Q2 2023
GLOBAL CURRENCY & MACROECONOMIC HIGHLIGHTS

1 April 2023

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MGI Economics

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EXECUTIVE SUMMARY

MILLENNIUM GLOBAL INVESTMENTS

Economic Views

- Our central case is that the Federal Reserve has the ability to ring fence financial stability concerns
- Higher funding costs for small and regional banks are likely to tighten US financial conditions via the credit channel, where lending standards were already being tightened due to monetary policy
- While we expect growth to slow over Q2, we expect no immediate recession given momentum in consumption, a strong labour market and little disruption to lending from large US banks
- We expect the growth impact from the excess credit tightening (i.e. that above monetary policy) to be relatively small (c.0.5pp) with a two quarter lag. Coupled with previous tightening, we expect a mild recession in Q4
- A moderation in shelter inflation should slow US inflation, but strength in wider service inflation and employment should push the Fed to do a final hike in May
- Euro area disinflation should continue but we expect core inflation to remain elevated, leaving the ECB hiking through the quarter, reaching a terminal of 3.5%. We also see one more rate hike from the BoE, but expect the BoC and RBA on pause from here
- We expect Japan to exit yield curve control in June and change its rate guidance to a neutral (from dovish) stance
- We expect China to grow strongly over the quarter, driven by a recovery in consumption and a fading drag from the property sector. However we still expect inflation to remain low and monetary policy to retain a small easing bias

FX Views

- Credit tightening in the US accelerates the Fed tightening cycle by hurting growth and reminding the Fed there are lags to monetary policy
- While we disagree with near term cuts from the Fed priced by markets, our view that inflation and growth should moderate continues to pose downside risks to US 2-year yields
- This leaves our view of dollar weakness unchanged as a receding terms of trade shock and China reopening improve the growth outlook for Europe and Asia, giving rise to interest rate convergence (US vs Europe and Japan)
- We see dollar weakness being broad based. Crucially, this reflects our near-term positive view on equity risk as fears of banking stress prove overdone, inflation in the US softens and China fully reopens. The latter should also support commodity prices, despite slower growth in developed markets
- We most like EUR (+) and GBP (+) given resilient banking sectors, improved growth outlooks and hiking central banks.
- We like safe-havens JPY (+) and CHF (+) mainly through the lens of risk-reward. A dovish PBOC suggests AUD (+) is the better expression of China reopening than CNH (0) given a backdrop where equities and commodities are supported and there are hawkish risks around the RBA. We see CAD (0) as the most likely to underperform given little domestic driver.
- We continue to like BRL (+) and MXN (+) for their attractive carry, underpinned by relatively hawkish central banks
- We keep our views tactical, given the uncertainty around the size of the credit tightening and our longer-term caution around recessionary risk, which would likely prompt a defensive rotation

Currency Outlook: April 2023

USD (-)
Receding terms of trade shock and China reopening improve the growth outlook for Europe and Asia, giving rise to interest rate convergence, most notably in Europe and Japan

EUR (+)
Helped by improved growth outlook and an ECB should keep tightening monetary policy

JPY (+)
Still very cheap with good risk-reward given the outlook for US inflation and downside growth risks

CAD (0)
Slowing growth and interest rate cycle ahead of the Fed's leaves it vulnerable in a recession scenario.

GBP (+)
A pro-risk beneficiary of dollar weakness with an improving growth outlook and rate support

CNH (0)
An easing bias from the PBoC and weaker current account means difficult to translate growth boost into currency gains

BRL (+)
Very restrictive monetary policy should support BRL while fiscal uncertainty is reduced.

CHF (+)
Risk agnostic view on US duration helped by an SNB that wants to avoid any currency weakness

