Q4 2023
GLOBAL CURRENCY & MACROECONOMIC HIGHLIGHTS

5 October 2023

MGI Economics

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MILLENNIUM GLOBAL INVESTMENTS

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EXECUTIVE SUMMARY

MILLENNIUM GLOBAL INVESTMENTS

Economic Views

- We expect US growth to slow as the economy digests a fading fiscal impulse, tighter credit conditions and higher oil prices along with a government shutdown and auto strikes
- We expect inflation to fall via shelter, food and labour market rebalancing, but the pace of core disinflation should slow
- We continue to believe in a US soft landing given the progress already made in bringing down unit labour costs. The Fed have also signalled they are nearly done despite strong growth forecasts
- Higher back-end yields are a symptom of a higher interest rates, large deficits and QT. We now think the Fed are done with their interest rate hiking cycle given the feedback loop from tighter financial conditions
- In Europe, we expect growth to be in recessionary territory, helping disinflation continue. This raises the risk that the ECB overtightens monetary policy at the expense of undershooting the inflation target in the future
- We see progress in Japanese “reflation” and expect Japan to exit yield curve control in Q4. Disagreement amongst the committee about the sustainability of inflation suggests they will not raise interest rates until sufficiently convinced. We pencil in Q2 next year
- We continue to have a pessimistic structural view on China given various headwinds, but cyclical growth is improving. We still expect inflation to remain low and monetary policy to retain a small easing bias

FX Views

- The market has come around to our long-held view of a soft landing and higher US rates (both in the front and back end) have helped push the dollar higher
- Our message is to pare back dollar longs here. We now see the rates and commodity support which pushed the dollar up fading
- As US yields stabilize, this should generally be supportive of risk assets, though we bear in mind that valuations are challenging
- Overall we stay neutral the dollar, **DXY(0)** given decent carry and the weak outlook in Europe which points to little US-European growth convergence
- Our view that US yields can stabilize and give equity & commodity risk some respite, generally supports G10 cyclical FX such as **AUD (+), CAD (+)** and **NOK (+)** which also offer more value than European FX
- We downgrade the European complex (**GBP, EUR** and **CHF)** further to negative **(-)** as developments in growth and inflation warrant faster cutting cycles than generally priced and for the likes of the SNB, a more relaxed approach to the currency (less in favour of FX strength)
- Our view that “higher for longer” is now well priced results us downgrading the yen to neutral, **JPY (0**), as FX intervention and valuation risk generally points to risk-reward being long yen
- Higher US yields have providing a better entry for carry strategies: we like LatAm, including **BRL (+)** where real rates remain high. We also like **MXN (+)** and **KRW (+)** in the EM space
- Finally, though cyclical growth is improving in China, the interest rate differential versus the US is still negative and the flow picture remains poor. We are negative **CNH (-)**

Currency Outlook: October 2023

USD (0)
While the dollar still has attractive carry, we think the Fed are done and 10-year is well priced. Ultimately, rates and commodity support are fading so we are neutral

CAD (+)
Support from the commodity (and risk) axis as well as a renewed hawkish BoC

BRL (+)
A steady cutting cycle should only erode BRL's high carry and along with positive fiscal news should continue to support BRL

EUR (-)
See cyclical downside risks to both growth and inflation This argues to fade the "higher-for-longer" message of central banks including the European Central Bank (ECB),

GBP (-)
Activity is now more clearly softening in the UK giving rise to downside risks to rates which are priced to be the most restrictive in G10 in two year' time.

CHF (-)
A clear low yielder and inflation under control should leave the SNB walking away from the recent FX stance of a stronger currency

NOK (+)
Stable US yields, improvement in China activity, turn in global manufacturing and high commodity prices should help unleash some value

JPY (0)
Risk reward building for long yen given higher US rates but BoJ in no hurry

CNH (-)
Monetary policy divergence vs the US continues and flow picture remains negative

AUD (+)
Attractive entry, China recovery and respite for equities should help support AUD

*All views except CHF are vs USD *CHF is vs EUR Source: MGI Economics, 5 October 2023*

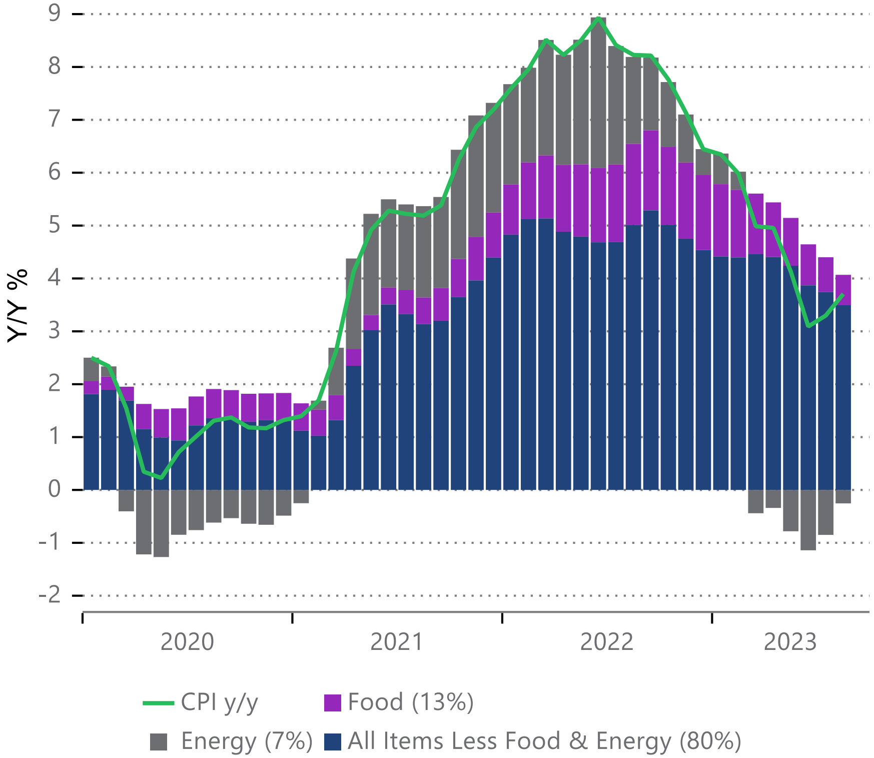

ECONOMIC OUTLOOK
MILLENNIUM GLOBAL
INVESTMENTS

The US has seen disinflation despite strong growth

GDP growth still above potential

Source: Macrobond, MGI Economics, 3 October 2023

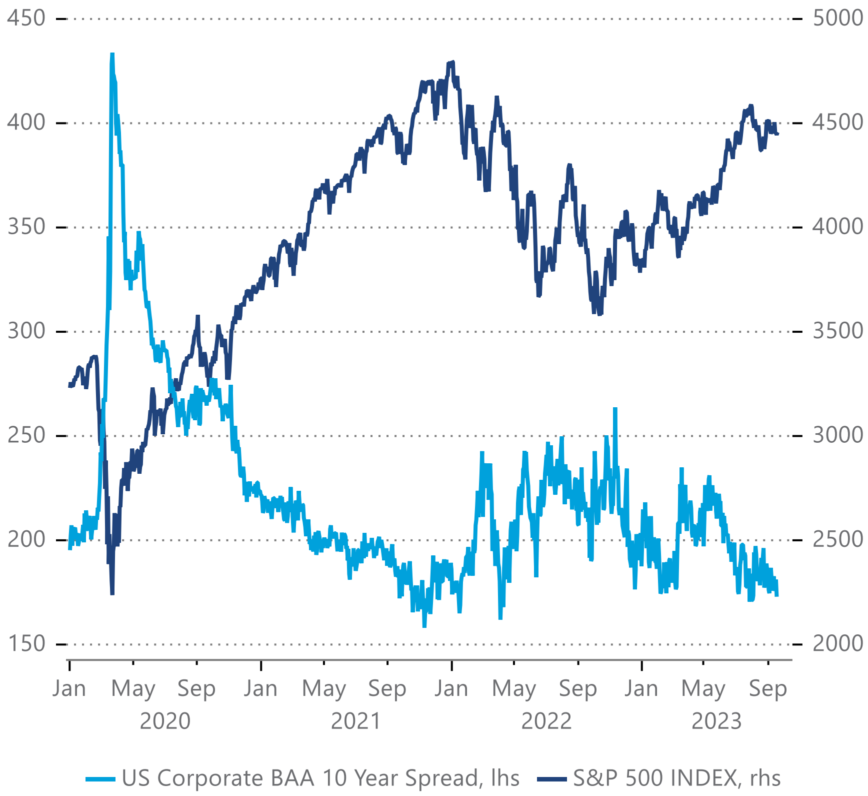
But inflation has come down



Source: Macrobond, MGI Economics, 3 October 2023

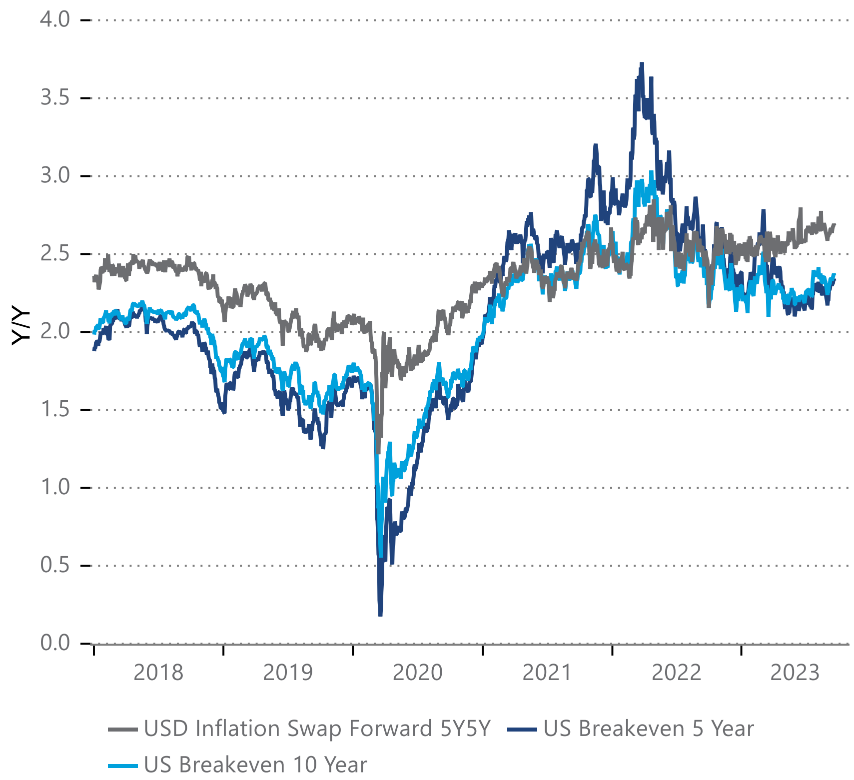
This has been embraced by risk assets as a "soft landing"

Risk assets supported by "goldilocks"



Source: Macrobond, MGI Economics, 3 October 2023

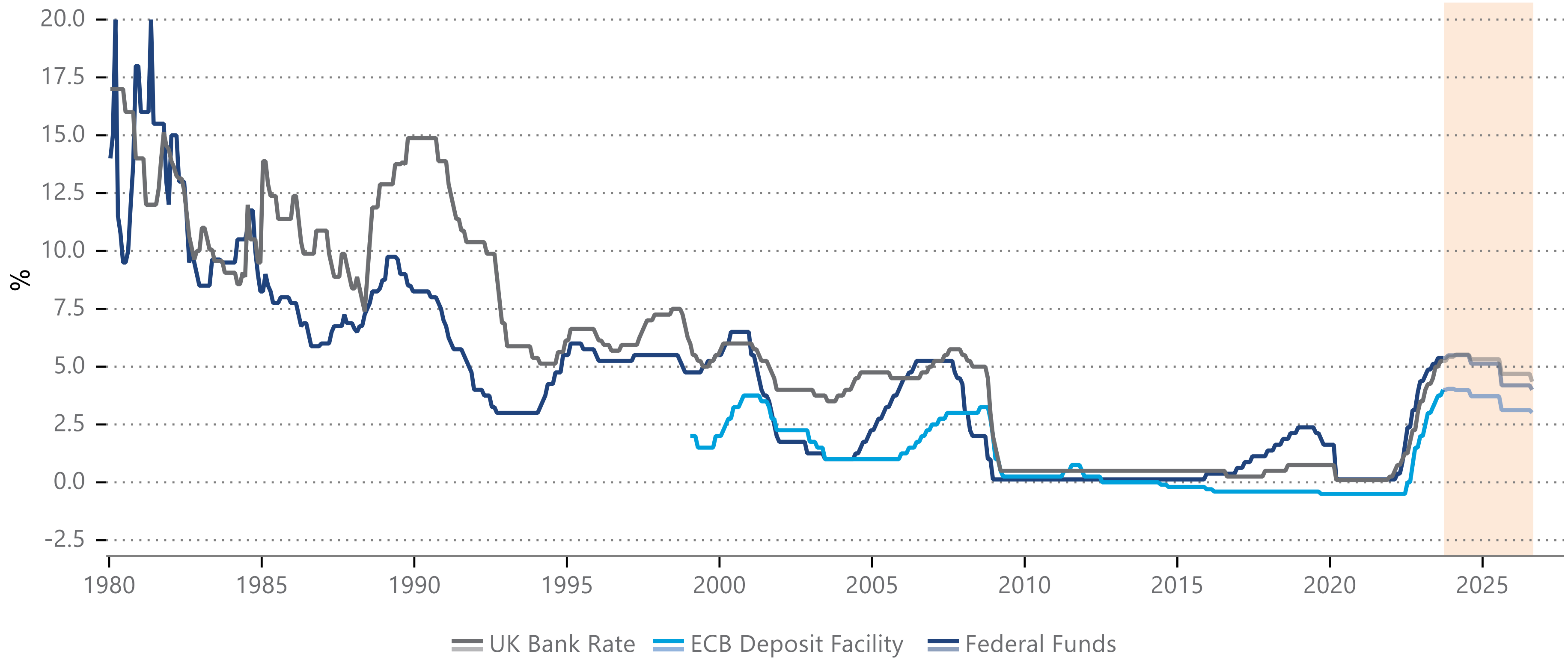
Inflation expectations stable



Source: Macrobond, MGI Economics, 3 October 2023

And priced in as "higher for longer" in interest rates

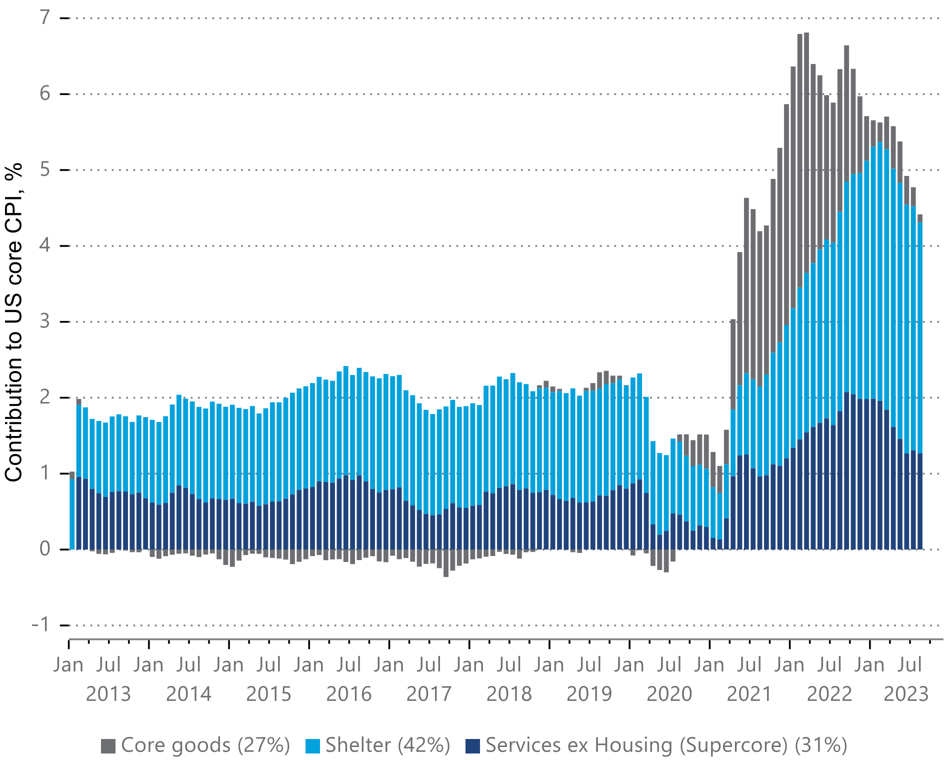
Shallow cutting cycles priced in DM



Source: Bloomberg, Macrobond, MGI Economics, 3 October 2023

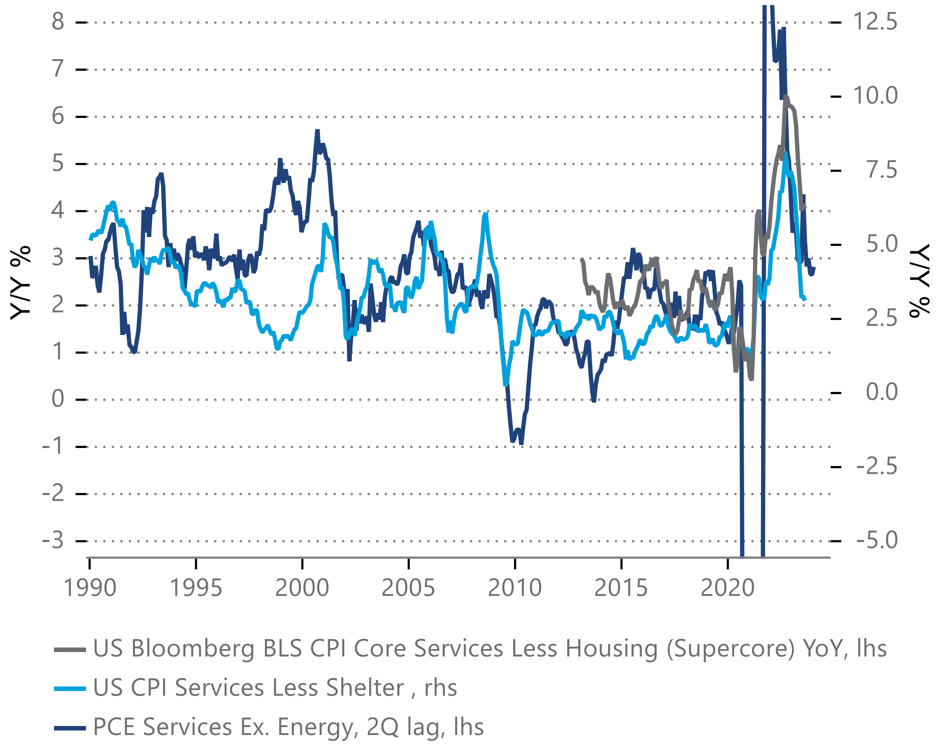
Normalisation in spending helps "supercore" move lower

