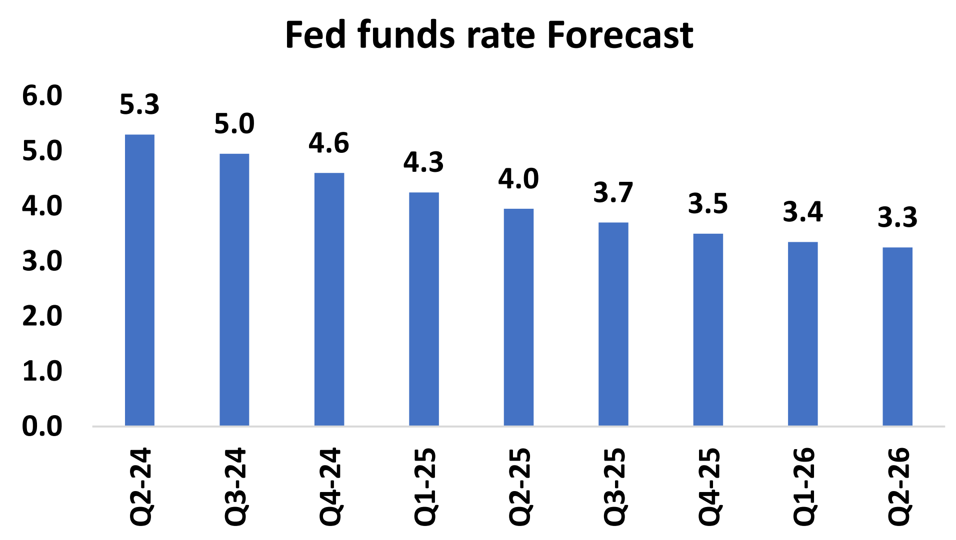
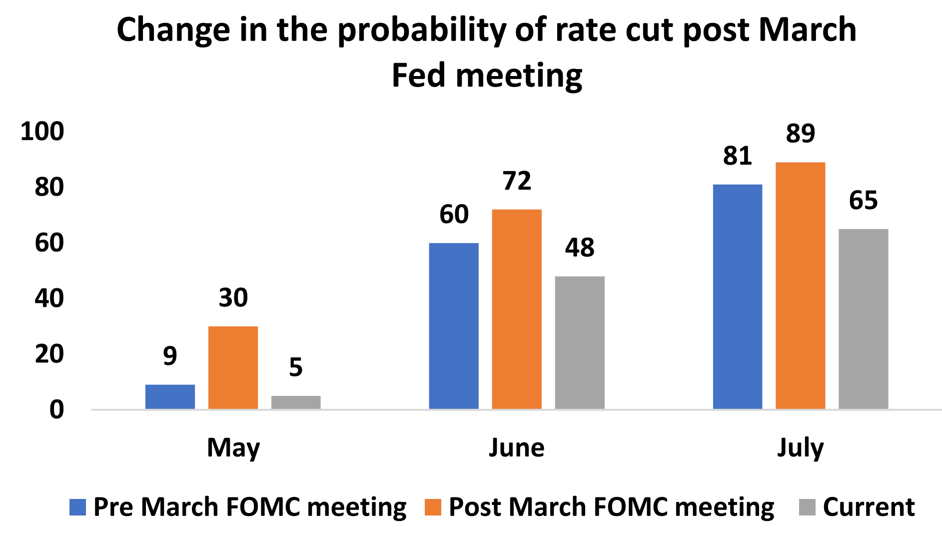
Markets expecting 2 to 3 cuts of 25bps each in 2024 (Fig.3)	Odds of rate cuts for June meeting rose post FOMC but now slipped below 50% for June meeting post strong data sets (Fig.4)
	
Source: CME Fedwatch Tool, Bloomberg, UBI Research	

All eyes on data

In this regard, all eyes will be on the next set of jobs and inflation data indicators. NFP additions above 300,000 for Mar'24 highlights continued strength in labor markets. Inflation reading would also be keenly watched with recent two readings showing that last mile to inflation returning to 2% would be the most difficult. Fed mentioned that despite higher readings in the past two months, disinflation process is continuing. Fed Chair Powell also mentioned that road to 2% inflation target would be bumpy. Next set of readings would be closely watched. FOMC meeting minutes would be closely eyed for more clues regarding next set of Fed's actions. Fed is expected to start the rate cut cycle before US elections in Oct-Nov month.

Going forward, other factors such as geo-political developments and overall risk sentiment in the markets would be watched closely for the trends in the greenback.

Next set of datapoints and comments by Fed and other central banks would be key for trends in the US dollar.

INDIAN RUPEE (₹ - INR):

Rupee clocks fresh lows

Continued surge in oil prices may pose challenge to rupee stability

Despite strong fundamentals, USDINR has clocked fresh record lows above 83.40 levels as oil prices have moved above 90 $/b threshold and strong Dollar weighed on the Indian rupee. In fact, rupee remained largely stable in the last few months but has started to witness volatility especially in the past few days.

