Liquid Insight

Growth-inflation trade-off and FX

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Rates and Currencies Research
Global

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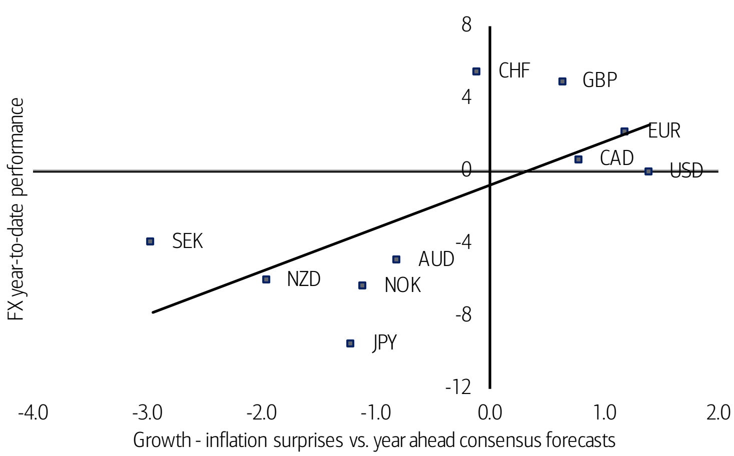
Key takeaways

- Soft landing is better than hard landing for FX. Reducing inflation without crushing the economy is good for markets.
- FX appreciated in G10 that surprised positively on growth and negatively on inflation this year, reflecting better trade-offs
- Better US data mix vs. the Eurozone supports our still bearish EURUSD view for the rest of the year.

By Athanasios Vamvakidis

Exhibit 1: Growth-inflation trade-off and G10 FX performance year-to-date
Better growth and lower inflation vs. consensus lead to stronger currencies



Source: Bloomberg, BofA Global Research.

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Reward for reducing inflation without hurting growth

We find that G10 economies that have surprised the consensus positively on growth and negatively on inflation this year have seen their currencies appreciate (Exhibit 1). The former is intuitive, but the latter may sound counterintuitive. However, our results suggest that lower inflation without much economic pain—soft landing—is better for a currency than persistent inflation with economic pain—hard landing/stagflation—which we do find intuitive. Economies facing a better growth-inflation trade-off as they try to reduce inflation from a high level will see their currencies appreciate. In this context, a better US data mix compared with that of the Eurozone supports our still bearish EURUSD view for the rest of the year, despite remaining bearish USD for next year based on valuation.

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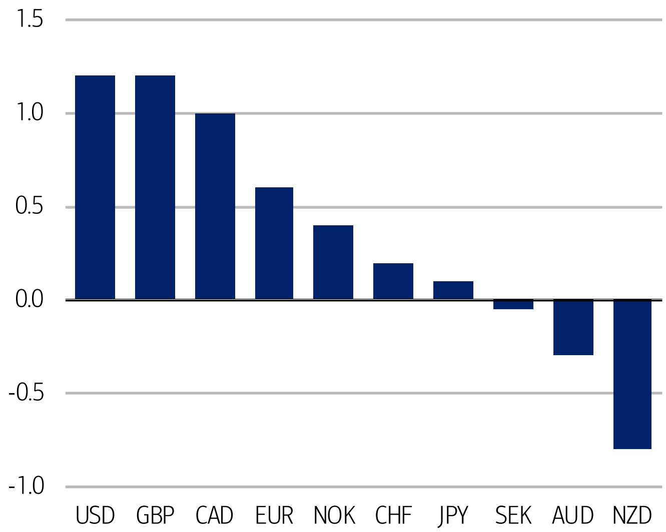
Growth and inflation have both surprised to the upside

In our year ahead report we had argued that the consensus was too optimistic on growth; we were wrong. We were both not optimistic enough. Compared with year-ahead consensus forecasts, G10 growth has mostly surprised to the upside (Exhibit 2). Growth has been particularly strong compared with consensus forecasts in the US, the UK and in Canada. Growth has only surprised negatively in New Zealand and in Australia, most likely because of the weak recovery in China after reopening.

