UniFX - Monetary policy divergence stays key theme; Politics adds to volatility

18th June 2024

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Dollar reigned supreme with monetary policy divergence key theme

The US Dollar Index (DXY) is showing volatility as the market pricing of rate cut cycle has seen a see-saw amid data fluctuations even as bouts of geopolitical tensions keep the safe haven demand supported. Consequently, these factors continue to drive the US Dollar, with the uncertainty remaining regarding timing of start of rate cut cycle while some G10 central banks have already begun monetary easing.

Uncertainty remains on timing of start of FED rate cut cycle

Hence, the underlying theme in FX markets is monetary policy divergence, with sub-themes as follows:

- *FED- Likely to hold rates till November and support Dollar in near term*
- *ECB – Hawkish start to rate cut cycle; political instability puts Euro under pressure*
- *BoE – Next G8 economy likely to cut rates; GBP also at mercy of political outcome*
- *BoJ- Dovish surprise in June policy; intervention risk remains in JPY*

US Dollar likely to stay strong, but till when!

Markets have been predicting a likely shift in Dollar trend towards weakness for past few months yet the timing keeps getting shifted on Fed policy uncertainty. Hence, the greenback has continued to extend its dominance against most major currencies, with the dollar index up 4.10% this year.

DXY likely to remain choppy in near term

Meanwhile, after hitting 114 levels in Sep'22, the DXY index has seen sharp correction to stabilize in the range of 104-106. The range break is likely once the uncertainty regarding the timing of start of rate cut cycle fades away.

US data: a mix of strong growth yet cooling inflation

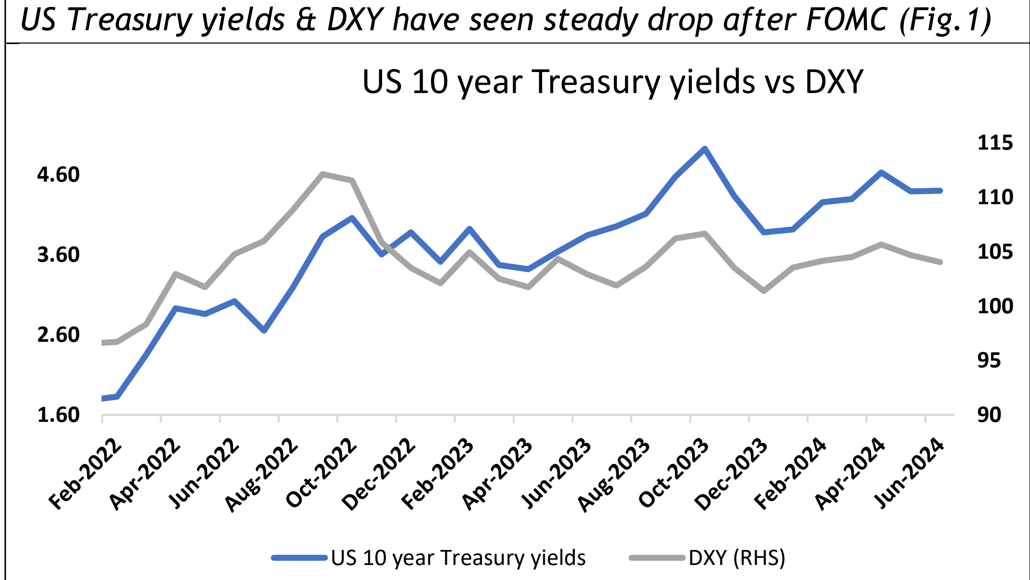
Nonfarm Payrolls (NFP) data in the US rose sharply to 272K in the month of May vis-a-vis market expectation of 195K. The fact that the previous reading of 185k got revised down to 165k makes this number much stronger. Meanwhile, the unemployment rate inched up to 4% vs previous reading of 3.9%.

While labor market dynamics continue to show resilience, the recently released US CPI data revealed that inflation cooled slightly in May to 3.3% YoY, below market consensus of a flat reading of 3.4%. Also, core CPI eased to 3.4% YoY vis-à-vis 3.6% below 3.5% expected.