Global Scenario uncertain

Fed rate cut repricing may boost Dollar and weigh on rupee

In the global developments, US inflation proved to be stubborn with all the inflation readings such as CPI, PPI and PCE based inflation remaining elevated. Fed members also aired their views and mentioned that they need more data to get confidence that inflation is moving towards its 2% target. Recent geopolitical tension and surge in oil prices may push inflation higher and make the job of global central banks as well as RBI tough going forward. Hence, going forward, Fed's meeting and US data would also be key and if inflation resurges in US then Fed may keep rates higher for longer and this will also weigh on rupee.

Other factors may also play their part with surge in oil prices key concern

Rise in oil prices may weigh on rupee

Apart from Dollar, there are other factors which may affect rupee in short term. Oil prices rose above 90 $/b (Brent crude) and any further upside movement in oil prices will be negative for rupee. It needs to be noted that India's C/A deficit shows high oil price sensitivity – every 10 $/b change in annual oil price average affects C/A deficit by $ 15bn.

Strong fundamentals likely to cap the upside in USDINR

Economy robust, inflation under control

In terms of data points, inflation slowed to 5.09% in Feb'24 from 5.10% in Jan'24. GDP data surprised on the upside with revisions in the previous quarters showing GDP growth of above 8% for all three quarters of FY24. Trade data showed that merchandise trade deficit narrowed and net services exports rose to record high levels. Bond markets received inflows ahead of inclusion of Indian bonds in the global bond indices. All these factors supported the Indian rupee with dollar rupee pair falling to as low as 82.65. But recent volatility pulled rupee again back to near record low levels.

Foreign fund inflows supporting rupee

Strong trend in Foreign funds flows

Equity as well as debt markets also continued to receive inflows and trend is likely to persist which is likely to provide support to the Indian rupee. RBI in its monetary policy meeting announced that they will continue to do fine-tune operations to manage liquidity and remained pat on rates and stance of withdrawal of accommodation.

FIIs remained net buyers both in the bond and equity markets in the month of March. However, RBI likely absorbed some of the flows to smoothen the rupee's rise and to build on the forex reserves kitty. Inclusion of Indian bonds in the global bond indices (JP Morgan Global diversified and Bloomberg Emerging market index) are expected to attract global foreign fund inflows into the markets and the same is expected to provide fillip to the Indian rupee in year ahead.

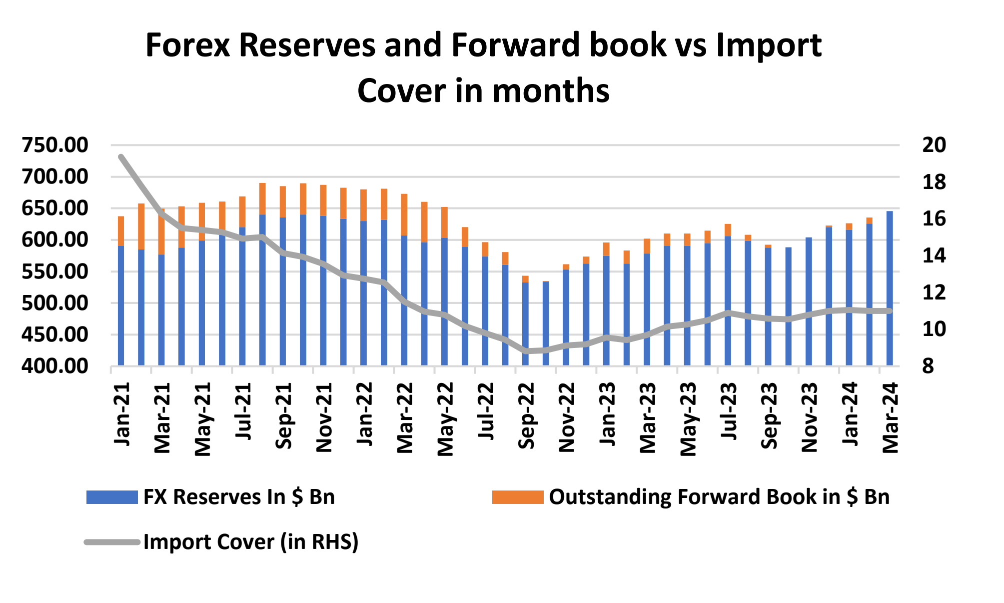
Global investors looking to be part of Indian growth story

Bonds continue to attract flows ahead of Indian bond inclusion in the Global bond index