Supercore contribution has come down by 0.7pp



Source: *Macrobond, MGI Economics, 3 October 2023*

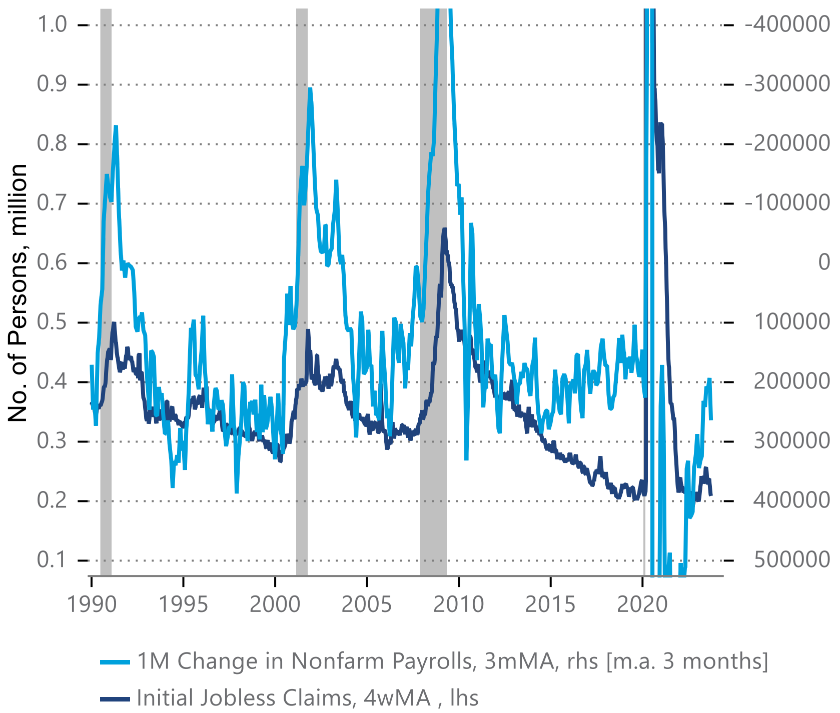
Helped by normalizing service consumption



Source: *Macrobond, MGI Economics, 3 October 2023*

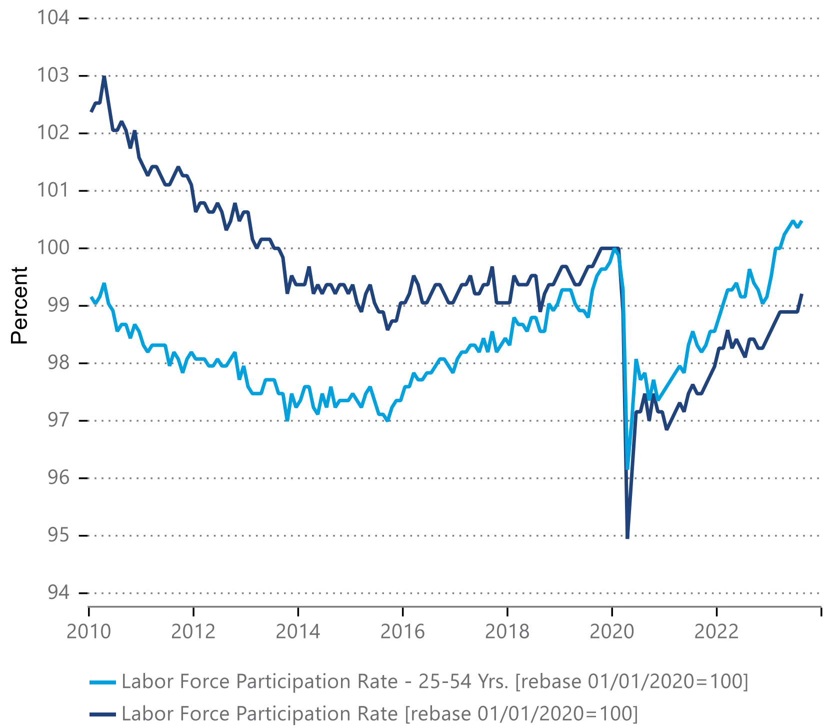
Labour market rebalancing is also progressing

Payroll growth has come down



Source: Macrobond, MGI Economics, 3 October 2023

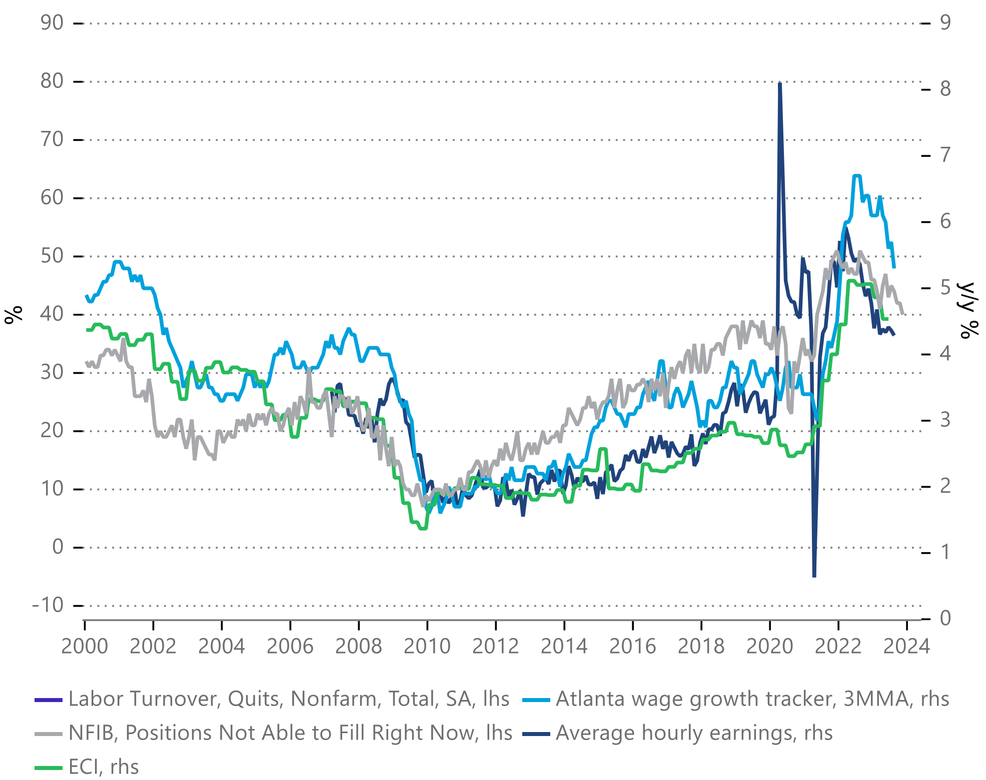
Labour force participation improves



Source: Macrobond, MGI Economics, 3 October 2023

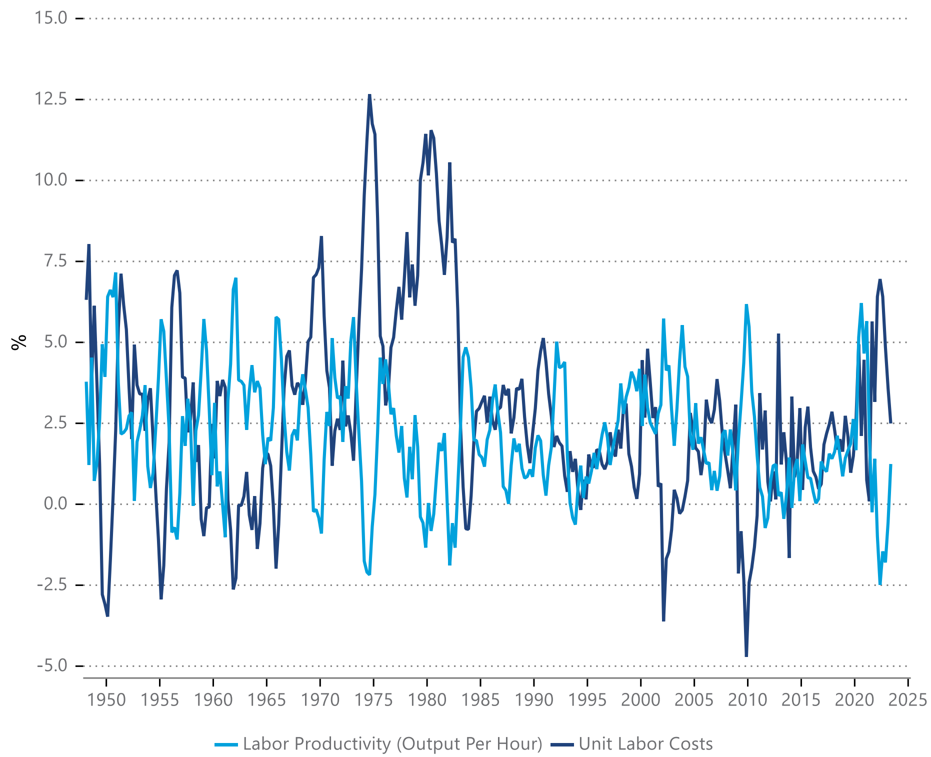
Wage growth and unit labour costs not far from "right" level

Wage growth is c.5%



Source: Macrobond, MGI Economics, 3 October 2023

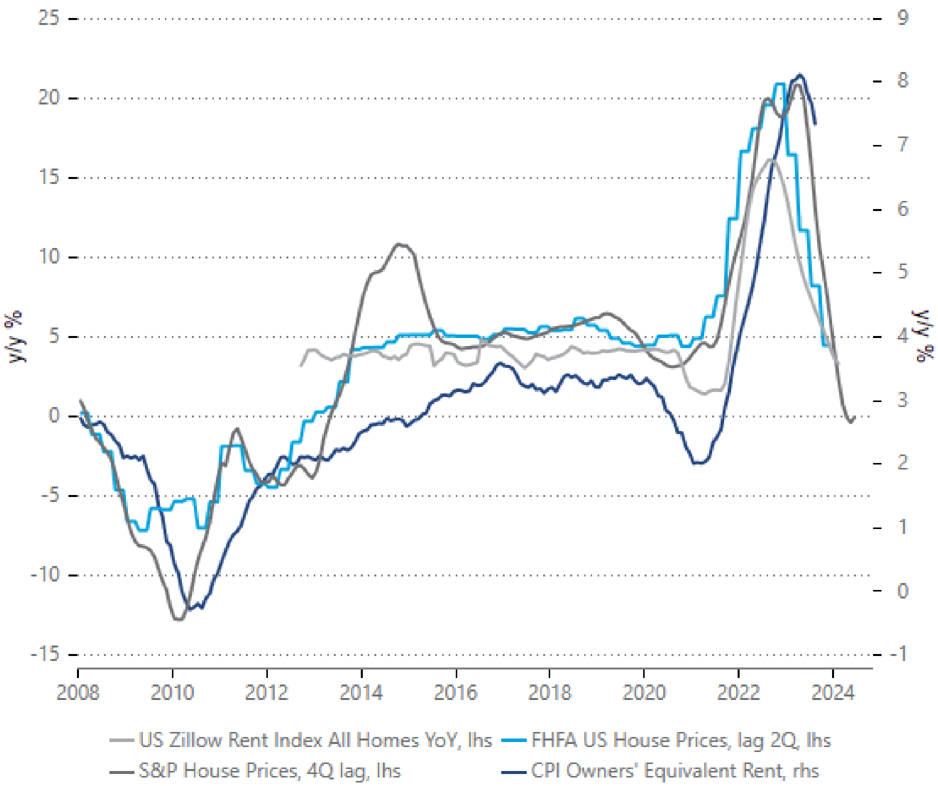
Unit labour costs have come down to 2.5%



Source: Macrobond, MGI Economics, 3 October 2023

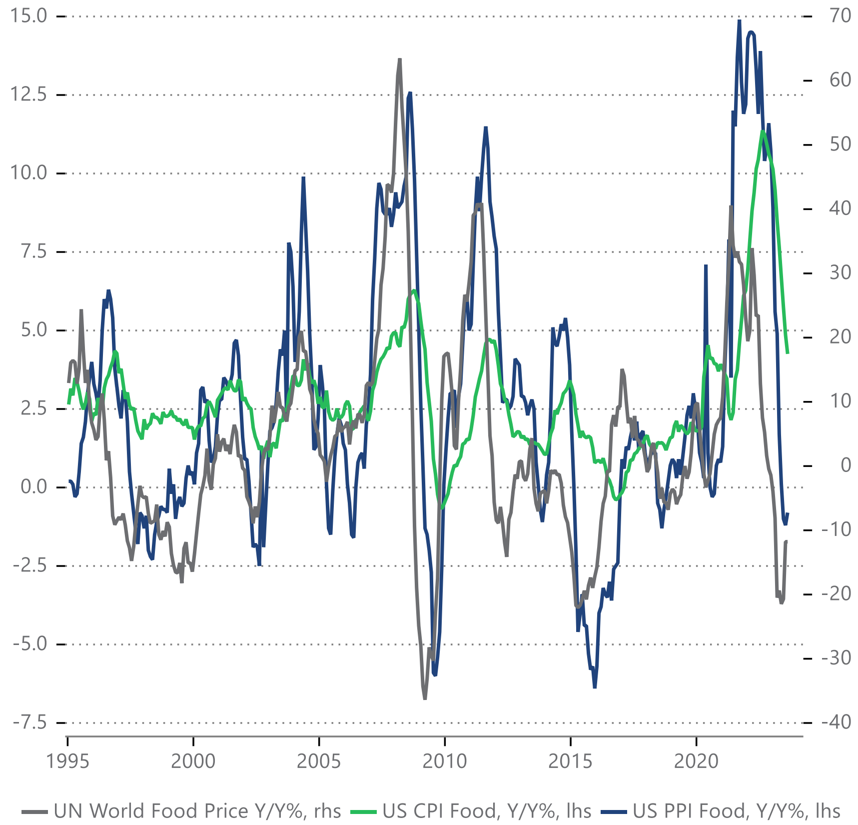
Headline disinflation should continue

Shelter



Source: Macrobond, MGI Economics, 3 October 2023

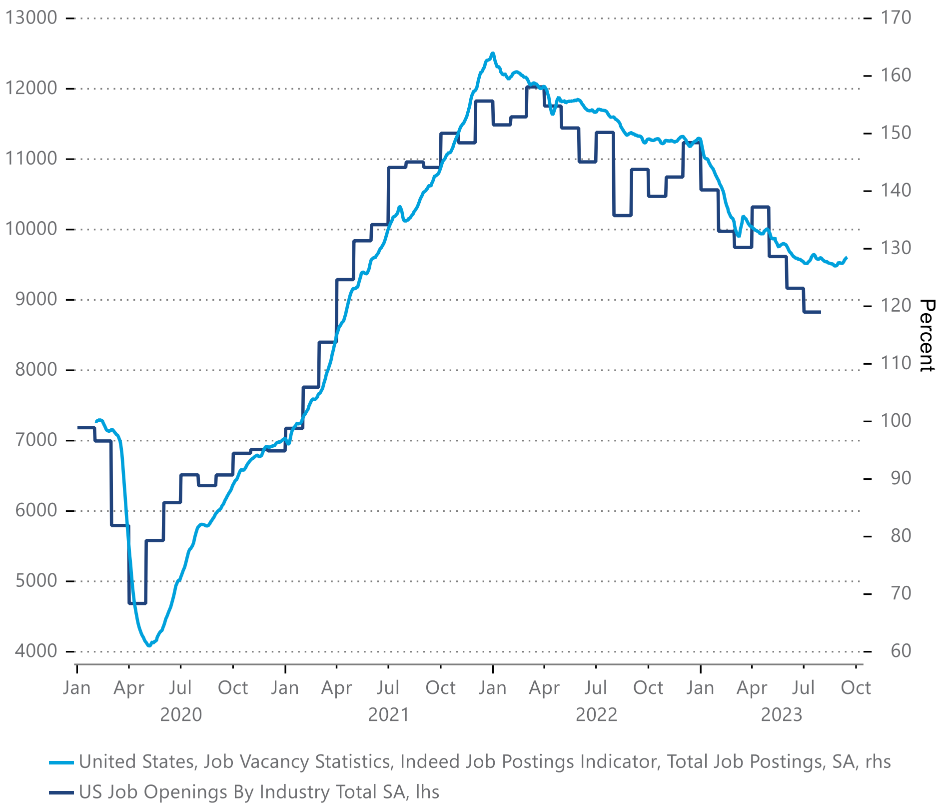
Food



Source: Macrobond, MGI Economics, 3 October 2023

Though slow at the underlying level

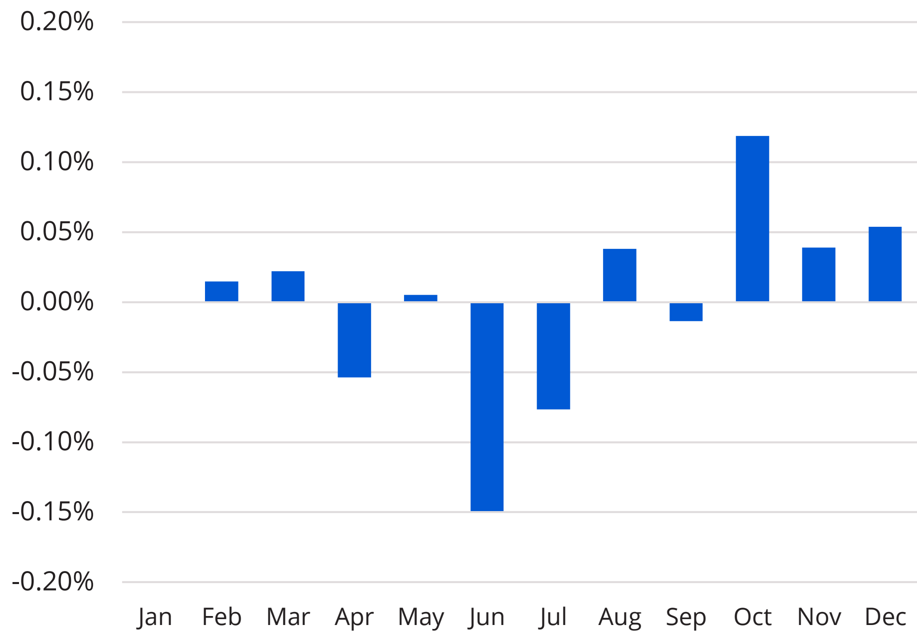
Labour demand slowing



Source: Macrobond, MGI Economics, 3 October 2023

Technical factors likely to play a part

Estimated effect on monthly core CPI increases from revisions to seasonal factors since pre-pandemic



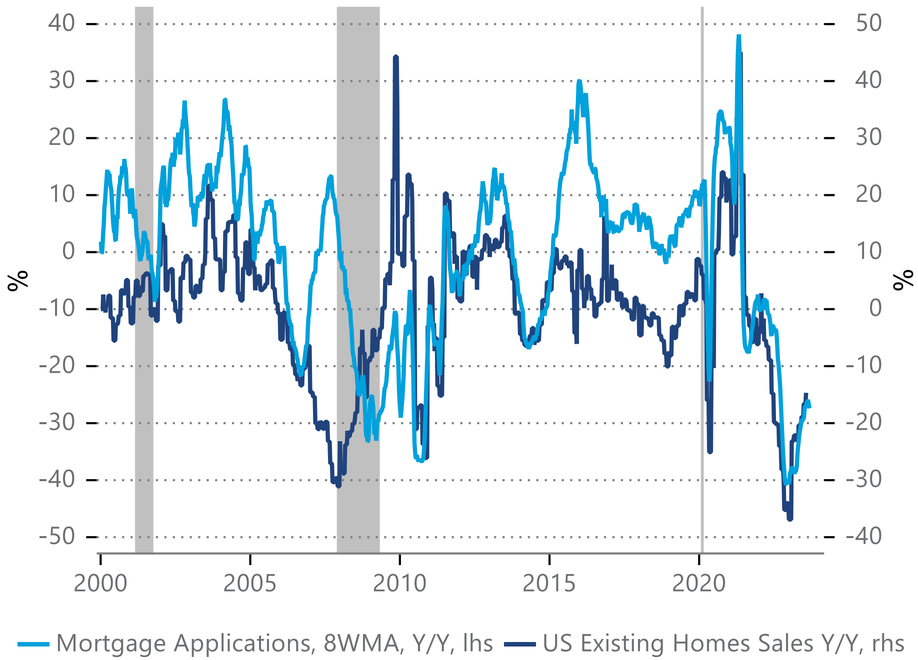
Source: Macrobond, MGI Economics, 3 October 2023