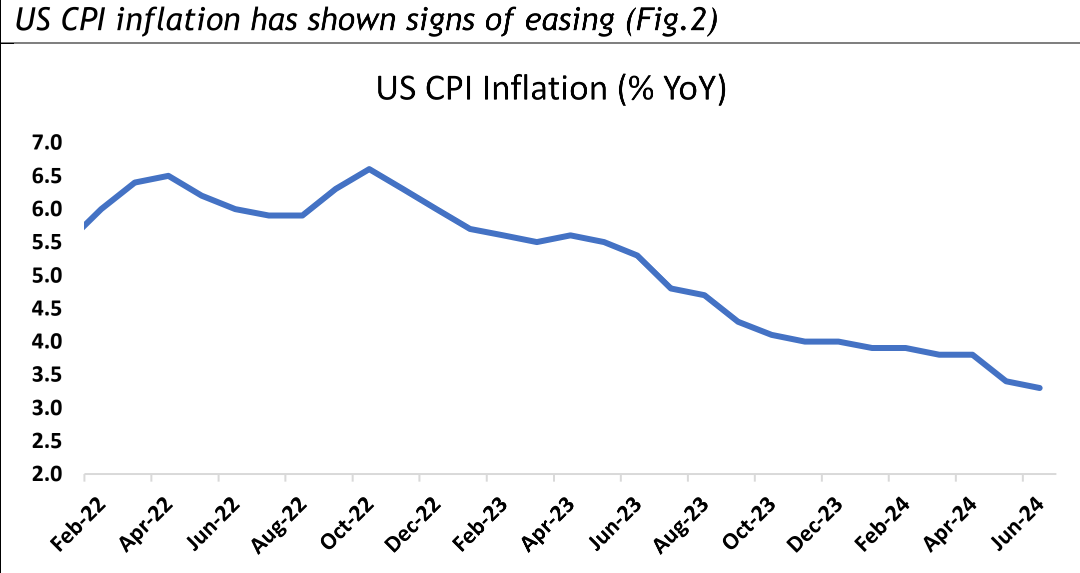
June FOMC in hawkish mode while market moves are dovish

In recently concluded June FOMC, Powell kept rates steady at 5.25-5.50% for straight 7th

US Treasury yields & DXY have seen steady drop after FOMC (Fig.1)



US CPI inflation has shown signs of easing (Fig.2)



Source: Cogencis, UBI Research

Election outcome to drive Dollar trends in Biden vs Trump contest

straight meeting, indicating only one rate cut before end of 2024, citing elevated inflation. Officials raised 2024 inflation forecast from 2.4% to 2.6%. Median forecast shows 100 bps of rate cut in 2025. The CME Fed-Watch tool shows there is 80% probability for start of rate cut cycle in Nov'24. The US 10Y touched highs of 4.73% in Apr'24 but started softening to clock 4.22% post June FOMC amid easing inflation data.

US Presidential elections In November may lend some volatility to Dollar

The recent trends of US election polls reveal a neck-to-neck fight between Biden and Trump. A tough fight is expected by markets between Biden and Trump, with voters concerned about the former's age and the latter's legal problems.

While the Presidential election is still five months away, financial markets are continuing to weigh in on the final outcome of the tight race. As markets do not like uncertainty, therefore the US elections are likely to bring in increased volatility in USD. The continuity and stability offered from Biden may be welcomed by US investors in the near term however in the medium term, focus will shift on Biden's domestic priorities along with the fiscal policy. Meanwhile, in case of a victory for former President Trump, the presumptive Republican nominee, expectations of pro-business policy and possible escalation of trade disputes may boost the Dollar, in our view.

Geo-political tensions remain on watch

Geo-political tensions supporting Dollar's safe haven demand

The persistent geopolitical tensions, notably the conflicts in the Middle East and Ukraine, and Western sanctions against Russia, underscore the interconnectedness of global economic and political landscapes. The Black Sea region, a crucial hub for agricultural exports, has seen severe interruptions, causing ripple effects in global food prices and exacerbating inflationary pressures in importing countries.

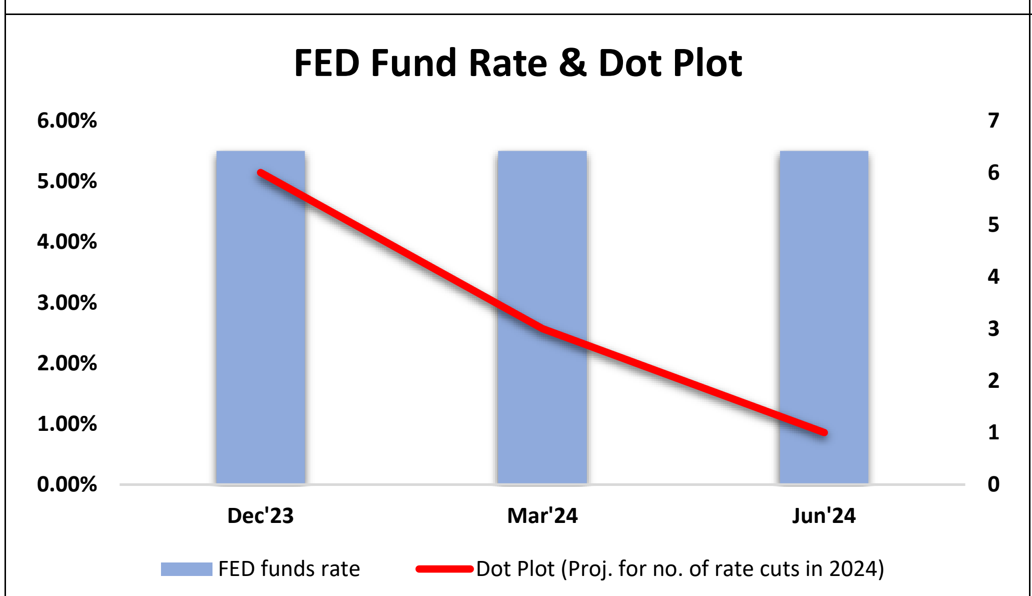
The ongoing conflict in the Middle East between Israel-Gaza is also keeping the market under uncertainty. The conflict which stared by an attack from Hamas on October 2023, which lead to military response from Israel has been ongoing. Any further escalation in other parts of Middle east may see the safe-haven demand from greenback receiving a boost.