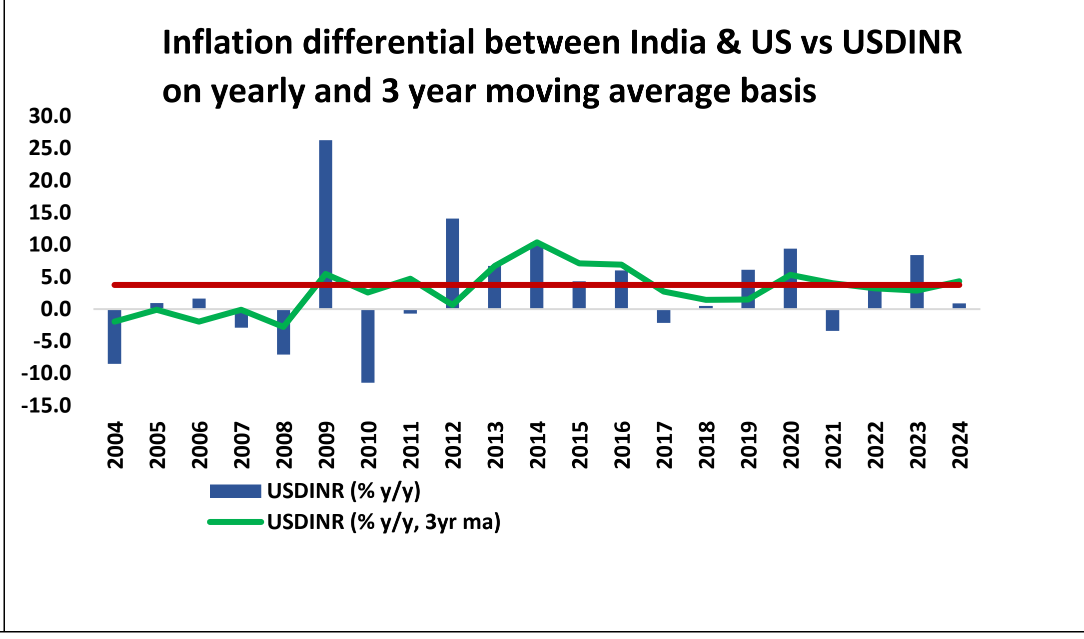
Announcement by the Bloomberg of Indian bond inclusion in its Emerging Markets index as against expectation of inclusion in its main Global Bond Aggregate index meant that foreign fund inflows would be lesser than earlier thought, however the development overall was positive in terms of rupee's medium-term trajectory. Indian debt market received around $ 10bn since November 2023 as global investors position ahead of global bond index inclusion starting from Jun'24. Additionally, $ 4-5bn flow seen in SUPRA bonds which do not hit domestic shores.

With the likely easing in QT by the Fed as it starts rate cut cycle this year, an additional $ 20-30bn of FPI flow is expected in domestic bond markets this year.

Forex Reserves touched highest on record but below highs recorded in Oct'21 inclusive of outstanding forward book (Fig.5)



3-4% average inflation differential means rupee may also depreciate by same quantum annually on average (Fig.6)



Source: RBI, UBI Research

RBI is expected to build on to its Forex Reserves kitty

Forex Reserves at record high levels

It is expected that RBI will continue to build on the forex reserves and buy the dollars going forward. Forex Reserves plus Outstanding forward book reached its record highest level of c.$690 Bn in the month of Oct in 2021, which shows that RBI can still add on to its existing tally of c.$645 Bn. Forex Reserves cushion can be used by the RBI to control increased volatility arising post India's inclusion in the global bond index (with RBI Gov. warning that bond inclusion is a double edged sword) as well as to improve the import cover (currently at c.11 months).

Rate cuts by RBI still has some time to come

Rate cuts later rather than sooner

In terms of RBI's monetary policy action, with economy showing strong momentum and inflation still above the RBI's mid-point of the target band of 4%, it is expected that RBI would wait for the major central banks to lower rates before going ahead with cuts which are expected later in the year. Moreover, robust credit growth may also weigh on RBI's rate cut decision which may come in October meeting as per our expectations.

Rupee is expected to see mild appreciation in 2024

We maintain our appreciation bias for rupee

Overall rupee is expected to see some appreciation bias however large moves on the upside for rupee are not expected with RBI expected to absorb some of the flows and global scenario still filled with uncertainties. Apart from that, overall risk sentiments in the markets, dollar's trajectory, crude oil price movement, geo-political developments and FPIs inflows/outflows would be watched. In terms of technical levels for USDINR, on the downside, zone near 82.50-82.65 would act as a support. On the upside, 83.50 would be a key level to be watched.

For the next one year, we expect rupee to appreciate towards 81-82 but also expect that rupee may not breach 81 level with absorption of flows by the RBI expected. However, in the medium term, rupee is expected to see some downward pressure due to covered interest parity expected to pull rupee lower in medium term (pls see next section for covered interest parity).

Uncertainty regarding timing of start of rate cuts by the Fed and if upward pressure on oil prices persists (90$/b is a critical threshold) may continue to lend volatility to Rupee in the near term.

