FX Viewpoint

Financial Conditions & FX. Be Careful what you wish for

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G10 FX Strategy
Global

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Squaring the FCI Circle.

Financial conditions have been a hot topic in policy circles against the backdrop of the most aggressive policy tightening in a generation. The "conundrum" facing central banks has been why rate hikes so far have not translated into tighter financial conditions in a similar way to previous cycles. As we discuss in this note – this needs some context: financial conditions have tightened but in an orderly manner, when it doesn't, something has broken. The Financial Conditions Index (FCI) is often used as a broad-brush phrase to encapsulate how policy impacts a broad set of market variables. However, the nuance is that a sharp tightening in financial conditions historically comes against the backdrop of "something must break" which ultimately feeds into market stress. So, be careful what you wish for: major standard deviation tightening in financial conditions have invariably come against the backdrop of a market crisis and rising financial market stress. This setting is not the basis for the soft-landing that central banks are looking to achieve.

Tighter FCI – A natural by-product of higher rates

A tightening in financial conditions is a by-product of the higher rates and is a litmus test of whether the transmission mechanism of monetary policy is working effectively. What is important is that higher FCI is something that should not be feared by markets if it is orderly. This has been the case through the recent tightening cycle. In historical terms, the March tumult was relatively contained, and time limited despite market fears that something had to break being crystalised. G10 FX performance was similarly perplexing, and we believe that breadth and duration of the shock was not sizeable enough for markets to move beyond stage one of the crisis playbook – deleveraging. Indeed, the GBP crisis in October 2022 was a bigger market event.

It was all too predictable

If the markets could have chosen the perfect "something must break" scenario, then a bank crisis would have been it. A by now well-established policy banking crisis play book has been rolled out and quickly ring-fenced the financial system. None of the policy measures have come as a surprise to the markets and crucially for FX performance, measures of solvency and liquidity did not deteriorate markedly. We believe that this explains why the likes of GBP and SEK performed well through a period where market volatility rose. Longer-term correlations show that solvency has been a stronger driver for G10 FX performance and supports the markets priors on the FX hierarchy through times of market stress. Solvency matters more for G10 FX than other measures of stress because it taps into the structural dynamic of current account surplus/deficits countries as it did through "black-box" events such as the global pandemic in 2020 and the GBP crisis in 2022. Uncertainty over the policy reaction function (as in 2020 and 2022) is likely to have a bigger impact on solvency metrics and see the market revert to a traditional responses and a return of the positive "USD smile" reaction to a risk-off event.

The FCI Paradox

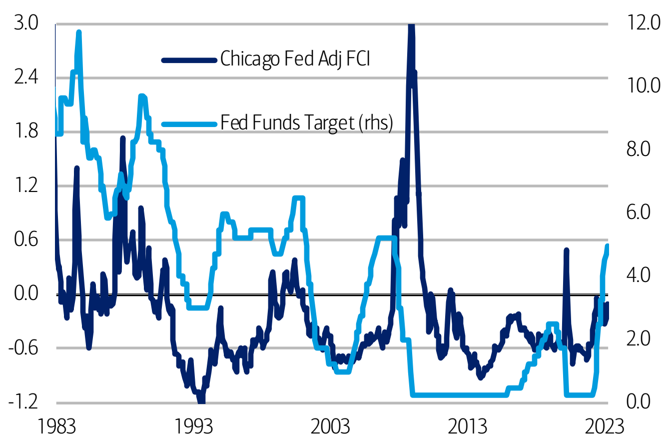
Against the backdrop of one of the most aggressive global policy tightening cycles in recent history, one of the key challenges for policy makers has been to understand why higher policy rates have not led to the degree of financial conditions tightening as may have been expected. As we discuss below, this needs to be contextualised due to the construction of many Financial Condition Indices, but nonetheless, many central banks have been urged to continue raising rates to combat elevated inflationary pressures. The nature of the current cycle – macro slowdown/tight labour markets – may mean that traditional policy prescriptions are the wrong antidote to what essentially has become a supply side rather than demand side problem could explain part of the reason why central banks are concerned about the level of FCI.