Growth verging on "no landing" zone

Capex

Source: Macrobond, MGI Economics, 3 October 2023

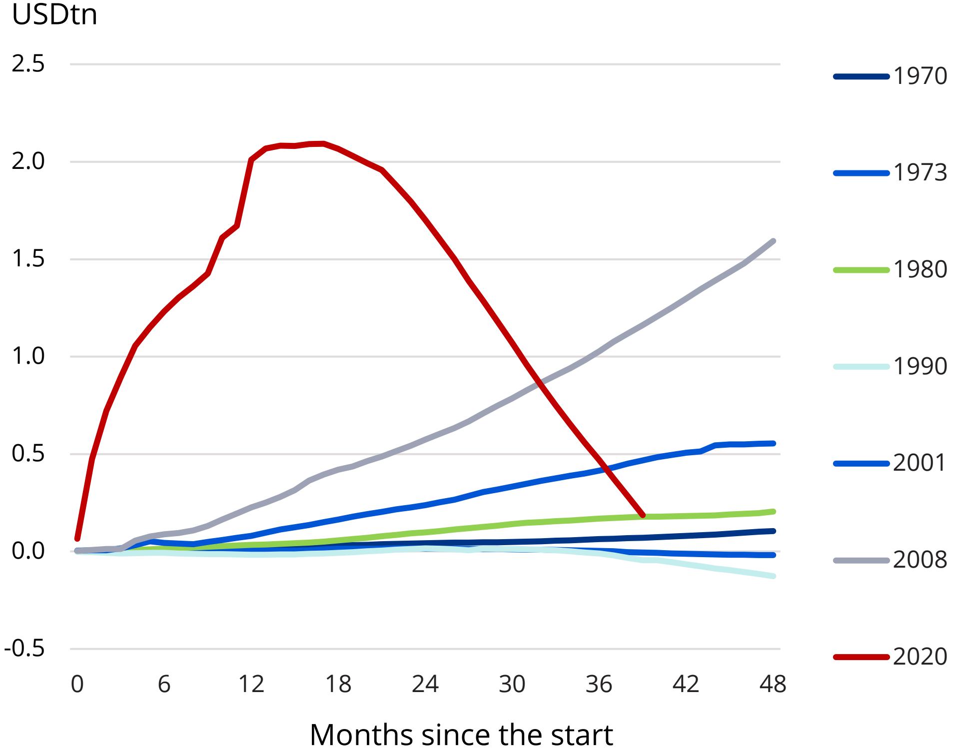
Housing



Source: Macrobond, MGI Economics, 3 October 2023

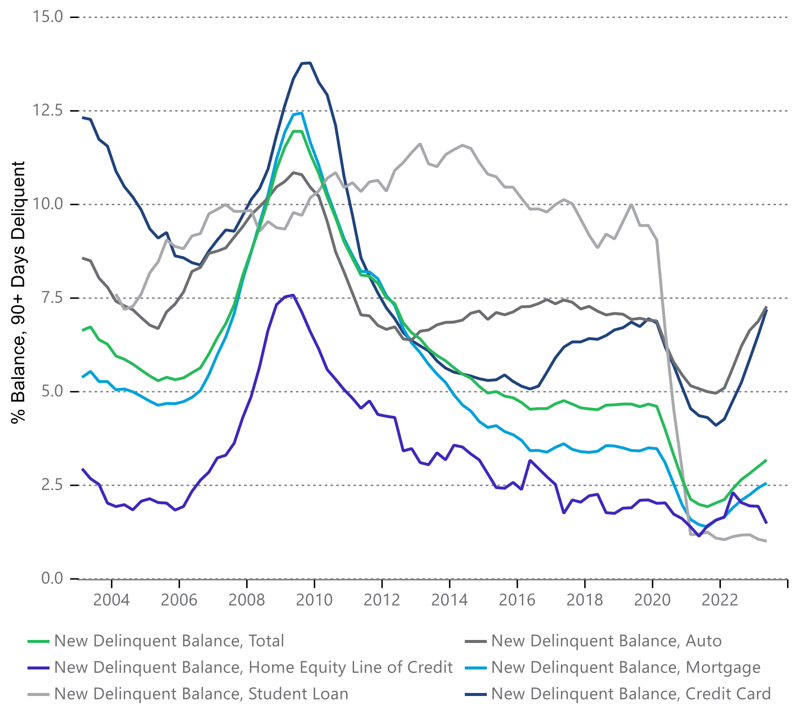
But fading impulse from fiscal support should weigh on growth

Stock of excess savings should run out this year



Source: San Fran Fed, MGI Economics, 3 October 2023

Repayment of student loans begin



Source: Macrobond, MGI Economics, 3 October 2023

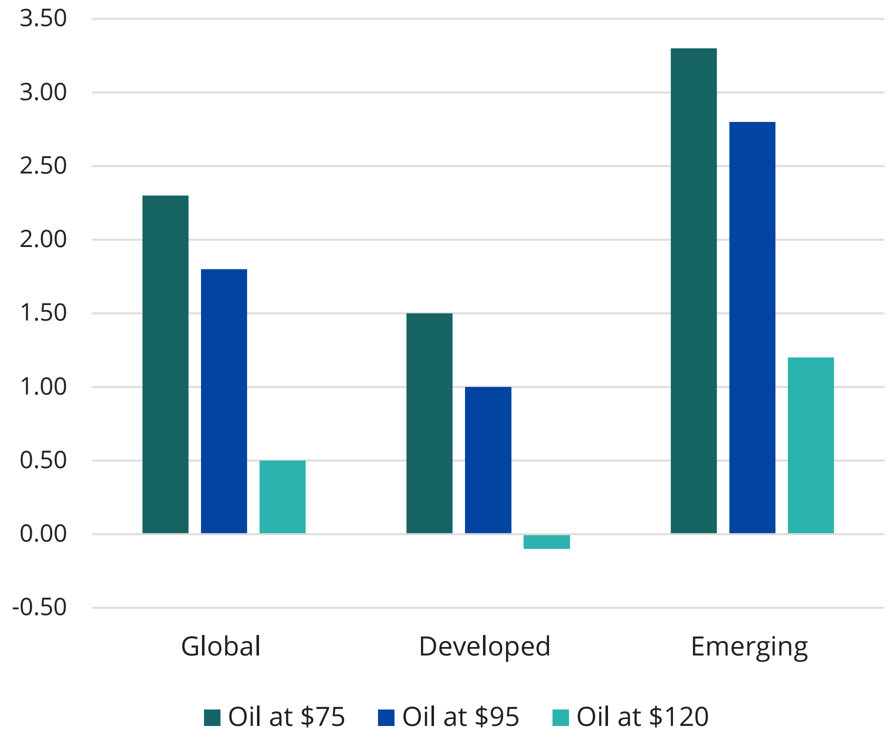
Supply driven rise in oil prices also negative growth shock

Rise in oil prices mostly supply driven

Source: Macrobond, Bloomberg, MGI Economics, 3 October 2023

Shock wipes off 0.5pp to growth

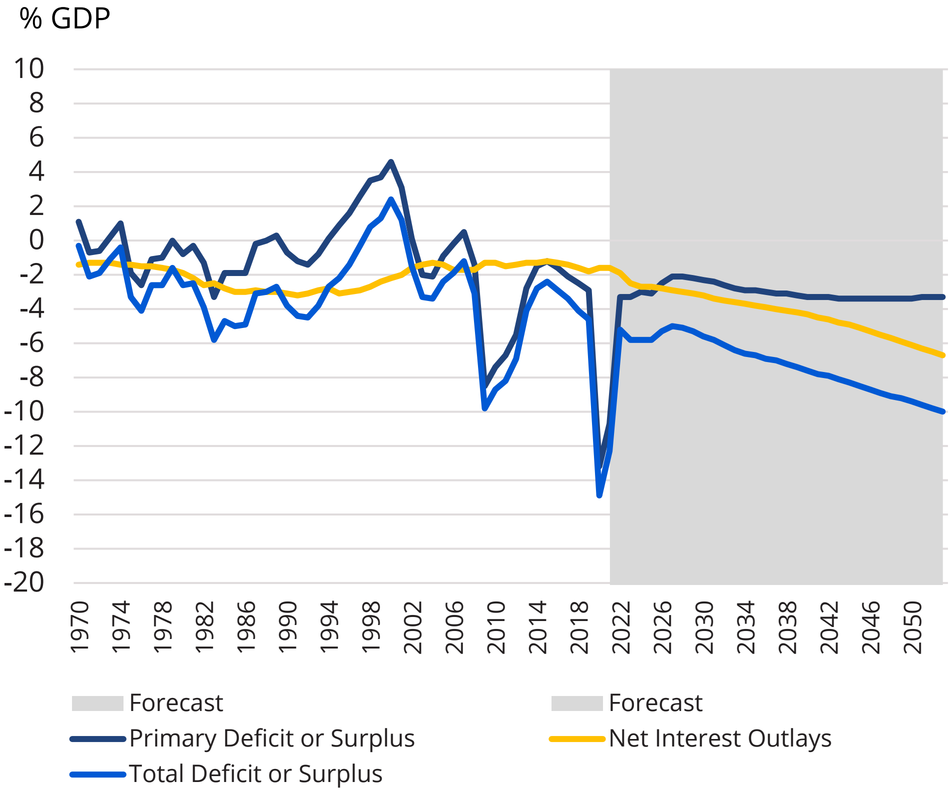
JPM GDP growth forecasts



Source: JPMorgan, MGI Economics, 3 October 2023

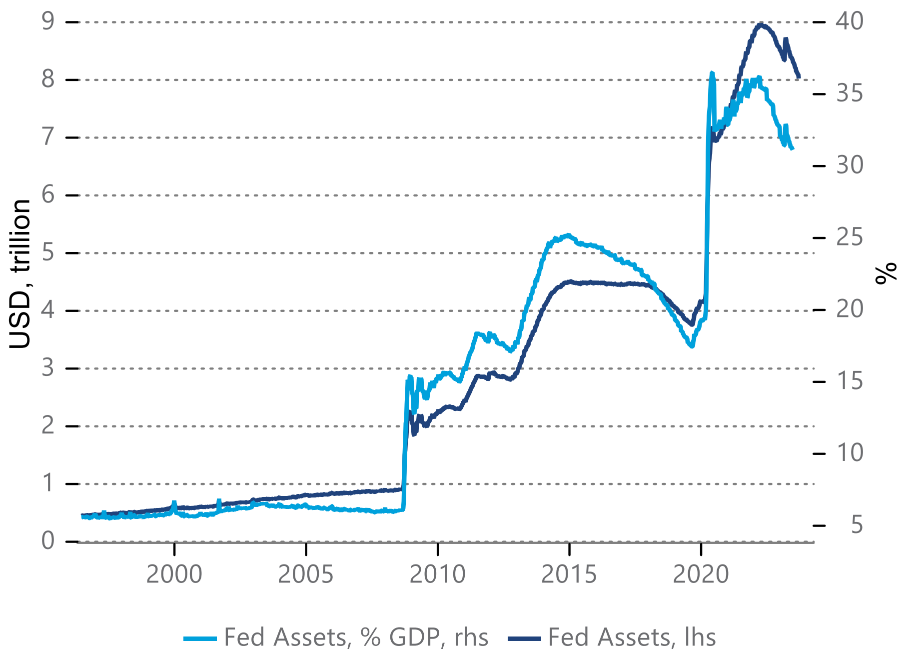
Shutdown underscores deterioration of US fiscal health

Persistent deficits point to supply



Source: CBO, MGI Economics, 3 October 2023

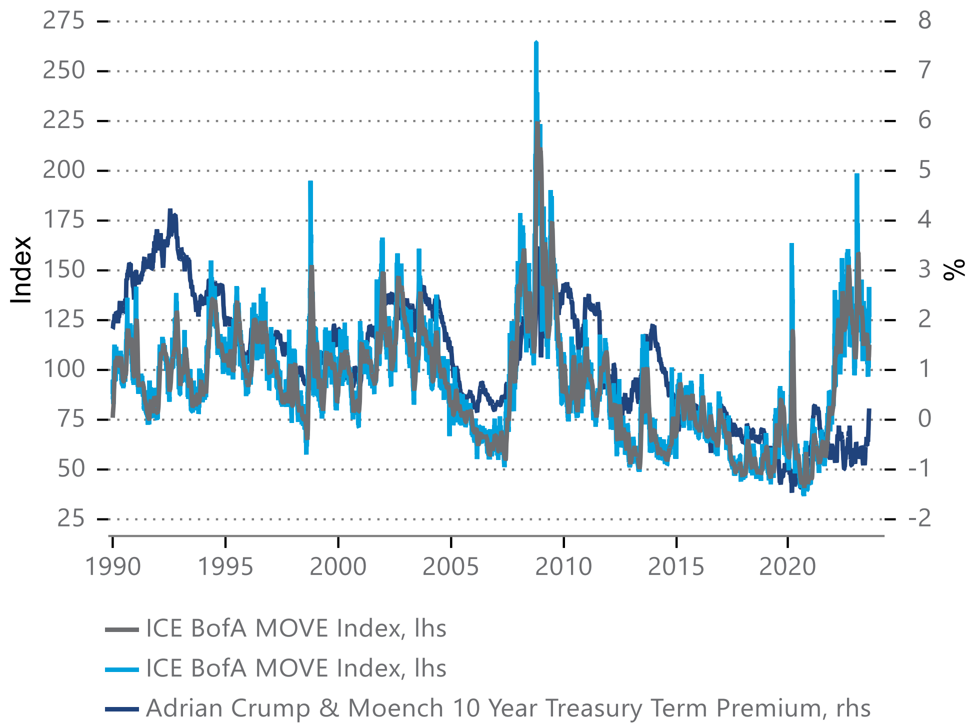
While Fed steps back from buying



Source: Macrobond, MGI Economics, 3 October 2023

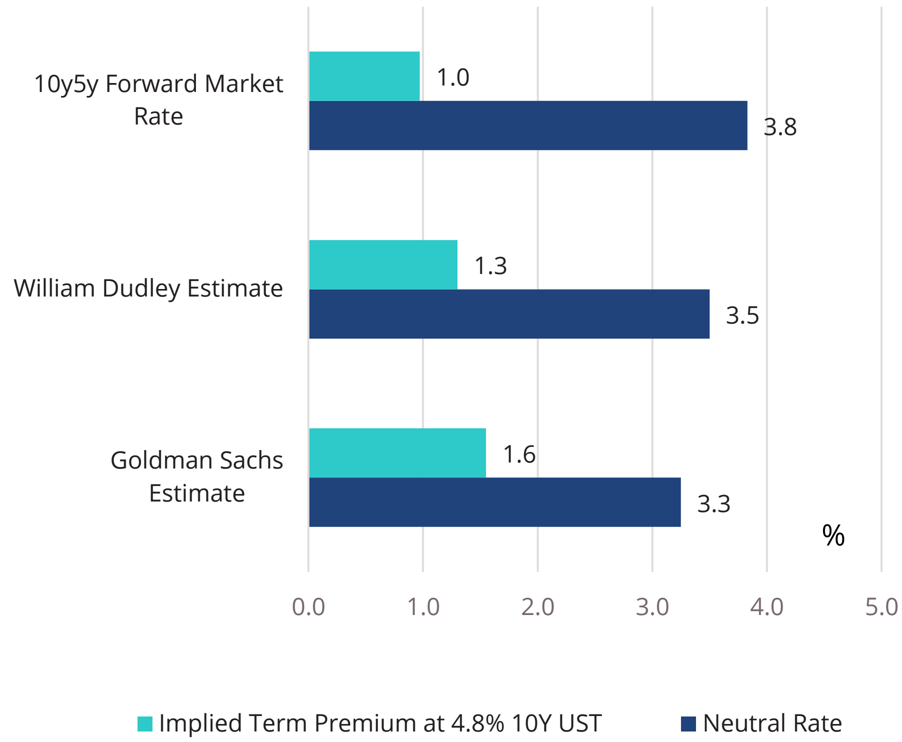
Higher for longer and higher term premium priced in

Bond volatility points to term premium c.1%



Source: CBO, Macrobond, MGI Economics, 3 October 2023

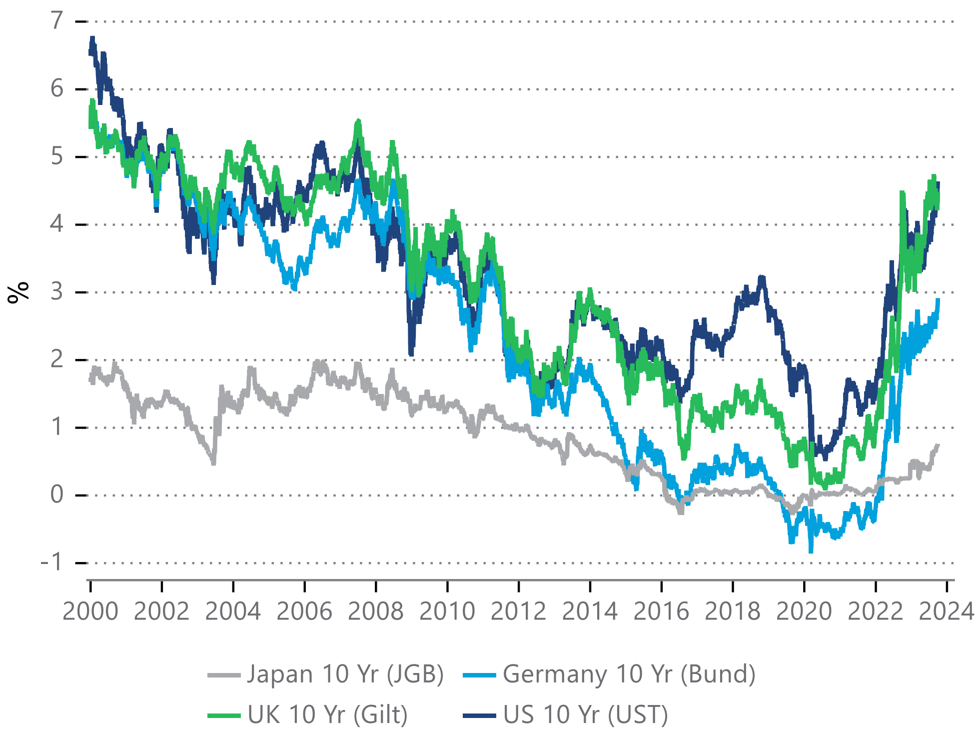
Neutral estimates imply we are "about right"



