GLOBAL FIXED INCOME & CURRENCY STRATEGY

A Unique Mind On The Markets

September 27, 2024

Stronger China = Weaker U.S. Dollar

- The Chinese authorities announced a slew of stimulus measures this week and more could be in store in the coming months.
- A brighter outlook for Chinese growth just as the Fed is easing policy should weigh on the U.S. dollar.
- With the RBA being relatively hawkish, the Australian dollar could be an outsized winner among the G10 currencies.
- The Fed is more concerned about downside risks to the labor market rather than upside risks to inflation. Rising unemployment could force the Fed to cut rates more forcefully.
- The Riksbank remains much more aggressive than the Norges Bank in cutting interest rates. Investors should continue to favor Swedish over Norwegian bonds. NOK/SEK is oversold and due for a bounce.

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The slumping Chinese economy has been a drag on non-U.S. global growth, which has allowed the dollar to be stronger than it would otherwise be. This is because the U.S. is a relatively closed economy and is less dependent on trade with China than the other major economies.

The severe crackdowns by Beijing on the property market and the tech sector, along with the disastrous Covid lockdowns, dealt a long-lasting blow to consumer and business confidence. The sinking stock market and the meltdown in Chinese bond yields were clear signs of weakening demand and escalating deflationary pressures (**Chart 1**).

Chart 1 The Writing Was On The Wall

With the government's annual GDP growth target looking increasingly out of reach, the Chinese central bank and financial regulators announced a slew of stimulus measures this week:

- The PBoC cut several benchmark policy rates and lowered the reserve requirement ratio to increase bank liquidity and loanable funds.

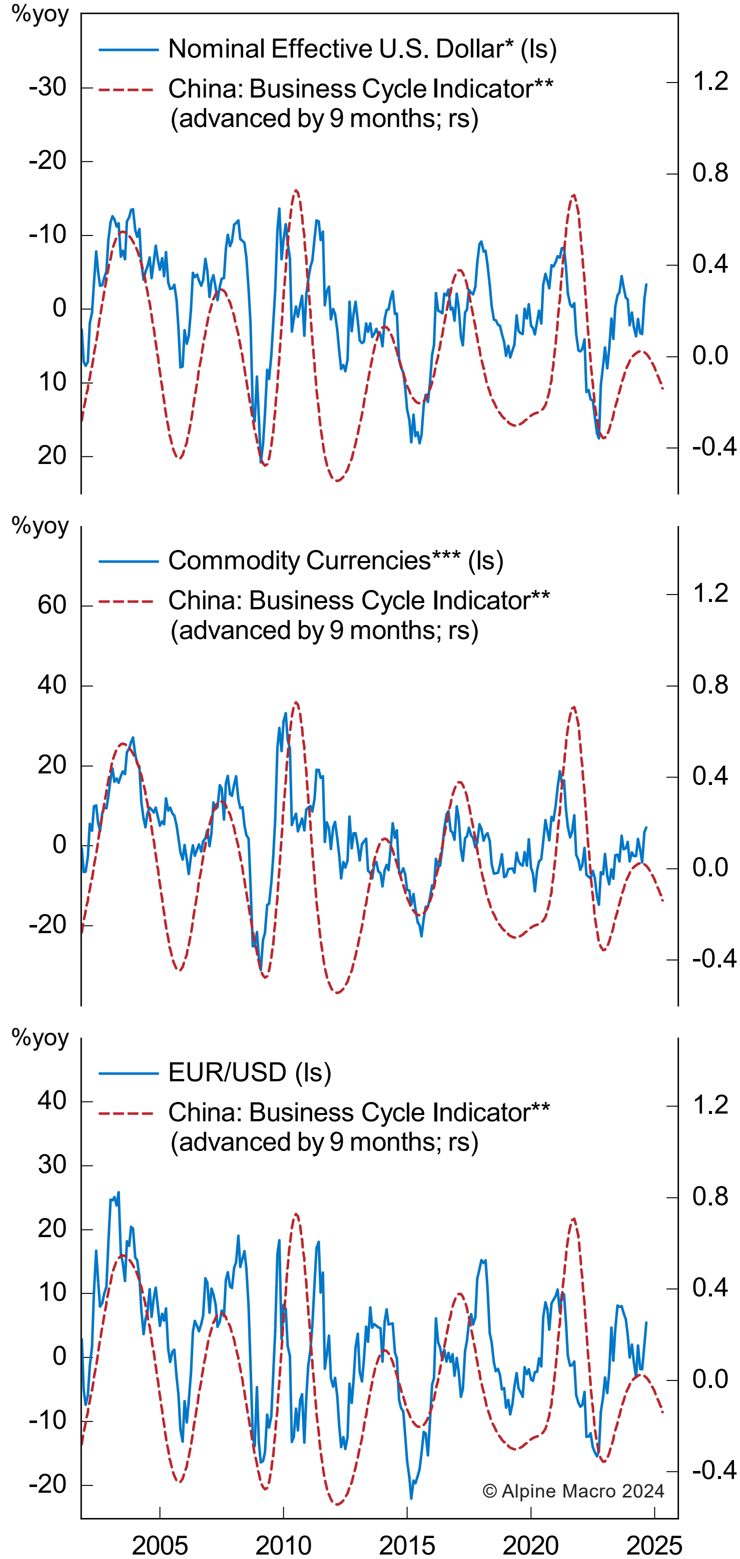
- On housing, downpayment requirements were lowered to 15% for both primary residences and investment properties. Additionally, existing mortgage rates will be trimmed by 50bps, which will reduce households' debt service costs.