Average inflation differential between India and US is expected to provide depreciation bias in the medium term

Historical Inflation differential between India and US remained at around 3-4% which mean that rupee is likely to depreciate by same magnitude in the medium term on average, according to covered interest parity. With rupee showing depreciation of around 9% in FY23, it is expected that it may again see steep depreciation in medium term (probably in FY26) after remaining largely stable last year with some appreciation expected in FY25. However, there is a risk that some of the depreciation moves expected in the next year (FY26) may come this year and limit the upside expected in FY25.

EURO (€ - EUR):

ECB likely to cut before Fed

ECB signalled start of rate cuts in June

ECB was the first major central bank announcing the policy decision in the month of March. ECB kept the rate unchanged but signalled that it is near the start of the rate cut cycle. ECB mentioned in its statement that ***"we will know a little more in April, but we will know a lot more in June".*** So, June rate cuts are widely expected with total rate cuts expected in 2024 are 120 bps.

ECB Chair Lagarde acknowledged in March that growth is weak and inflation is coming down. ECB reiterated that they will continue to keep restrictive policy as long as necessary to bring inflation lower to 2% and future decisions will be data dependent. Given higher market probability of start of rate cut cycle by the ECB in June vis-à-vis the Fed, the Euro has been under pressure.

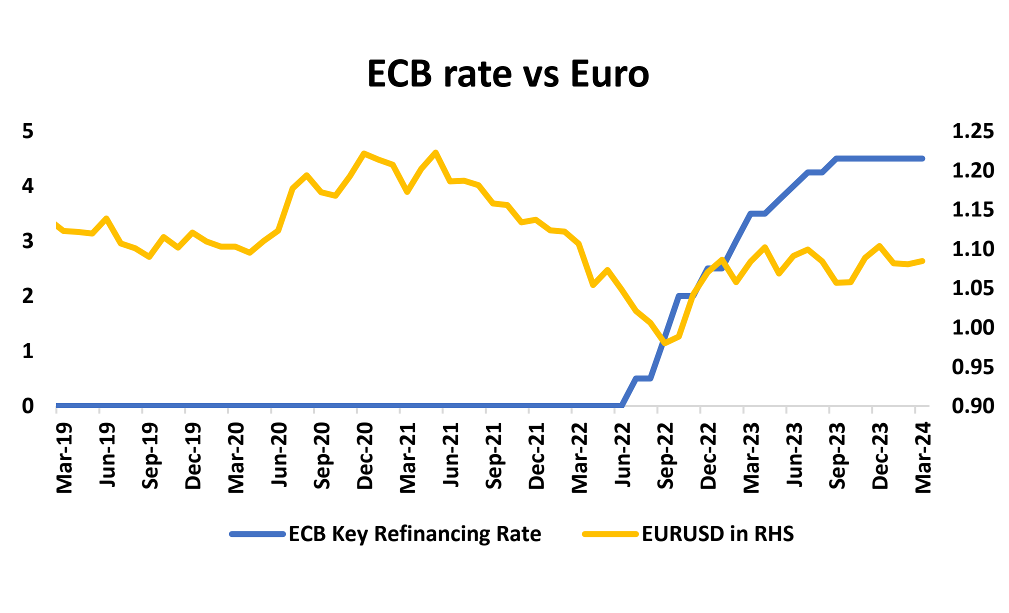
Economic data supporting rate cuts

Inflation cooling in Eurozone

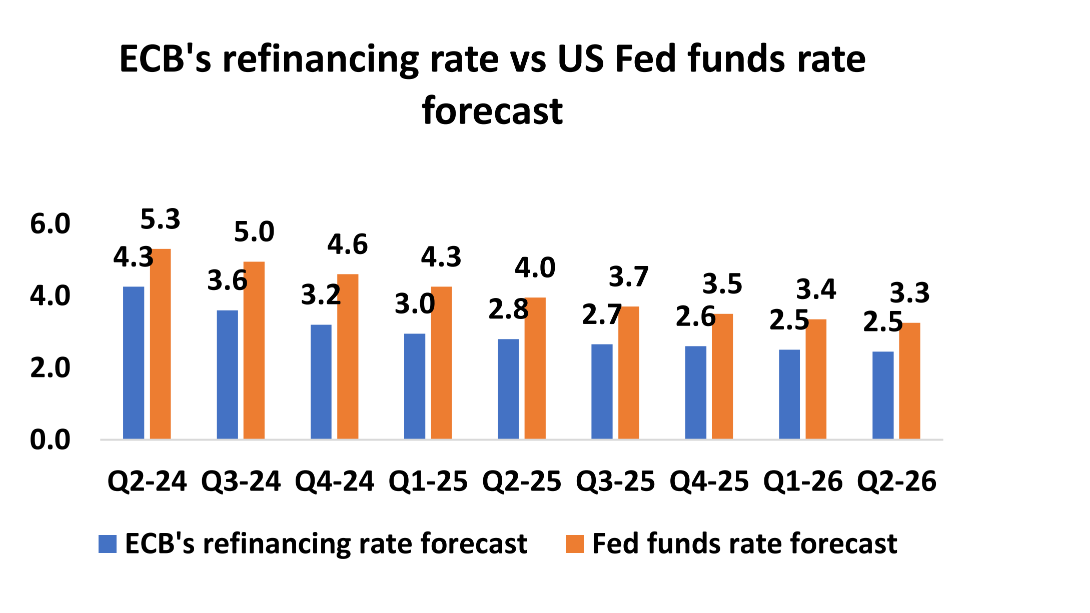
According to ECB staff projections, inflation has been revised down, in particular for 2024 (2.3%) which mainly reflects a lower contribution from energy prices. Core inflation projections have also been revised lower. ECB also mentioned that although most measures of underlying inflation have eased further, domestic price pressure remain high, in part owing to strong growth in wages. ECB mentioned that financing conditions are restrictive and our past interest rate increases continue to weigh on demand, which is helping push down inflation.