Source: Macrobond, MGI Economics, 3 October 2023

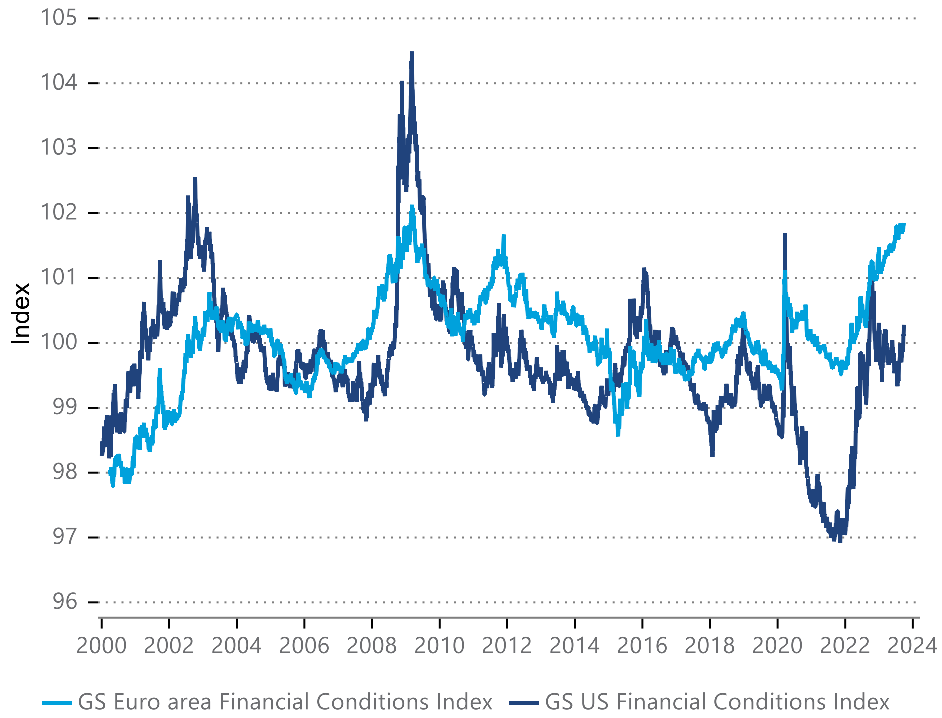
Higher back-end yields point to work being done for the Fed

Back-end yields



Source: Macrobond, MGI Economics, 3 October 2023

Tightening financial conditions

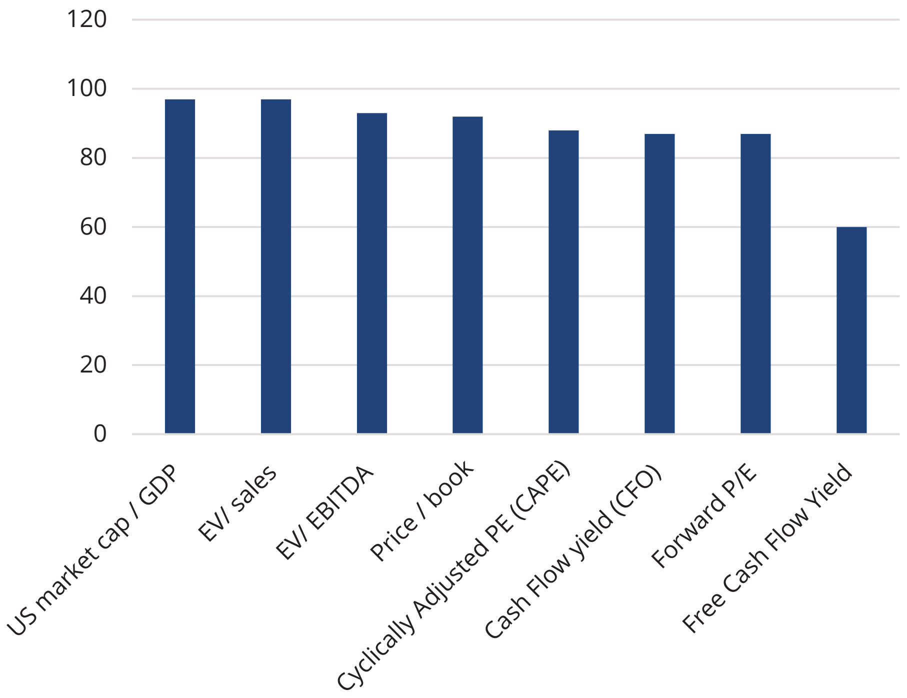


Source: San Francisco Fed. Macrobond, MGI Economics, 3 October 2023

Equity valuation still challenging

Absolute valuation

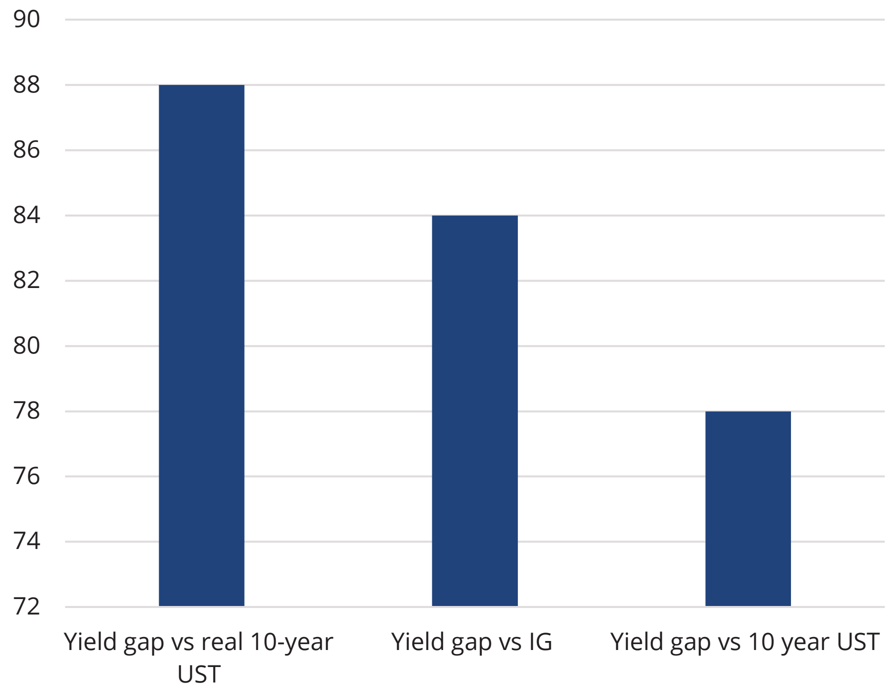
Aggregate Index, Historical Percentile



Source: Goldman Sachs Research, 16 September 2023

Relative valuation

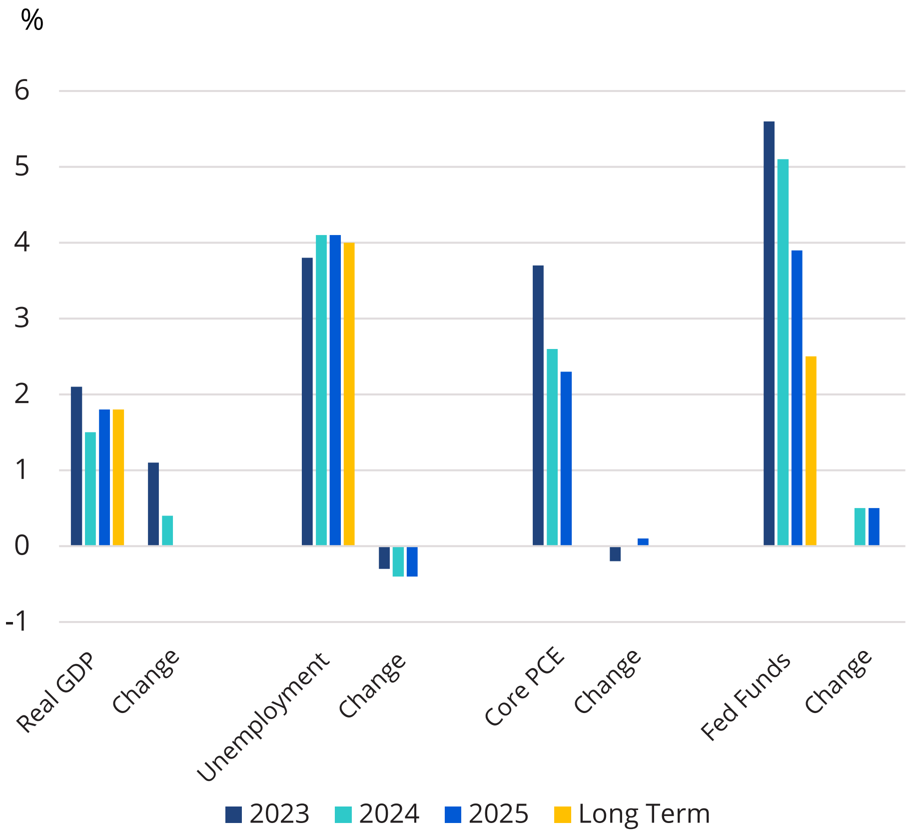
Aggregate Index, Historical Percentile



Source: Goldman Sachs Research, 16 September 2023

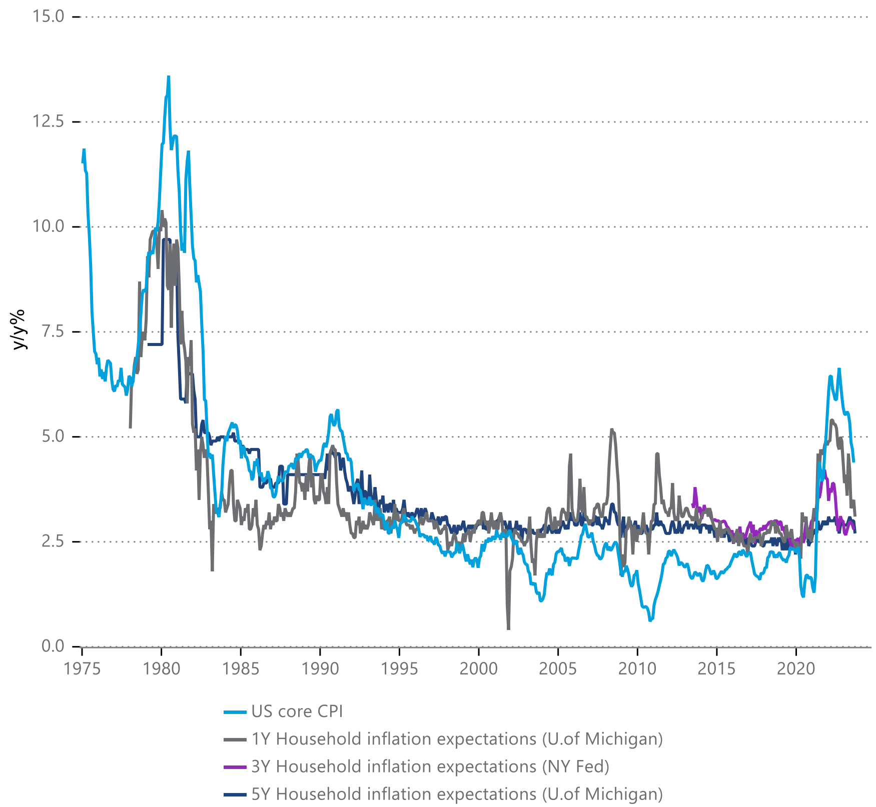
Fed now embracing little need for mandate trade off

Latest Summary of Economic Projections



Source: Fed SEP, MGI Economics, 20 September 2023

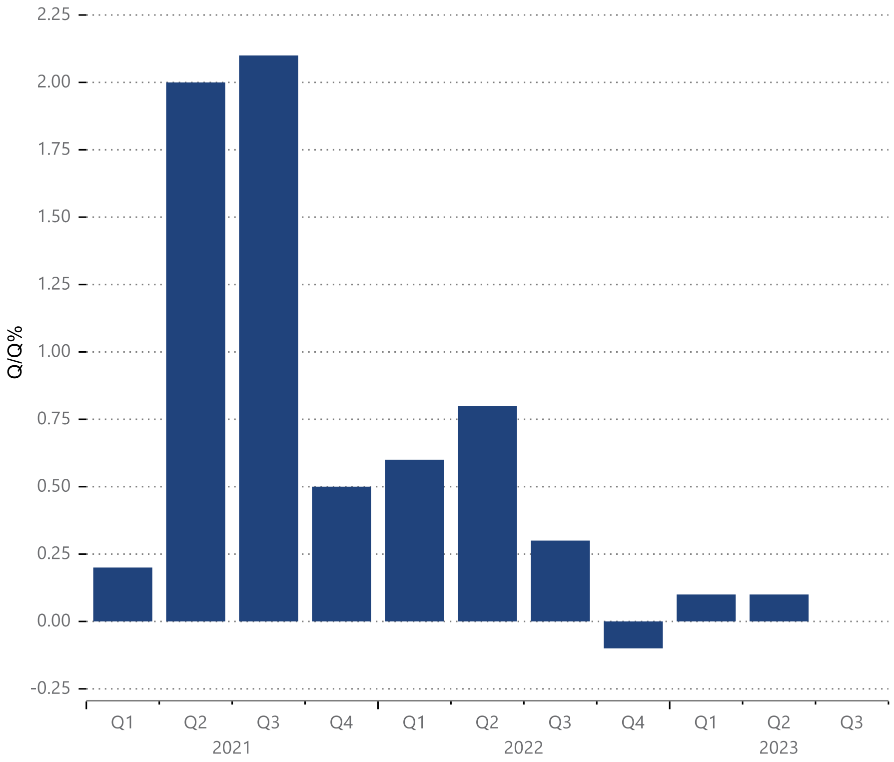
Inflation expectations allow them to do so



Source: Macrobond, MGI Economics, 3 October 2023

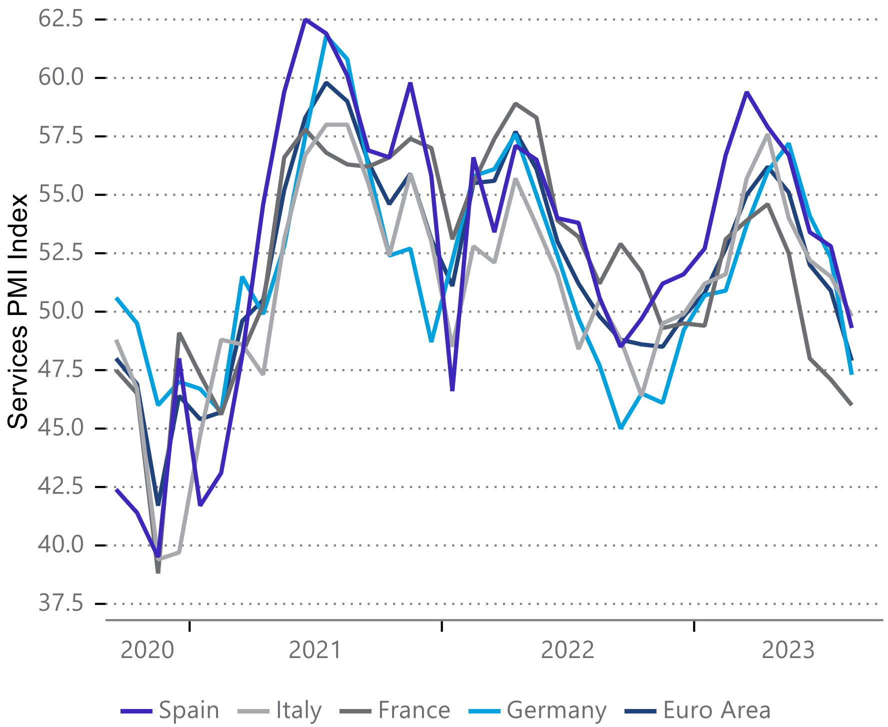
Euro area stagnant as service activity moderates

GDP growth has been extremely weak



Source: Macrobond, ECB, MGI Economics, 3 October 2023

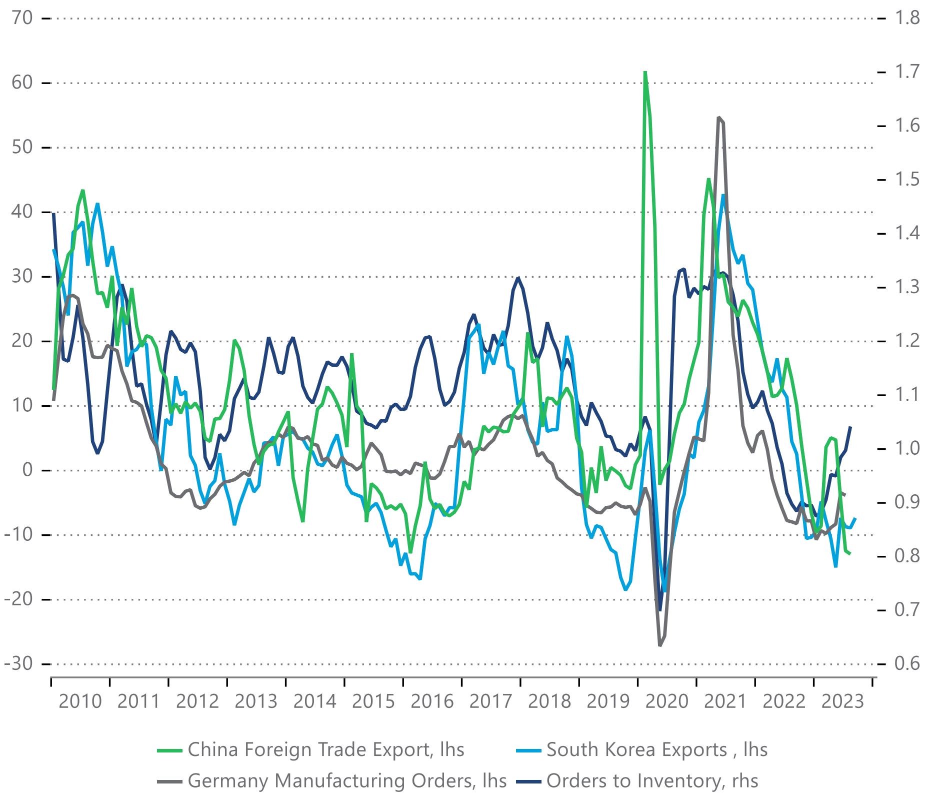
Surveys signal moderation in activity



Source: Macrobond, ECB, MGI Economics, 3 October 2023

Manufacturing remains weak despite goods cycle turn

Global good cycle turning



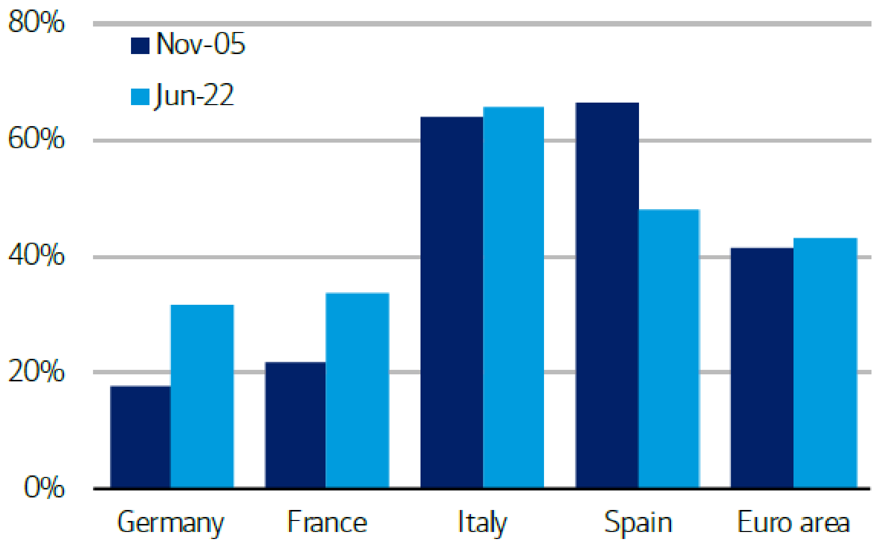
Source: Macrobond, ECB, MGI Economics, 3 October 2023

