Liquid Insight

The FX implications of an early pause

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Rates and Currencies Research
Global

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MLI (UK)

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 20 7995 0279
athanasios.vamvakidis@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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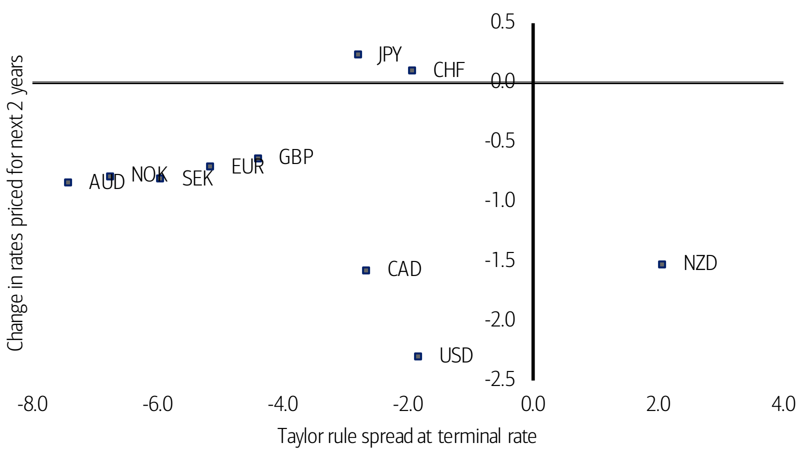
Key takeaways

- G10 policy rates may have to be high(er) for longer than markets expect, to bring inflation sufficiently down.
- However, markets are pricing aggressive cuts to start soon after central banks pause.
- Our analysis suggests that tighter-than-market pricing policies could support USD, CAD, NOK and AUD vs. the rest of G10.

By Athanasios Vamvakidis

Exhibit 1: G10 monetary policies
Markets pricing aggressive easing, although policies not tight enough at terminal rates



Source: Bloomberg and BofA Global Research.

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What if interest rates remain high(er) for longer?

As G10 central banks have reached or are about to reach their terminal policy rates, the key question is whether this is enough, particularly as markets are pricing aggressive policy easing to follow soon. Although monetary policies affect the economy with a lag, measures in this report suggest that they may not be tight enough and markets may also be too optimistic on policy easing. We also repeat our concern that fiscal policies are in most cases loose, particularly in the US. Assuming central banks remain committed to their inflation targets, our analysis suggests that monetary policies may have to be tighter than current market pricing suggests—more tightening or less/later easing—particularly in the case of the US, Canada, Norway and Australia, suggesting upside risks for USD, CAD, NOK and AUD vs. the rest of G10.

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At the terminal

G10 central banks have reached or are about to reach terminal policy rates. Markets are not pricing another Fed hike. They expect two more hikes from the ECB and the BoE. If market pricing is right, by mid-summer most G10 central banks would have reached their terminal rates, after the most aggressive policy tightening cycle of the last four decades.

The key question for markets as we reach terminal rates is whether this is enough. Headline inflation has already been coming down in most of G10 this year, but core inflation remains stuck at levels well above the target. Unemployment is also at historic lows in all G10 economies and has either stabilized at low levels or in some cases continues falling. Wages are increasing at the core inflation rate across the board. All this suggests to us that central banks expect most of the impact from their policy tightening to be ahead, as monetary policies affect the economy with a lag. They may also expect some tightening of credit conditions from the recent bank turmoil. We will know in the next few months whether the terminal rate is enough or not.

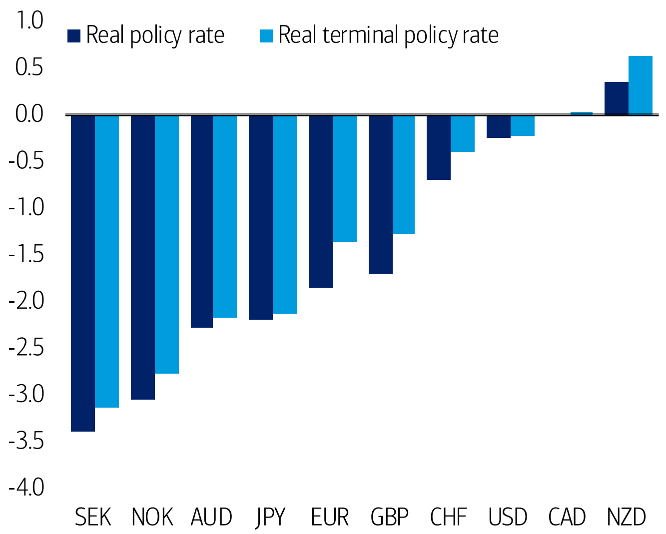
However, what still concerns us is that markets are pricing a very aggressive easing cycle to start soon. Effectively, markets seem to believe that central banks have overshot in their policy rates, inflation will come down fast and that policy rates will have to start declining soon. If core inflation remains persistent and labor markets tight, we would not expect early easing from G10 central banks. Moreover, one cannot ignore the risk that they may actually have to hike even more than markets are currently pricing. Markets may be wrong to expect a pause as the last step before policy easing, as the RBA latest hike after an initial pause has shown.

