BofA SECURITIES

Liquid Insight

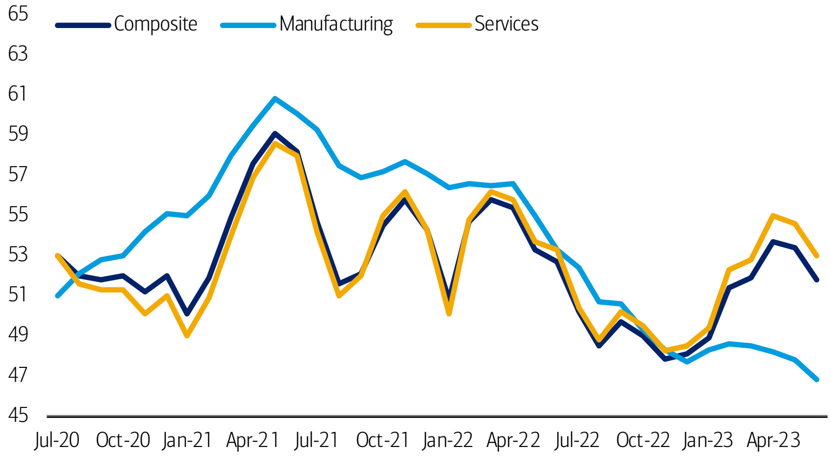
Six landing scenarios

Key takeaways

- We discuss six landing scenarios and FX market implications in G10 economies for the second half of the year.
- We remain concerned that markets are too optimistic on what it will take to bring inflation down.
- FX will depend on which scenario we will see in each G10 economy and how the central bank will react in each case.

By Athanaslos Vamvakidis

Chart of the Day: Average PMIs in Advanced Economies
Landing could be about to start; it took longer due to strong services



Source: Bloomberg, BofA Global Research. Average PMIs for US, EZ, UK, JP, AU.

BofA GLOBAL RESEARCH

Six landing scenarios

We discuss six landing scenarios and FX market implications in G10 economies for the second half of the year: 1/ non-landing: scenario so far, not sustainable, but could take longer; 2/ soft landing: still the consensus, still unlikely; 3/ a harder landing: our baseline; 4/ hard landing: something may break, an increasing risk; 5/ stagflation: the worst case scenario, not as unlikely as you may think; 6/ central banks blink: postponing inevitable landing, increasing hard landing risks. One size does not fit all, and FX implications will depend on which scenario we will see in each G10 economy and how the central bank will react in each case.

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Non-landing: scenario so far, not sustainable, but could take longer

The data so far in this year in G10 economies has been consistent with a non-landing scenario. Headline inflation has come down, while the economy has been resilient and the labor market stretched. This is even better than the optimistic consensus for a soft landing (see below). It is also consistent with the argument that inflation was transitory after all and is falling on its own. Monetary policies have been tightened, but either had no impact on the economy, or somehow have only affected inflation and not the real economy.

We strongly believe that the non-landing scenario is not sustainable. The part of inflation that has come down so far was the easy part in our view, the one that had to do with energy prices and the pandemic related supply bottlenecks. This was indeed transitory. We have been arguing that the part that remains has to do with the stretched labor markets and will be much more difficult to bring down. Indeed, core inflation, and particularly in services, has been sticky.

However, we may stay in a non-landing scenario for longer. In our year ahead report we had expected the landing to take place in the first half of the year; we then moved it to the second half; and we now expect it by the end of the year or early next year. The resilience of the labor market is particularly surprising, with unemployment at multi-decade lows in every single G10 economy, almost regardless of anything else.

It is all a matter of time, in our view. The market pricing of rate cuts by early next year would once again prove to be wrong in a non-landing scenario—as was the case with market pricing of cuts in the second half of this year in spring. The longer it takes to land, the longer interest rates will have to be high, or even higher, forcing a landing at some point.

The Chart of the Day shows that we have been in a non-landing scenario this year because of strong services. Services is usually a much larger share of the economy in G10. As a result, although manufacturing has been weakening, strong services have kept the overall economy resilient. The two were weakening together last year, but services got stronger since Q4 last year. However, services has now started to weaken.

As long as the non-landing scenario continues, we would expect FX to remain in the current tight ranges. Low vol should support carry trades, as has been the case this year so far. The USD should continue doing well against JPY, particularly if the market prices out Fed cuts for next year.

Soft landing: still the consensus, still unlikely

The consensus has consistently been expecting inflation to drop back to 2% in about a year, without unemployment increasing by much, with central banks cutting rates in 6 months. This has been the case in the last two years, as inflation first kept rising and as it has now proved to be sticky on the way down. The market keeps shifting the timing of this soft landing to six months ahead, despite having proven wrong so far.

Rates and equities are also consistent with a soft landing scenario. It seems inconsistent that rates are pricing cuts in 6 months, while equities are performing so well. However, this would be exactly the case in a scenario in which inflation comes down on its own, without the economy weakening much, and central banks realize that they don't need high interest rates any more.

Again, although focusing on the drop in headline inflation so far this year would be consistent with the soft landing scenario, the sitcky core inflation suggests otherwise. As we argued above, the data so far has been consistent with a non-landing scenario that is not sustainable. We just don't see how inflation can come anywhere close to the 2% target in the foreseeable future, with unemployment being so much lower than the natural rate and wages already increasing at the core inflation rate.