But manufacturing indicators remain weak

Source: Macrobond, ECB, MGI Economics, 3 October 2023

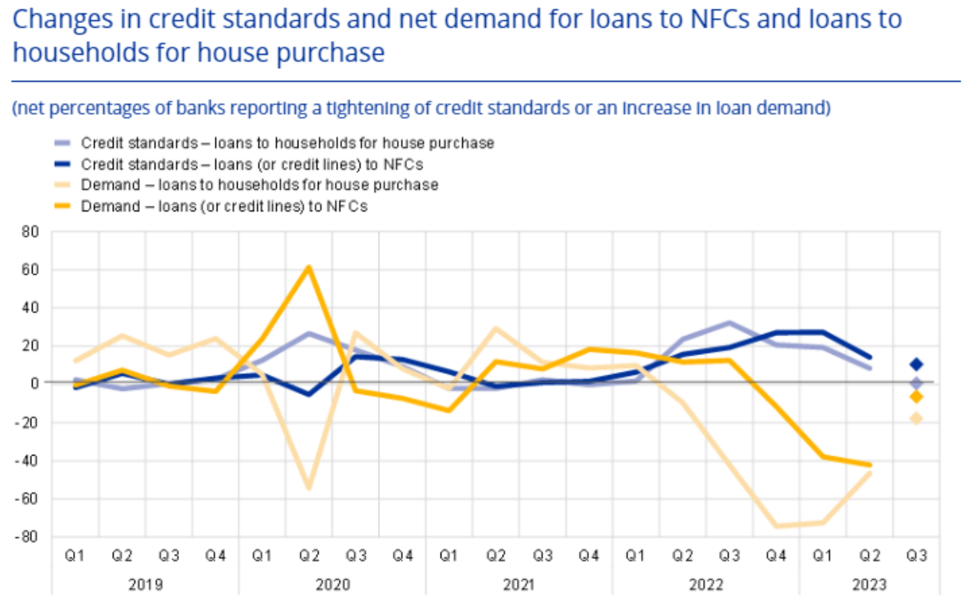
ECB monetary policy transmission is working

Pass through to Non-Financial Corporates in Euro area vs 05 hiking cycle



Source: BAML Economic Research, 3 October 2023

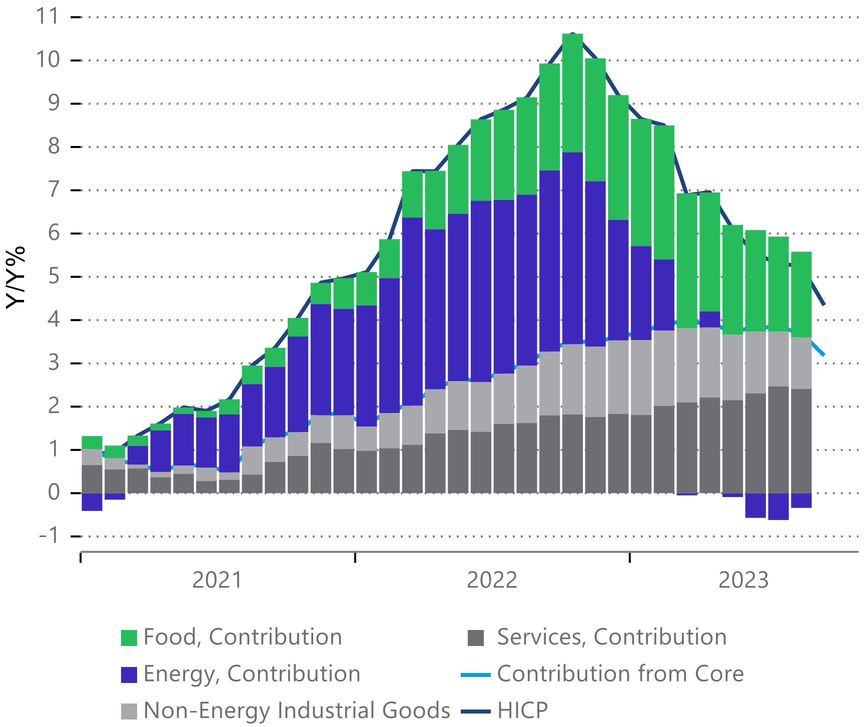
ECB Bank Lending Survey shows loan demand contracting as policy works



Source: Euro area Bank Lending Survey, MGI Economics, 3 October

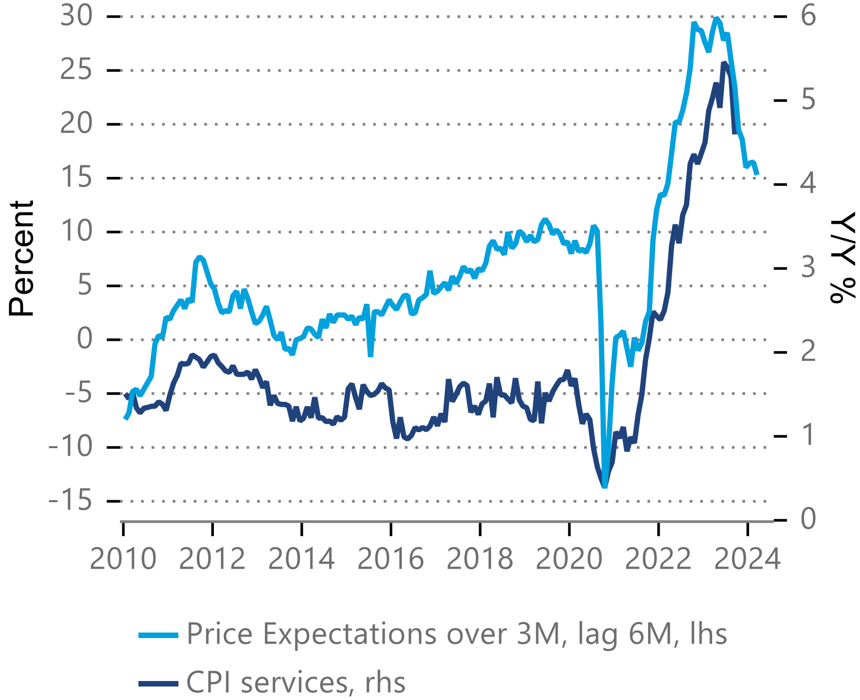
Disinflation progressing slowly but surely in Euro area

Service and food inflation key going forward



Source: Macrobond, MGI Economics, 3 October 2023

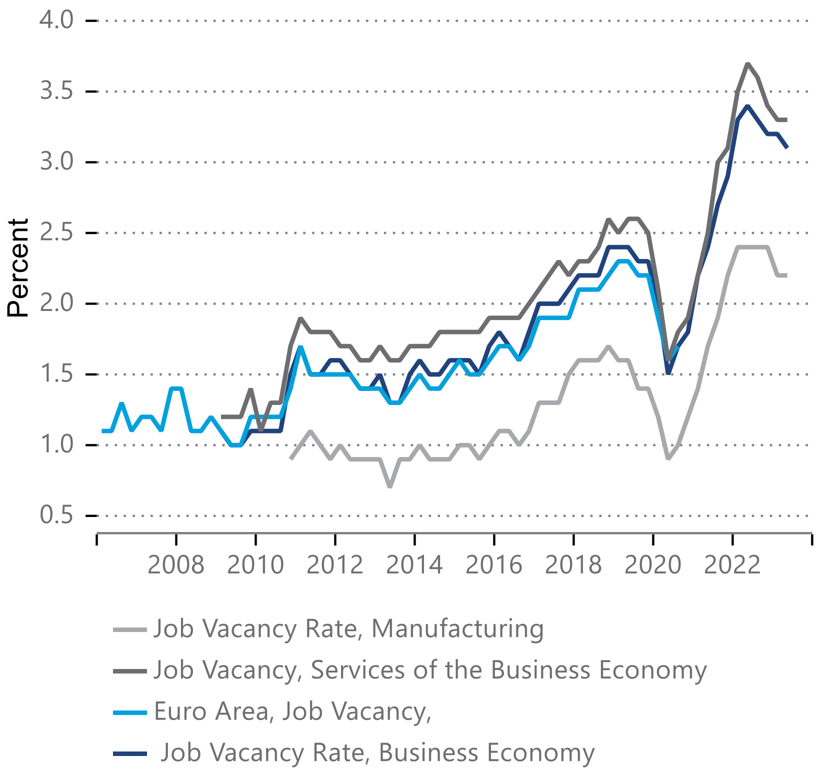
Surveys point to lower service inflation



Source: Macrobond, ECB, MGI Economics, 3 October 2023

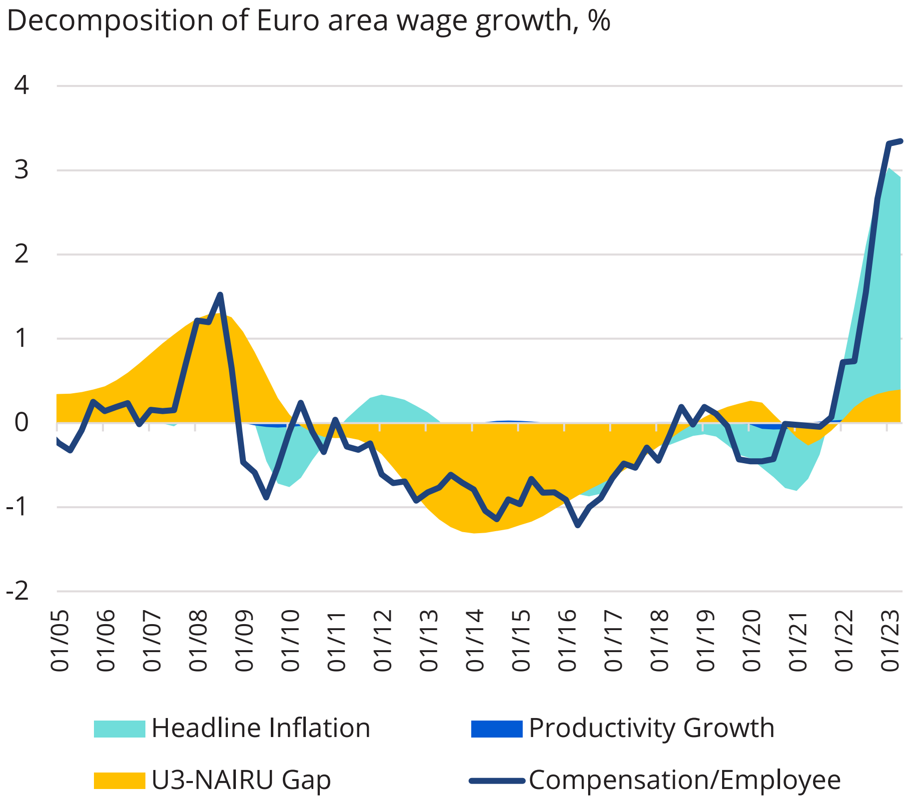
Meanwhile labour market shows more signs of cooling

Labour demand softens



Source: Macrobond, ECB, MGI Economics, 3 October 2023

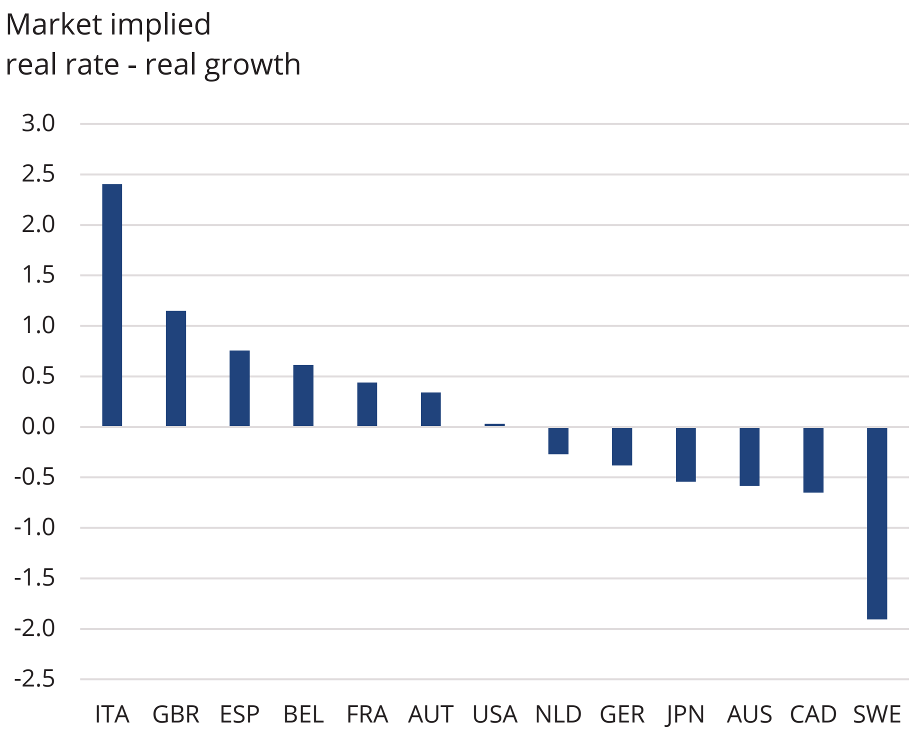
Wage rise more "catch-up" than slack driven



Source: Macrobond, ECB, MGI Economics, 3 October 2023

Higher real rates and lower growth put pressure on Italy

R-G point to surpluses needed in Italy



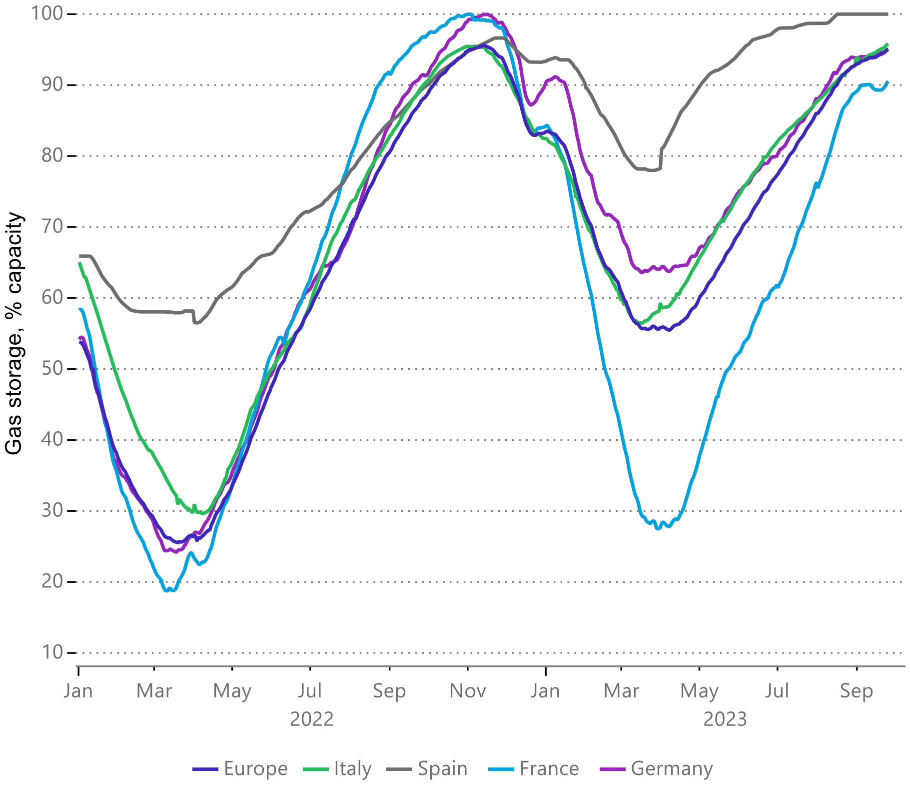
Source: GS Estimates, MGI Economics, 3 October 2023

Or wider BTP-Bund spreads

Source: Bloomberg, Macrobond, MGI Economics, 3 October 2023

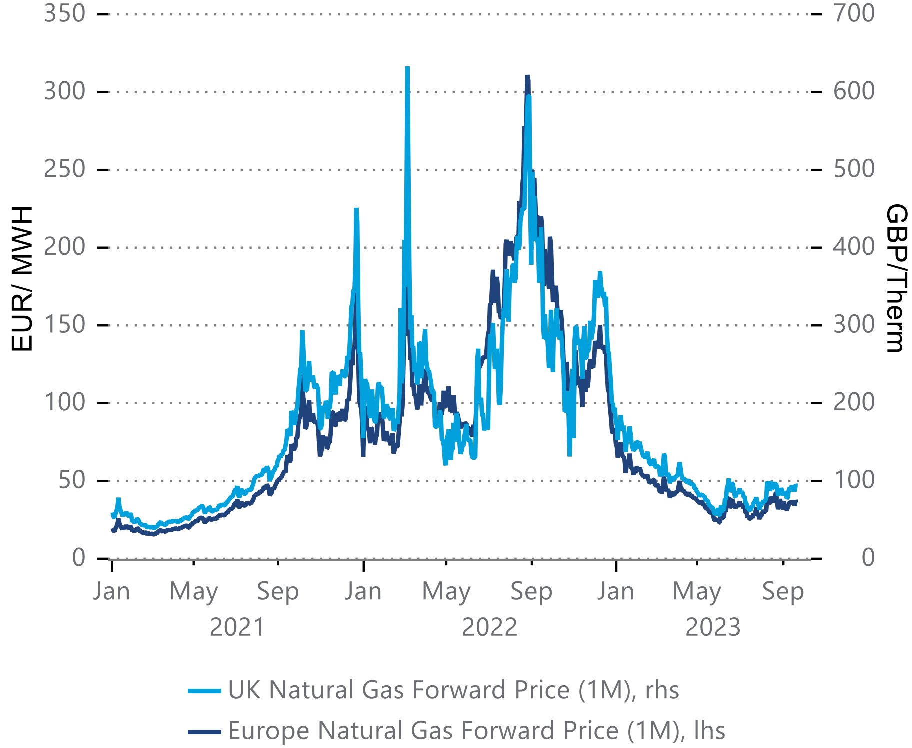
High storage levels limit concern around gas spikes