- The central bank established two facilities totaling CNY800 billion for non-bank financial institutions to purchase stocks and for corporate buybacks. Moreover, Governor Pan Gongsheng suggested that these programs could be expanded if needed.

The critical question is whether these policies will be sufficient to turn the Chinese economy around. If so, it would have a material effect on FX trends. **Chart 2** illustrates how the major currencies closely track the ebbs and flows of the Chinese cycle:

- The first panel of the chart shows that the U.S. dollar has been inversely correlated with China's cycle (the dollar is shown inverted in the chart). This reflects the fact that the greenback is a counter-cyclical currency. Investors flock to the relative safety of U.S. assets during periods of weak growth. Capital flows more freely to riskier assets outside of the U.S. when global growth is

Chart 2 China's Business Cycle & Currencies



*Shown inverted; source: BIS
**Truncated at 1.2; Alpine Macro proprietary indicator
***Equally-weighted average of AUD/USD, NZD/USD and CAD/USD

strong. As China powers the global economy, the dollar is negatively correlated with the Chinese business cycle.

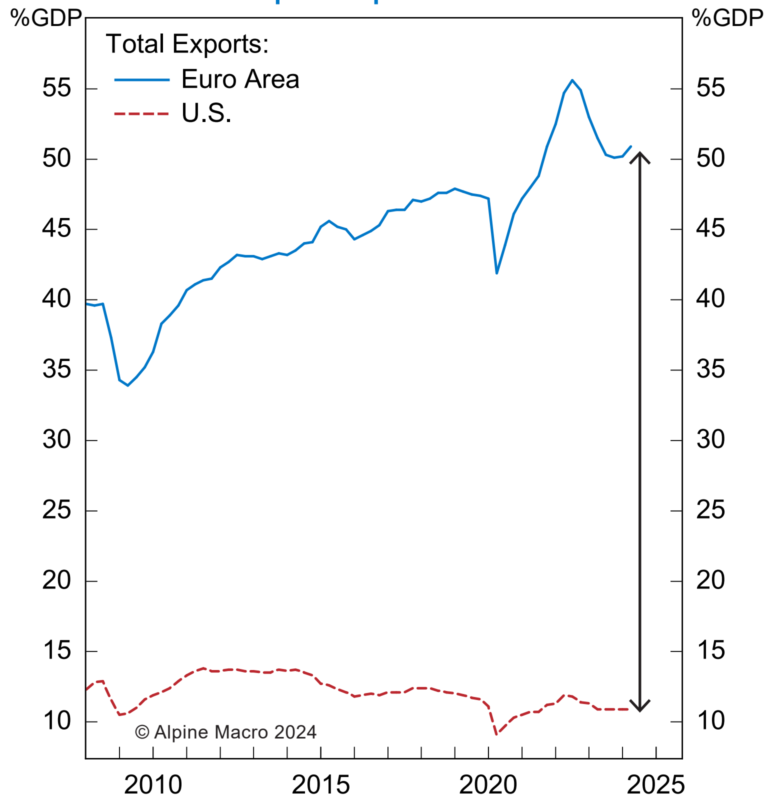
- Not surprisingly, the commodity currencies are closely tied to China's economy. China is the world's largest consumer of resources and drives prices. Therefore, the fortunes of commodity producers and their currencies depend on Chinese demand.

- The euro is also very sensitive to Chinese growth due to two reasons. First, the eurozone economy lacks vibrant domestic demand. Therefore, cyclical trends in the euro area are driven by external demand, namely from China. Exports account for over 50% of the eurozone's GDP versus near 10% for the U.S. (**Chart 3**). Second, the euro is the "anti-dollar". If the dollar is inversely correlated with China's cycle, then the euro must behave in an opposite manner.

Our *Emerging Markets & China Strategy* team believes that this week's policy announcements are encouraging and long overdue, but more will be needed to ensure that the economy experiences a sustainable recovery.[1] More liquidity cannot lead to stronger credit growth if loan demand remains weak. Buybacks alone cannot fuel a durable bull market in stocks if corporate earnings do not recover.

Importantly, China needs more fiscal stimulus to complement the easing in monetary policy. With the economy experiencing broad-based deflation and in a potential liquidity trap, easier monetary policy cannot be effective without an accompanying fiscal impulse.