In our year report we had also argued that the consensus was too optimistic on (lower) inflation; we were right. Compared with year-ahead consensus forecasts, G10 inflation has mostly surprised to the upside (Exhibit 3)—this is even more pronounced for core inflation, but we don't have consensus core inflation forecasts for all G10 economies. Inflation has surprised to the upside particularly in Sweden, but also in Norway and in Japan. Inflation has surprised to the downside in the Eurozone but mostly because of lower energy prices—Eurozone core inflation has been sticky—and slightly in the US.

Exhibit 2: Change in G10 consensus growth forecasts 2023
G10 consensus growth forecasts revised mostly upwards this year



Source: Bloomberg and BofA Global Research. Note: Change in consensus growth forecasts since year ahead reports.

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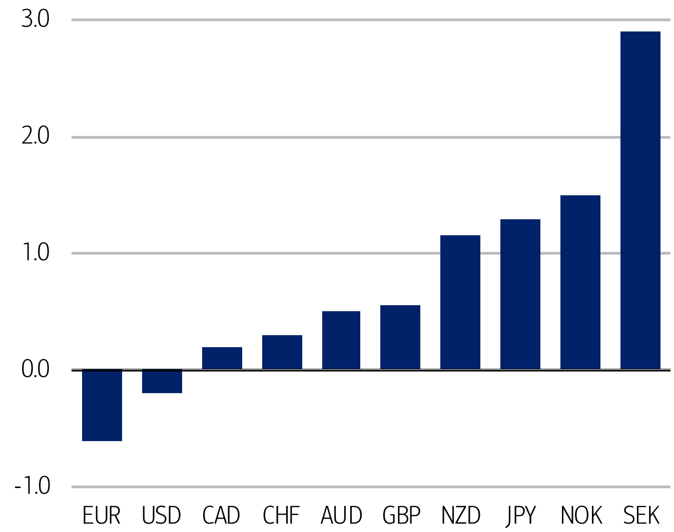
Exhibit 3: Change in G10 consensus inflation forecasts 2023
G10 consensus inflation forecasts revised mostly upwards this year



Source: Bloomberg and BofA Global Research. Note: Change in consensus inflation forecasts since year ahead reports.

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What these comparisons suggest is that we are still not in a landing scenario. G10 economies have on average done better and inflation has been stickier than year ahead market expectations. In our year ahead report we had argued for a harder landing than the consensus had expected. Even-though we also had to revise our growth and inflation forecasts upwards during the year, we still expect stickier inflation than the consensus, and as a result later and slower rate cuts than market pricing. The verdict is still out.

Reducing inflation without hurting growth is good for FX

Not surprisingly, faster growth than market consensus leads to a stronger currency. Indeed, the correlation of the change in the year-ahead consensus growth forecasts and G10 FX performance so far this year has been positive (Exhibit 4).

What may be surprising is that higher inflation than market consensus can lead to a weaker currency. The correlation of the change in the year-ahead consensus inflation forecasts and G10 FX performance so far this year has been negative (Exhibit 5). This may be counterintuitive. High inflation is supposed to call for more central bank policy tightening, in turn leading to a stronger currency and eventually lower inflation. Indeed, most of the times FX appreciates (and short-term yields go up) immediately after a positive inflation print surprise. However, our results suggest that this initial market rection is not sustained and eventually turns out to be exactly the opposite.

