UniFX - Monetary policy divergence continues to drive FX moves

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Key themes

- **US exceptionalism and sticky inflation delaying rate cuts by Fed**
- **Some softness in US data witnessed yet labor market stays broadly strong**
- **Monetary policy divergence continues to drive G-10 FX moves**
- **Geo-political tensions keeping commodity prices elevated**
- **Other tail risks on watch – CNY Devaluation**

Flight to quality also helped burnish dollar

Dollar reigned supreme with monetary policy divergence key theme

A lot has changed since we published our last edition of UniFX, but few things still remain unchanged. Geo-political tensions have flared up yet again with Israel and Iran conflict keeping the markets on the edge. Oil prices jumped with Brent crude touching its highest level since Oct'23 at c.$90/b, before moderating back to $83/b. However, amidst all these developments, Dollar continued its winning run and DXY touched its highest level in the more that 6 months. Apart from flight to safety, few other factors such as continued strong data sets in US, hawkish commentary by the US Fed officials in the run-up to the Fed meet and market repricing of rate cuts provided support to dollar. Sharp surge in US dollar nudged central bankers such as from Korea and Japan to issue warning regarding likely intervention as they described recent fluctuation as excessive and not based on fundamentals. Divergence theme is still in play with Bank of Indonesia delivering surprise rate hike in interest rate defence of the currency and other central banks decoupling in terms of interest rate moves. Back home, rupee also touched its lowest level on record as FPIs resorted to selling with surge in oil prices and US Treasury also pulling rupee lower. Yet Rupee continues to outperform other G4 peers.

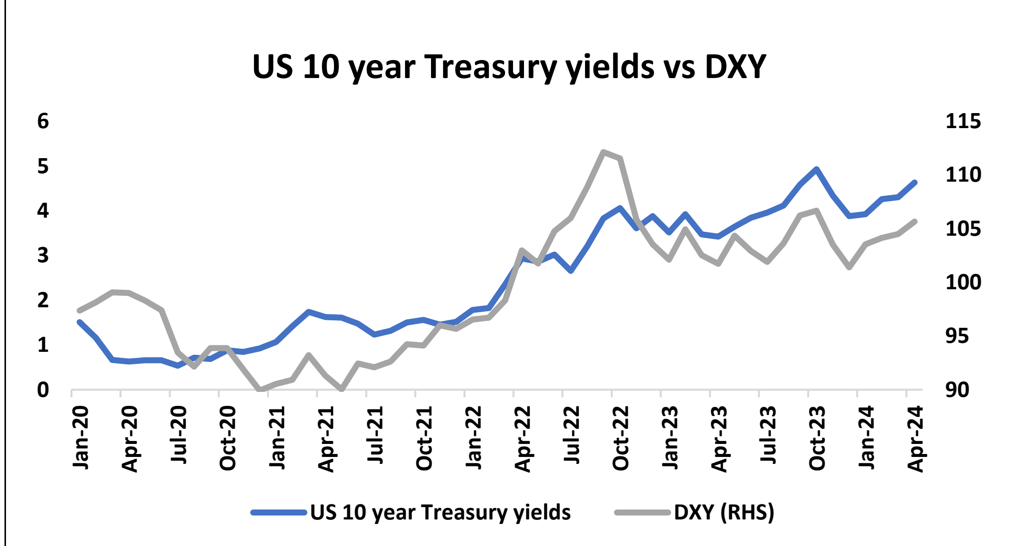
What can challenge dollar's exceptionalism?

US DOLLAR INDEX ($ - DXY):

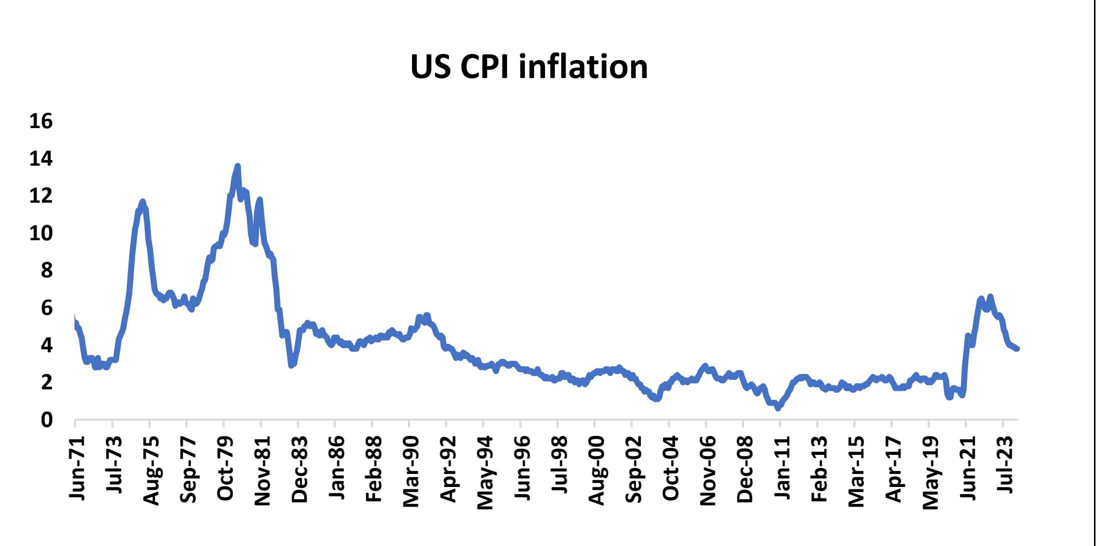
US exceptionalism continues, adding to Dollar strength