Chart 3 **The Eurozone Is Much More Export-Dependent Than The U.S.**

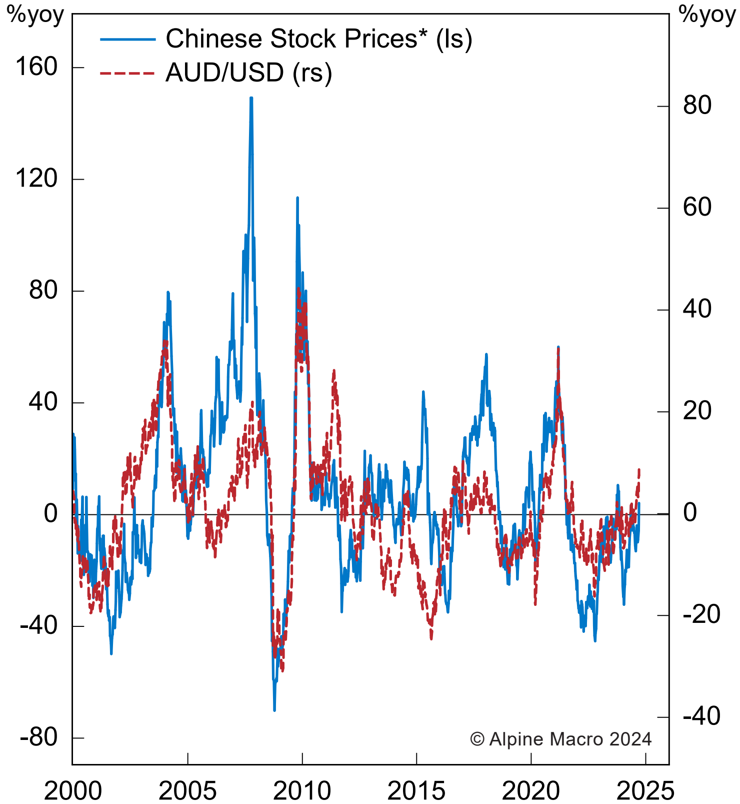


We are optimistic that the Chinese authorities will follow up with fiscal measures. While lacking specifics, the Politburo pledged to issue CNY2 trillion of special sovereign bonds. This is to be used to stimulate consumption and support local governments. More policy initiatives can also be revealed at the upcoming Central Economic Work Conference.

A combination of a cyclical upturn in the Chinese economy and continued easing by the Federal Reserve should result in a weakening U.S. dollar. We have been playing for a decline in the dollar through long positions in the British pound and the Japanese yen. This week, we are adding a new speculative trade by going long AUD/USD.

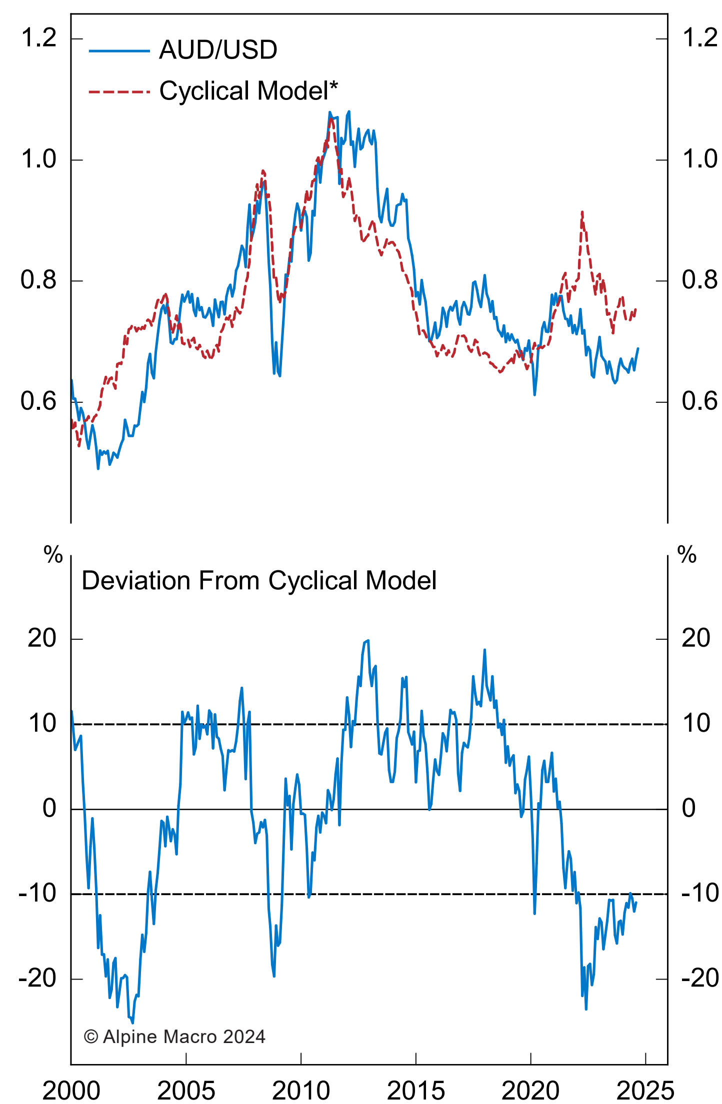
1 Alpine EM & *China Strategy Special Alert* "China's 'Whatever It Takes' Moment?" (September 24, 2024).

