Liquid Insight

The G10 FX Jigsaw Puzzle

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Rates and Currencies Research
Global

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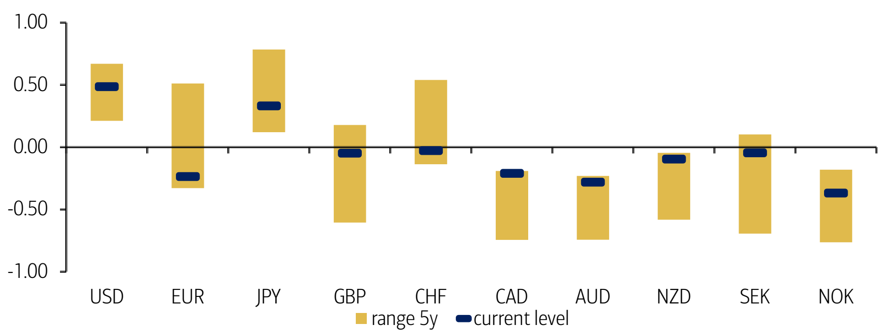
Key takeaways

- Markets have appeared frustrated with the lack of follow through in G10 FX performance since the start of the year.
- FX high beta underperformance can be explained by d/ward revisions to growth despite backdrop. Inf/growth mix important to FX
- Like FX, macro does not move in straight lines & Q2 = more meaningful comeback vs USD. Our preferred expression is via GBP

By Kamal Sharma

Chart of the Day:1yr rolling correlation between TWI & GFSI relative to 5yr min/max range
With exception of USD, FX correlation to risk in G10 is the weakest in 5years.



Source: BofA Global Research, Bloombeg

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It's not where you're at, it's where you're going to

"Why is high beta currency XXX not performing better in this low volatility environment?". This is a question we have heard frequently from investors since the start of the year. Whilst this is a fair response to the lethargic performance of high beta FX, we think the low volatility environment masks a blind spot (or complacency) that such a backdrop should translate into enhanced growth prospects. Against one the of most favourable labour market dynamics heading into a "slowdown" ever seen, the ability of some currencies to convert this into robust growth has faltered. In our view, inflation in and of itself is not the story; it is how prices interact with real activity. The USD has for now capitalized on a favourable mix of inflation/growth but economies do not move in straight lines and a lot of good news has come from the economy. We and consensus are close to current levels in terms of Q1 forecasts. Q2 will probably be another story as the ability of the US economy to continue to deliver positive surprises wanes, lending support to the rest of G10 through to the end of the year. Our favoured expression is long GBP into a seasonally friendly environment and the potential for favourable fiscal stimulus tailwinds.

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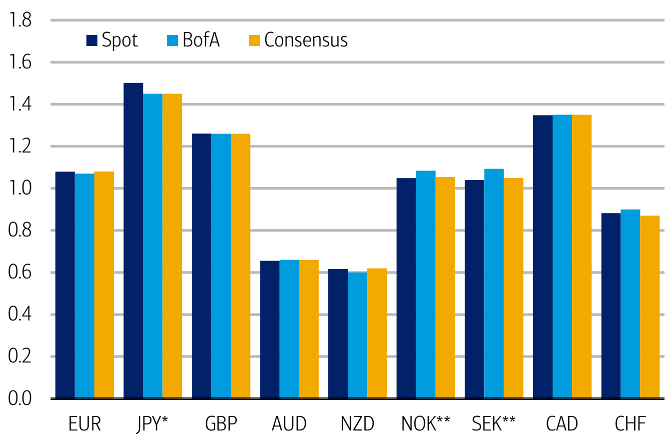
Where's the year of the turn?

Frustration, exasperation, irritation, and annoyance. These are all superlatives that have been used to describe G10 FX price action since the start of the year. 2024 was meant to be the year of the turn in USD and our year-end forecasts look for the greenback to end lower and continue to weaken into 2025 (see: [Global FX Weekly: On track 16 February 2024]) in what we would describe as measured depreciation. Yet since the turn in the USD in December, the TWI has retraced nearly 50% of that depreciation and is the best performing currency in G10 this year. Whilst we have sympathy for the market frustration in the lack of follow through in USD depreciation in 2024, we are not wholly surprised. The adage that markets do not move in straight lines is certainly applicable here. Put another way, we have expected that the path to a weaker USD would be a choppy one. This can be best illustrated in our forecast profile G10 FX vs USD for end Q1 '24. Exhibit 1 plots BofA and consensus forecasts for G10 FX vs USD and the current spot rate (please note asterisk footnotes). The chart shows very little discrepancy between current spot rates and end quarter forecasts: markets and BofA have been correct to assume that USD weakness would not be a continuous line.