Exhibit 4: Change in G10 consensus growth forecasts and FX 2023
Currencies have appreciated when growth surprised to the upside

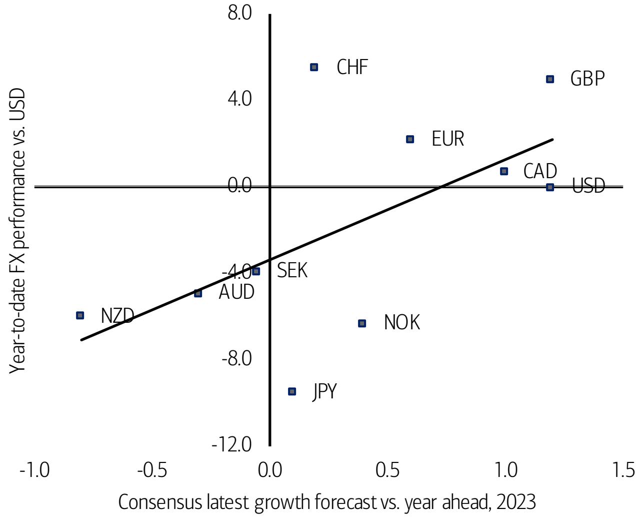

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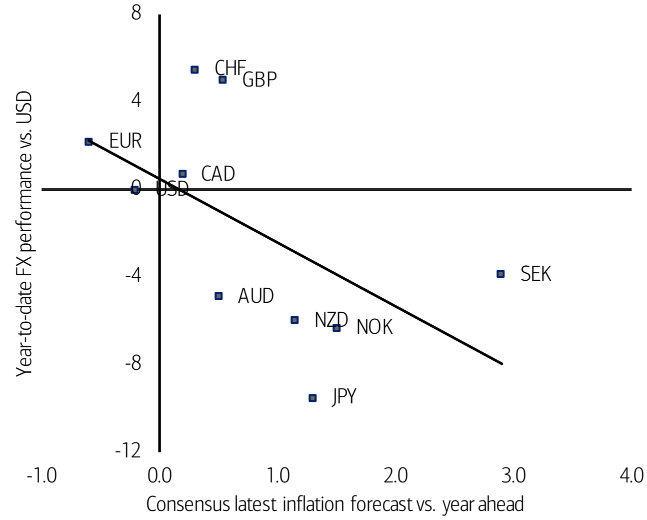
Exhibit 5: Change in G10 consensus inflation forecasts and FX 2023
Currencies have weakened when inflation surprised to the upside



Source: Bloomberg and BofA Global Research.

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The reason is that reducing inflation without hurting growth is actually good for a currency. Economies that have surprised the consensus upwards on growth and downwards on inflation have seen their currencies appreciate. Exhibit 1 subtracts consensus inflation surprises from consensus growth surprises, finding a positive correlation with G10 FX performance so far this year. A better growth-inflation trade-off compared with consensus forecasts explains why CHF, GBP, EUR, CAD and USD have done better than JPY, NOK, NZD, AUD and SEK this year.

Implications ahead

These results have implications for the FX impact from possible landing scenarios ahead. Assuming that all central banks stick to their inflation target and do whatever it takes to get there, it is all a matter of time and how much economic pain it will take to "land." Our results suggest that soft landing is better for a currency than hard landing, which should be intuitive. If an economy can reduce inflation without crashing the economy, its currency will do better than in an economy that reduces inflation by crashing the economy. The former case reflects better fundamentals. It will also most likely lead to later and slower policy rate cuts and a higher r* (natural rate of interest).

Our results also suggest that if a central bank gives up on its inflation target, the currency will weaken. Growth may be higher temporarily, but inflation will be higher permanently, weighing on the currency.

If central banks allow for different times to reach the inflation target, our results suggest mixed FX implications. It will all depend on the growth-inflation trade-offs during this path. If slightly more time to reach the inflation target allows a softer landing, the currency may even strengthen. However, if a central bank takes too long to reach its inflation target, the currency is likely to weaken, even if growth is faster.