While the current U.S. presidential elections may affect the ongoing trade tensions with China and impact on safe have demand for the greenback.

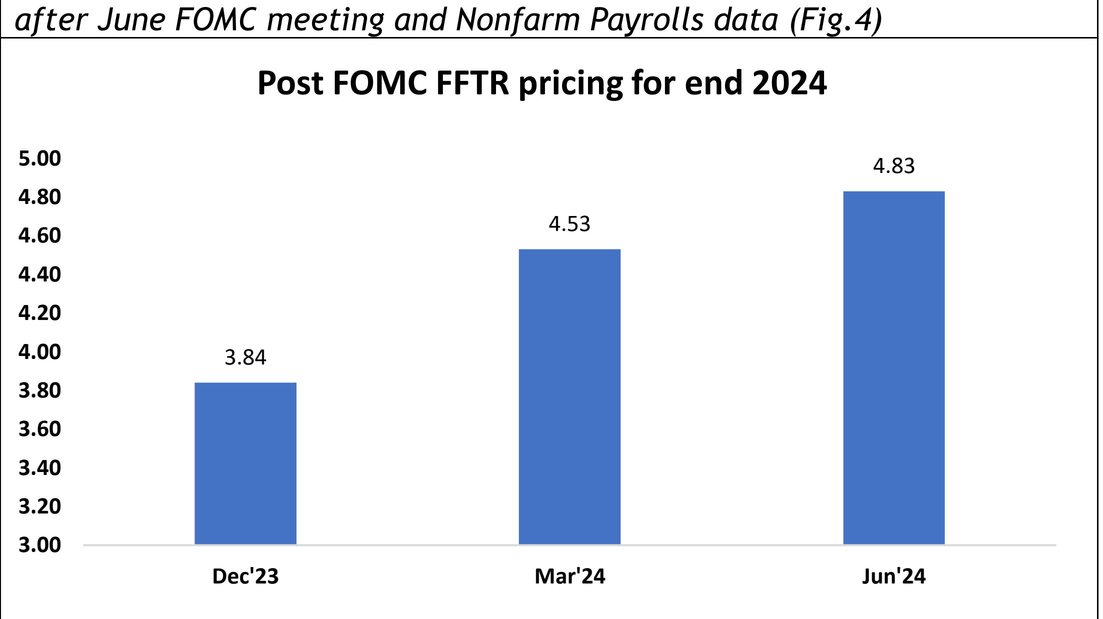
US Dollar Index ($ - DXY) view:

The recent appreciation should not be seen in correlation with the recent softening in the US economy, which could still bring more easing in the greenback over the coming months. On the downside, the DXY is supported at 104.00 levels while the upside is capped

FOMC expects a cut of 25bps by end-2024 (Fig.3)



Odds of the start of rate cuts for September meeting rose above 50% after June FOMC meeting and Nonfarm Payrolls data (Fig.4)



Source: CME Fedwatch Tool, Bloomberg, UBI Research

US GDP growth cooled slightly to 1.6% in Jan to Mar'24 quarter. GDP growth for Q1'24 came lower than the market's expectations of 2.4%. Growth for Q1'24 was the slowest witnessed since Q2'22. This trend shows that there is some cooling being witnessed in the economic activity in the latest data. ISM Manufacturing PMI registered 49.2 in April, down from the 50.3 recorded in March. Conference board consumer confidence dropped for 3rd month in a row to 97 in April. NFIB Small Business Optimism Index plummeted to 88.5 in March, marking the 27th consecutive month the index fell short of the 50-year average of 98.