Eurozone CPI inflation in Mar'24 cooled further to 2.4% as against 2.6% reading for the month of Feb'24, according to the official preliminary estimates. Although there are upside risks from energy prices but recent inflation readings are showing progress made especially after prices pressure post Russia-Ukraine war. Meanwhile, latest reading showed GDP growth remaining flat. Economic activity is expected to remain subdued in the near term.

Euro under pressure on rising rate cut prospects (Fig.7)



ECB expected to start rate cut cycle before Fed (Fig.8)



Source: Bloomberg, UBI Research

ECB may lead the Fed and BoE in terms of rate cuts

Markets are widely factoring in the possibility of a June rate cut. ECB members' commentary has turned more dovish with some members saying that ECB should go ahead with rate cuts irrespective of Fed moving on rates. ECB meeting is scheduled in the month of April which would be keenly watched especially after recent fall witnessed in inflation levels. However, we expect that the ECB may be watchful and keep rates unchanged in April meeting before starting rate cut cycle in June.

In the near term, Euro faces pressure with expectation of ECB cutting rates before US Fed. Euro may test the levels of 1.07 when ECB starts cutting rate. However, as the Fed initiates monetary easing from June, we may see gradual appreciation in Euro emerge. However, as seen in the last two years, Euro faces a technical resistance of 1.11-1.12 given fundamental weakness in the economy.

POUND (£ - GBP):

Inflation and wage pressures keep rate cuts at bay despite technical recession in the UK

BoE may start cutting rates after ECB and US Fed

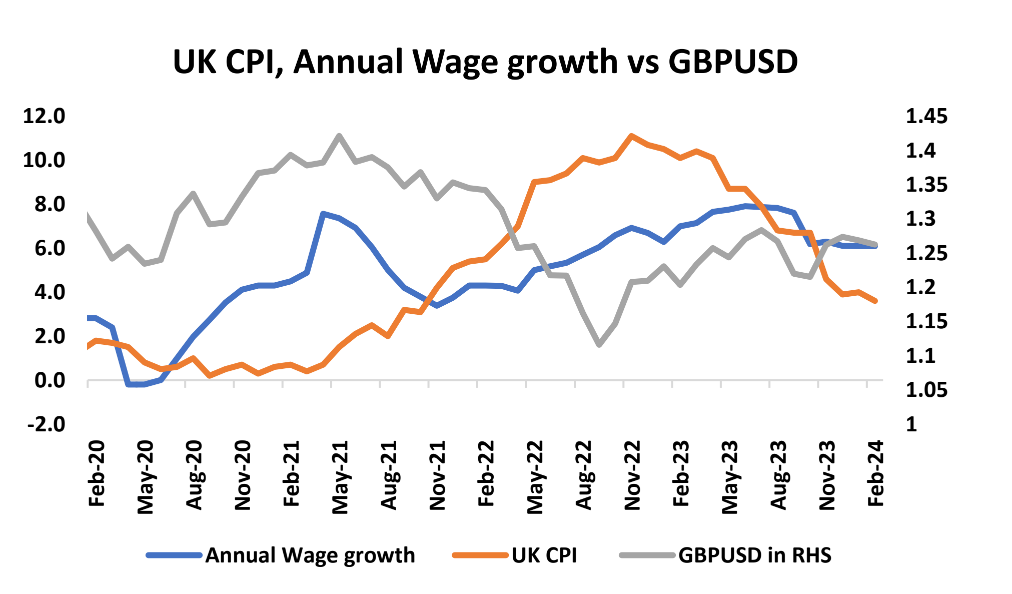
Pound has received support on the back of expectations that BoE will continue with higher rates despite concerns on growth front as inflation there remains elevated. Bank of England in its latest policy announcement in March decided to keep rates unchanged. BoE acknowledged that inflation pressures persist in the economy with services inflation still high. Wage growth has moderated but remains elevated.