Dollar's strength is the major theme in the FX market with strong data continues to pour cold water on the market's expectations regarding rate cuts. Odds of rate cuts have changed drastically since the start of the year 2024. Fed members' commentary has turned more hawkish with Fed Chair Powell also acknowledging that inflation has not made much progress towards its 2% target. Also, the recent inflation and jobs reports gave Dollar broad-based strength notwithstanding the last jobs print which lent a slight dovish tone to FX markets.

US Treasury yields and DXY surged on Fed's rate cut repricing (Fig.1)



US CPI inflation cooled but showing its sticky nature and threat of 70s like reacceleration persists (Fig.2)



Source: Cogencis, UBI Research

Are we there yet? Not yet

There has been continuous shift in Fed rate cut repricing. After recent Fed meet and NFP data, Fed rate cut expectations again shifted sooner to September. Earlier there were expectations that Fed would cut only at the end of the year post series of higher inflation prints. Fed Chair Powell also mentioned that recent data points have not given much confidence to cut rates which means rates will stay at these levels for some time.

Fewer and later

Fed kept rates unchanged, announced start of QT Tapering beginning June

Fed in its latest policy announcement kept rates unchanged which was largely on the expected lines. However, the tone of the Fed Chair Powell was not as hawkish as markets were expecting. Fed acknowledged that inflation has eased over the past year but remains elevated. Also, statement mentioned that, in recent months, there has been a lack of further progress toward the committee's 2% inflation objective.

US fiscal deficit to remain elevated which will keep pressure on yields intact

Treasury yields dropped post the announcement in FOMC statement that beginning in June, the committee will slow the pace of decline of its securities holdings by reducing the monthly redemption cap on Treasury securities from $60 bn to $25 bn. However, according to estimates by the Congressional Budget Office, fiscal deficit is expected to remain at c. 6% in this decade. Also, recent Treasury announcement showed that most of the bond supplies will come in the shorter duration bonds.

Last mile to 2% inflation target most difficult

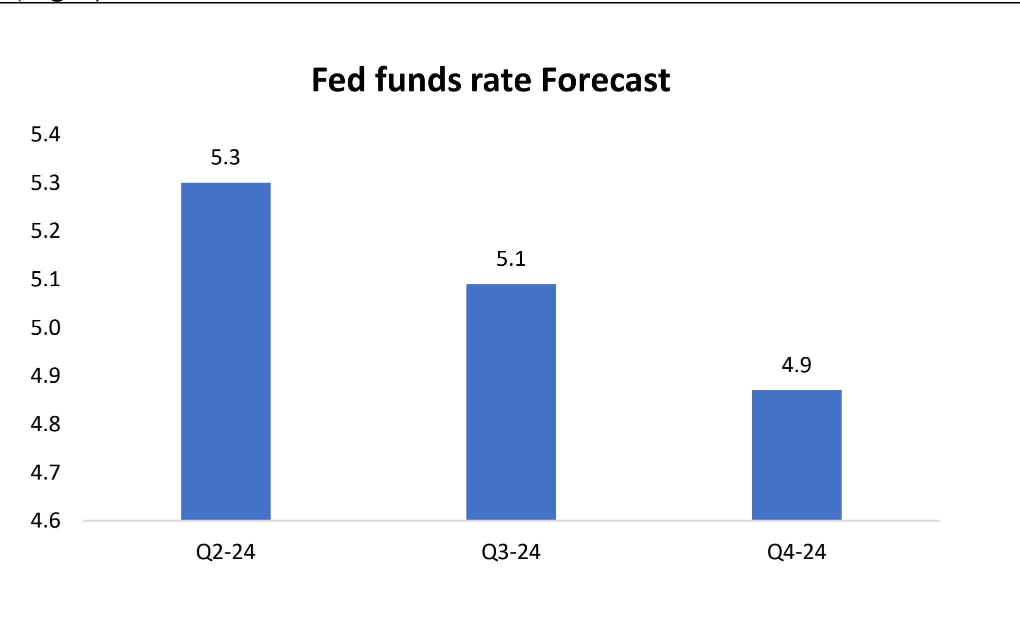
US inflation remains sticky and slow glide path is likely to delay rate cuts by Fed