Exhibit 1: Spot vs BofA vs Consensus F'casts for Q1 '24

BofA & consensus expect USD/G10 close to current spot levels by Q1 end



Source: BofA Global Research, Bloomberg. * scaled by 100; **scaled by 10

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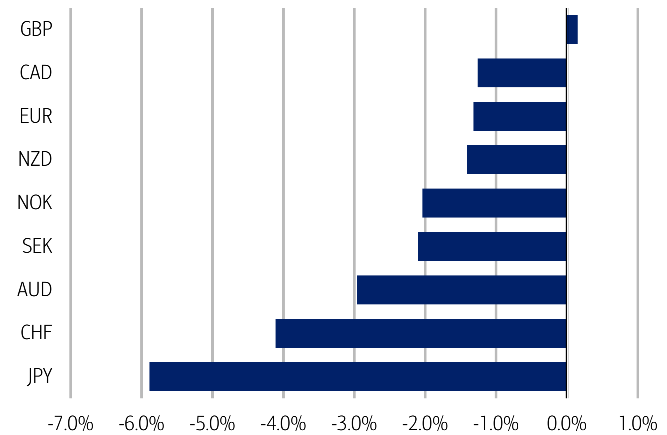
Exhibit 2: Total YTD Returns G10 FX vs USD

With exception of GBP, high beta FX performance has been poor



Source: BofA Global Research, Bloomberg

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USD price action has been important as it forms the fulcrum for broader FX performance and because it is one currency where long-term anchors have been very stable. Our thesis at the start of the year for a managed global slowdown; rates cuts (less than was priced) and a risk supportive backdrop should have played into the hands of the "USD Smile" advocates: USD underperformance versus high beta FX as global rates recouple in a risk friendly environment. However, as Exhibit 2 shows, whilst CHF and JPY underperformance conform to the narrative of low beta underperformance, high beta FX performance has been underwhelming. This is encapsulated in our Chart of the Day which plots 1yr rolling correlation between FX TWI and the BofA GFSI relative to the 5yr range. The chart shows except for USD and EUR, the correlation between the rest of G10 FX to moves in risk is at the weaker end of the 5yr range. This helps to contextualize the disconnect between global risk vs G10 FX performance. The question is why?

It's the whole package – growth and inflation.

Whilst the repricing in G10 rates markets has been the primary focus for FX markets and has played a large part in FX price action this year, it would be wrong to assume that this has been purely a function of price data. Inflation is sticky but is expected to fall through the rest of the year. However, this is one half of the story. There is recent evidence that the global economy is regaining growth momentum, as proxied by upward revisions to developed economy consensus growth forecasts for 2024 (Exhibit 4). Given the recent upward trajectory in global macro data surprises, this should have been positive for high beta FX. Quite the opposite as Exhibit 4 which looks at the 1yr rolling correlation between G10 FX and global data surprise versus the 1yr range. Unusually, most of the high beta currencies, particularly CAD are exhibiting negative correlations to data surprise. Even more surprising is the positive correlation between JPY and data surprise.

Exhibit 3: Developed GDP consensus forecast growth for 2024, %y/y
Forecasts growth upgrades have accelerated since the turn of the year.

Source: BofA Global Research, Bloomberg

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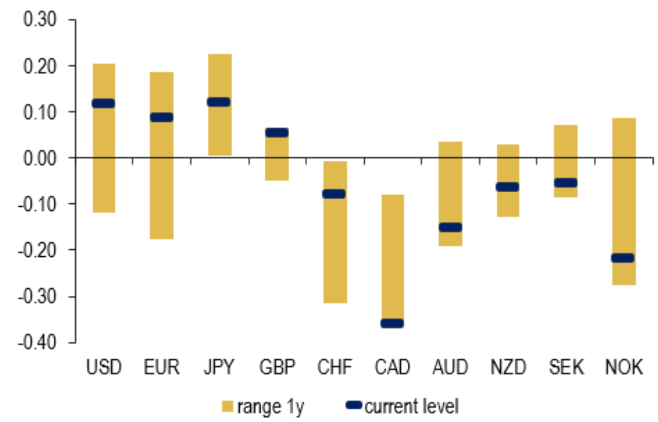
Exhibit 4: 1yr rolling correlation between FX & global data surprises.
Most high beta FX are trading with a negative correlation to data surprises.