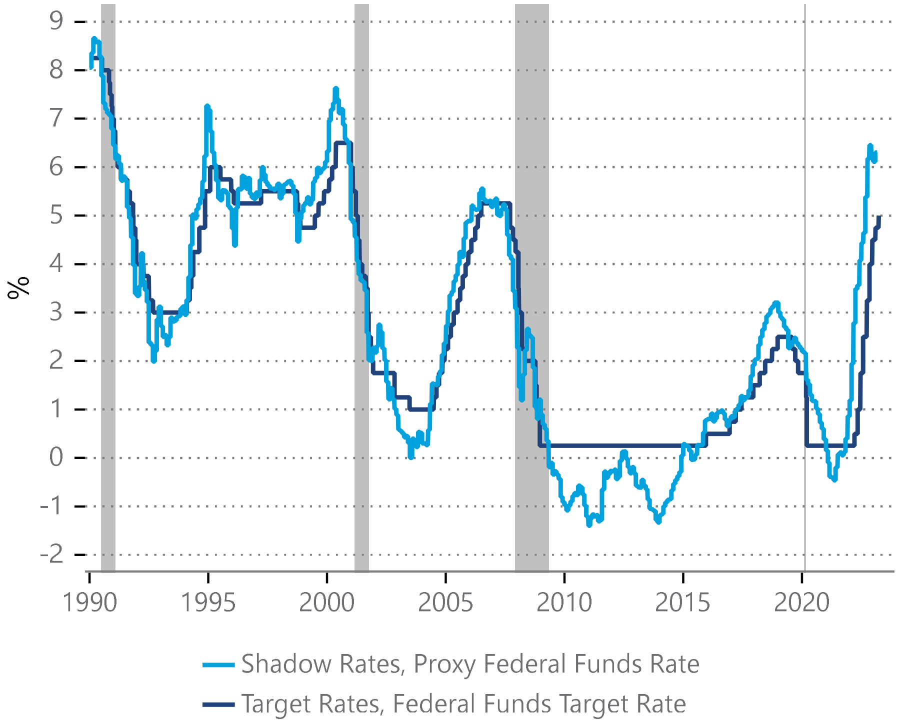
AUD (+)
Equity environment should be supportive in the short term while hawkish risks to RBA remain

All views vs USD. Source: MGI Economics, 02 April 2023

ECONOMIC OUTLOOK

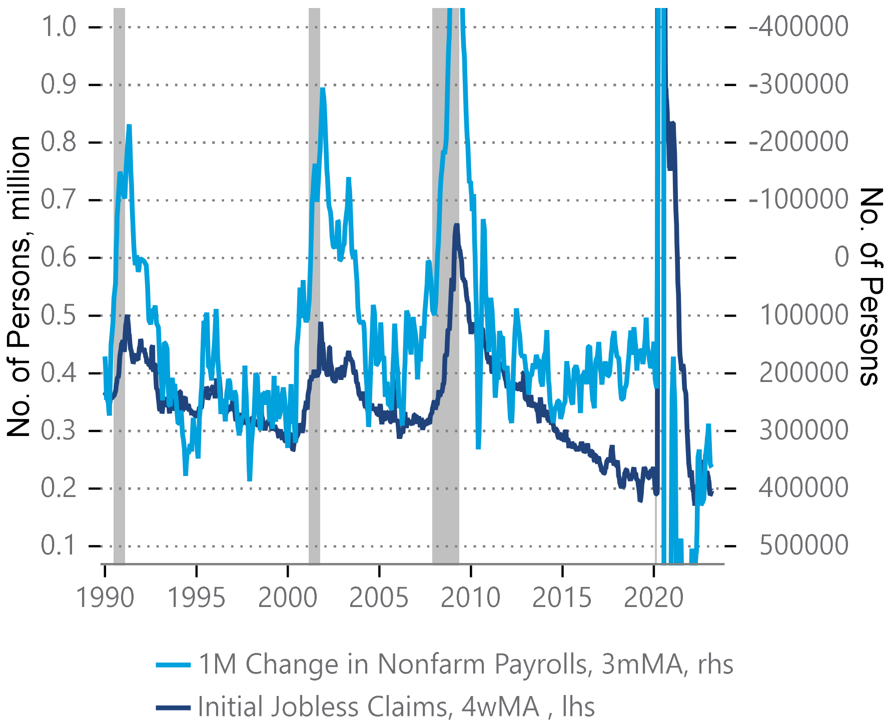
Strength of the economy led Fed to question neutral rate (r*)