While disinflation is underway, the pace is slow in terms of return to the 2% target. Various inflation indicators like CPI, PPI, PCE and ECI (Employment cost index showing compensation increasing by 1.2% in quarter ending in Mar'24), showed likely price pressures continuing. PCE, the most watched inflation metric by the Fed, inched up to 2.7% in Mar'24 from 2.5% in Feb'24, moving further away from the 2% target. More importantly, Core PCE based inflation came in at 2.8%. Going forward all eyes will be on the inflation data prints such as CPI and PCE price index.

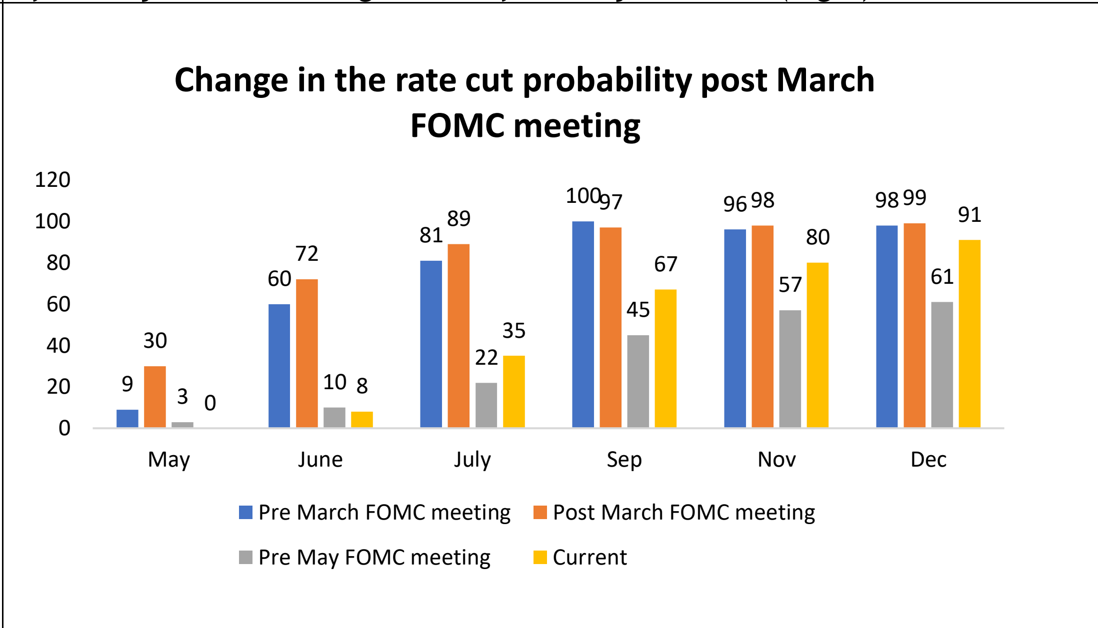
Some softness in US data yet labor market stays broadly strong

Nonfarm payrolls (NFP) addition came in at 175K in April after job gains averaged 276K jobs per month in the first quarter. NFP additions dropped below 200k for the first time since Dec'23. A reading above 200k indicates robust labor market. Treasury yields and dollar also dropped after data release. However, unemployment rate remained below 4% in the last 27 months in a row and it is the first time it is happening since late 60s which shows underlying strength of the labor market. Also, annual growth witnessed in average hourly earnings dropped to 3.9% in April, the first time the reading coming below 4% post pandemic. US job openings dropped in March to the lowest level in 3 years which is indicating some softness coming in the economy.

Markets expecting less than 2 cuts of 25bps each in 2024 (Fig.3)



Odds of the start of rate cuts for September meeting rose above 50% after May 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.