Chart 4 An Upturn In Chinese Stocks Is Bullish For The AUD



*Source: MSCI

Chart 5 AUD/USD Is Attractive



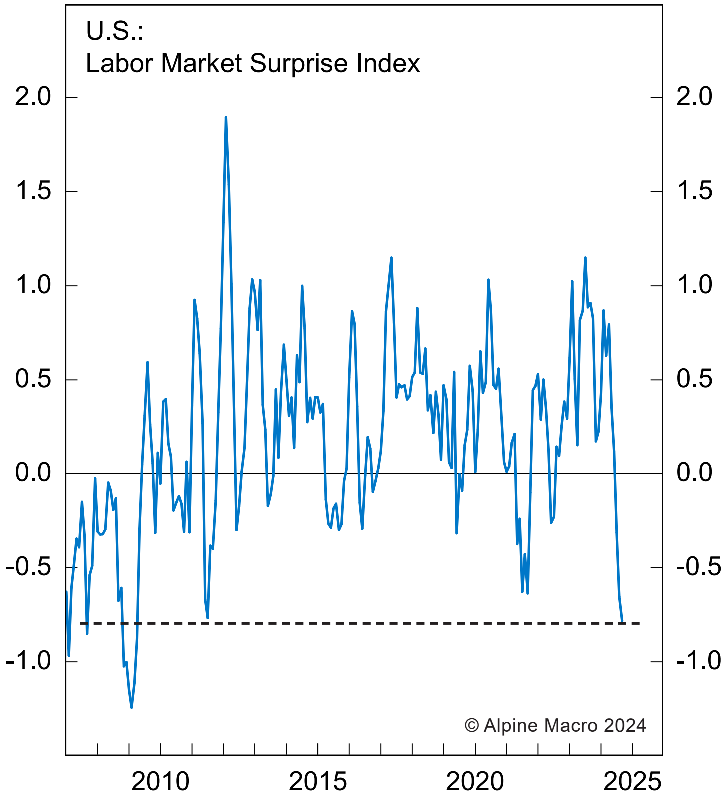
*Based on expected central bank policies and the RBA Commodity Price Index

As discussed above, an improvement in Chinese growth should spell particularly good news for commodity plays like the Australian dollar. China remains Australia's largest export market, accounting for nearly 40% of its overseas shipments. **Chart 4** shows that the Aussie dollar is closely correlated with Chinese equities. Greater optimism over China's economy should have a spill-over effect to the AUD.

Additionally, a favorable growth impulse from China will keep the RBA wary of easing policy too quickly. The RBA has not followed the other major central banks in cutting interest rates and struck a cautious chord at this week's policy meeting. The RBA noted that its *"forecasts do not see inflation returning sustainably to target until 2026."* As a result, the policy stance *"will need to be sufficiently restrictive until the Board is confident that inflation is moving sustainably towards the target range."*

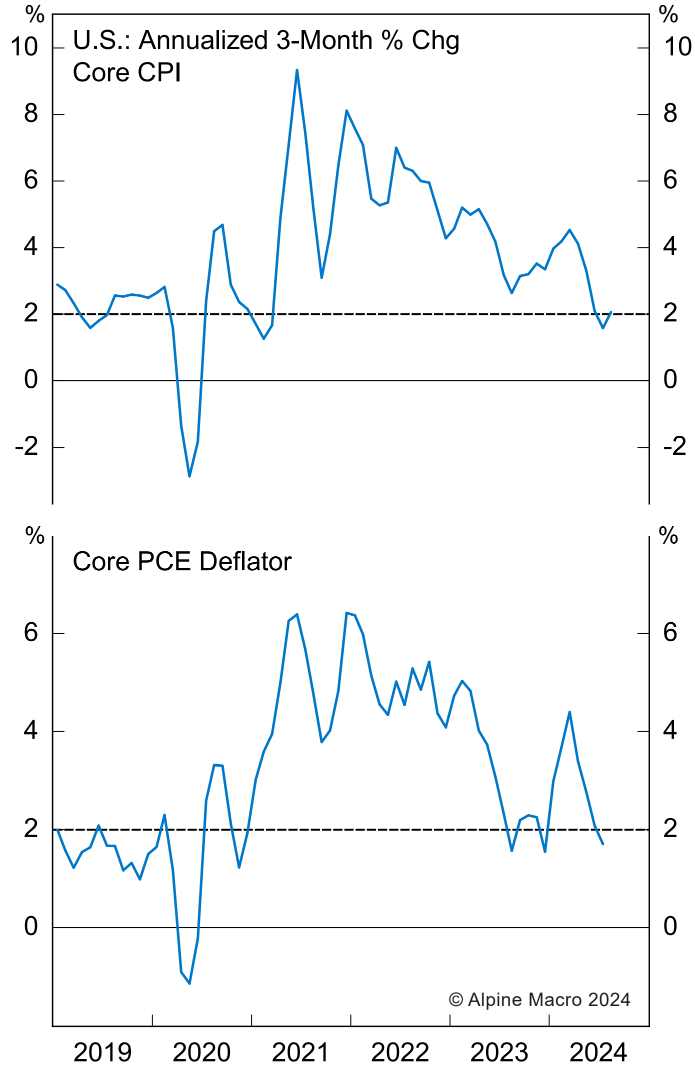
Finally, our cyclical model indicates that the Aussie is undervalued relative to the current level of commodity prices and expectations for short-term interest rate spreads (**Chart 5**). If commodity prices