Source: BofA Global Research, Bloomberg

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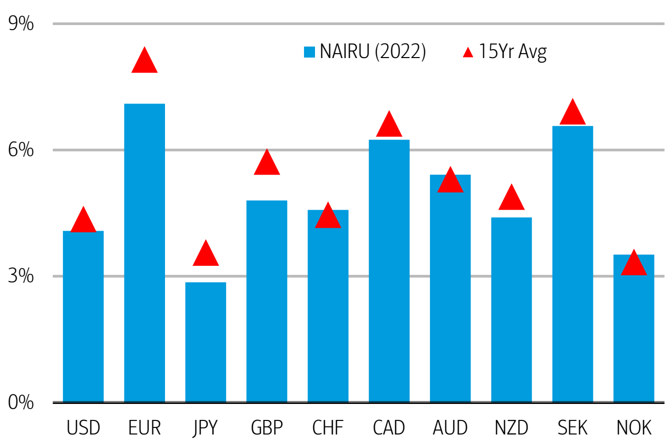
Of course, while there are idiosyncratic developments at play across G10, each country shares a common trend – strong labour markets. According to the latest data from the OECD, NAIRU, the non-accelerating inflation rate of unemployment has fallen or is close to the lows throughout G10 (data as of 2022). As Exhibit 5 highlights, the majority of G10 economies have lower NAIRU levels versus their respective 15yr averages. The labour market is therefore not the issue for economies. This is what makes this current "slowdown" so unique in attempting to anchor rate cut timing.

Exhibit 5: G10 NAIRU (2022) vs 15yr Average
NAIRU is currently lower in most countries than l/term average.



Source: BofA Global Research, Bloomberg, OECD

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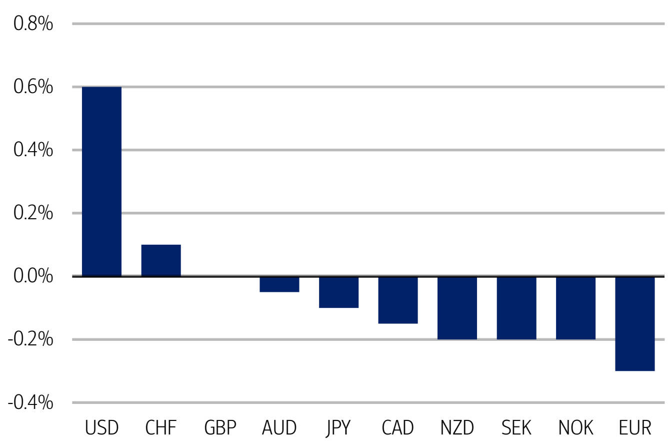
Exhibit 6: 3mth change in 2024 growth forecasts, %
High beta FX performance can be explained by growth downgrades



Source: BofA Global Research, Bloomberg

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Whilst the global cycle matters for high beta currencies, so does the regional outlook. Markets are concerned with the growth/inflation trade-off rather than isolating inflation as the primary driver for FX. Some of the largest recalibrations in G10 rate expectations have occurred against the backdrop of a healthier mix of inflation/growth: sticky inflation and improving growth = good for FX; sticky inflation and slowing growth = bad for FX. For this, we once again turn to the consensus forecasts for growth in 2024 as shown in Exhibit 6. This chart helps to contextualize the headwinds that high beta currencies have faced since the start of the year. Consensus growth projections for 2024 have been downgraded for all major currencies bar USD, CHF and GBP. This chart also helps to explain why GBP has performed stronger than many had anticipated: from the perception of stagflation to progressive upgrades to UK growth particularly since the start of the year. Our main takeaway is as follows: whilst the risk backdrop has been conducive, this has not helped currencies which would normally benefit from such a scenario. Whilst there has been a recalibration in rate pricing, many central banks are ultimately likely to be moving in the same direction (with the exception of JPY); a 25bps incremental move for/against a currency is unlikely to shift the dial. What has become apparent is how countries growth profile have failed to take advantage of an environment where liquidity remains abundant and vol remains low. Tracking data surprises is currently not the best indicator for a read across into G10 FX largely because there is little variation in employment levels across G10. For this reason, we expect lead indicators such as PMI and consumer sentiment readings to hold greater sway with the markets.

So where now? What's the trade?

As much as FX markets do not move in straight lines, neither does the global economy. Sizeable growth upgrades particularly in the US coupled with elevated positive data surprises, risks a growing asymmetry in the G10 FX response. Our major forecasts are close to current market levels. Our end-Q2 forecasts expect further USD depreciation versus G10. We are still guided by our carry framework so would avoid expressions that involve long CHF or CHF. Our preferred expression in the high beta FX space would be long GBP but not solely because of the well-established seasonality in April. With the Spring Budget approaching on March 6th, the focus has turned from a potentially destabilizing budget (September 2022) to one which could potentially be stimulative for the economy and had credence to the BoE higher for longer strategy on rates. With upward growth revisions according to the consensus and evidence that UK Plc remains under-owned, we would look to GBP as a good candidate to express longs having recently closed out our long GBP/CHF recommendation (see: FX Alpha: Close GBP/CHF 13 February 2024).

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
- Carry me away, **Liquid Cross Border Flows**, 12 Feb 2024

Rates, FX & EM trades for 2024

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: On track 16 February 2024

Global Rates Weekly: Duration divergence 16 February 2024

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