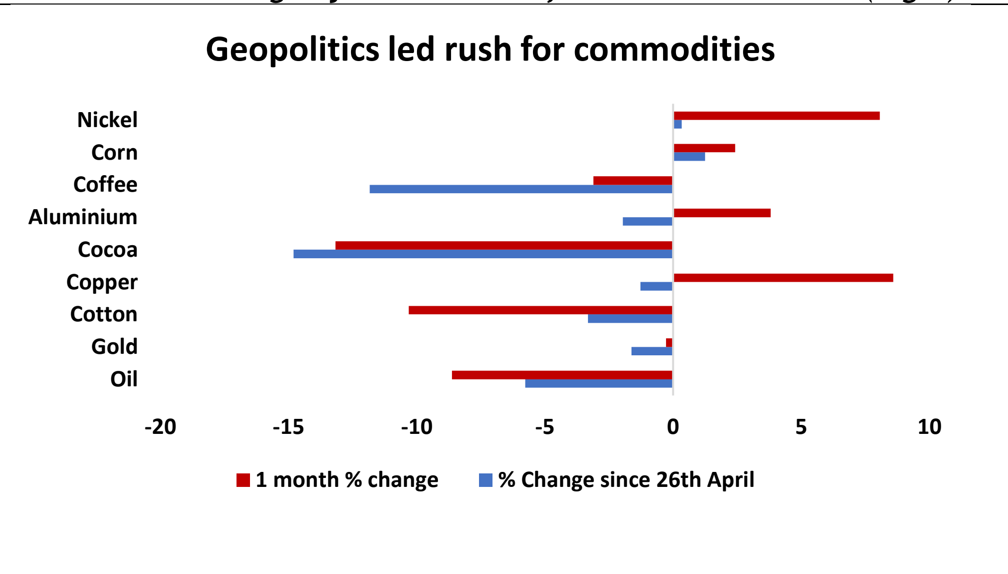
INDIAN RUPEE (₹ - INR):

Moderation in oil prices may provide comfort but rupee may still remain under pressure

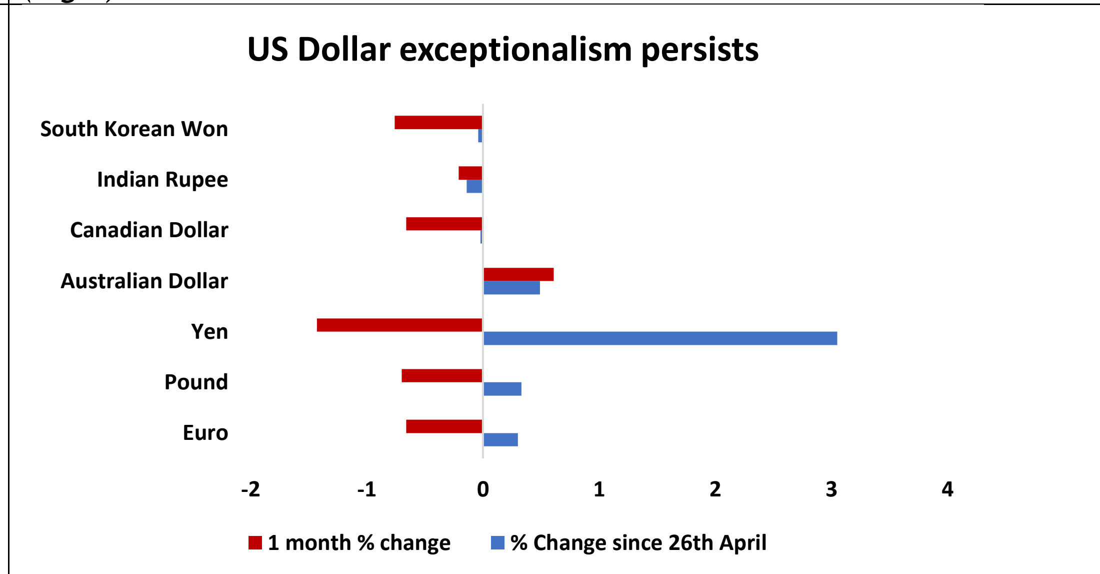
Rupee near record lows but still outperforming G4 peers

Despite strong fundamentals, USDINR has clocked fresh record lows above 83.50 levels. Even though rupee fell to record lows, it still performed better than G4 currencies. Selling by FPIs due to dampened risk sentiments and elevated oil prices weighed on rupee.

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



Rupee at record lows against $, yet outperforming other major peers (Fig.6)



Source: Bloomberg, UBI Research

Global Scenario uncertain

In the global developments, US rate cut repricing likely to keep dollar higher and weigh on Indian rupee. However recent announcement of QT taper to start from June. Apart from that, start of JP Morgan bond index inclusion may provide rupee support.

Rise in oil prices may weigh on rupee

Oil prices rose above 90 $/b (Brent crude) before cooling 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.

Economy robust, inflation under control

Strong fundamentals likely to cap the upside in USDINR

In terms of data points, inflation slowed to 4.85% in Mar'24 from 5.09% in Feb'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. Other agencies have also upgraded their India's growth forecasts. Trade data showed that Q4-FY24 clocked first non-crisis C/A surplus in 17 years. Other high frequency data such as PMIs and GST collections also came stronger. These factors point to strong fundaments which is likely to provide support to Indian rupee in medium term.

