

Liquid Insight

The FX anatomy of landing from different starting points

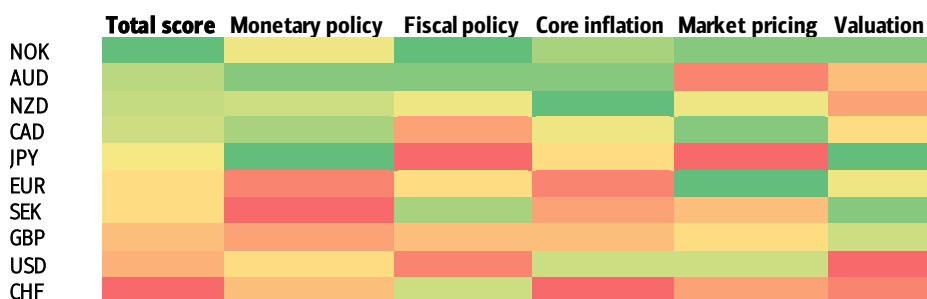
Key takeaways

- FX heatmap based on monetary and fiscal policy, core inflation trend, market pricing for rate cuts and valuation.
- Results positive NOK & AUD, negative USD & CHF, positive EURUSD & EURCHF, negative USDJPY.
- Consistent with our year ahead trades for long EURUSD, short GBPAUD, short EURNOK.

By Athanasios Vamvakidis

Exhibit 1: G10 FX heatmap

Indicators positive for NOK and AUD, negative for CHF and USD



Source: BofA Global Research. Unweighted sum of simple rankings, using excel conditional formatting.

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An FX heatmap for the year ahead

We put together an FX heatmap based on the monetary policy and fiscal policy stance, core inflation dynamics, market pricing for central bank policies and valuation (Exhibit 1). We rank G10 currencies based on these criteria, equally weighted. Our analysis is positive for NOK and AUD, and negative for USD and CHF. It is also positive for EURUSD, negative for USDJPY and positive for EURCHF. These results are consistent with our year ahead trades for long EURUSD, short GBPAUD and short EURNOK.

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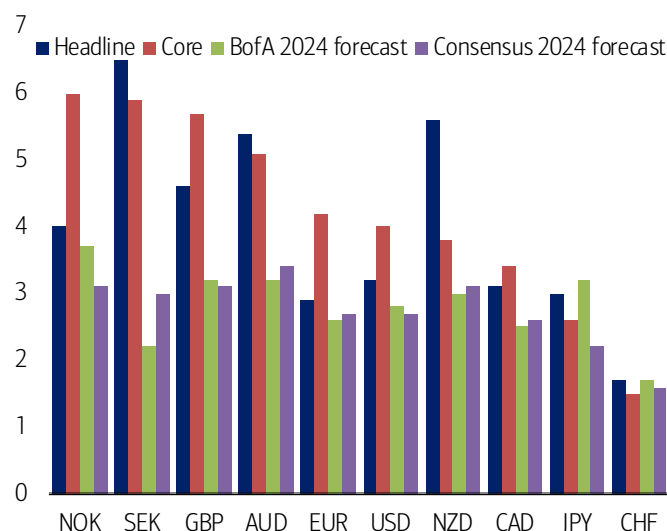
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Consensus for landing

With minor differences, we and the consensus expect lower inflation and weaker growth in G10 economies next year. Core inflation has been stickier than headline inflation, but both have been moving in the right direction. Assuming this trend continues, it is reasonable to expect convergence towards the target next year (Exhibit 2). Growth surprised upwards this year, particularly in the US, but we would expect weaker growth next year, which we believe is necessary to push inflation further down (Exhibit 3). However, we also see risks for stickier inflation on the way down and/or a harder landing, as our year ahead reports discuss in detail (see Global Macro Year Ahead: Hope for the best, prepare for the worst 19 November 2023 and [G10 FX Year Ahead: The year of the landing 20 November 2023](#)).

Exhibit 2: Headline and core inflation rate in G10 economies

Forecasts see further drop in inflation next year

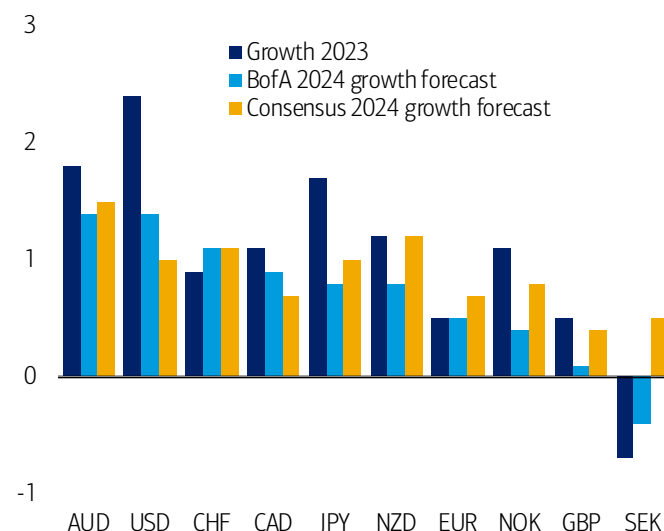


Source: Bloomberg, BofA Global Research.