Fastest hiking cycle in history



Source: Macrobond, MGI Economics, 28 March 2023

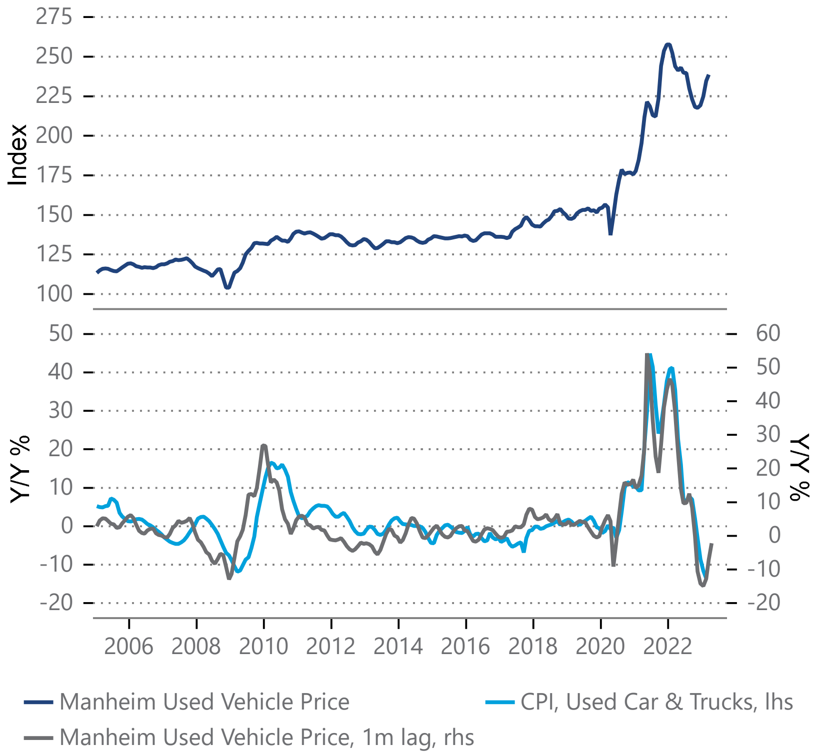
Yet hiring is still at 300K per month



Source: Macrobond, MGI Economics, 28 March 2023

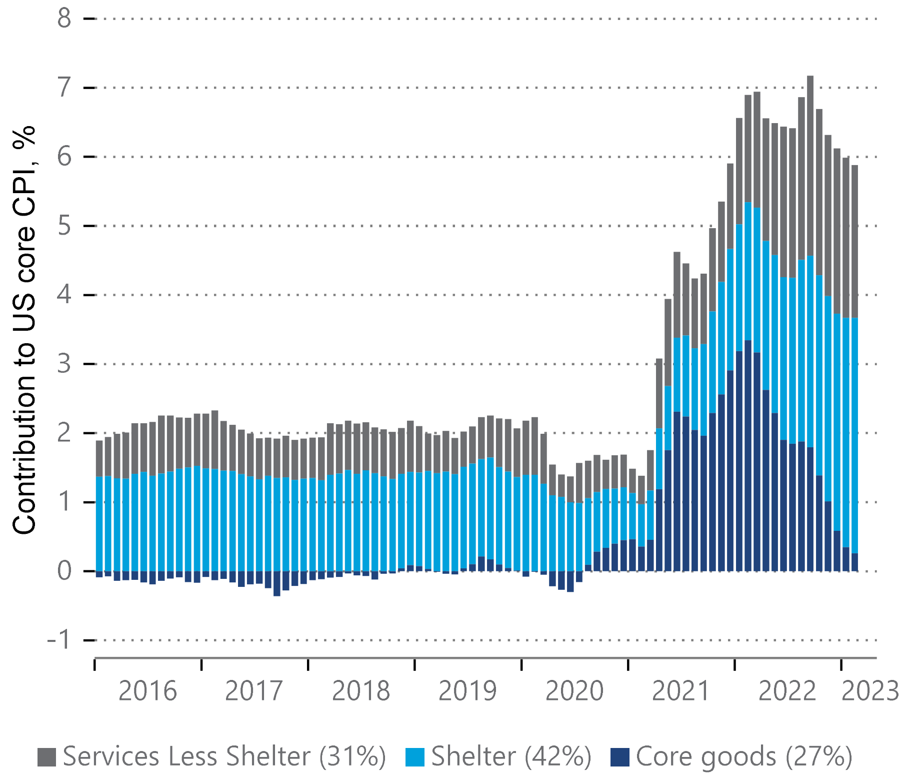
Inflation now almost exclusively driven by core services

Parts of goods inflation likely to rise



Source: Macrobond, MGI Economics, 28 March 2023

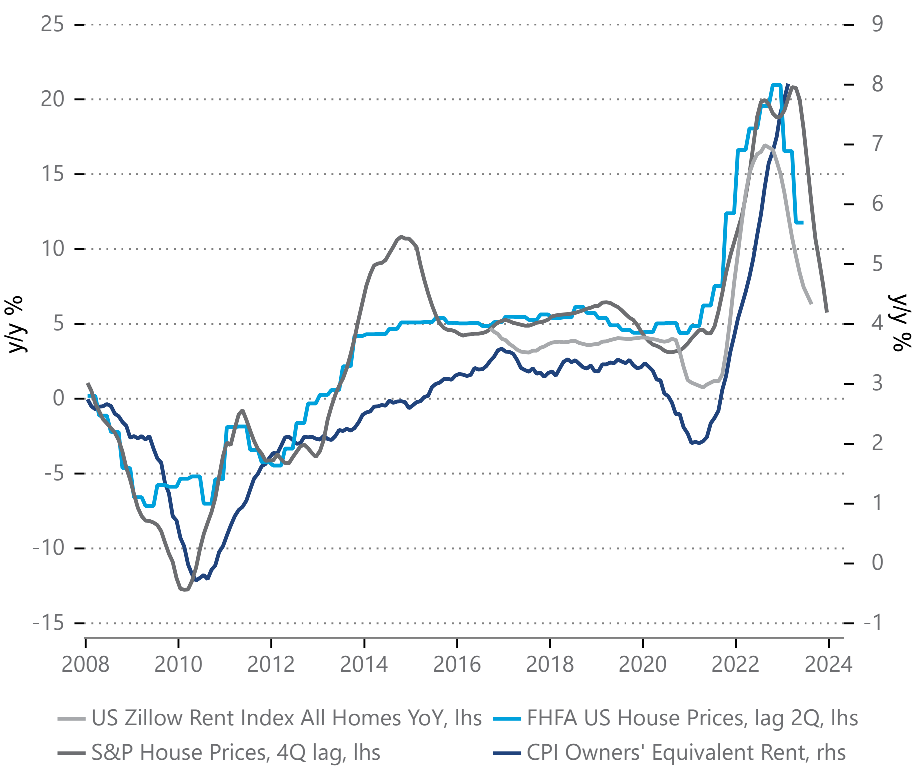
Though "big picture" no longer the issue