April month witnessed reversal of trend in Foreign funds flows

Foreign investors turned net sellers in April

Equity as well as debt markets witnessed reversal of the recent trend of foreign fund inflows with foreign investors remaining net sellers in the month of April. This was led by flight to quality amid renewed geo-political tension between Iran and Israel as well as sharp surge in US Treasury yields on the back of rate cut repricing. FIIs turned seller in the month of April in the debt market after 10 straight months of inflows. 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.

Forex Reserves at record high levels

Forex Reserves may limit upside in USDINR

Forex Reserves cushion of c. $637 bn can be used by the RBI to control volatility arising from Dollar's strength and 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 later rather than sooner

Rupee is expected to trade near record lows

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.

Longer duration bonds remain attractive

Demand for bonds remain high with supply remaining limited due to moderation in fiscal deficit to 5.1% as per budget announcement. This is contrast to US where fiscal deficit is expected to remain elevated.

In the short run, Rupee may continue to touch new record lows

Rupee may continue to trade near its lowest levels despite strong fundamentals with key risks mentioned above expected to weigh on rupee. Bond index inclusion staring in June, may provide support to rupee going forward.

EURO (€ - EUR):

ECB signalled start of rate cuts in June

ECB likely first to ease rates despite Fed's rate cut repricing

ECB announced its policy decision earlier in the month of April and kept the rates unchanged as expected and signalled that it is near the start of the rate cut cycle. It acknowledged that inflation dropped, led by lower food and goods price inflation. Statement also mentioned that financing conditions remain restrictive and ECB's past interest rate increases continue to weigh on demand, which is helping to push down inflation.

ECB Chair Lagarde also mentioned that ECB remains data dependent and not Fed dependent. Various ECB members also indicated that June would be the most likely meeting in which ECB will start the rate cuts. However, markets will keenly keep an eye on the commentary regarding next set of steps by the ECB.

Economic data supporting rate cuts

Inflation cooled in Eurozone while economy stays in recession

ECB also mentioned that most measures of underlying inflation are easing, wage growth is gradually moderating, and firms are absorbing part of the rise in labour costs in their profits. ECB mentioned that financing conditions remain restrictive and the past interest rate increases continue to weigh on demand, which is helping to push down inflation.

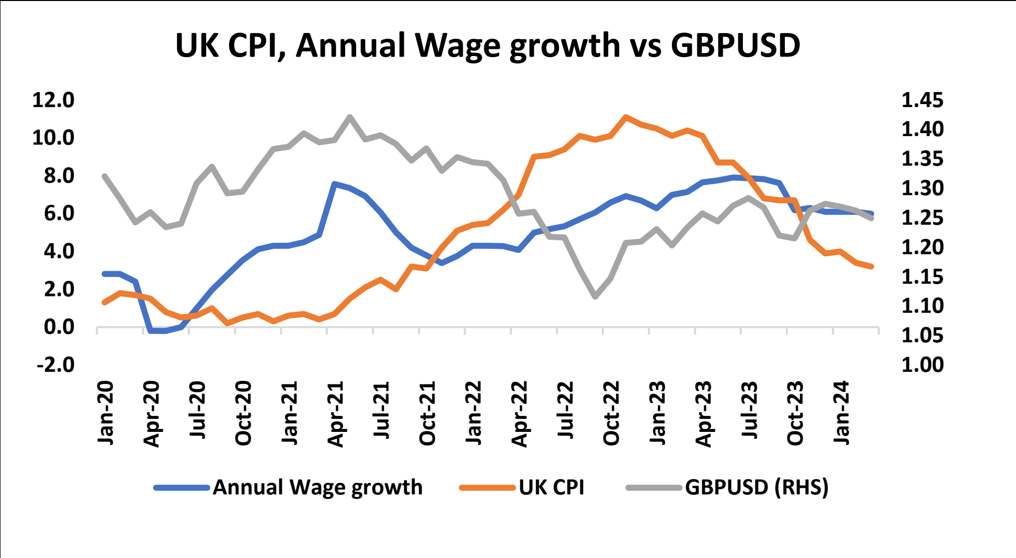
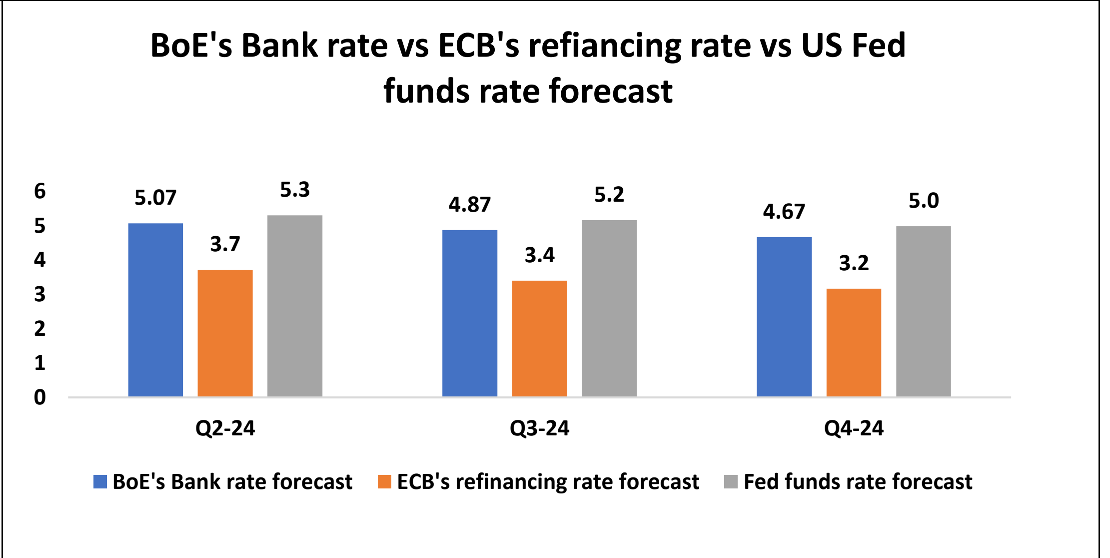
Eurozone CPI inflation in Apr'24 remained steady at 2.4%. Meanwhile, latest reading showed GDP growth coming in at 0.3% in Q1 after showing a decline of -0.1%. Surveys point to a gradual recovery over the course of this year. Other indicators such as Ifo business climate index showed that business sentiments improved in Germany for third consecutive month. PMI also seems to have bottomed out which is a positive sign for the economic activity.