CPI inflation is projected to remain above the 2% target over nearly all of the remainder of the forecast period, owing to persistence in domestic inflationary pressures, according to BoE's own projections which may delay the start of rate cuts by BoE. This is in contrast to other major central banks which are seeing marked fall in inflation such as Fed and ECB.

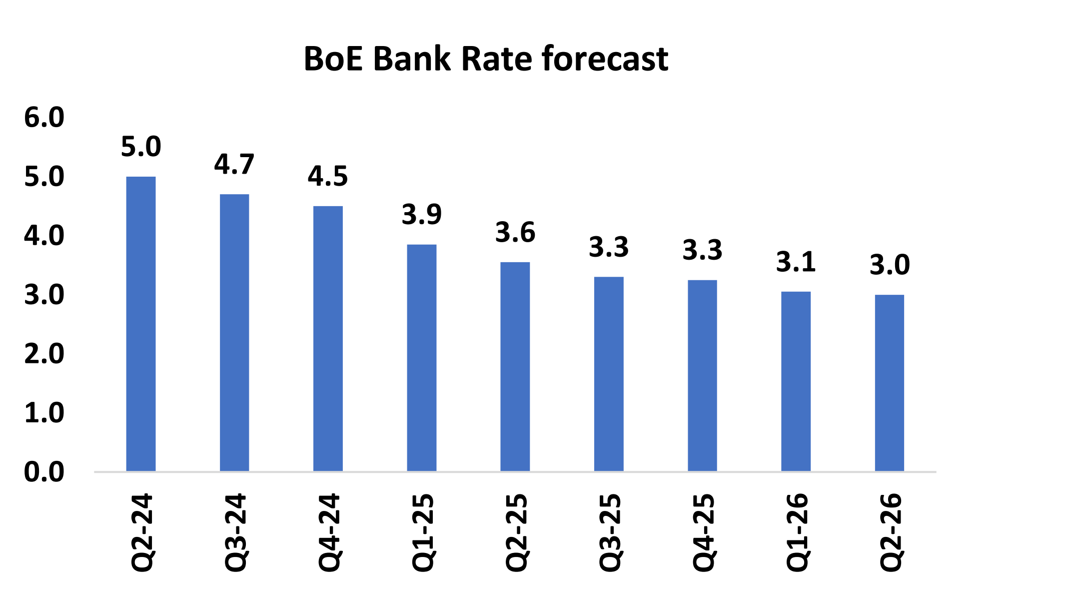
On growth front, BoE acknowledged that there is growth divergence between US and UK with US faring better. UK real GDP had fallen by 0.3% in 2023 Q4, this had followed a 0.1% decline in Q3 which means that UK faced technical recession.

March policy minutes showed that there is no divergence between BoE members with all the members except one voting for rates to remain unchanged. One of the members voted for rate cut and none of the members voted for rate hike. Meanwhile, in the previous meeting, there was a lack of consensus and members voted for all the three options i.e. hike, hold and cut the rates.

Annual Wage growth still elevated in UK and above 6% (Fig.9)



BoE expected to make larger cuts going forward when inflation starts to drop (Fig.10)



Source: Bloomberg, UBI Research

Pound may continue to outperform on monetary policy differential

Markets expect BoE to start cutting rates from June though we believe that the wage and other price pressures in the economy may force the BoE to wait a little longer.

Going forward, key data points especially related to labour market and inflation data would be on close watch. Off-late pound has overperformed G10 FX on account of monetary policy differential.

Fed meeting and its commentary would also be key. Lastly updates on geo-political developments would be key for overall risk sentiments. Our view is that BoE may enter the rate cut cycle later than Fed and ECB which will give support to the pound in the coming months. However later BoE may expedite rate cuts if inflation pressures cool sharply in H2 2024.

Overall continued dollar exceptionalism will limit the upside movement in Pound. Going forward, we expect Pound to gain towards 1.29 once Fed starts cutting rates in Q3 but then as BoE enters the rate cut cycle, Pound is expected to see moderation 1.24 key level to watch for.