The Financial Conditions Index (FCI) has featured regularly in the central bank lexicon of phraseology that describes the impact of policy decisions on a broader set of financial variables and their subsequent influence on the broader economy. Financial conditions matter for central banks as it provides evidence that the transmission mechanism of monetary policy is working effectively, allowing changes in rate setting to impact a broad cross-section of the economy. If the pass-through works efficiently, then the evolution of the FCI through a rate cycle should be seen as endogenous – an FCI should reflect changes in monetary policy to validate the efficacy of policy transmission. This is important for FX because as we discuss below, inflexion points in financial conditions are a natural process in a business cycle and should not be the cause for immediate concern for G10 FX.

Many central banks and private sector organisations have created their own FCI's and whilst the term has often been used liberally, it is important to note that not all FCI's are created equally – an important nuance that is important for FX markets. Academic literature is replete with analysis on the significance in creating a credible FCI. Bill Dudley, former President of the NY Fed has been a particular proponent of the FCI having created one of the first widely used Indices whilst in the private sector. At the core of many FCI are the following components: short/long term rates; credit spreads; exchange rates; equity markets. The Chicago Fed National FCI is amongst the most comprehensive, using 105 indicators grouped under three broad headings: risk; credit and leverage.

Exhibit 1: Chicago Fed Adj FCI versus Fed Funds Target Rate

Financial conditions historically track the policy cycle.



Source: BofA Global Research, Bloomberg. * FCI>0 means tight financial conditions.

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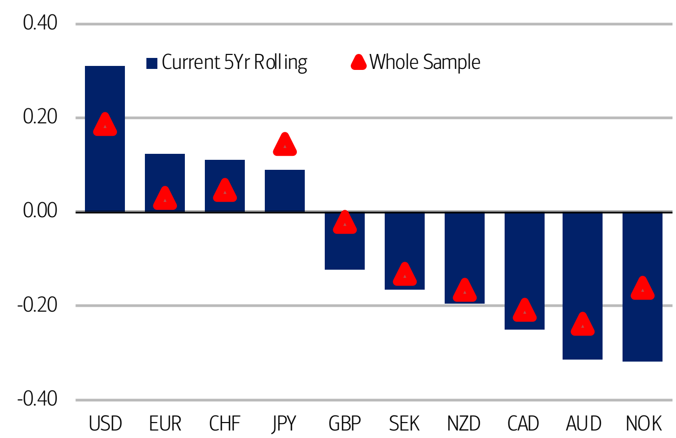
Exhibit 2: Chicago Fed Adj FCI correlation versus G10 FX*

USD has shown most consistent relationship to FCI



Source: BofA Global Research, Bloomberg. * Whole sample = 1995-

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We begin by establishing the basic principle that the rate cycle is a dominant driver of financial conditions. We compare the Chicago Fed FCI to the Fed Funds rate (which provide the best long-term sample for comparison). Unsurprisingly – FCI tracks the policy cycle, as it should in a normally function financial system (Exhibit 1). The notable exception was the period through 2011 at the height of the EZ sovereign debt crisis where financial conditions tightened despite steady Fed rates. The Exhibit shows that the three times in which FCI has been positive have all been associated with “crises”: 2001/2002 TMT crash; 2008/2009 GFC; 2020 pandemic. So far, this tightening cycle has not systemically broken something as it did through the previous three occasions and the 10yr average for this FCI is -0.5%. The current reading is -0.27. If history is any guide, then it perhaps suggests that something has broken and financial stress has increased.

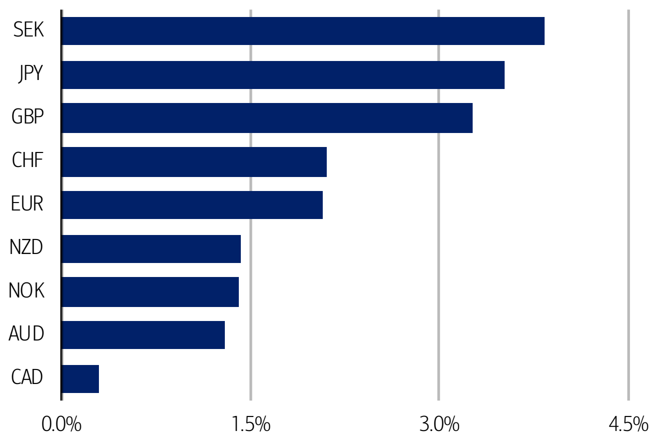
Indeed, in a note introducing the BofA financial conditions index, our US economics team has made a very similar point that financial conditions are not the same as financial stress indicators – and it is this critical distinction that matters for FX markets. The BofA Indicator of US Financial Conditions have tightened towards the peaks seen over the past 30 years.