Fed Chair Powell mentioned in its post policy press conference that next move is unlikely to be a rate hike. He dismissed the fears of stagflation. However, he also mentioned that Fed may need greater confidence which may require more time. So, rate cuts are going be delayed and with US economy remaining largely strong, dollar's supremacy is likely to continue with focus squarely on the next set of inflation readings.

What can challenge dollar supremacy?

Dollar is expected to largely remain elevated in 2024 due to various risks

In the coming months, the key theme in FX markets remains with respect to how long the USD exceptionalism will persist. We expect first rate cut is expected to come in September meeting. Inflation remains stubborn in US which is likely to keep dollar elevated. In the coming months, we expect dollar to remain elevated with upcoming data crucial as any indication of softness in data should be keenly watched.

Geo-political tensions remain on watch, keeping commodity prices elevated

Geo-political tension seems to have subsided however risks still persists that further escalation may pull oil prices higher, dampen the risk sentiments and pull rupee lower.

Chinese yuan devaluation remains key tail risk to monitor

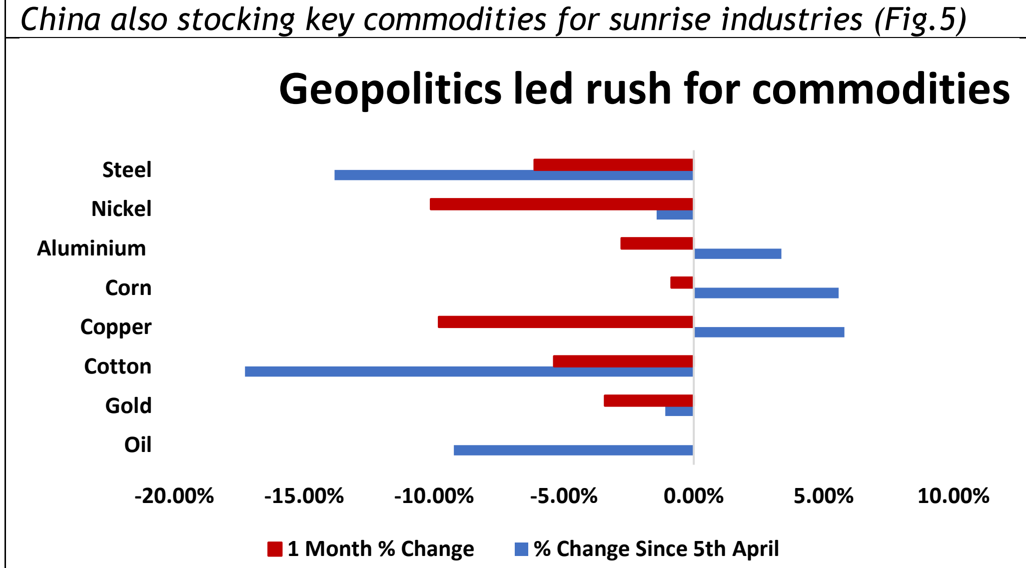
Reports of Chinese yuan devaluation presents a threat to Asian currencies including Indian rupee. China has been stocking commodities which is considered to be a precursor for devaluation similar to 2015. However, we expect that devaluation step may not be easy for Chinese authorities with inclusion in IMFs SDR basket post 2015 remaining a key hurdle apart from negative signal to foreign investors from devaluation. However, it still remains a key risk to watch out for.

INDIAN RUPEE (₹ - INR):

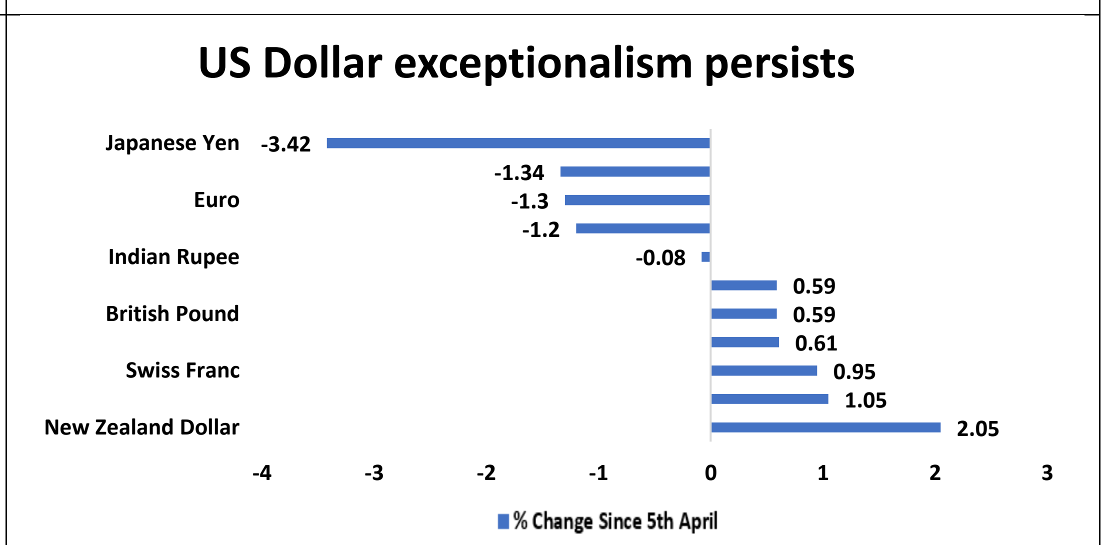
Rupee slipped to record low of 83.59 levels post election results