Not tight enough yet

Looking at real policy rates, it is hard to argue that monetary policies are tight in G10 economies. Exhibit 2 looks at the latest policy rates and also at the terminal rates that markets are pricing, in real terms, using the latest core inflation rate. In both cases, monetary polices still look loose in most of G10. Of course, this could change soon if core inflation starts coming down as a result of the policy tightening that has already taken place. But otherwise, some G10 central banks not only will not be cutting rates in the months ahead, but they may need to start hiking again.

Using a Taylor rule leads to similar conclusions, although the ranking changes in some cases. We adjust the Bloomberg Taylor rule calculations in a number of ways: we look at core inflation; we assume the natural real rate is 1% instead of 2% in Bloomberg (because this is what markets are pricing, as we discuss below); we assume the natural rate of unemployment (NAIRU) is equal to the pre-pandemic level, rather than a much higher level in most cases in Bloomberg; and we take the terminal rates that markets are currently pricing as given. Exhibit 3 shows the results. With the exception of New Zealand, monetary policies in G10 economies at the terminal rate that markets are currently pricing are still loose. Again, this calculation does not take into account lags of the impact from monetary policy. However, they do point to a risk that at least in some cases more may need to be done, or at least it may be too early to expect policy easing, with the relative ranking also having market implications.

Exhibit 2: G10 real policy rates (using latest core inflation)
Real policy rates mostly negative in G10, both current and at terminal rate priced (using latest core inflation)



Source: Bloomberg and BofA Global Research.

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Exhibit 3: Taylor rule spread at terminal rate priced
G10 monetary policies not tight enough at terminal rates priced

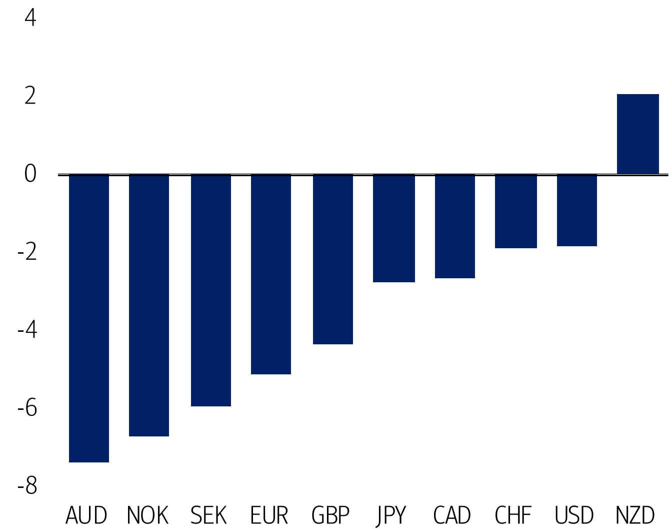

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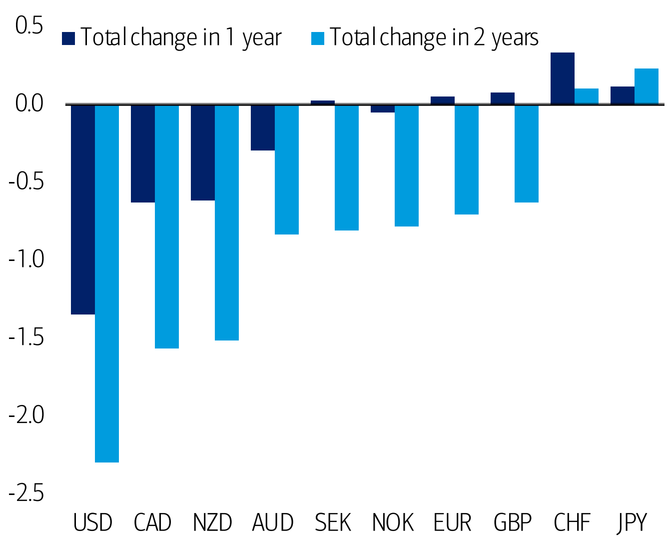
Exhibit 4: Market pricing for change in G10 policy rates
Markets expect aggressive policy easing in G10



Source: Bloomberg and BofA Global Research.