The G10 FX reaction to the tightening of financial conditions as central banks started hiking rates was exactly as expected last year. The G10 FX reaction this year has been different (including during the bank turmoil in March but also before and after), but for some reason financial conditions stopped reacting to policy rate hikes this year, which may in turn explain the different FX reaction this year. In other words, policy tightening affected FX as expected last year because it led to tightening of financial conditions, but not this year because for some reason it has not led to further tightening of financial conditions.

Maybe rate hikes this year have been less effective in tightening financial conditions because they are already priced in, while markets were surprised by the surge of inflation and the central bank hawkish pivots last year. This is actually intuitive, markets move only when central banks surprise them. Looking ahead, this suggests that financial conditions will tighten again and will have the expected impact on FX either if central banks hike more than markets are pricing, or if something breaks.

Exhibit 3: G10 FX performance vs USD during March banking crisis*

All major currencies outperform USD and some unexpectedly.



Source: BofA Global Research, Bloomberg. * 7th March – 21st March.

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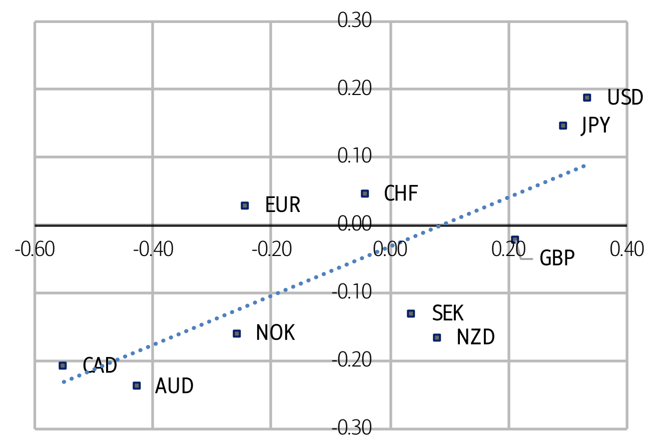
Exhibit 4: YTD correlation vs all sample correlation FCI vs G10*

YTS correlations for SEK, GBP and NZD have bucked long-term trends



Source: BofA Global Research, Bloomberg. * x-axis = YTD correlation; y-axis = all sample correl

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Exhibit 2 looks at the correlation between the Chicago Fed FCI and G10 FX TWI, using all sample correlations (since 1995) and the 5-year rolling correlation. Exhibit 2 follows similar patterns we have seen with other relationships: positive correlations to FCI between low beta currencies plus USD and negative correlations to the high beta (traditionally current account deficit) currencies. USD dominance in the correlation league table has likely been driven by the Fed having the most aggressive tightening cycle in G10.

Our key focus in FX is the following: how and why do Financial Conditions impact FX in different ways through a business cycle? This is relevant within the context of the recent debate on the FX/Risk disconnect through March. Against the backdrop of tightening financial conditions, there has been some debate as to why the high beta FX complex remain relatively resilient to the March tumult? We start by taking the window of the recent crisis to be 7th March – 20th March.

Exhibit 3 shows the performance of G10 FX versus USD through the March period. The immediate standout is USD underperformance across the board; strong performance of traditional high beta currencies such as GBP and SEK on a par with traditional low beta currencies such as JPY and CHF. We have previously stated that markets can identify a crisis playbook and how it evolves. In our recent note, we concluded that part of the risk/FX anomaly could be attributed to deleveraging as markets chased other fault lines in the global markets. Exhibit 4 shows the relationship between YTD correlations between FCI and G10 FX vs all sample correlations. SEK, GBP, NZD have all shown a positive correlation to financial conditions, which runs counter to longer-term averages. More broadly, high beta FX has been more resilient to the recent tightening in financial conditions than history would suggest. This already lends some credence to the deleveraging narrative.