Post-exit polls; we saw a sharp improvement in the market sentiments due to the political stability and rupee appreciated to 83/$ levels. However, due to the huge difference between exit poles & post-election results entire domestic market saw a big fall; rupee depreciated near to the all-time lows of 83.53/$ levels and got settled there.

Geo-politics led rush pushed prices of commodities higher with China also stocking key commodities for sunrise industries (Fig.5)



Rupee at record lows major yet outperforming G4 peers (Fig.6)



Source: Bloomberg, UBI Research

Election results declared; Coalition government formed by NDA

Given the sharp improvement in investor sentiment after weekend exit polls were released, disappointment in the markets was palpable as the results were announced. On 4th June 2024, equity markets fell by 5-6%, 10Y IGB yields were higher by 9bps, while USD-INR was up by 0.5%. As expected, most of the impact has been seen in equity markets, relative to USDINR and the rates market.

Despite this, we see Rupee gaining strength in the next 1-3 months, on JP Morgan bond index inclusion later in June amid a sharply improved outlook for fixed income. The RBI's record dividend announcement with a fiscal boost of 0.4% of GDP in FY25 has led to expectations of further consolidation in fiscal deficit in the Final Budget. Additionally, Dollar is likely to weaken in the next 3-6 months as the Fed is expected to start rate cut cycle.

Bond index inclusion flows likely to support FX

Balancing the bond inclusion flows

JP Morgan had, in September 2023, announced the inclusion of Indian government bonds in its GBI-EM Global index suite starting June 2024.

The index inclusion is expected to attract $25 to $30 billion in inflows in the next 10 months till March 2025 according to estimates. While we estimate front running of c.$15 billion of index flows has already happened, fresh bout of inflows are expected in coming months tracking strong macro fundamentals.

Bloomberg Index also to add India bonds to its emerging markets index in January 2025, however flows may be limited to $3-5 bn.

Dividend bounty, improved fiscal metrics and expectations of rating upgrades by major rating agencies

The RBI announced a surplus transfer worth INR 2.10 trn to the government in FY25, 140% y/y jump from INR 874 bn last year against a budgeted expectation of 1.20 trn.

The fiscal boost of 0.4% of GDP has led to expectations of further fiscal consolidation and hence borrowing cut for dated G-Secs in the final budget for FY25 even as our bias remains towards greater allocation for capex.

RBI likely to continue to cap FX volatility

The improved fiscal outlook has led the S&P ratings agency to revise the outlook for India's sovereign rating to Positive from Stable for the first time since 2007.

Repeat of strong BoP surplus may provide support to rupee in medium term

India may continue to remain BoP surplus (c.$50 bn in FY25) aided by strong trend in services exports, remittances as well as expected flows in the bond and equity markets.

USD/INR to trade range bound in the near term

An improved fiscal outlook along with index inclusion flows, and ongoing G-sec buybacks, are likely to give a cushion to rates from external volatility.

Rupee is hovering near it's all time low of 83.5800 levels but there is swing of selling around the current levels as RBI's FX stability management amid ample FX reserves (More than 11 months of import cover) is likely to limit any sharp depreciation. INR is expected to see inflows driven appreciation in the near term. However, Dollar is likely to stay the key driver in medium term, with expectations of a weakening trend as Fed starts rate cut cycle before end-2024.

Equally, RBI's persistent efforts to build FX reserves and limit FX volatility may cap Rupee gains as well and will let INR to trade range bound in the near term in our view.

ECB started rate cut cycle in June while future uncertain

Euro likely to stay under pressure on political uncertainty

EURO (€ - EUR):

ECB implements a hawkish rate cut in June

The European Central Bank (ECB) announced a cut in its main refinancing rate from an all-time high of 4.00% to 3.75%. Based on an updated assessment of the inflation outlook, monetary policy restrictions were eased after nine months of holding rates steady. However, ECB warned that inflation is likely to remain above the ECB's 2% target, averaging 2.5% in 2024 and 2.2% in 2025. As per policy guidance, the ECB would keep interest rate policy "sufficiently restrictive for as long as necessary" to bring inflation down to the Bank's 2% target.