ECB may lead the Fed and BoE in terms of rate cuts but rate cut bets dropped since start of the year

Markets are widely factoring in the possibility of a June rate cut. ECB members' have almost made it certain for the markets that the rate cut would be coming in June meeting unless very adverse developments take place from now till then. Some members are now even discussing the timing of next rate cut post June meeting. However, we expect that ECB may remain watchful before cutting rates in back to back meetings i.e. both in June and July.

In line with our expectations in last edition of UniFX, Euro did test the 1.07 levels and fell below 1.06 levels as well. However, despite strength witnessed in Dollar, Euro did not lose much ground and got strong support near 1.06 levels which was likely due to some stronger data points

In the near term, Euro faces pressure with expectation of ECB cutting rates before US Fed. **Euro may test the levels of 1.05 levels as well when ECB starts cutting rate with Fed expected to stay higher for longer**. Over a medium term, markets are expecting ECB to make almost 3 rate cuts of 25 bps each. Expectations of rate cuts by the end of 2024 by markets narrowed from what it was at the start of the year (6-7 rate cuts of 25 bps each). However current expectations of 3 cuts of 25 bps each for ECB is still higher than less than 2 rate cuts of 25 bps each for Fed which is likely to keep pressure on Euro intact in short term. In the medium term, Euro may gain as confidence builds that Fed is near the rate cuts. However, post strong jobs and inflation readings, Fed rate cuts are only expected to come in September.

Annual Wage growth still elevated in UK and near 6%, Inflation dropped to lowest since late 2021(Fig.7)	*ECB expected to start rate cut cycle before Fed (Fig.8)*
	

Source: Bloomberg, UBI Research

Pound faced pressure on risk averse sentiments post resurgence of geo-political tensions

POUND (£ - GBP):

BoE may start cutting rates after ECB but before US Fed

Pound dropped in the month of April on the back of sharp fall witnessed in inflation with CPI based inflation dropping to lowest since late 2021. Bank of England in its last 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.

As mentioned in the last edition of UniFX, Pound did test the key 1.24 levels against dollar with risk sentiments dampened due to geo-political tension. Also, Fed rate cut repricing, fall in UK inflation and dovish commentary by BoE Gov. Bailey in which he mentioned that "UK faces less inflation risk than US" pulled pound lower.

Cooling inflation making case of BoE rate cuts but not too soon

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. However, if sharp fall witnessed in inflation continues, BoE may well cut rates before US Fed as US is witnessing exceptionalism on growth front. This is a revision from our last edition of UniFX as inflation in UK dropped with BoE members' commentary also turning dovish.