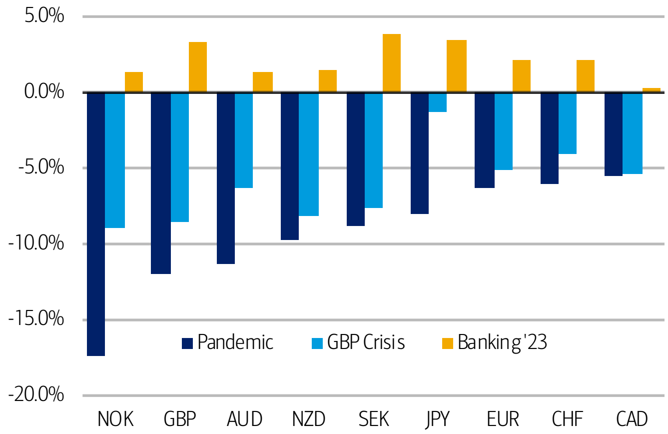
As highlighted above – tightening in global financial conditions should be seen as a natural consequence of global policy tightening. Many central banks have argued that they can rein in inflation, slow growth and deliver a soft landing. That roadmap is heavily contingent on nothing breaking in the financial system. March appeared to have brought us close with the bank failures and comparisons were made with the events through the Global Financial Crisis (GFC). Since then, the global economy has been hit by several shocks (EZ sovereign debt crisis, Brexit etc) but the single most significant development since GFC has been the concept of the central bank put – the belief that central banks will do whatever it takes to counter emerging tail risks.

It’s what you know and how you know it

Market turbulence through March may have proved fleeting and authorities have been relatively successful in ring fencing the concerns over the banking sector. If the market could have chosen a “good market crisis” to have, it would probably have been a banking crisis. Policy makers have developed a sizeable policy tool kit and knowledge base since GFC to leverage from. The banking upheaval of the kind we saw in March is now almost plain vanilla and not the black box that it used to be. This in turn means that markets also have a good handle on how the playbook evolves.

This is important because it helps to anchor our views on when financial conditions matter and when they do not. Fortunately, we have several case studies from which we can gain insights. Our bottom line here is the following: the March tumult did not somehow mark a change in G10 FX reactions to a tightening financial conditions. Markets were rational enough to understand how the situation would play out. This was not a black box event like March 2020 or October 2022 so therefore did not impact financial stress measures such as liquidity and solvency to the same extent as the aforementioned.

Exhibit 5: G10 FX Performance vs USD through recent "crises"
2023 was more plain vanilla than the previous black box events...



Source: BofA Global Research, Bloomberg

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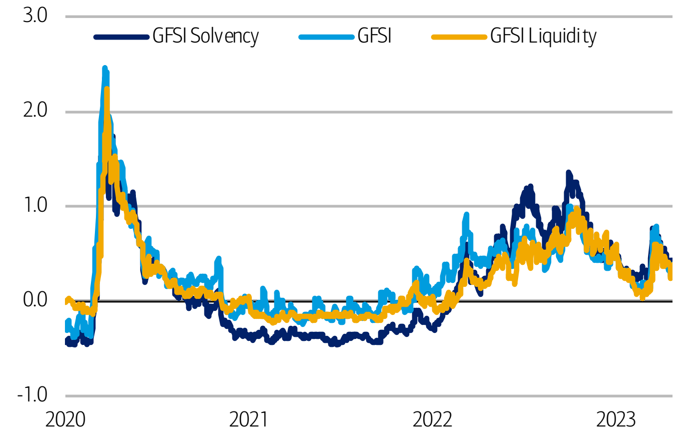
Exhibit 6: BofA GFSI vs Liquidity and Solvency Sub-Components.
Pandemic & GBP crisis had more pronounced impact on solvency/liquidity