JAPANESE YEN (¥ - JPY):

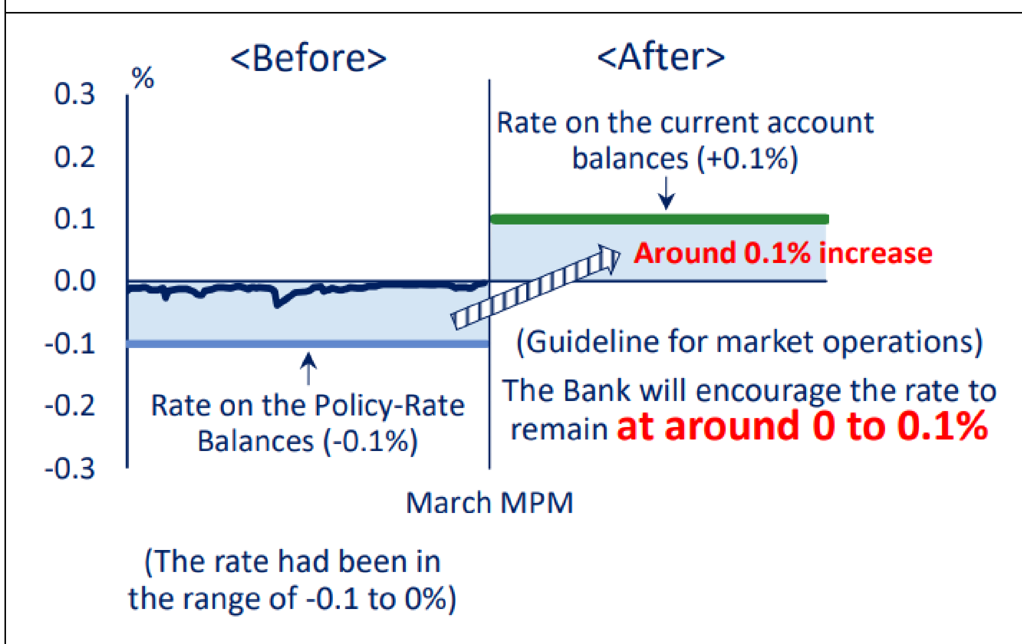
First rate hike after 17 years

End of negative interest rates era

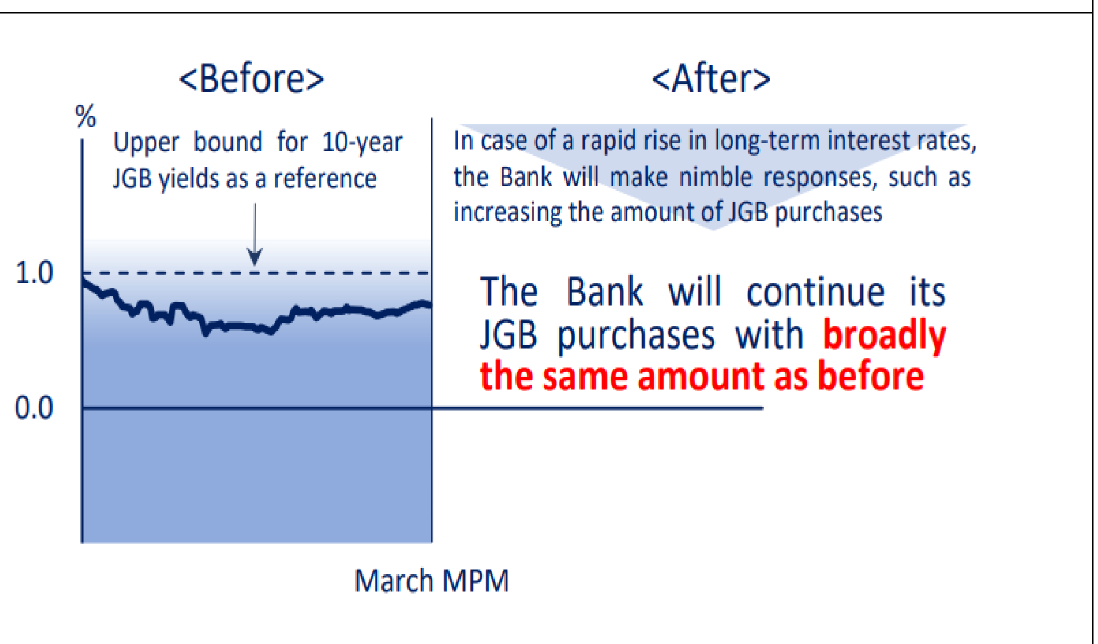
Bank of Japan remained an outlier in the global central banking fraternity and raised rates recently at a time when other central banks are near pivot from tightening to easing of monetary policy. Bank of Japan has removed its negative interest rate policy (NIRP) and raised rates for the first time since 2007. It raised the shorth term rates (uncollateralized overnight call rate) from -0.10% to 0% earlier to 0% to +0.10% now. Bank of Japan has been the last major central bank having negative interest rates in recent years.

Japanese yen depreciated by almost 30% since the start of 2022 to Oct'22 as other major central banks were tightening the monetary conditions but Bank of Japan remained an outlier. Yen recovered some ground in 2023 only to fell again as Bank of Japan tweaked its YCC program but continued with its negative interest rate policy. Imported inflation pressures raised the CPI inflation to above the BoJ's target level. BoJ's decision of rate hike came as CPI based inflation remained above BoJ's 2% target for more than a year. But will inflation sustain above 2% level is a big question which only time will answer as it has rose above 2% target in 2014 (when BoJ announced stimulus) only to again slip towards 0%.