Source: Macrobond, MGI Economics, 28 March 2023

Shelter should help inflation turn lower

Shelter inflation should fall this quarter



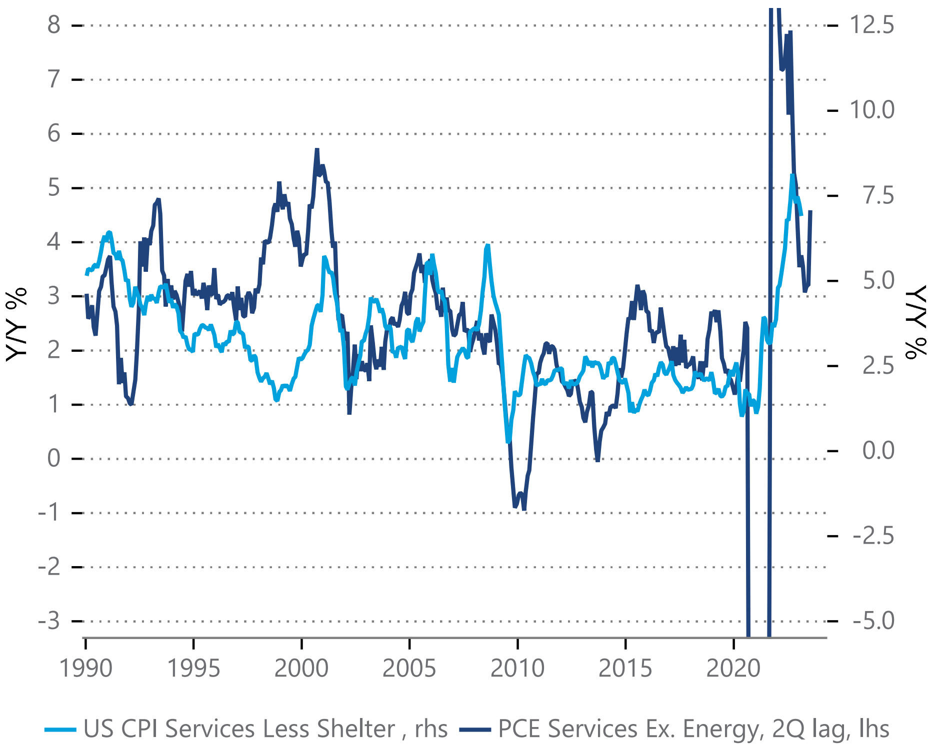
Source: Macrobond, MGI Economics, 28 March 2023

And continue to be a drag for some time

Source: Macrobond, MGI Economics, 28 March 2023

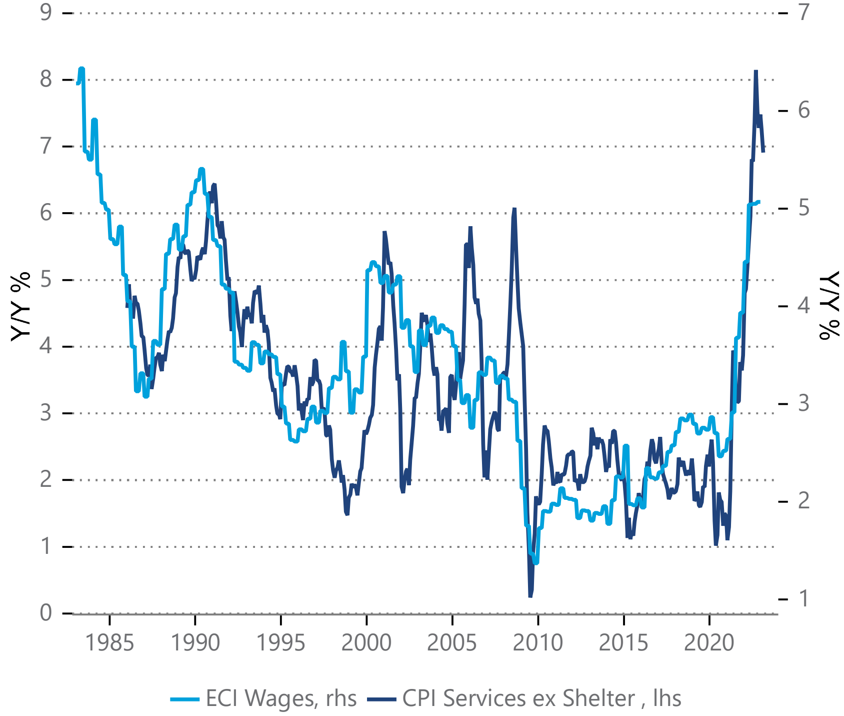
Though broader service inflation will likely remain high