Source: BofA Global Research, Bloomberg

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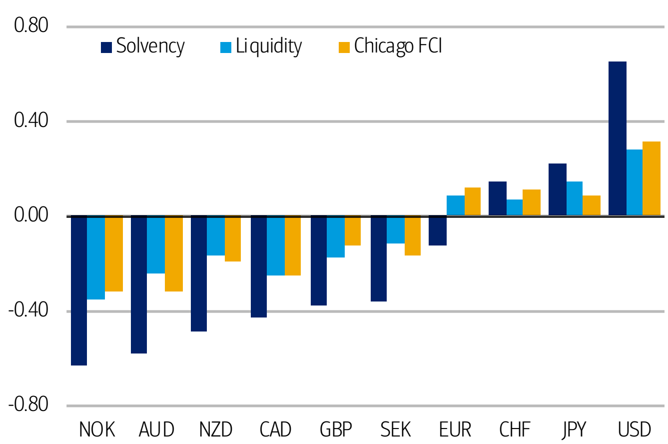
Exhibit 5 compares G10 FX performance versus USD through the last three major market dislocations: pandemic (2020); GBP crisis (2022) and the banking tumult (2023). What is clear is that 2020 and 2022 witnessed the consummate USD smile reaction to a major market event and a significant tightening of financial conditions. We would almost consider this as being textbook.

However, as Exhibit 6 highlights, a tightening in financial conditions is only relevant for FX markets when it leads to solvency or liquidity concerns. For all the warnings about "something must break" (see: Global FX weekly: This was not the Q1 you may have expected 24 March 2023), the March tumult has barely registered as an event for liquidity and solvency in comparison to the pandemic and the GBP crisis. Solvency and liquidity are often bundled into the broad category of market risk. We have written extensively on the events through that period (see: FX Watch: Financial turmoil, Fed re-pricing & the USD 29 March 2023) and reiterate those findings: the extent to which any further tumult in markets extends beyond deleveraging will likely cause more significant issues in FX and the end point will be a higher USD.

Exhibit 7: 5yr rolling correlation FX TWI versus GFSI risk metrics
Solvency is the most significant driver for G10 FX through crises.



Source: BofA Global Research, Bloomberg

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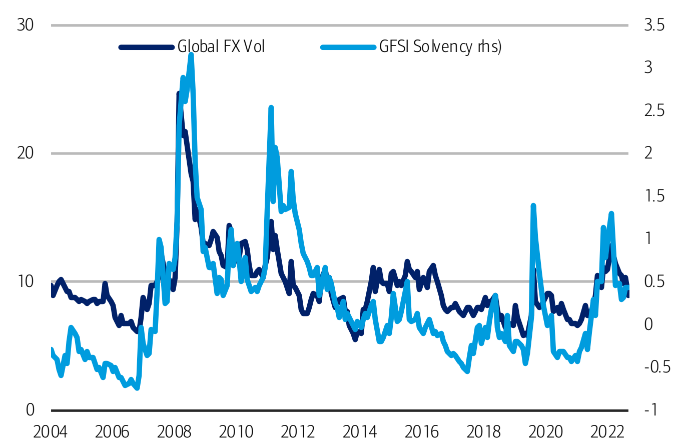
Exhibit 8: Global FX Vol vs GFSI Solvency.
Solvency is important driver for FX volatility



Source: BofA Global Research, Bloomberg

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However, as Exhibit 7 shows, this distinction is important. The 5-year roiling correlation between G10 FX TWI and three components of the GFI are presented in Exhibit 7 shows that solvency has been the dominant risk driver for G10 FX using 5yr rolling correlations. Intuitively this makes sense: crises are precipitated by a "something must break" narrative which leads to a chain of events that ultimately finds its way into the world of FX. Crises are driven by a fault-line (usually high levered/populated), deleveraging and reduced risk reduction. For FX – that translates into the search for defensive assets – generally those currencies whose markets are deep enough (USD) or which have well established external current account durability (JPY, CHF, EUR). Cross-border capital flows are compromised during crises, thus pressuring the external financing of current account deficits.

We would go further by adding that solvency may be the more appropriate index to track signs of inherent FX stress. The point here being that after the epicentre of the crises, vol and financial conditions may start to normalise but solvency still remains a concern. Higher vol and tighter financial conditions do not break FX – solvency concerns do as the UK found to its cost last September.

Where March differed from the GBP crisis and the pandemic shock is markets belief that the policy maker put would be quickly put in place to address a shock that has not been uncommon in the last 20yrs. By contrast "black-box" events such as the pandemic and GBP crisis were unique in their development and so came with significantly more uncertainty. The March tumult could not extend beyond the deleveraging phase, and we are confident in arguing that if the situation had run its course, then USD would have come out as the major beneficiary as relative current account positions depth of market would have reasserted themselves as a driver and USD status as a reserve currency would dominate.

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