Last monetary policy meeting showed that BoE MPC members voted by 8-1 to keep rates unchanged with one-member voting for rate cut. This is in contrast to prior meeting which showed few members voting for rate hikes so the next move is expected to be a cut or a pause. Going forward, key data points especially related to labour market and inflation data would be on close watch. The unemployment rate averaged 4.2% in the quarter ending in February, up 0.3% points from the previous 3-month period. 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 ECB which will give support to the pound in the coming months. However, given the sharp fall witnessed in UK inflation and persistence of US price pressures, it is expected that the BoE may precede Fed in rate cuts.

Overall continued elevated Dollar due to sticky inflation is likely to limit the upside movement in Pound. Going forward, we expect Pound to test 1.22 levels once BoE starts cutting rates in Q3 with 1.20 key levels to watch out for. However, as Fed enters the rate cut cycle and risk sentiments improve, Pound is expected test 1.30 level on the upside.

Other things to watch will be the geo-political tensions and overall risk sentiments in the markets.

JAPANESE YEN (¥ - JPY):

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

Heavy intervention supported yen after it hit lowest in 34 years

Bank of Japan remained an outlier in the global central banking fraternity and raised rates recently in March meeting. However, yen fell despite the rate hikes by BoJ as rate hike did not do much on rate differential front between US and Japan. Also, Bank of Japan abolished YCC program but mentioned that it will continue with bond purchases.

In the recently concluded April meeting, BoJ kept the rates unchanged which was on the expected lines. However, USDJPY depreciated and dropped to its lowest levels since June 1990 and breached all the key levels from 152 to 155 to 158, due to absence of any hawkish details in the policy announcement. Yen later dropped to 160 in US trading session but then strengthened significantly likely on the back of intervention by the Japanese authorities. According to media reports, authorities in Japan spent $34.8 billion in the intervention on that day with low liquidity due to holiday in Japan making the yen moves even sharper.

Another intervention likely happened on the day of Fed meeting late in US session in which Japanese authorities likely used $23 bn according to media reports. Japanese authorities however did not make any comments regarding the intervention. Yen rose against dollar from 158 to 153 levels post FOMC. Official data will be watched closely in the next month to get confirmation of intervention.

BoJ remained non-committal to future rate hikes

No incremental steps from BoJ in April meeting

Yen move was exacerbated as the monetary policy statement was bereft of any details regarding change in the Bank's bond purchase program which the markets were expecting after YCC was abandoned in the last policy announcement.

The statement was one of the shortest as seen in the recent times and mentioned that policy board decided by a unanimous vote to keep key interest rates (uncollateralized overnight rate) to remain at around 0 to 0.1%. The statement also mentioned regarding purchases of Japanese government bonds, CP and corporate bonds; that the Bank will conduct the purchases in accordance with the decision made in the March monetary policy meeting announcement.

Despite the recent moves in yen, BoJ head Ueda remained non-committal to any future rate hikes in the near term which pulled down Yen further post the press conference.

No change in the bond purchase program, accommodative conditions to stay

BoJ's too little too late approach pulled yen to lowest levels in more than 3 decades

Markets were anticipating some change in the commentary regarding the bond purchases by BoJ. However, BoJ mentioned that it will continue with bond purchases as mentioned in the March policy statement.

To provide historical context, in the March meeting, BoJ mentioned that although it is doing away with the Yield Curve Control program (bond purchases by the BoJ to maintain the upper bound of yields for 10-year JGBs at around 1% level then) but also mentioned that Bank will continue its JGB purchases with broadly the same amount as before (6 trillion yen per month).

Inflation yet to rise sustainably above 2% as per BoJ projections

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 Tokyo 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 still under intervention threat

Intervention will remain in play but main theme would continue to be rate differential

Markets were anticipating intervention by the Japanese authorities near 152 and then 155 levels for USDJPY. Infact there were warnings also from Japan's finance minister Shunichi Suzuki who said that the government is watching currency market moves with "a high sense of urgency". Intervention came near 160 levels as yen moves became excessive. Now that the yen has strengthened, both 152 and 155 levels would be keenly watched again with 160 levels acting as the red line for USDJPY.

Interest rate differential between US and Japan would remain the key theme as rate cut expectations from Fed are shifting further down the road while BoJ is not showing any urgency to hike rates. Intervention may pull USDJPY lower however it may prove to be temporary.