"Pull" factor: Service Consumption



Source: Macrobond, MGI Economics, 28 March 2023

"Push" factor: Wages



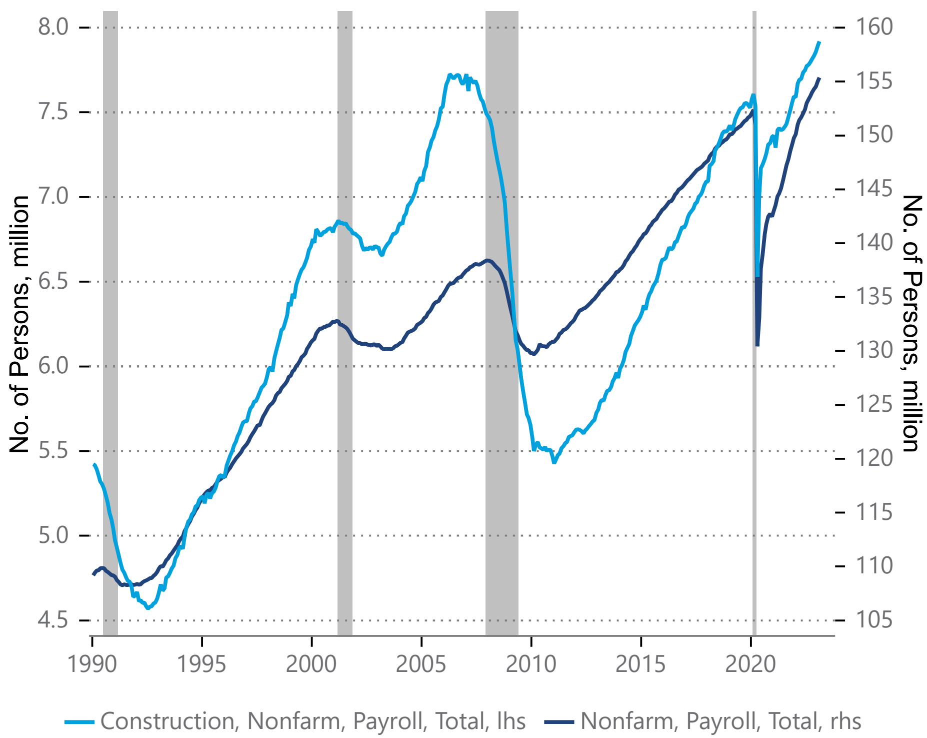
Source: Macrobond, MGI Economics, 23 March 2023

This leaves the Fed's main aim to slow the labour market

Labour demand is softening

Source: Macrobond, MGI Economics, 23 March 2023

But hampered by labour hoarding



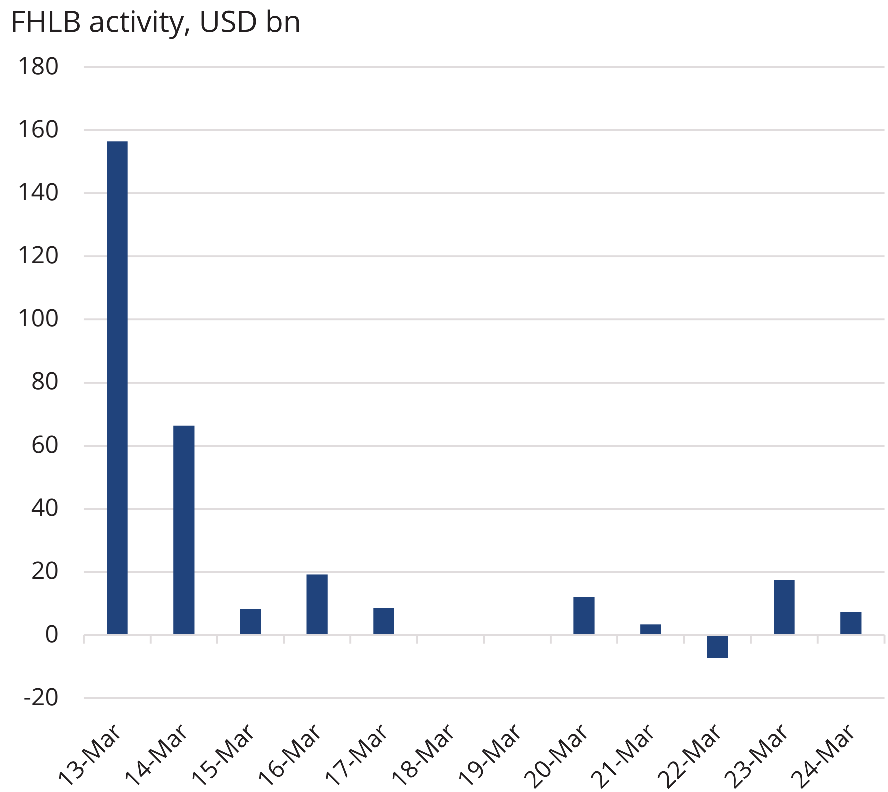
Source: Macrobond, MGI Economics, 23 March 2023