However, ECB President Lagarde asserted in post policy press conference that "we are not pre-committing to a particular rate path." Market pricing of rate cuts by end-2024 in Eurozone stands at 3.2% vs 4.8% in the US.

Political uncertainty weighing on the Euro

The Euro was relatively flat post June policy decision. However, it took a battering in response to the surprise election results in the European Parliament, prompting French President Macron to call on a snap election in order to halt the rise of rival and far-right Marine Le Pen. The dissolution of the National Assembly and the calling of snap parliamentary elections in France has been witnessed for the first time since 1997.

May'24 inflation remained sticky

Inflation in Eurozone has risen marginally for the first time in five months to 2.6% in May vis-à-vis 2.4% against expectation of 2.7% while core inflation has also risen to 2.9% vs 2.7% against expectation of 2.7%. Inflation in Eurozone has eased significantly from 6.1% a year ago.

Meanwhile, growth outlook has started to improve, as the ECB projects annual real GDP growth at 1.4% and 1.6% in 2025 and 2026 respectively from 0.9% in 2024. Compared with the March 2024 projections, the outlook for GDP growth has been revised up for 2024, owing to the positive surprise at the start of the year and improved incoming data. The GDP growth outlook has been revised down marginally for 2025 and remains unchanged for 2026.

EURO (€ - EUR) view:

In the near term, we expect Euro to face some selling pressure amid political uncertainty and stronger US dollar. Euro may test 1.06 levels in the near term with Fed expected to keep the rates higher for longer time but once FED likely starts rate cut cycle in November, we may see levels of 1.10 being tested. Expectations of rate cuts by the end of 2024 by markets has narrowed from the start of the year (3-4 rate cuts of 25 bps each). In the medium term, Euro may appreciate as confidence builds that Fed is near the start of rate cut cycle.

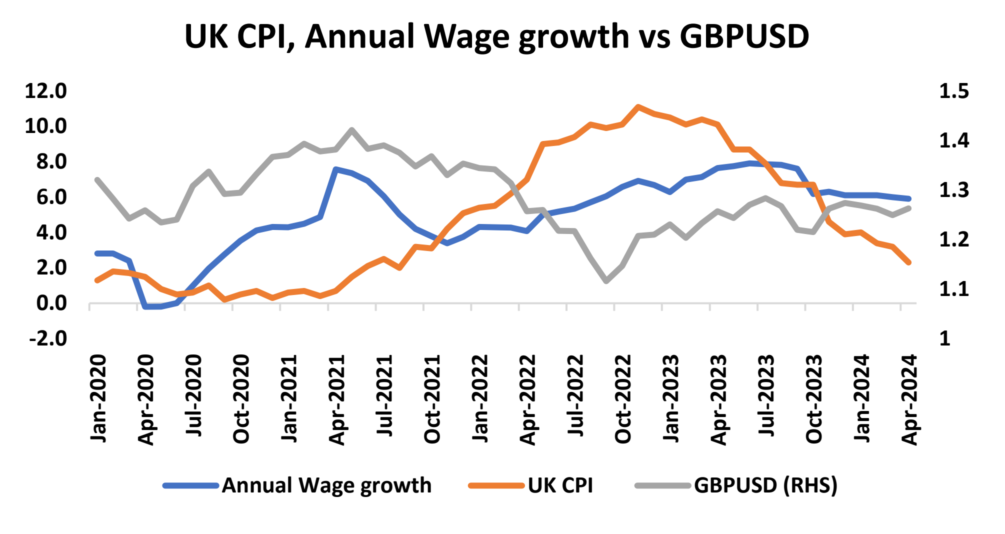
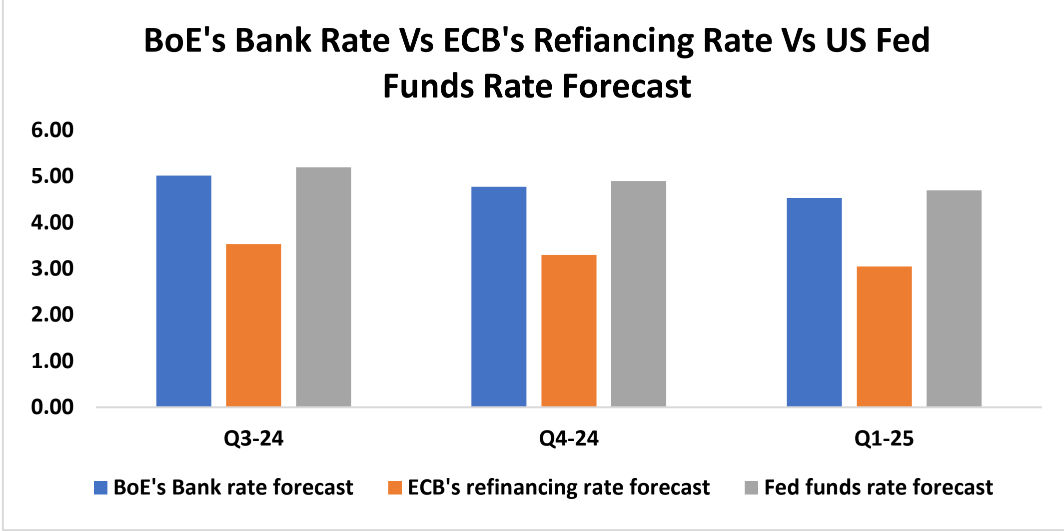
POUND (£ - GBP):