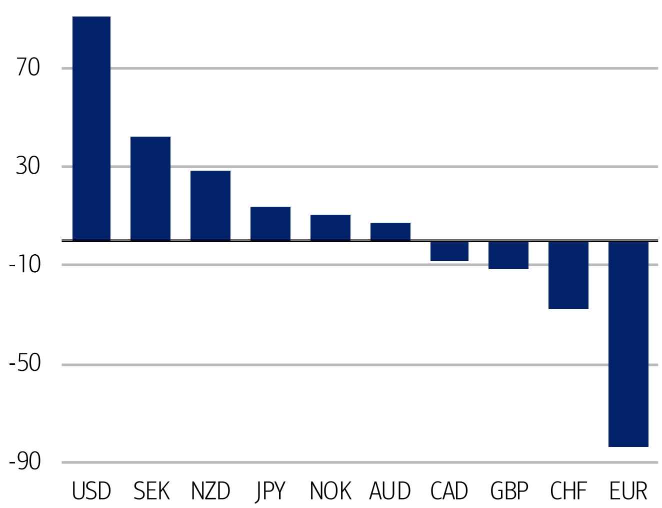
We still like the USD

The above could explain why EURUSD has failed to sustain a rally, disappointing the bullish consensus—we have been bearish. Compared with year-ahead consensus forecasts, growth has surprised positively and inflation negatively in both the Eurozone and the US. However, growth has surprised more positively in the US, while inflation more negatively in the Eurozone—although the latter has primarily to do with lower energy prices and core inflation is now lower in the US than in the Eurozone. These mixed data have kept EURUSD in a range.

The implications looking ahead explain why we remain bearish EURUSD for the rest of the year. While we are at the consensus for the year as a whole on Eurozone growth and inflation (0.6% and 5.4%) and on US inflation (4.1%), we are well above consensus on US growth (2.1% vs. 1.6%). We expect the US to have lower inflation than the Eurozone—4.1% vs. 5.4%—and faster growth—2.1% vs. 0.6%. This is a much better growth-inflation trade-off in the US than in the Eurozone. This would be consistent with a weaker EURUSD for the rest of the year, and indeed our forecast is 1.05, which is well below the consensus forecast of 1.12 and our 1.15 forecast for next year.

Subtracting the latest inflation surprises from the overall data surprises compared with consensus forecasts also points to USD upside in the short term. This measure of the growth-inflation latest trade-offs vs. consensus expectations is currently the most positive in the US and the most negative in the Eurozone in G10 (Exhibit 6). Since the surge of inflation in recent years, such a divergence has been correlated with a weaker EURUSD (Exhibit 7).

Exhibit 6: Latest data surprises – inflation surprises
US has the best growth-inflation mix while the Eurozone has the worst compared with G10 consensus forecasts



Source: Bloomberg and BofA Global Research.

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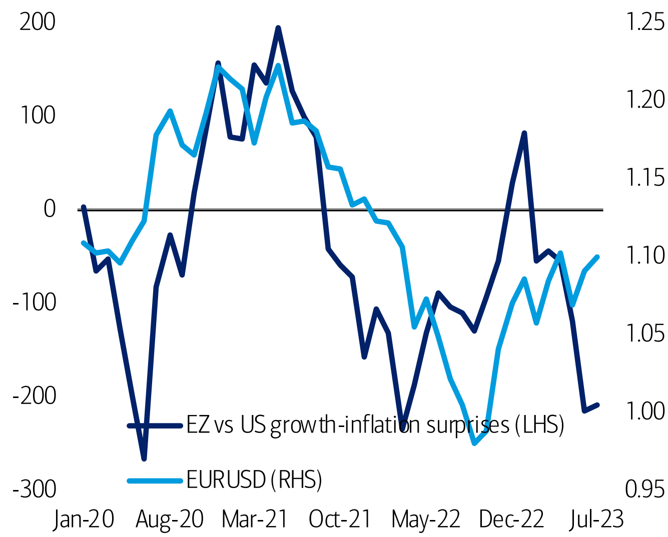
Exhibit 7: US vs. Eurozone, overall data – inflation surprises
The latest US growth-inflation mix vs. the Eurozone compared with consensus points to EURUSD downside



Source: Bloomberg and BofA Global Research.

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Miracle on Main Street **Global FX Weekly**, 11 Aug 2023
- R*s be our guide **Global Rates Weekly**, 11 Aug 2023
- The market bias against the USD, **Liquid Cross Border Flows**, 7 August 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: Miracle on Main Street 11 August 2023

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