Storage levels now at capacity



Source: Macrobond, MGI Economics, 3 October 2023

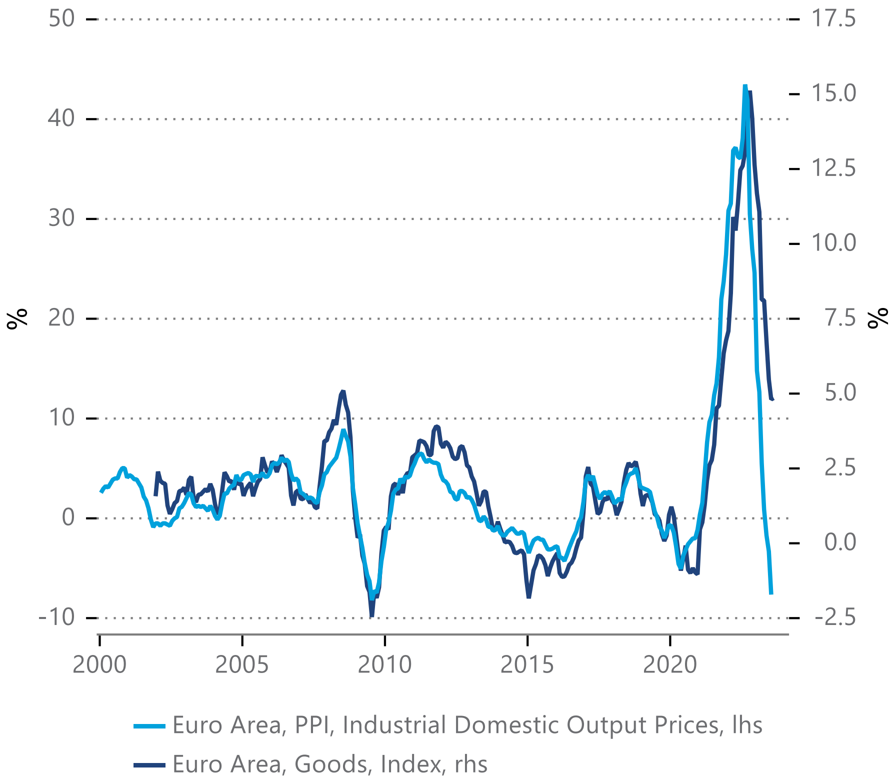
European Gas prices reasonably low



Source: Macrobond, Bloomberg, MGI Economics, 3 October 2023

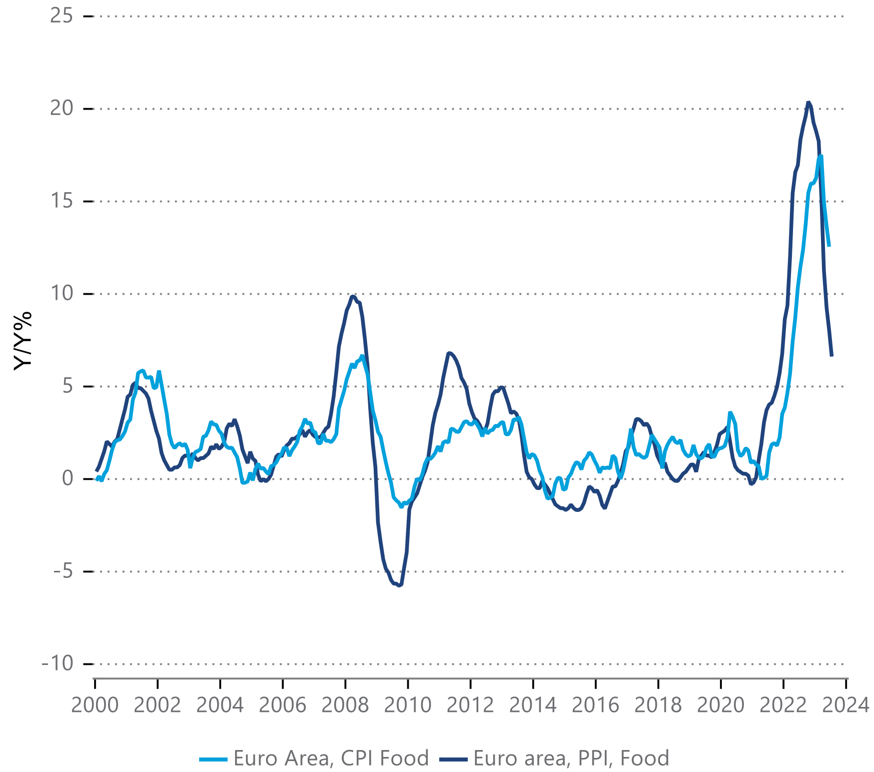
Further broader disinflation in the pipeline

Goods disinflation in pipeline



Source: Macrobond, MGI Economics, 3 October 2023

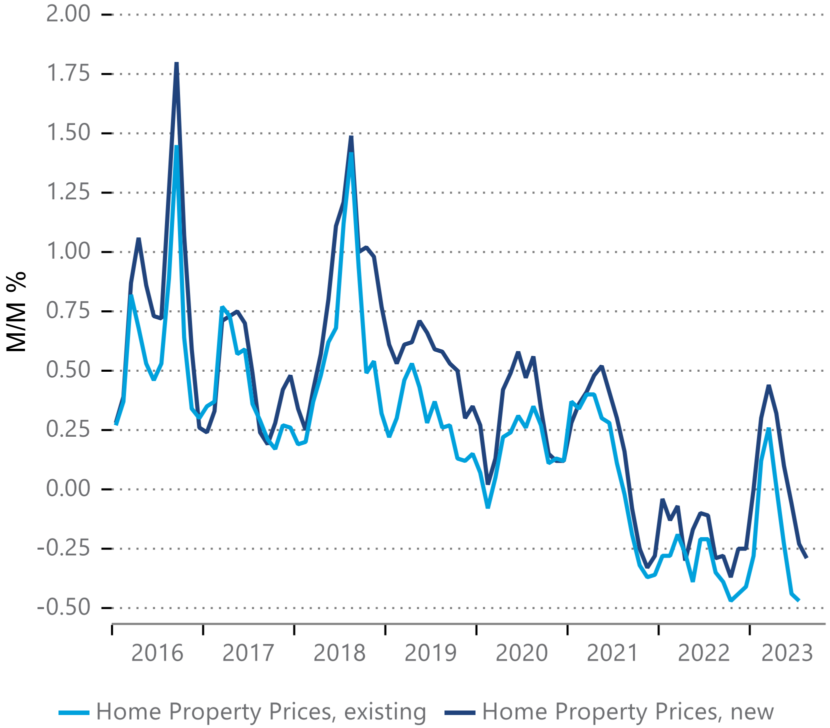
Food disinflation



Source: Macrobond, MGI Economics, 3 October 2023

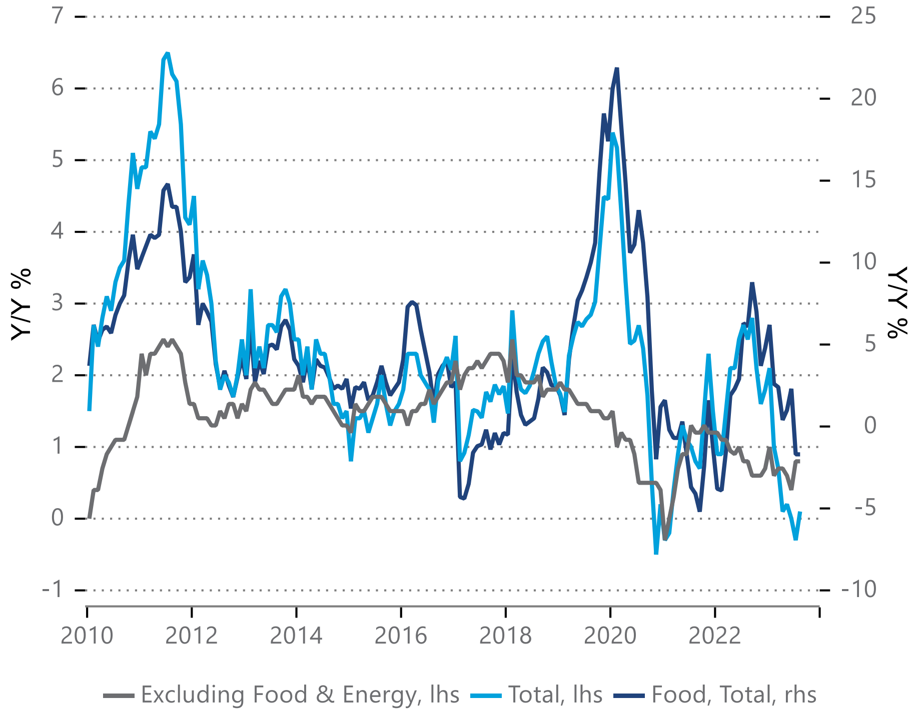
Structural headwinds remain for China

Property sector still weak



Source: Macrobond, MGI Economics, 3 October 2023

Low inflation indicative of excess supply

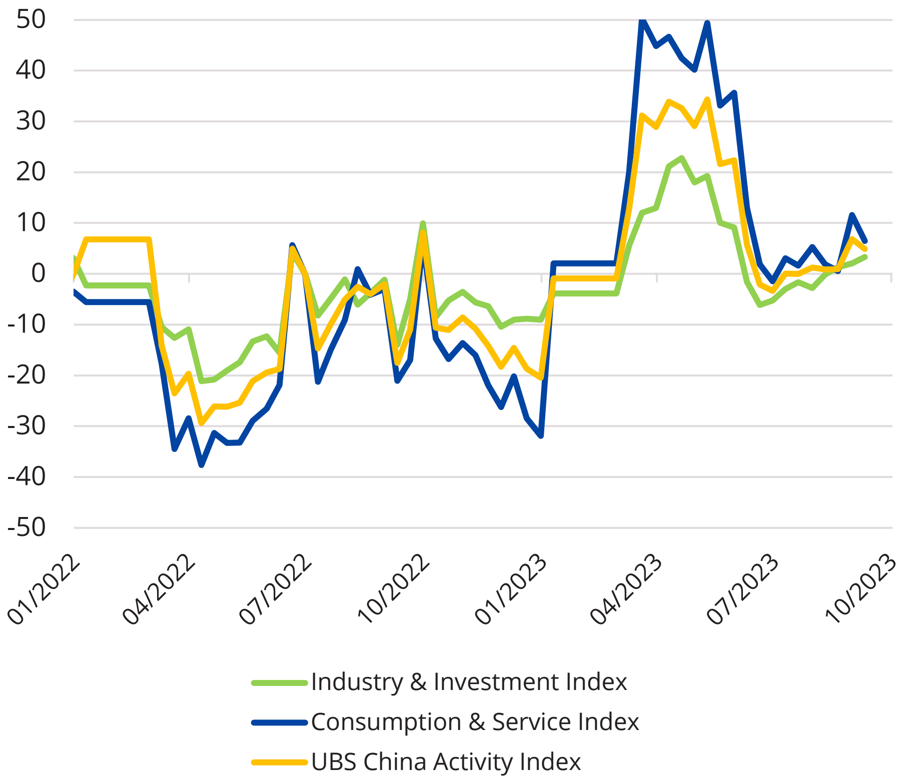


Source: Macrobond, MGI Economics, 3 October 2023

But cyclical outlook improving, helped by policy support

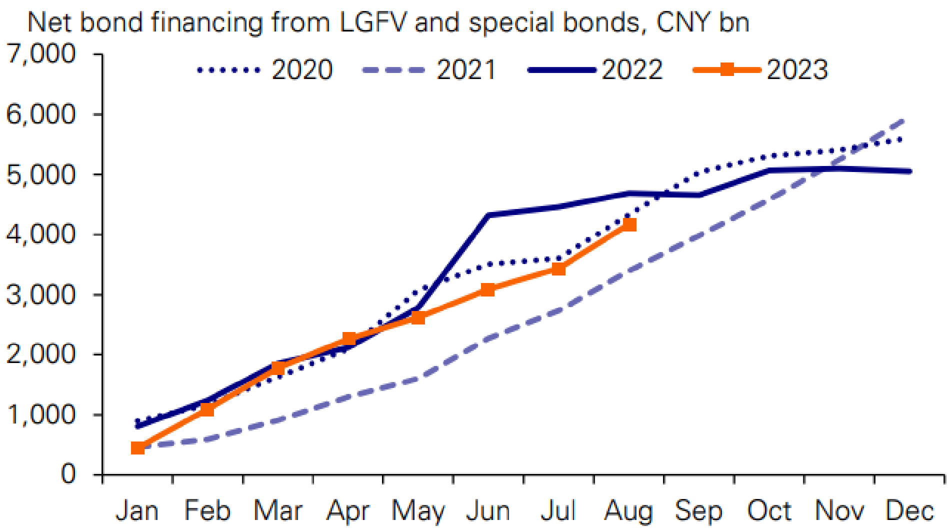
Chinese growth bottoming

Growth y/y % (10 day)



Source: Federal Reserve, Macrobond, MGI Economics, 3 October 2023

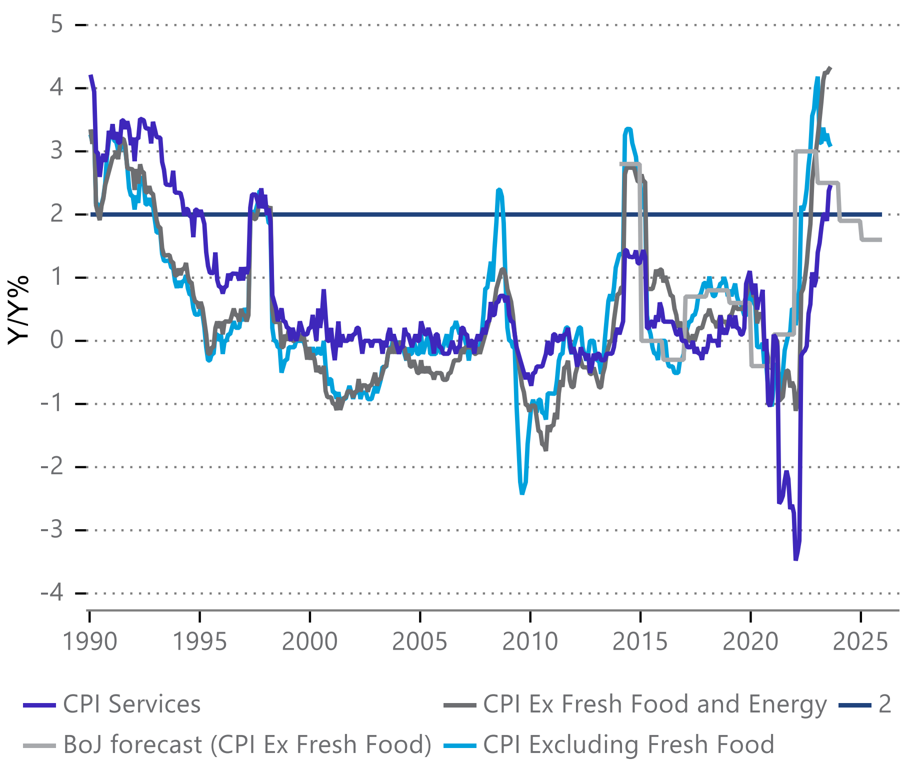
Acceleration in local government special bond issuance in August



Source: Deutsche Bank Research, September 2023

Japan continues to make progress on "virtuous cycle" of inflation

Inflation vs BoJ forecasts



Source: Macrobond, Bank of Japan, MGI Economics, 3 October 2023

Wages versus exports

Source: Macrobond, MGI Economics, 3 October 2023

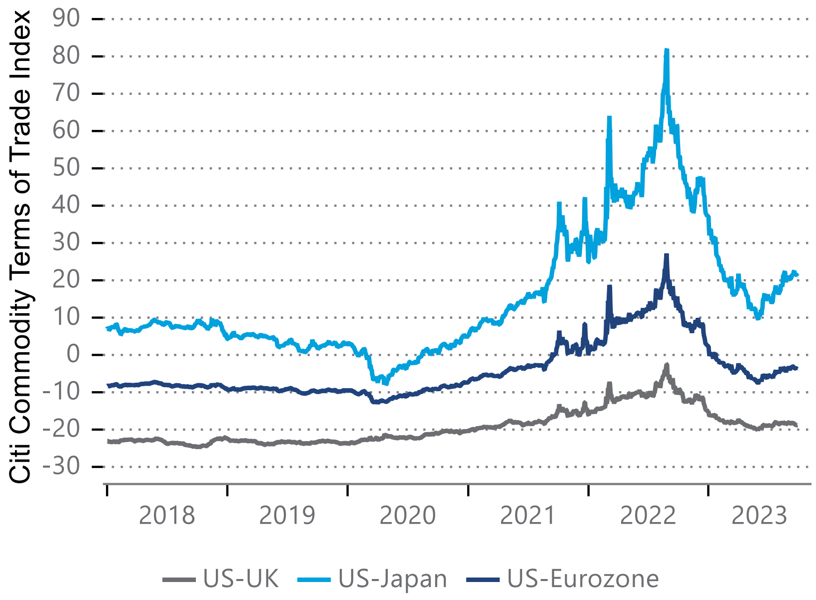
CURRENCY VIEWS

MILLENNIUM GLOBAL INVESTMENTS

MILLENNIUM GLOBAL

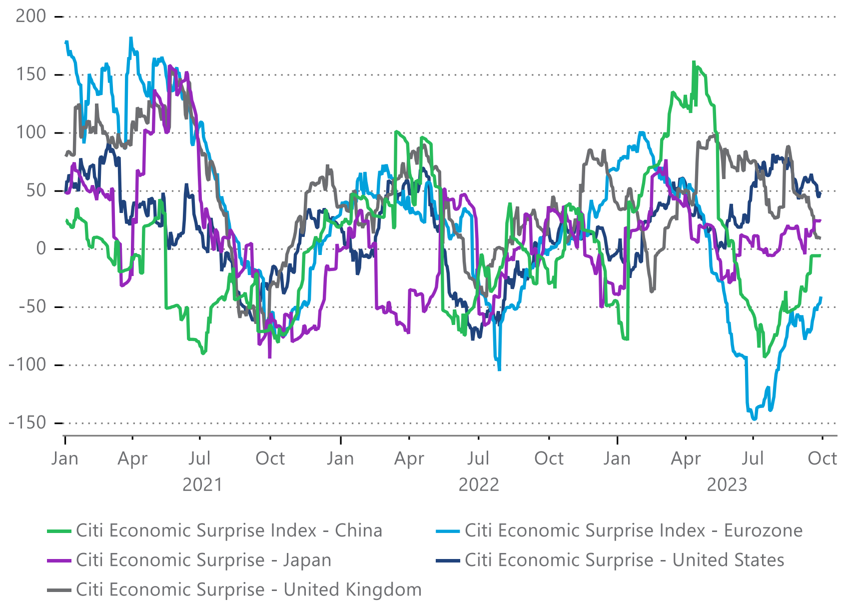
USD (0) Rates and commodity support fading

Higher oil prices have helped the dollar



Source: MGI Economics, Macrobond, 3 October 2023

"Surprises" trough in Europe and China

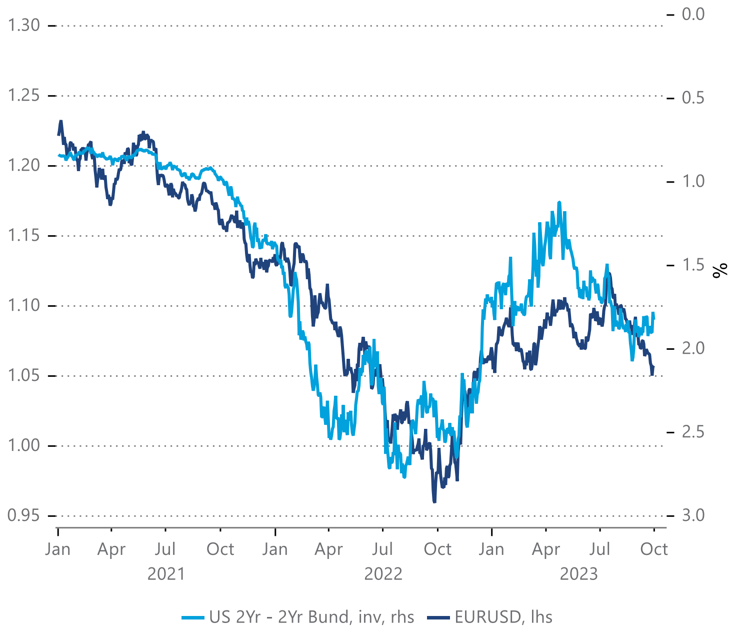


Source: MGI Economics, Macrobond, 3 October 2023

The recent dollar support has been via the move higher in back-end yields, helped also by higher oil prices and US growth "exceptionalism". Going forward, we see little scope for US yields to move higher. This stems from our view that the Fed are done raising interest rates and the 10-year has moved to price "higher-for-longer". As growth slows, this should also provide some stability to US yields, which should allow risk assets to grind higher. Combined with an improvement in Chinese activity and the global manufacturing cycle, this should erode the relative growth differential and help weigh on the dollar. However, our view that there are downside risks to European growth and inflation point to continued relative rate support for the dollar vs Europe. While this keeps us neutral the dollar overall, we think that higher yielding risk proxies with commodity and Asia exposure could still benefit from this pro-risk dynamic, with European FX lagging behind.