Silicon Valley Bank (SVB) failure sparks deposit flight

Flows go to large banks and money markets

Source: Macrobond, MGI Economics, 28 March 2023

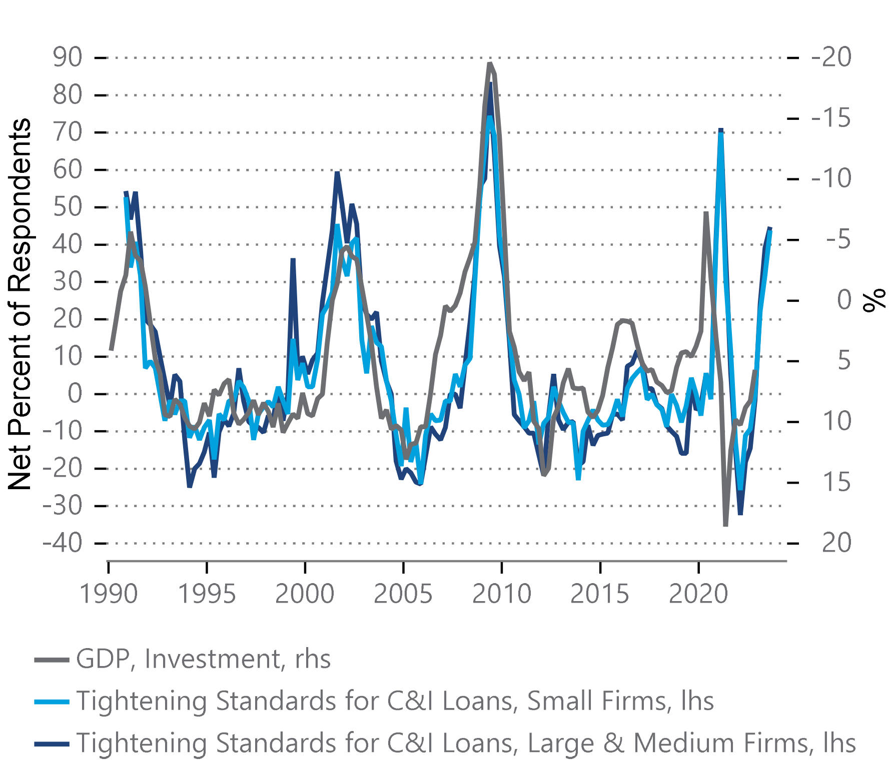
While banks reach for additional liquidity



Source: Macrobond, MGI Economics, 28 March 2023

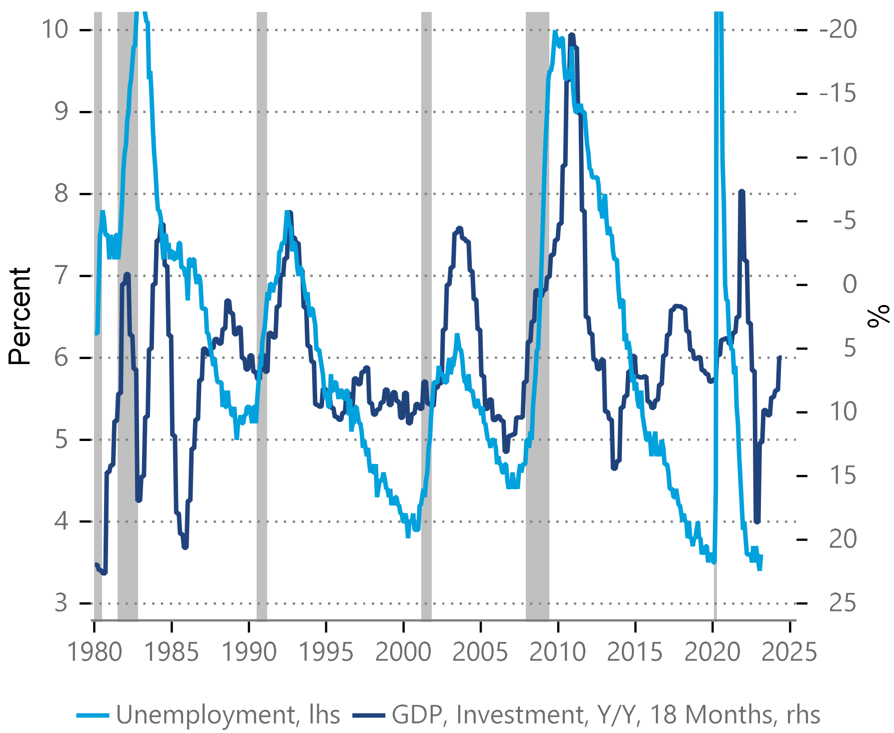
Lending standards already pointed to a US recession