UK economy bounced back from recession & heads into general election

UK's economy stagnated in April after emerging from recession in the first quarter of 2024, as per official data ahead of the country's general election in 4th July'24. UK GDP is estimated to have increased by 0.6% in Q1'24, following declines of 0.3% in Q4'23 and 0.1% in Q3'23.

Cooling inflation likely to supports BoE to cut rates

Inflation in the UK has fallen to its lowest level since September 2021, from a peak of 11.1% in November 2022 to 2.3% in May 2024. While markets are pricing in a status quo at 5.25% at the BoE's June meeting, and watching key economic data, BoE is not in rush to cut interest rates in the upcoming deliberations.

Annual Wage growth still elevated in UK while inflation has eased (Fig.7)	*ECB cut rates and BoE expected to cut soon before Fed (Fig.8)*
	
Source: Bloomberg, UBI Research	

BoE likely to follow the ECB in terms of shift in policy cycle

Last monetary policy meeting showed that BoE MPC members voted by 7-2 to keep rates unchanged while two-members voted for a rate cut. This is in contrast to prior meeting which showed only one-member voting for rate cut. Going forward, key data points especially related to labor market and inflation data would be on close watch.

Political uncertainty will likely to keep GBP volatile

The UK general elections will be taking place on 04th July'24. The poll of polls suggests a victory for the Labor party and this could be on course for a change in government. The election is expected to bring volatility in GBP in the near term while in the next 3-6 months, the fiscal and monetary policies are likely to give further direction to the market.

POUND (£ - GBP): View

GBP likely to remain volatile on political uncertainty

In the near term, we expect the currency to stay volatile due to political uncertainty. In the next monetary policy on 20th June 2024, the BoE is expected to keep the policy rate unchanged at 5.25%, while the future guidance and voting pattern of various members will be watched closely. We expect BoE to start cutting rates from month of August. The GBP may test the levels of 1.2550 with FED expecting to keep the interest rate higher for longer time along with UK political uncertainty, but the pair may bounce back to 1.29 levels in the medium term.

JAPANESE YEN (¥ - JPY):

Short USDJPY trade to remain in play due to intervention moves in short term

The Bank of Japan in recently concluded June monetary policy where it kept the interest rates unchanged at 0-0.1% and held the rates for second straight meeting after hiking for the first time since 2007 in March meeting. The BoJ announced plan on reducing its $ 5 trillion balance sheet by reducing the bond purchases, the BoJ decided will effectively reduce its JGB holdings and move into quantitative tightening (QT). However, it didn't provide a new target, saying it will decide on detailed plan for bond purchases over the next one or two years at the next monetary-policy meeting in July after discussion with market players. For many years the BoJ has been stimulating the economy through quantitative easing QE, hence expanding its balance sheet. When the BoJ dropped its policy of controlling Japanese government bond yields in March, it has said it would continue buying JGBs worth of around 6 trillion yen every month to maintain ease monetary conditions.

BoJ keeps policy rate and bond buying program unchanged

Japan's economy in January-March 2024 shrank 0.5%

The May'24 industrial production has dipped from previous -1% YoY to -1.8% in April and clocked -0.9% MoM, way below forecast of -0.1%.

Japan's currency, which has fallen around 27% against the USD since the beginning of 2022, to 34-year low of 160.00 against the USD in April. After the announcement of the policy the Yen slumped versus the dollar, while the 10-year government yields slipped. While Governor Ueda repeatedly shown determination to gradually normalize policy after more than a decade of massive stimulus, the perceived pushing back of a change in bond buying points cautions the markets.

Recent inflation data and projections were underwhelming

Along with the monetary policy statement, BoJ also released its quarterly projections for the economy "Outlook for Economic Activity and Prices" which showed that although inflation forecasts for FY25 was revised higher (from 1.8% to 1.9%), however it still remained below 2% which mean that there is still some time before inflation rises above 2% sustainably.