Chart 6 Downside Surprises From The U.S. Labor Market



Source: Bloomberg Finance L.P.

Chart 7 Short-Term U.S. Inflation Rates Are Down To 2%



trend higher and expected interest rate differentials widen, the Australian dollar will look even more attractive.

Bottom Line: A brighter outlook for Chinese growth just as the Fed is easing policy should weigh on the U.S. dollar. With the RBA being relatively hawkish, the Australian dollar could be an outsized winner.

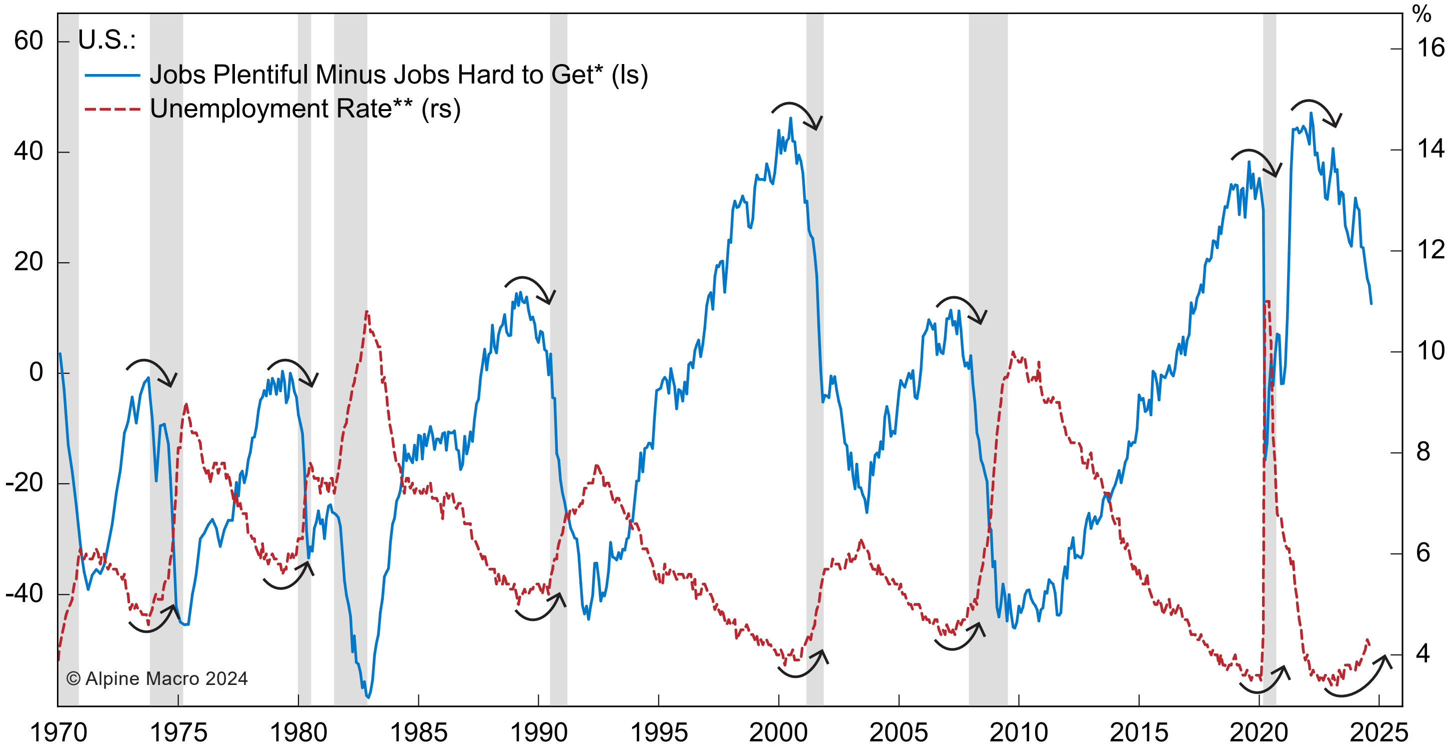
It's All About The U.S. Labor Market

Several Fed officials spoke this week and provided more color behind the decision to cut rates by 50bps at the recent FOMC meeting. The message was quite clear: the Fed is much more concerned about downside risks to the labor market rather than upside risks to inflation. Indeed, Bloomberg's U.S. labor market surprise index has plunged to levels last seen during the 2008/09 GFC (**Chart 6**).