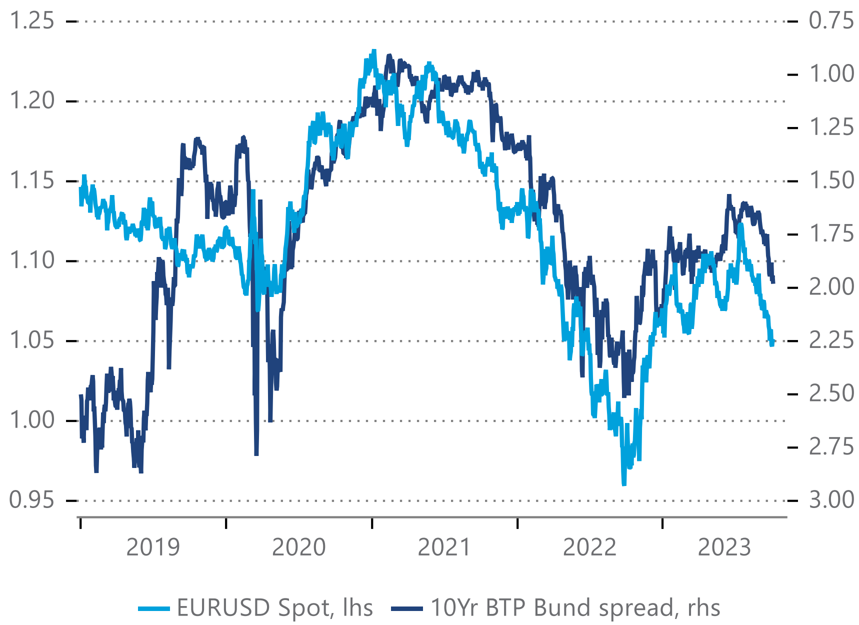
EUR (-) Fade the "higher for longer" ECB message

US-Europe yield differential



Source: MGI Economics, Macrobond, 3 October 2023

BTP-Bund spreads

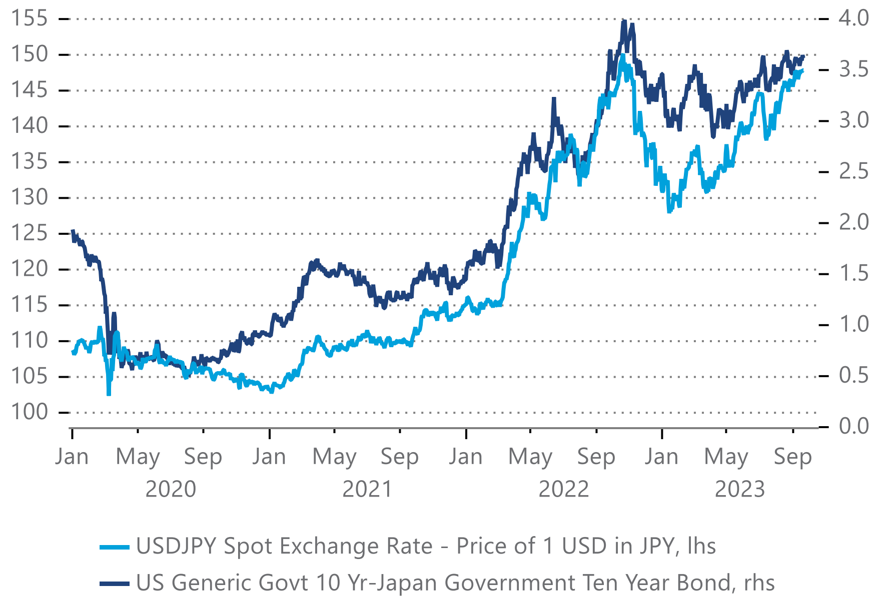


Source: MGI Economics, Macrobond, 3 October 2023

Our view on the euro is quite simple here - we see cyclical downside risks to both the growth and inflation trajectory. This argues to fade the "higher-for-longer" message of central banks including the European Central Bank (ECB), where European rates price the trajectory to be in restrictive territory for the next two-to-three years time. Moreover, low growth points to less convincing evidence that the neutral rate has moved up in same way as the US. The debt dynamics of Italy also worry us, given the unfavourable (r-g) arithmetic. While this is unlikely to weigh on euro via front end rates (which would happen in the scenario that Italy imposes fiscal consolidation), higher BTP-Bunds spreads are likely to weigh on the euro. We are therefore negative euro vs dollar, but also think the euro can underperform the yen and other risk currencies in FX.

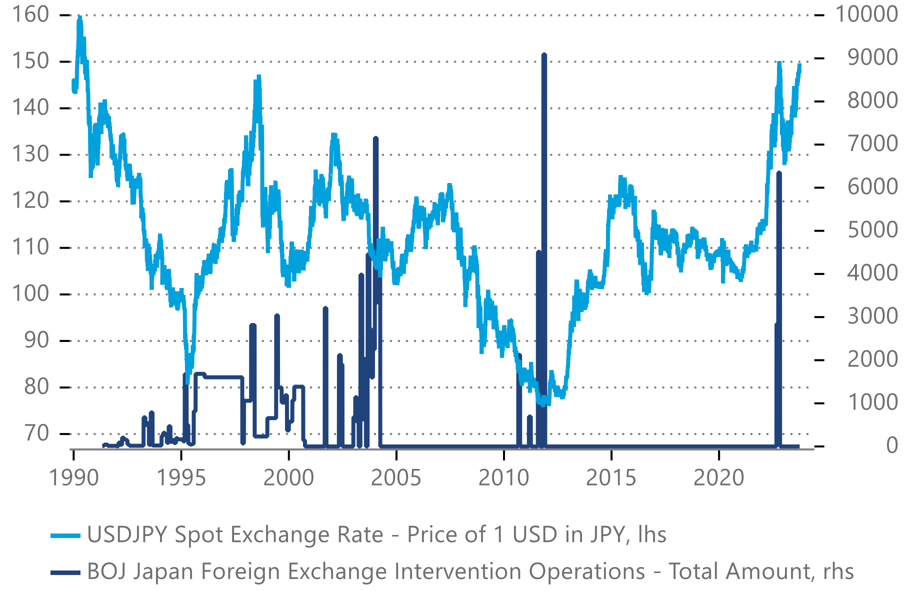
JPY (0) Risk-reward for short yen now poor

USDJPY vs 10Y yield differentials



Source: MGI Economics, Macrobond, 3 October 2023

JPY Intervention

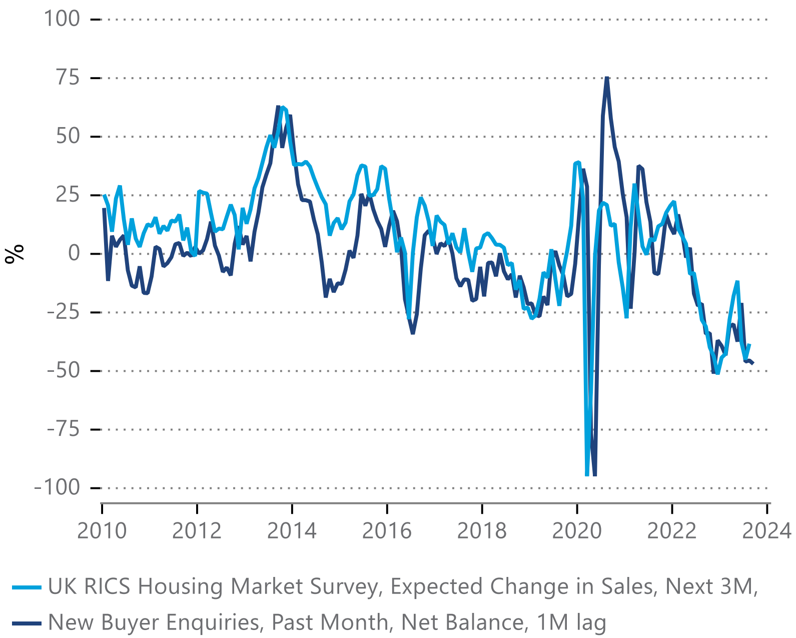


Source: MGI Economics, Macrobond, 2 July 2023

We admit that the yen still has no yield (vs US at 5.5%, Euro at 4%) which should continue to weigh on the currency, however other macro factors point to little risk-reward left in the yen. Firstly, we think the move higher in 10-year Treasury yields now reflects economic fundamentals and that the tightening in financial conditions leaves the Fed done. Moreover, the rates (and equity) market is vulnerable to growth disappointment in the US. On the Japanese side, we see USDJPY at 150 as a line in the sand for the Ministry of Finance to intervene (thus capping cross-yen higher) and meanwhile, inflation pressures continue to rise in Japan. Finally, valuation, although ultra-stretched for some time, continues to flash as a warning signal being 50% cheap on a REER basis and even 15% undervalued if REER can revert to a linear trend. We generally like cross yen lower and on any growth disappointment in the US, would see this as a signal to upgrade the yen further versus the dollar.

GBP (-) Weakening activity data should weigh on rates

UK growth weakening



Source: MGI Economics, Macrobond, 5 October 2023

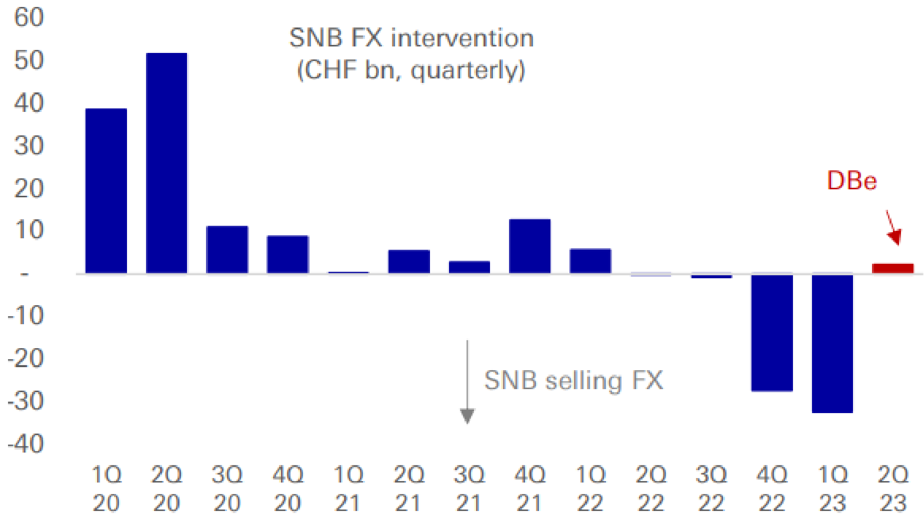
EURGBP falls as equities rise

Source: MGI Economics, Macrobond, 5 Octoober 2023

We think risks are skewed to sterling weakness. Firstly, activity is now clearly softening in the UK – we see this is in PMIs, housing data and importantly, the labour market. If inflation also disappoints, this will likely erode rate support for GBP, which is currently priced to be the most restrictive in G10 in two years' time. Meanwhile if inflation surprises on the upside, the Bank of England will be forced to hike the economy into a clear recession. While we do not see fiscal tightening ahead given the election, higher back end yields also put pressure on the budget, so the scope for fiscal support is limited to turn the growth trajectory around. Taking stock, we are negative sterling, though conscious that the currency may find a little support from the risk axis (or positive beta to equities) if US rates were to stabilise.

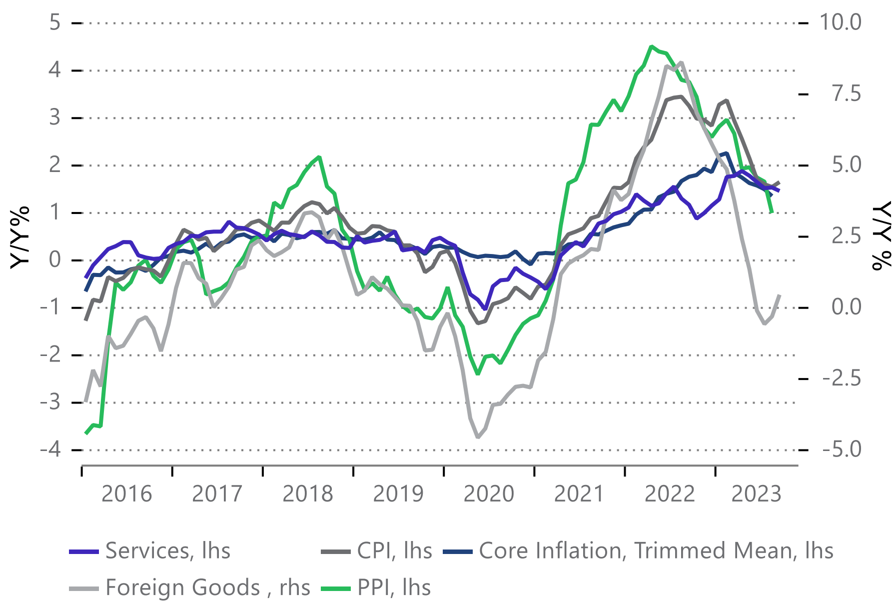
CHF (-) SNB's FX stance likely to change

Estimated SNB intervention on FX



DBe is DB estimate. Source: MGI Economics, Macrobond, 4 October 23

Swiss inflation

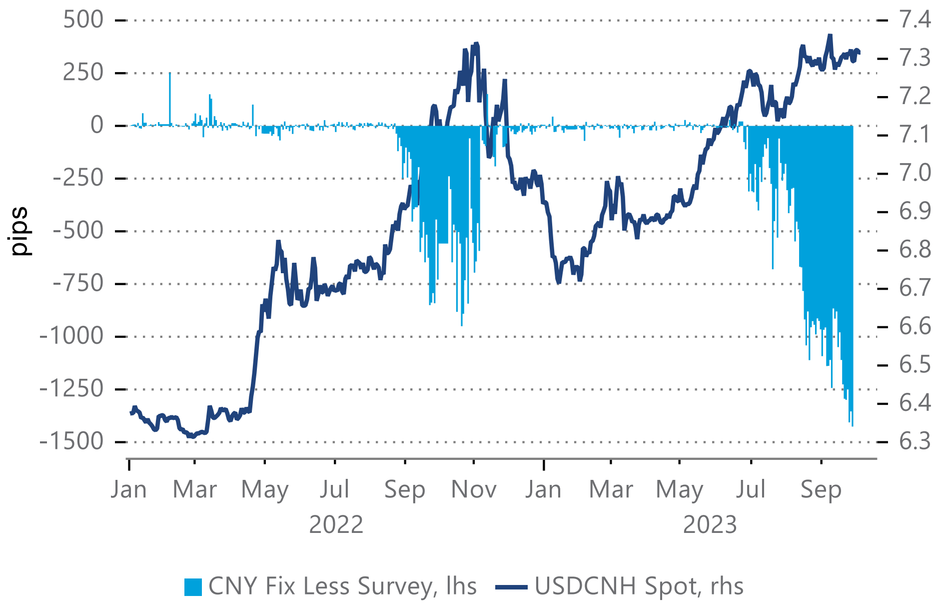


Source: MGI Economics, Macrobond, 4 October 2023

The swiss franc strengthened significantly last year as higher European natural gas prices weighed on European risk and caused a "terms of trade shock" that hurt the Euro area more than Switzerland. But natural gas prices have since fallen significantly and the swiss franc continues to be strong: both relative to history and versus fair value. The culprit has been the Swiss National Bank (SNB) who has been averse to currency weakness in an environment of "high" inflation. Inflation dynamics suggests this should be done and latest SNB balance sheet data suggests intervention has fallen. Moreover, the swiss franc should stay a "low yielder" in a wider market environment that becomes a little more supportive of risk. We are more pessimistic about the franc versus the dollar than the euro, given our view that BTP-Bund spreads are likely to widen further.

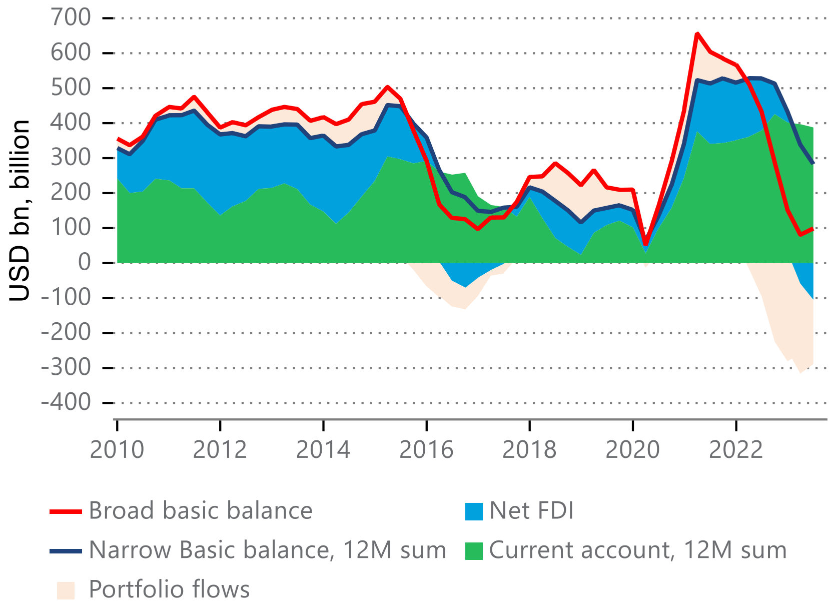
CNH (-) China attempts the "impossible trinity"

CNH fixings



Source: MGI Economics, Macrobond, 5 October 2023

Flows

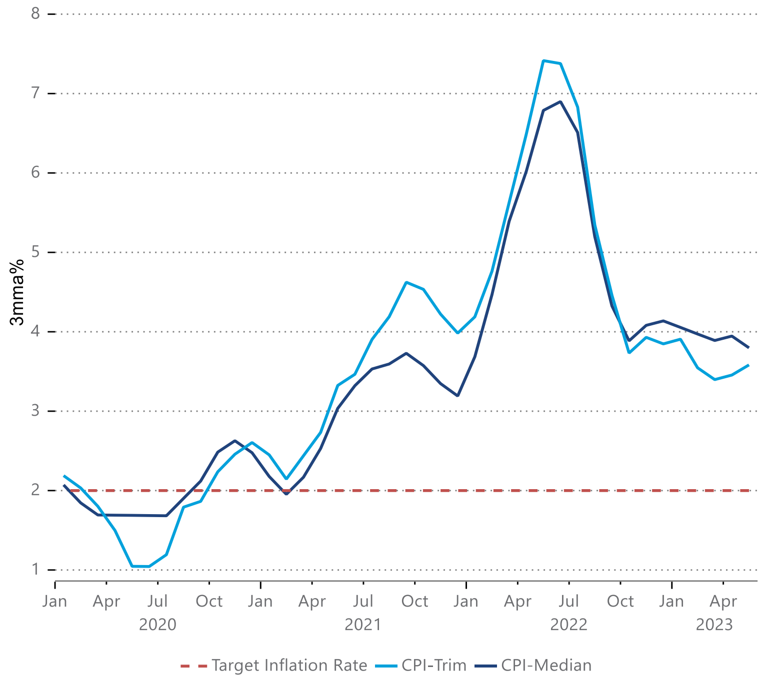


Source: MGI Economics, Macrobond, 5 October

While the China cyclical story is improving following some policy support (slide 30) the main reason for the stabilisation in USDCNH has been direct FX intervention by the PBoC. In the medium term, China's structural slowdown will likely require low rates for an extended period. This not only leaves a large interest rate differential between China and the US, it leaves the flow picture also poor (from a trifecta of portfolio outflows, a rise in the tourism services deficit and now negative FDI flows). Ultimately, China cannot achieve the "impossible trinity" – a fixed exchange rate, free capital flows and independent monetary policy. More broadly, we prefer expressions of adding to China proxies (instead of CNH) on signs that US yields have peaked.