Lending standards were already tightening



Source: Macrobond, MGI Economics, 28 March 2023

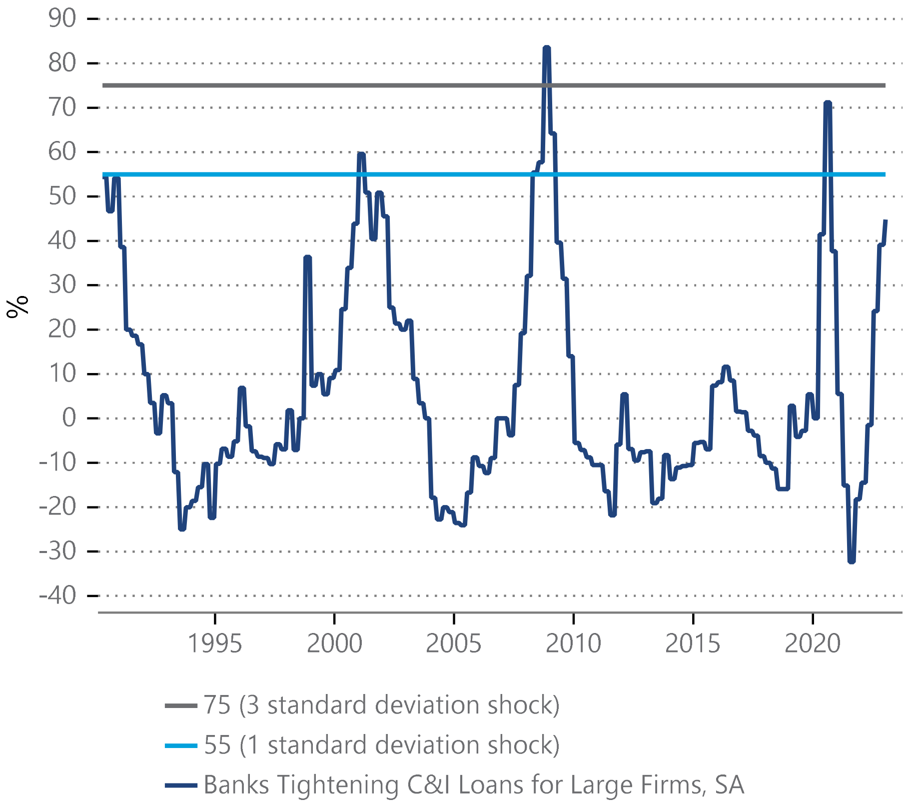
And pointed to unemployment rising



Source: Macrobond, MGI Economics, 28 March 2023

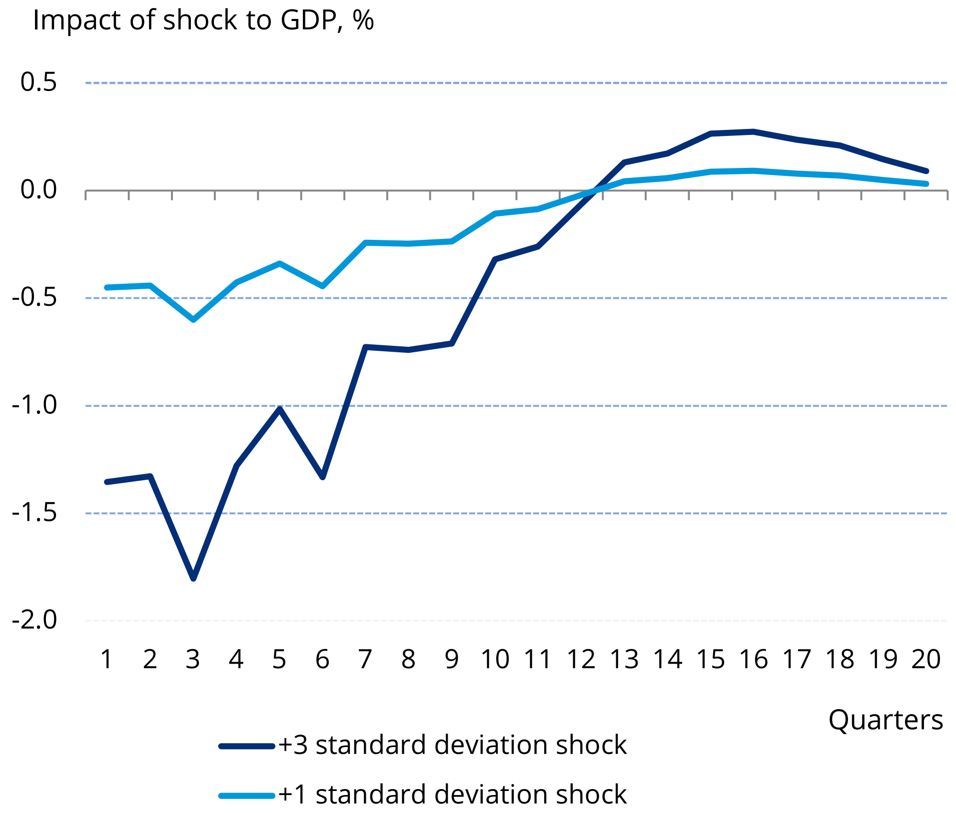
Higher funding costs likely to tighten credit conditions

Lending likely to be even tighter



Source: Goldman Sachs Research, MGI Economics, 28 March 2023

GDP impact likely at least 0.5pp within 2-3 quarters



Source: Macrobond, MGI Economics, 28 March 2023

This could even be structural if regional bank model broken