We believe Chicago Fed President Austan Goolsbee's comments were particularly insightful to the Fed's thinking. Goolsbee started by noting that U.S. economic conditions are largely consistent with the Fed's dual mandate:

- While annual inflation rates are still a little above 2%, the shorter term rates of change have been in line with the Fed's target (**Chart 7**).

Chart 8 U.S. Unemployment Is Likely To Rise Further



*Source: Conference Board
**Truncated at 11%
Note: Shading denotes U.S. recessions

- On the labor market, the Fed's objective of maximum employment is met with the jobless rate at 4.2%.

Goolsbee said that he *"would love to freeze both sides of the Fed's dual mandate right here."* Keeping interest rates at the highest level in decades and being slow to lower them would put the dual mandate in jeopardy. As Goolsbee put it bluntly, *"If we want a soft landing, we can't be behind the curve."*

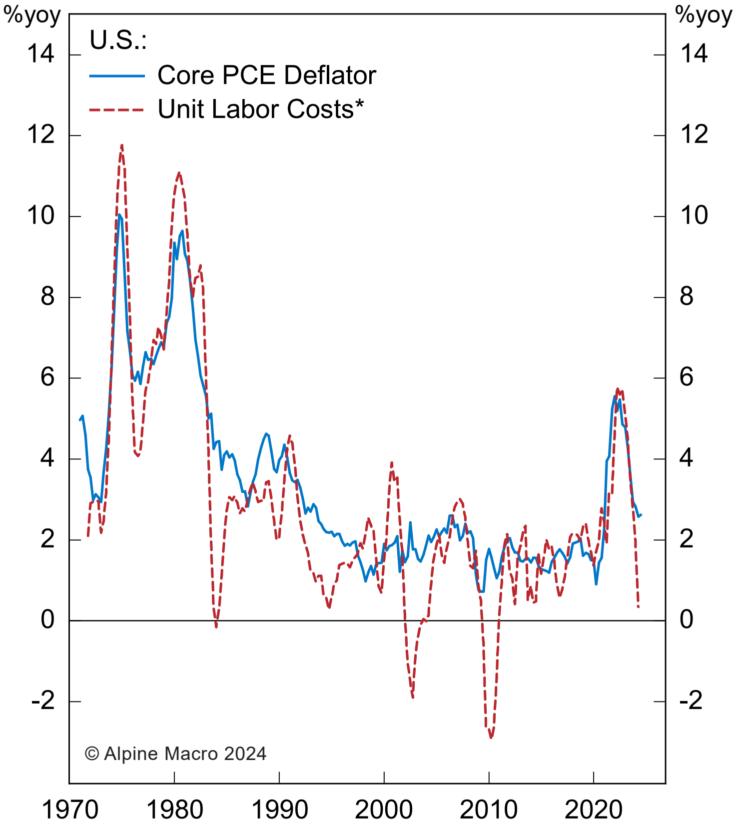
Focusing on the labor market, the Chicago Fed president noted that conditions can deteriorate quickly and for monetary policy *"it's just not realistic to wait until problems show up."* We believe that the risks are skewed in the direction of a further softening in the labor market.

In the Conference Board's consumer confidence index, the difference between "jobs are plentiful" and "jobs are hard to get" fell once again in September (**Chart 8**). For more than fifty years, this has signaled a rising unemployment rate and is warning that the labor market could soon fall short of the Fed's mandate for maximum employment.

As slack builds in the labor market, it should translate into lower wage pressures and inflation. The growth in unit labor costs has already slowed to just 0.3% y/y. Any further deceleration in wages and unit labor costs would increase the risk of inflation falling below the 2% target (**Chart 9**).