If we are wrong, then selling the USD would be the trade, almost across the board. A soft landing is negative for the USD both because of early Fed cuts and risk-off. The market bias to sell USD rallies this year is consistent with this view. High beta G10 currencies, as well as the EUR should perform well. USDJPY should also see a correction lower.

A harder landing: our baseline

We have consistently been expecting to take about 6 months to a year longer than the consensus for central banks to to bring inflation down to the target and to start cutting rates. We have also been forecasting a sharper increase of unemployment, to at least the natural rate. This harder landing, vs. the consensus has taken longer than we had expected, but remains our baseline.

This is consistent with our view that the remaining part of inflation has to do with the stretched labor market and will be much more difficult to reduce. Our reading of the data so far is that we are converging to a scenario of headline inflation, core inflation and wages all increasing but about 5%, still well above the comfort zone for inflation-targeting central banks. We don't see how we can get much lower inflation without higher unemployment.

In FX, this is consistent with a resilient USD for now, a stronger USD when the landing takes place, and a weaker USD after the landing. We don't expect the USD to get as strong as last year, when a perfect storm of negative shocks pushed it to historic extremes. However, as the market prices high(er) rates for longer and risk-off from landing, we would expect some more USD strength. Indeed we forecast EURUSD at 1.05 for the second half of this year and UDJPY at 147 in Q3. After the landing, we would expect a more consistent weakening of the USD towards it longer equilibrium, as the Fed starts to cut rates in the second half of -next year, with EURUSD at 1.15 and USDJPY 125 by the end of 2024.

Hard landing: something may break, an increasing risk

Doves were arguing against central bank policy tightening as inflation kept rising in the last two years, concerned that something could break. We had argued that it was too late and something had already broken, which was inflation. Central banks should had never allowed inflation to increase by so much in the first place; after it did, they had no choice. Still, nothing has broken so far, despite the most aggressive monetary policy tigheting in advanced economies in the last 40 years. Or at least, nothing has broken that is severe enough to suggest policy tightening was a mistake.

However, something can still break. As we argued recently, the interest rate high enough to bring inflation down to the target may be too high for financial stability (see The curious case of r** 23 June 2023). The longer it takes to bring inflation down, the longer we remain in a non-landing scenario, the longer interest rates have to remain high or get even higher, the more likely that only a hard landing will bring inflation down, as the risk increases that something does break.

The market implications of a hard landing are not straightforward. In theory we could see short-term USD strength on risk-off, followed very soon by USD weakness as the Fed pivots to rate cuts. FX vol will increase, from currently very low levels. It will all depend on how bad things will get and how long it will take for the Fed and other central banks to calm markets down.

Stagflation: the worst case scenario, not as unlikely as one may think

This has always been our key risk scenario. It is likely at least for few months, once the economy starts weakening. Imagine few months of rising unemployment and sticky, or even rising inflation. In any case, with unemployment so much lower than the natural rate, it will take some time for a weakening labor market to help bring inflation down.

This scenario is the most negative for risk and the most positive for the USD. Central banks will have to stick with high rates despite a weakening economy. The longer this goes, the higher also the risk of something breaking and eventually getting out of stagflatio scenario as something breaks. EURUSD could go back to parity in such a scenario.

Central banks blink: postponing inevitable landing, increasing hard landing risks

We have been arguing that central banks will face difficult policy dilemmas ahead, as their three mandates of price stability, employment and financial stability could be in conflict. So far, their job was easier, as employment has been strong and markets have taken policy tightening well—the bank shocks in March were successfully contained.

Some central banks may blink. At some point soon, we should start getting negative labor market data. Will central banks appear even more determined, as their policies will finally be working, and stick to their inflation commitment? Or will they call victory too early and prevent the economy from landing just as it has started descending? The latter would be a policy mistake in our view, will end up with a stop-and-go path and would hurt central bank credibility.

Any central bank that blinks will see its currency weakening in the short-term, and possibly in the long-term if damage control fails to restore credibility. Preventing a landing could eventually increase hard landing risks, as interest rates would have to be high, or even higher, for longer. The worst for a currency would be if a central bank gives up on its inflation target, just because it is difficult to reach it. As we have argued before, regardless of whether a 2% target is right or not, giving up now when above, while doing so much in previous years when below would make it almost impossible to commit to any new, higher target.

One size does not fit all

We have discussed the above six scenarios as if they apply equally to all G10 economies, but this may not necessarily be the case. The truth is that inflation has increased in all G10 economies in the last two years, labor markets are stretched in all of them, and all central banks, with the exception of the BoJ, have tightened policies aggressively. However, we may see more differentiation during landing, both in terms of economic performance and policy responses, which in turn will affect markets accordingly.

We assume that central banks remain committed to their inflation target, in which case the positive correlation between FX and inflation holds, unless something breaks. Indeed, a higher risk of a hard landing in the UK, as core inflation has started increasing again and the market is pricing aggressive further BoE policy tightening has been negative for GBP. However, as central banks react differently to policy dilemmas from sticky inflation, the FX market would respond accordingly. We just don't know yet which central banks will remain the most committed to their inflation target and what shocks they will have to deal with in the process.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- When carry rules **Global FX Weekly**, 30 June 2023
- In data denial **Global Rates Weekly**, 30 June 2023
- Change of heart, **Liquid Cross Border Flows**, 26 June 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: When carry rules 30 June 2023

Global Rates Weekly: In data denial 30 June 2023

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