Short term rates by BoJ now in positive territory (Fig.11)



YCC program abolished with no upper bound for 10 yr JGB yields (Fig.12)



Source: BoJ, UBI Research

Yen depreciated even after the first-rate hike in 17 years

Interestingly, Japanese Yen remained on the back-foot despite BoJ raising the rates. This seemed counter-intuitive but can be attributed to few things. First, the message was well telegraphed by the BoJ to the markets with rate hike decision well discounted ahead of the event. Last year when the BoJ tweaked the YCC program, it was followed by a knee jerk reaction but it was not the case this time round. Second, the BoJ mentioned that the wage negotiations happening in March (also known as Shunto) would give more clarity regarding inflation trajectory and rate path going forward. When Japan's largest federation of trade union, Rengo announced that country's biggest firms are set for biggest salary increase in 30 years, it cemented the expectations of policy normalisation by the BoJ. Lastly, USDJPY movement was decided not only by the BoJ decision but also by the movement of dollar ahead of US Fed's decision. With markets repricing their rate cut expectations by the US Fed, broad-based rise in dollar pulled the Yen lower. Yield differential between rates of US and Japan is still north of 5% which mean that carry trade remains a good prospect.

Wage hike cemented rate hike expectations

Biggest wage hike in 30 years

As highlighted above, wage hike this year topped the 5% mark for the first time in 30 years, according to trade union group Rengo. This is expected to feed into inflation going forward however it is still to be seen whether inflation stays above the 2% mark.

BoJ on a rate normalisation path

BoJ raised the rates by a majority of 7-2 to 0 to +0.1%. It also mentioned that it is doing away with its yield curve control (YCC) program. YCC program constituted bond purchases by the BoJ to maintain the upper bound of yields for 10-year JGBs at around 1% level. Bank of Japan mentioned that they will continue with its JGB purchases but refrained from mentioning any target level for 10-year yields. It also mentioned that in case of a rapid rise in long-term interest rates, it will make nimble responses such as by increasing the amount of JGB purchases.

Forward guidance remained neutral

BoJ is the only major central bank that buys stock funds or exchange traded funds (ETFs) to support the market in the easy monetary policy phase. BoJ announced that it will discontinue purchases of ETFs. However, Bank of Japan mentioned that given the current outlook for economic activity and prices, the Bank anticipates that accommodative financial conditions will be maintained for the time being.

BoJ Governor Ueda remained neutral in the press conference after the historic policy decision of ending the negative interest rate policy. Ueda kept the door open for both the possibilities going forward i.e. raising the rates further or maintain accommodative policy. He also emphasised that accommodative conditions will be maintained as long as price trends are below the 2% target.

Incremental steps from BoJ expected

What's next for Yen and BoJ

Although BoJ raised the rates but the rate hike did little to bridge the gap between interest differential between global central banks (which are still sitting at the peak of the rate hike cycle) and BoJ. Also, no clear forward guidance on the future steps to be taken by the BoJ was provided which means data on inflation will be key to watch and any upward pressure will push the BoJ to hike further. Yen depreciated and dollar yen pair breached 150 level and further downward pressure on yen may invite intervention by the BoJ and MoF. So, we expect that any upward movement in the USDJPY would be limited and restricted around 152 levels.

Next month, the projections by the BoJ would also be watched for upgradation of inflation after recent wage negotiations and any more clues regarding steps going forward. As per markets expectations, BoJ may hike rates further in the coming months. Our view is that BoJ may now be in a wait and watch mode and may raise rates later in the year only after becoming sure that inflation will remain sustainably above its 2% target. As confidence towards Fed rate cuts likely build up in Q3-2024, we see Dollar weakness and strength in Yen going forward.

Banking Research Team	
Kanika Pasricha **Chief Economic Advisor**	**kanika.pasricha@unionbankofindia.bank**
Suneesh K	suneeshk@unionbankofindia.bank
R Gunaseelan	gunaseelan@unionbankofindia.bank
Nidhi Arora	nidhiarora@unionbankofindia.bank
Rajesh Ranjan	rajeshranjan@unionbankofindia.bank
Jovana Luke George	jovana.george@unionbankofindia.bank
Ashish D Dhok	ashish.dd@unionbankofindia.bank
Rohit Yarmal	rohitdigambar@unionbankofindia.bank
S. Jaya Laxmi	s.jayalakshmi@unionbankofindia.bank
Ajinkya Tawde	ajinkya.tawde@unionbankofindia.bank
Kanhaiya Jha	kanhaiya.jha@unionbankofindia.bank
Maneesh Gupta	maneesh.gupta@unionbankofindia.bank