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Exhibit 3: Growth in G10 economies

Forecasts see weaker growth in G10 next year



Source: Bloomberg, BofA Global Research.

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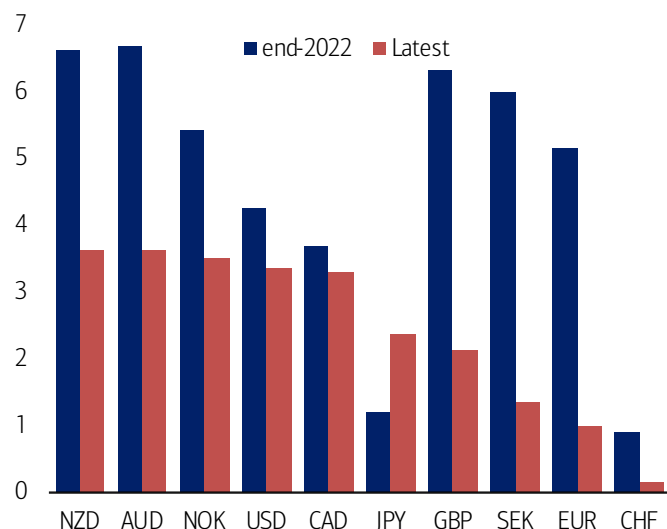
The starting point is not the same

Looking at the latest inflation trends, it seems to us that some G10 economies may have a harder time reaching their target. We look at seasonally adjusted, 3-month average, annualized core inflation (Exhibit 4). If this inflation measure is close to 2% today, we would expect much better chances to see inflation converging to 2% next year; otherwise, it could take longer. Using this criterion, our analysis suggests that Switzerland, the Eurozone, Sweden, the UK and Japan may reach their inflation target earlier than New Zealand, Australia, Norway, the US and Canada. Inflation in all cases is moving in the right direction, but faster in the former group than in the latter.

With the exception of the BoJ, G10 central banks are likely done hiking, but their monetary policy stance differs. We adjust the Bloomberg Taylor rule using as inflation input the latest seasonally adjusted, 3-month average, annualized core inflation (Exhibit 5). Not surprisingly, these estimates suggest that the BoJ is the furthest behind, as they have not even started hiking yet. Beyond the BoJ, these estimates suggest that the RBA, the BoC, the RBNZ and the Norges Bank may cut rates later than the Riksbank, the ECB, the BoE and the SNB, with the Fed in the middle.

Exhibit 4: Core inflation, seasonally adjusted, 3-M average, annualized

Inflation is falling, but half of G10 not yet on track for 2% target

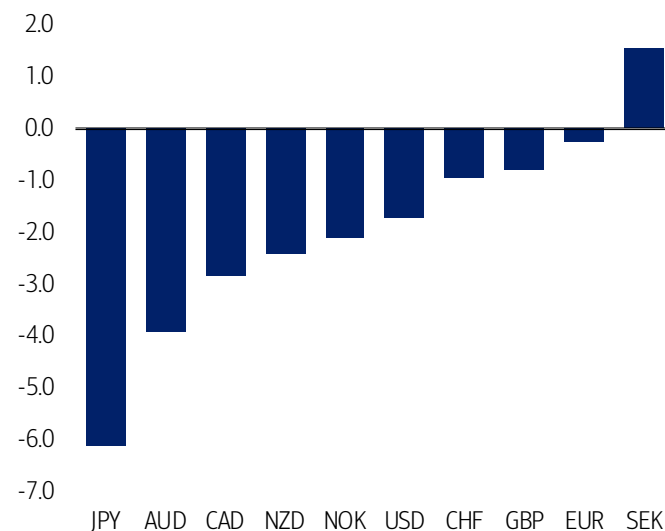


Source: Haver, BofA Global Research.