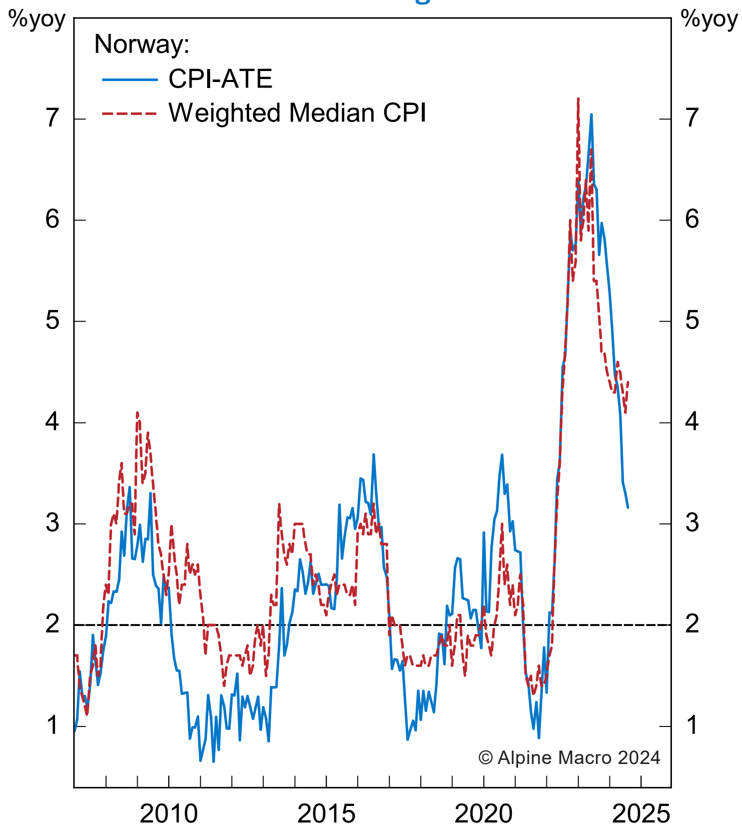
Goolsbee concluded by saying that current economic *"conditions are good on both sides of the mandate.*

Chart 9 Muted Wage Pressures Could Pull U.S. Inflation Below 2%



*Shown as a 4-quarter moving average except latest data point

Chart 10 Norway's Underlying Inflation Is Still Above Target



Rates need to come down significantly going forward if we want the conditions to stay that way." And if the Fed misses on its dual mandate, the rate cuts would need to be even more aggressive.

Bottom Line: We shifted duration to neutral in early August after the sharp pullback in global risk assets. A back-up in yields to 4% should be seen as an opportunity to increase duration again. Investors should also stay positioned for a steeper yield curve.

A Tale Of Two Central Banks

At last week's meeting, the Norges Bank kept its policy rate unchanged at 4.5% and signaled that interest rates will not be lowered until 2025 Q1.

While Norway's underlying inflation rate is trending lower, it remains above the 2% target (**Chart 10**).

The Norges Bank is concerned that strong wage gains, poor productivity growth, and a weak currency could restrain further disinflation. Consequently, the central bank believes that *"a restrictive monetary policy is still needed to bring inflation down to target within a reasonable time horizon."*

In sharp contrast, the Riksbank lowered rates by another 25bps this week to 3.25%. It also expects to cut rates at a more aggressive pace going forward. The Swedish central bank said that it could cut by 50bps at one of the two remaining meetings this year.