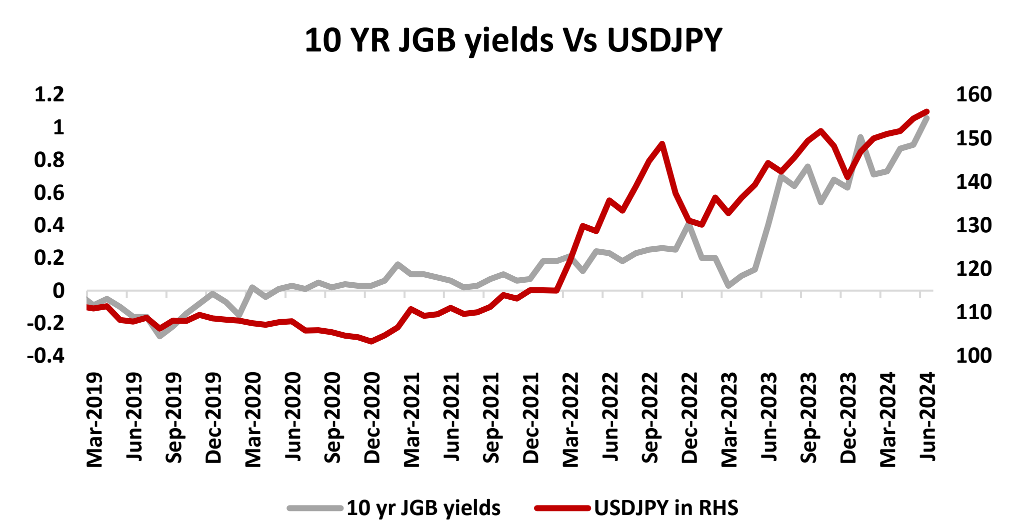
Core inflation in Japan for April fell below BoJ's target level of 2% and came in way below expectations. Also, BoJ Governor Ueda mentioned in the post policy press conference that "for now, the weak Yen has not had a big impact on underlying inflation".

Yen - Intervention risks remains high in near term

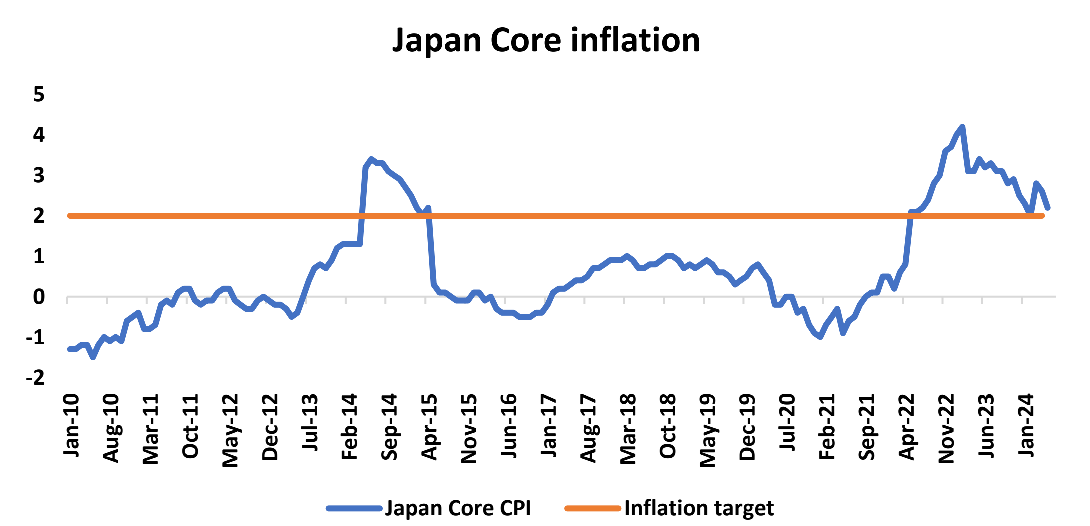
JAPANESE YEN (¥ - JPY): View

Interest rate differential between US and Japan would remain the key theme as rate cut expectations from Fed are shifting further down the road. We expect the USD/JPY pair to trade in the range of 155.00 to 160.00 and likely to remain higher. However, short USD/JPY trade remains on the table in the near term as intervention threats are persistent as USDJPY crosses the crucial 158 mark.

JGB yields remained below 1% even after YCC abolished as BoJ continued with bond purchase program (Fig.9)



Inflation remained above 2% in last 2 years but BoJ would wait to avoid 2014 like situation when inflation fell sharply after hitting 2% mark (Fig.10)



Source: Cogencis, UBI Research

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