BoJ remained non-committal to future rate hikes

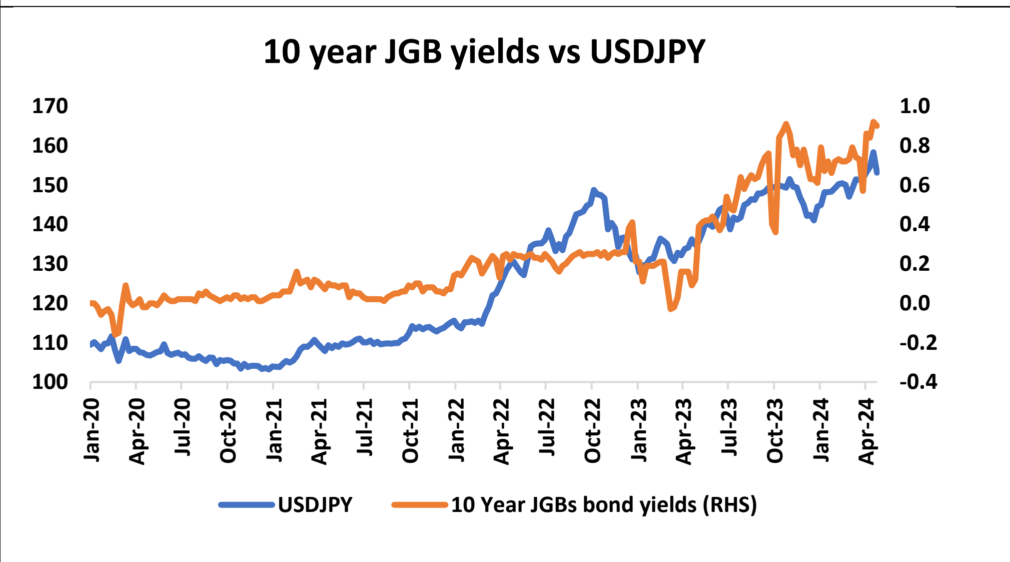
In the medium term, Yen may continue to face pressure on account of the large US-Japan interest rate differential

BoJ's reluctance to take incremental steps despite weakness in yen gave signal that BoJ will be in a wait and watch mode. We expect BoJ to raise rates only at the end of Q3 or in Q4 of 2024. Also, wage spiral due to the recent negotiation would take time to reflect into the price pressure. BoJ is expected to wait to see if inflation sustainably reached above 2% level before taking major steps on further rate hikes to avoid 2014 like situation when inflation fell just a few months after remaining above 2% level.

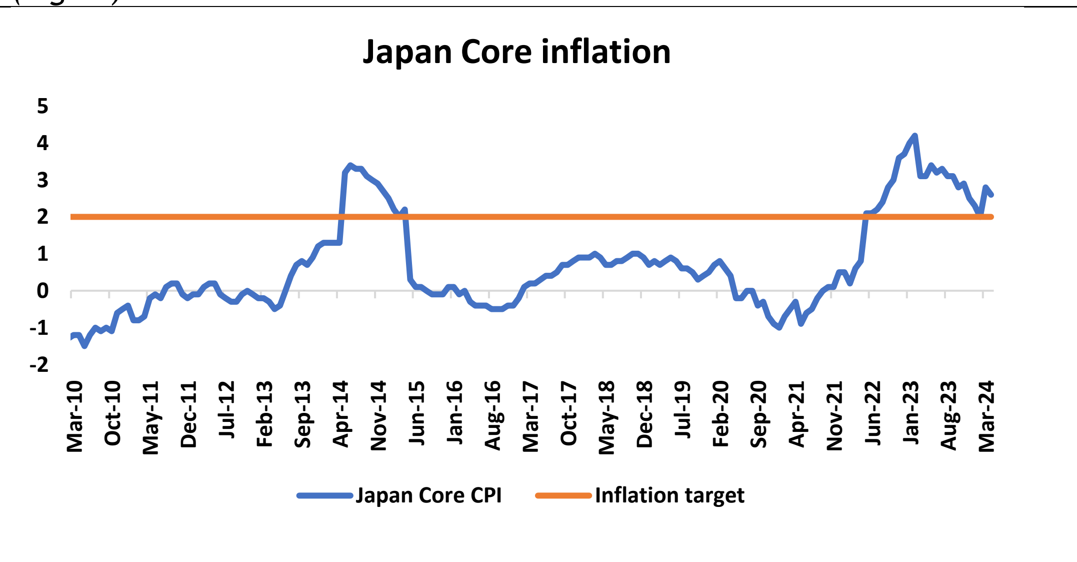
What's next for Yen and BoJ

US dollar exceptionalism has persisted due to stronger than expected economic data in US and subsequent repricing of rate cuts by markets (timing and quantum). Hence, the recent trend in the yen is likely to continue in short term (<3 months) unless Japan policymakers surprise with more intervention efforts. We will keep a close watch on the data/ central bank commentary from both US and Japan.

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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