Chart 11 Green Lights For The Riksbank To Be Aggressive

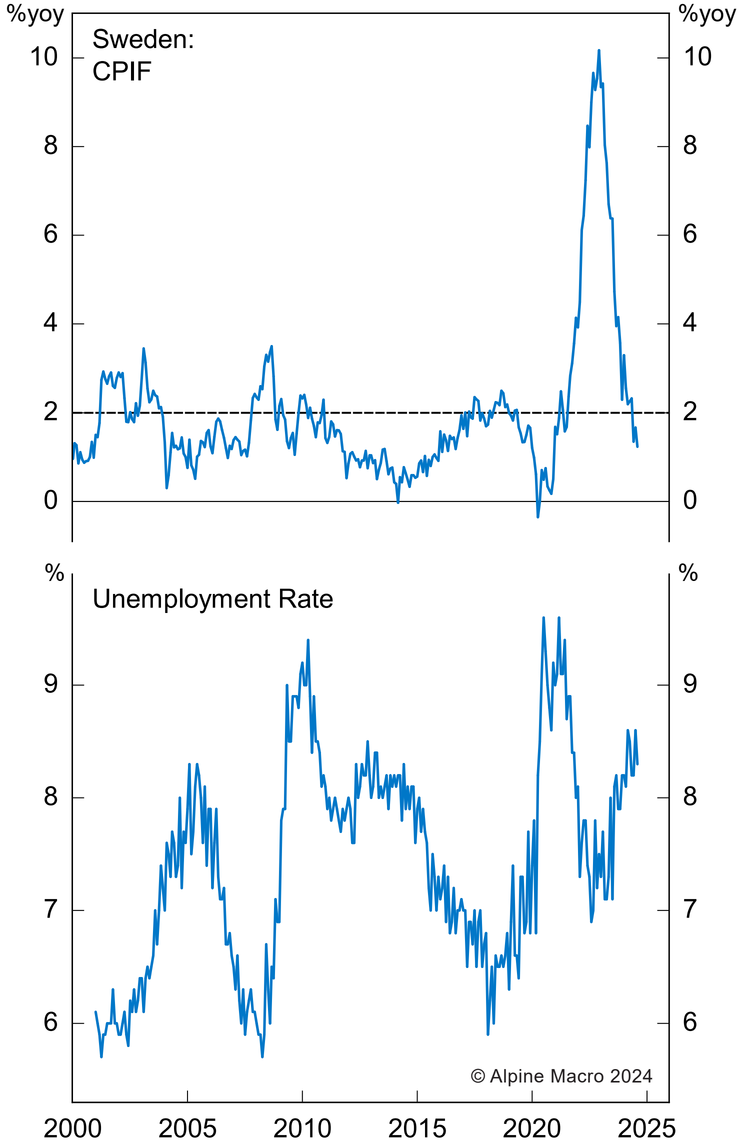
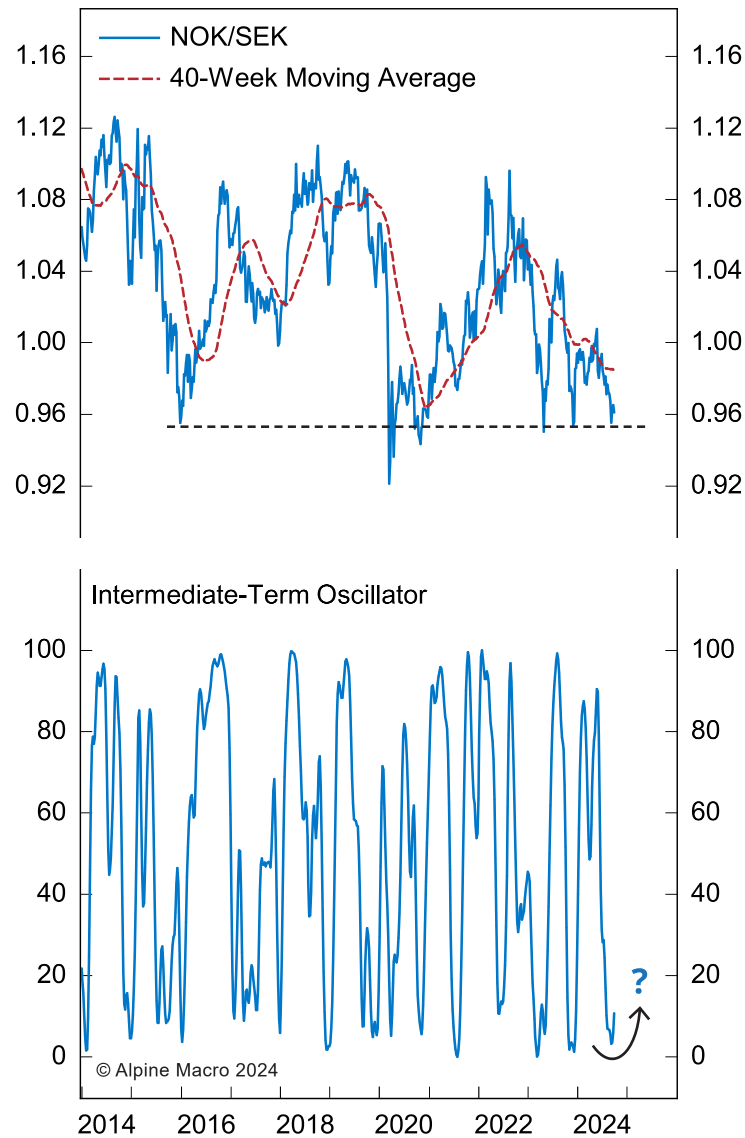


Chart 12 NOK/SEK Is Oversold



The more aggressive posture of the Riksbank is justified by the sharp decline in inflation and a significant weakening of the labor market (**Chart 11**). Sweden's underlying inflation rate has dipped below the 2% target and the unemployment rate has risen sharply.

Bottom Line: Global fixed income investors should continue to favor Swedish over Norwegian bonds. NOK/SEK is at the lowest levels since the pandemic and our intermediate-term oscillator is deeply oversold (**Chart 12**). A bounce is possible, but weakness in oil prices could limit the NOK's upside.

Harvinder Kalirai
Chief Fixed Income & FX Strategist

Currency Outlook

Vs THE DOLLAR

	1-3 Months	9-12 Months
EUR	UP	UP
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
CAD	FLAT	UP
AUD	~~FLAT~~ UP	UP
NZD	~~FLAT~~ UP	UP

Vs THE EURO

	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*

U.S.	4
Japan	1
Eurozone	3
Core	4
Periphery	2
U.K.	3
Switzerland	2
Norway	2
Sweden	3
Canada	4
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	3.09%	-4.04%	-0.94%
Long Gold	2022-03-04	1,928	-	-	38.81%	-	38.81%
Short USD/JPY	2024-08-23	146.23	-	-	1.12%	-0.48%	0.64%
Long GBP/USD	2024-08-23	1.3094	-	-	2.47%	-0.02%	2.45%
Long AUD/USD	2024-09-27	0.6896	-	-	-	-	-

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	89.36 bps

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