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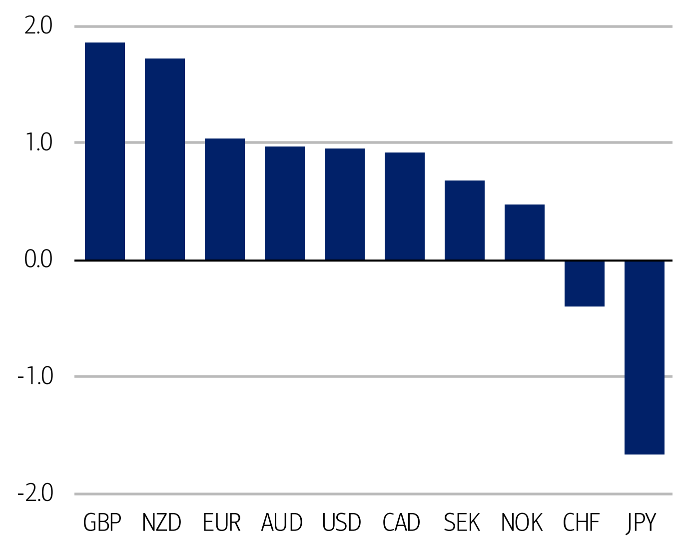
Exhibit 5: R* based on latest market pricing
Markets expect return to low interest rates



Source: Bloomberg and BofA Global Research.

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Easing does not automatically follow tightening

With some differences in timing, markets are pricing an aggressive easing cycle in G10 central banks to start as early as this summer. Exhibit 4 shows that markets expect the most aggressive policy easing from the Fed, followed by the Bank of Canada. Such market pricing assumes that inflation goes down to 2% and that the so called R* (natural interest rate) is 1% or even lower, with the exceptions of the UK and New Zealand where it is close to 2% (Exhibit 5). Both assumptions could prove to be wrong, suggesting later and less aggressive policy easing than markets expect.

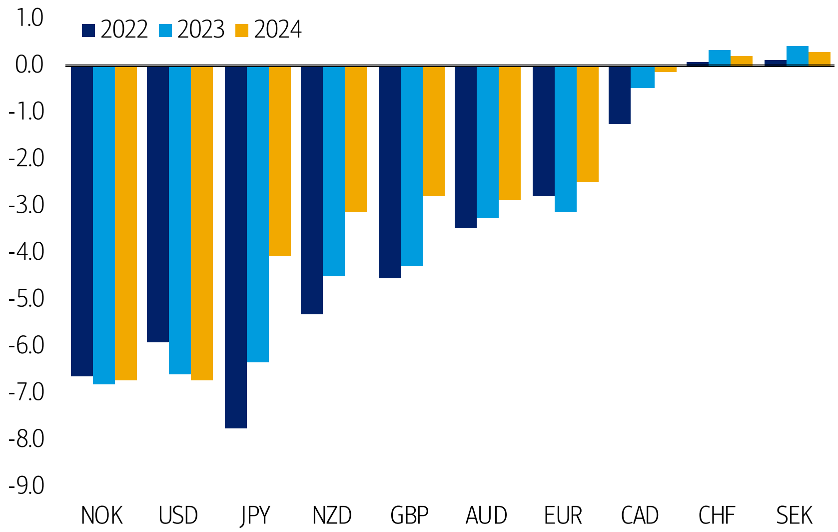
Fiscal policies loose in the meantime

We have repeatedly argued this year that loose fiscal policies are offsetting monetary policy tightening and may be responsible for the non-landing scenario so far, with sticky core inflation and tight labor markets. If our concerns are right, monetary policies will have to be tighter than otherwise and policy rates may have to be high(er) for longer. Exhibit 6 shows high structural deficits in most G10 economies—suggesting loose fiscal policies. Sweden, Switzerland and Canada are the only exceptions. Fiscal policies are the most loose in the US and in Norway.

Although fiscal policies seem to at least move in the right direction in most cases (using IMF forecasts) and are becoming less loose, the US is a notable exception. US fiscal policy is getting even more loose this year and next year—moving in the wrong direction. Indeed, according to data from the non-partisan Congressional Budget Office in the US, revenues are lower by 10% and spending is higher by 12% this fiscal year so far, with the federal deficit more than three times larger than in the same period last year. Of course, this could change depending on the current negotiations for the US debt ceiling, although could be far from the best possible way.

Exhibit 6: R G10 Structural fiscal balance

Loose fiscal policies in most of G10



Source: IMF and BofA Global Research

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FX implications of an early pause

As in FX everything is relative, what matters is for which central banks markets may be too optimistic about terminal rates being high enough and the easing cycle priced to be the most aggressive. We assume that no G10 central banks will consider giving up on their inflation target when inflation is still so high. This suggests that central banks will respond with more tightening—less easing—compared with market pricing if inflation proves to be persistent. Exhibit 1 points to upside USD and CAD risks from markets expecting too many rate cuts, and upside AUD and NOK risks from terminal rates not being high enough. Upside inflation risks from loose fiscal policies in the US and in Norway in Exhibit 6 also point to upside USD and NOK risks—a key assumption here is no fiscal dominance and that central banks remain independent.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- What to expect when pausing, **Global FX Weekly**, 12 May 2023
- The long and short of it**, Global Rates Weekly**, 12 May 2023
- Corporates buying USD/Asia FX, **Liquid Cross Border Flows**, 9 May 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: What to expect when pausing 12 May 2023

Global Rates Weekly: The long and short of it 12 May 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

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

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com