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Exhibit 5: Monetary policy stance based on a Taylor rule

Some G10 central banks may cut rates later than others



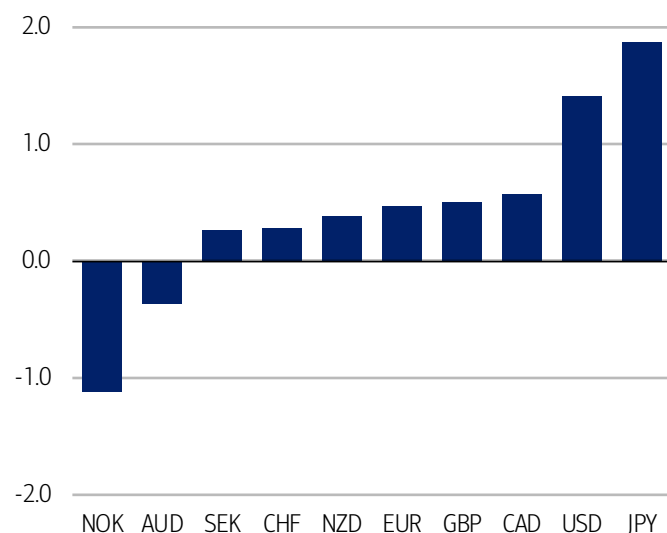
Source: Haver, Bloomberg, BofA Global Research. Note: Bloomberg Taylor rule spread, using as inflation input the latest seasonally adjusted, 3-month average, annualized core inflation. Negative for loose monetary policy.

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In addition to monetary policy, fiscal policy also matters for the inflation and growth dynamics ahead. In our last year's year ahead report we argued that loose fiscal policy was offsetting monetary policy tightening, pointing to risks of sticky inflation. This has clearly been the case in the US this year, with the very large deficit being the main reason of US decoupling in our view.

Exhibit 6: Change in fiscal policy stance, forecasts for 2024

Fiscal policy stance to tighten in most of G10 in 2024

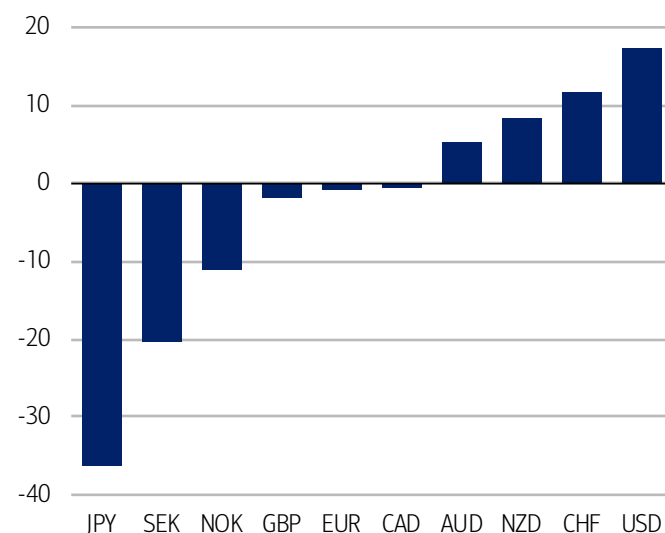


Source: IMF, BofA Global Research. Note: Change in the government primary structural balance, divided by potential GDP, using IMF estimates. Positive for fiscal policy tightening.

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Exhibit 7: G10 FX misalignment from equilibrium

USD and CHF overvalued, JPY and the Scandies undervalued



Source: IMF, Bloomberg, BofA Global Research.

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Looking into next year, the fiscal policy stance is likely to turn tighter in most cases. We estimate the structural primary balance as a share of potential GDP, using IMF estimates, and look at its change as a measure of fiscal policy tightening next year (Exhibit 6). Based on this measure, the fiscal policy stance will tighten the most in Japan and in the US, while it will loosen in Norway and in Australia.

Before we put everything together to assess FX implications, we also look at valuation. We use the IMF equilibrium model, but alternative models do not give very different results (Exhibit 7). The results suggest that JPY and the Scandies are undervalued, while the USD and CHF are overvalued.

Connecting the FX dots

Our heatmap in Exhibit 1 puts everything together, adding also market pricing for central bank policies next year. We sum up the rankings for each measure, equally weighted. Countries with highest overall ranking are likely to see sticker inflation, later central bank easing and stronger currencies. However, this is based on two key assumptions. First, central banks remain independent and committed to their inflation target. And second “nothing breaks,” meaning high interest rates for longer do not lead to a hard landing, at least not next year, which in turn would weaken the currency.

Keeping these caveats in mind, our analysis is positive for NOK and AUD, and negative for USD and CHF. It is also positive for EURUSD, negative for USDJPY and positive for EURCHF. These results are consistent with our year ahead trades for long EURUSD, short GBPAUD and short EURNOK (see [G10 FX Year Ahead: The year of the landing 20 November 2023](#)).

Notable Rates and FX Research

- **Global Macro Year Ahead 2024** - [Hope for the best, prepare for the worst](#), 19 Nov 2023
- **Global Rates Year Ahead 2024** – [Cloudy with a chance of landing](#), 19 Nov 2023
- **G10 FX Year Ahead** - [The year of the landing](#), 20 Nov 2023
- [Investors chasing the USD lower](#), **Liquid Cross Border Flows**, 20 Nov 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

[Global FX weekly: Turning point 10 November 2023](#)

Global Rates Weekly: What's your budget? 24 November 2023

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