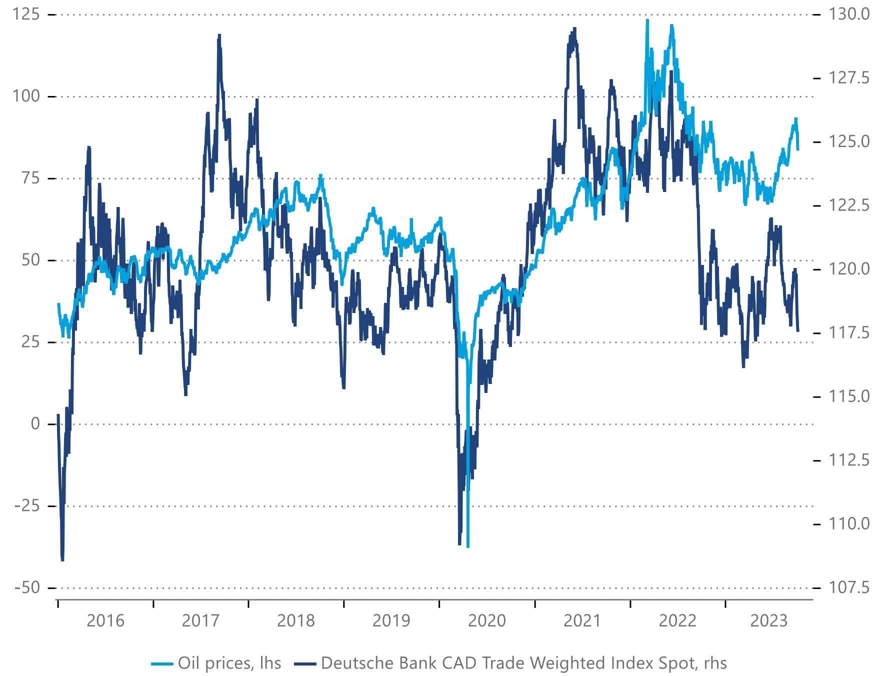
CAD (+) Another hike likely if disinflation stalls further

Disinflation stalling supports another hike



Source: MGI Economics, Macrobond, 5 October 2023

CAD weak vs oil

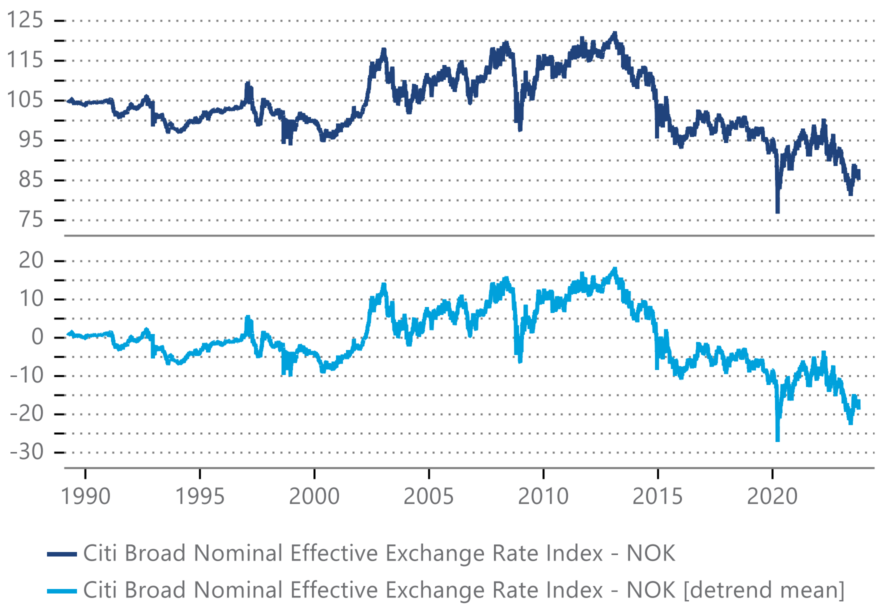


Source: MGI Economics, Macrobond, 5 October 2023

The global backdrop of a US soft landing scenario, combined with the potential for cyclical recovery in China, should provide a more favourable risk environment for both commodity prices and for risk FX proxies vs the dollar. Following the most recent Canadian inflation print, that showed a further acceleration in headline CPI to 4% YoY (Aug), we see one more rate hike from the BoC in Q4. Upside risk to short term rates pricing, in addition to stable oil prices, should provide further support for CAD vs USD and EUR. Risks to our view would be a sharper turn lower in US growth, leading to negative demand feedback into oil prices.

NOK (+) Turn in global cycle supports terms of trade

c.15% cheap on basket basis



Source: MGI Economics, Macrobond, 5 October 2023

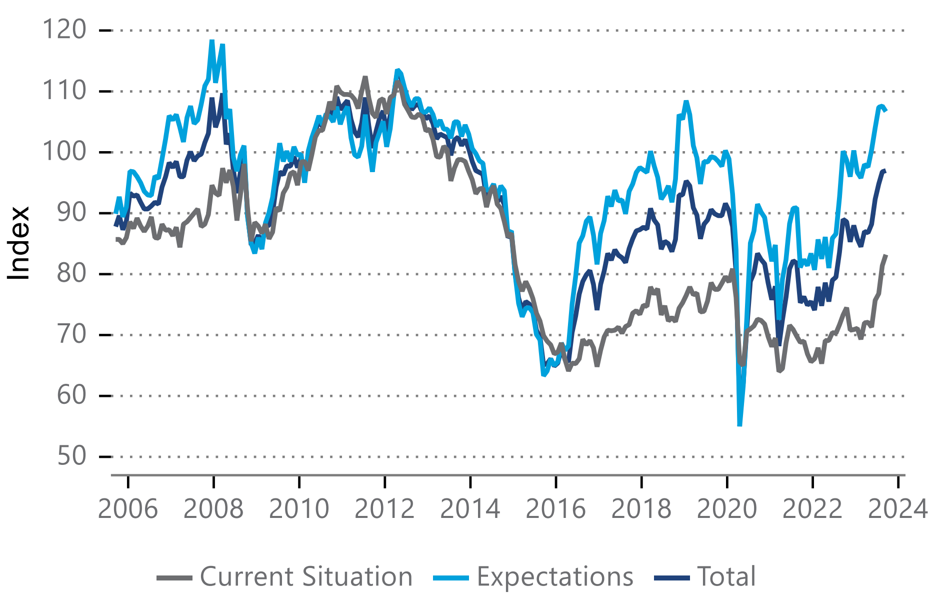
NOK - terms of trade vs oil prices

Source: MGI Economics, Macrobond, 5 October 2023

NOK will continue to trade as a cyclical currency, highly dependent on the outlook for US rates and global growth. The Norges bank are likely to hike just once more this cycle, as the disinflation cycle continues – but at the same time we see greater downside risks to 1 yr rates in Europe. A bottoming in China activity data and a turn in the global inventory cycle (see page 26/33) should keep oil prices supported at current levels. The turn in relative terms of trade for Norway vs Europe is supportive for the currency – furthermore, combined with the krone's relatively cheap valuation on a basket basis, we remain constructive on NOK vs EUR.

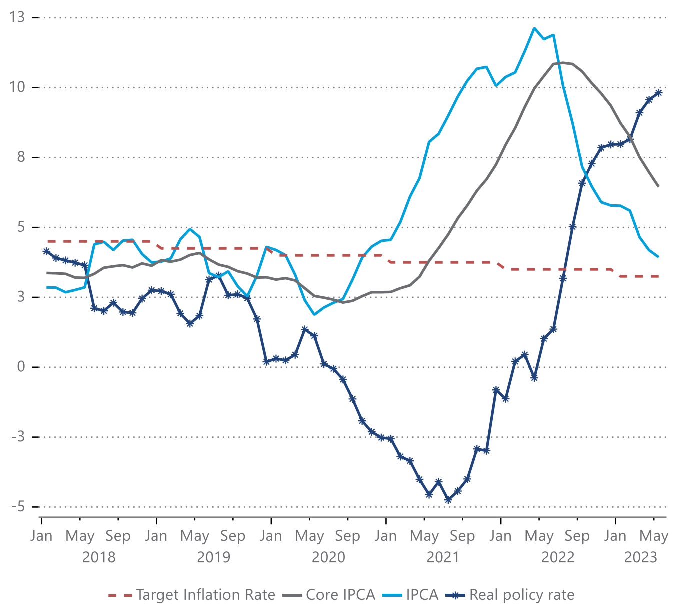
BRL (+) Steady BCB means high real rates continue

Consumer confidence rising



Source: Macrobond, MGI Economics, 5 October 2023

Real rates remain supportive amid disinflation

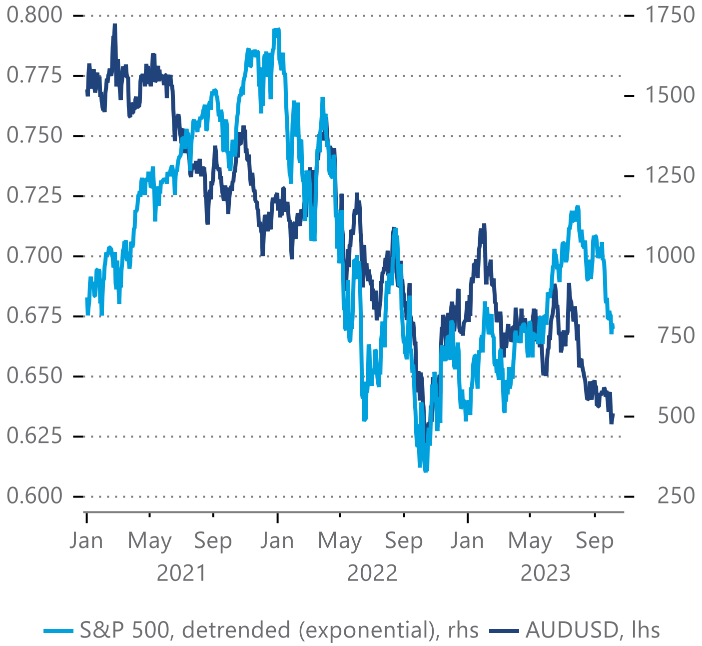


Source: Focus Survey, MGI Economics, 5 October 2023

The BCB look set to continue their interest rate cutting cycle at a steady pace (50bp increments), containing inflation expectations and keeping real rates high relative to the rest of the world. Hence, the carry to vol ratio and positive real rates, both remain favourable for BRL. Growth in Brazil has remained steady over Q2 at 3.4% YoY and is on track to remain stable with crop yields stronger than last year and consumer confidence rising. Fiscal uncertainty has lessened, although the receival of budget guidelines has been delayed further. The outlook overall is constructive and ultimately, with the US continuing to follow a soft-landing trajectory and China activity bottoming, high yield currencies should find near term support. The risk to our view would be a further shift higher in back-end US yields or a market risk event (prolonged US Government shutdown/US bank crisis) permeating into risk sentiment, both of which could see the USD strengthen further as a safe haven.

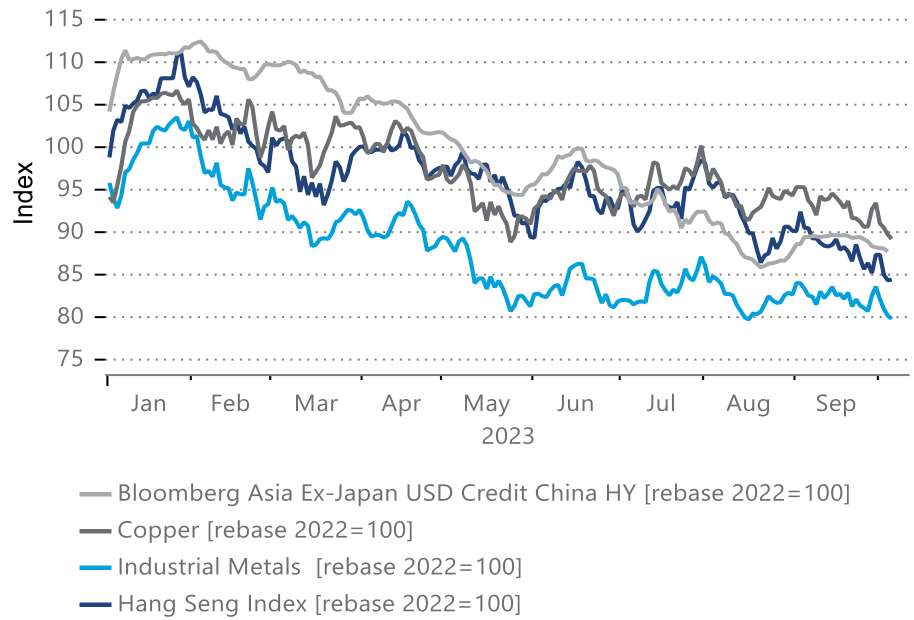
AUD (+) Equity risk and China bottoming

"Aussie" broadly a view on equity risk



Source: Macrobond, MGI Economics, 05 October 2023

China risk axis still very weak

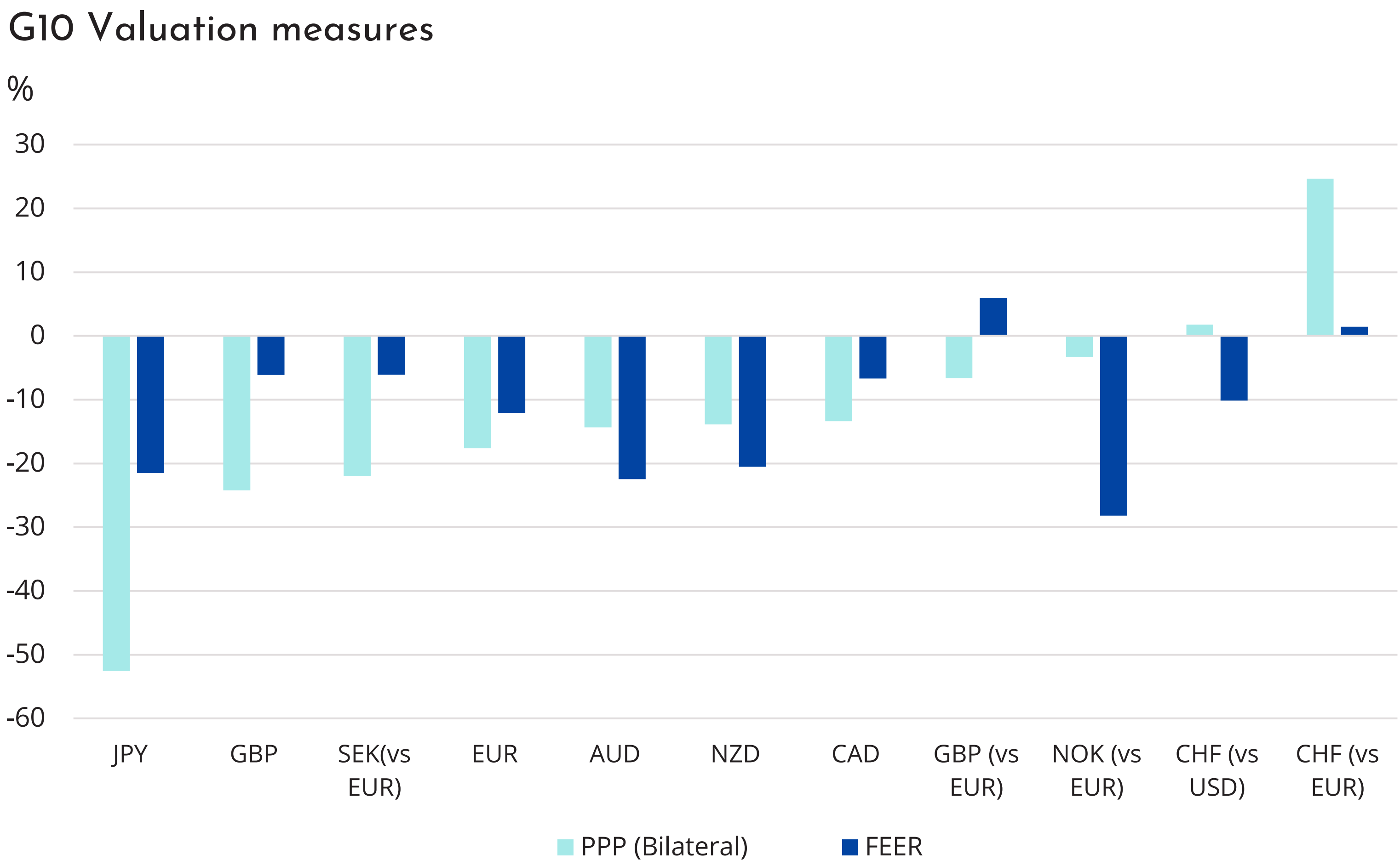


Source: Macrobond, RBA, MGI Economics, 05 October 2023

The Aussie dollar is weak on a nominal basis and has been one of the worst performing currencies year-to-date in the G10 space. We see an end to this underperformance given our view that a stabilization of US yields should help support equity risk and that China activity is improving in the context of a market that is still very pessimistic on China.


VALUATION
MILLENNIUM GLOBAL
INVESTMENTS

Valuation stretched in G10



Purchasing Power Parity (PPP)

One of the pillars of long run modelling for exchange rates. The main idea is that the price of similar goods in home and foreign countries should be the same, in order to have the respective currencies in equilibrium. Otherwise, a demand switch from the expensive goods to the cheaper goods, will follow. Based on the Law of One Price (LOP), this demand change will last until the demand and supply equalize the prices.

Fundamental Equilibrium Exchange Rate (FEER)

The equilibrium exchange rate that achieves both the internal and external balance. The internal balance is reached when the economy is at full employment and low inflation, while the external balance is reached when a country spends and invests abroad no more than the other countries spend and invest in it.

Positive is overvalued, negative is undervalued. Source: Macrobond, MGI Economics (PPP), GS Research (FEER). Data as of 05 October 2023.

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