Regulation a question of when not if…

Exhibit 1: Across Looking at the Current US banking regulatory framework, we see current risk that several regulations, including regional bank treamtment around TLAC, capital and liquidity regulations could be extended to a wider range of banks AOCI opt-out and LCR/NSFR most at risk

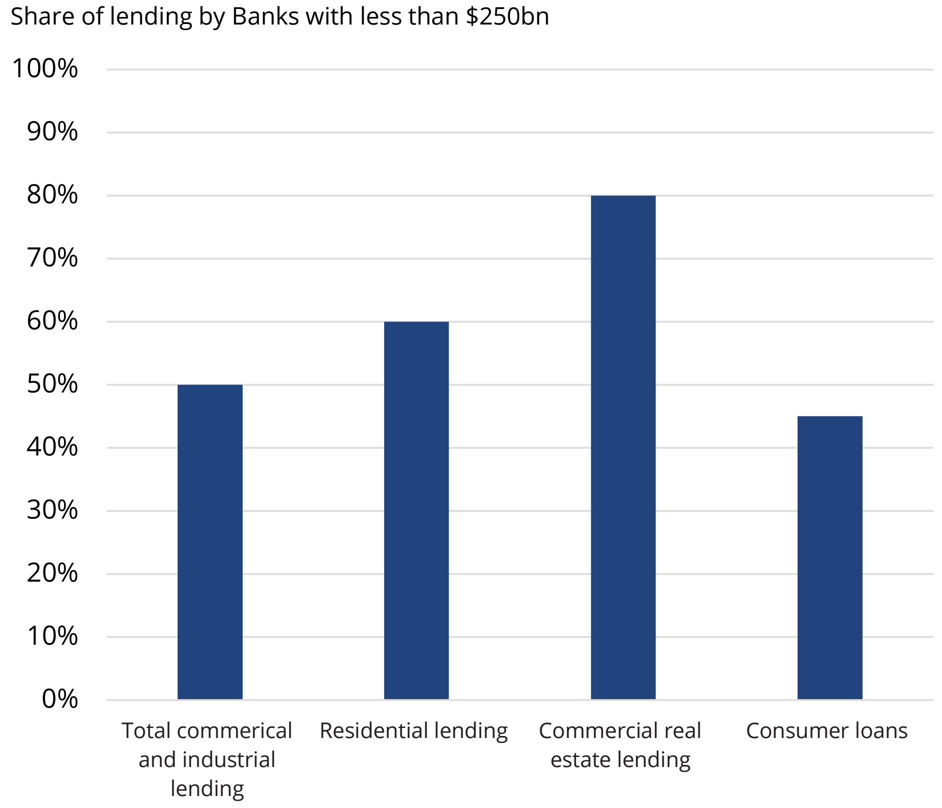
Category	Category 1	Category 2	Category 3	Category 4	Other banks
Category thresholds	US G-SIBs	≥$700bn in assets or ≥$75bn in X-juri activity	≥$250bn in assets / ≥$75bn in non-bank assets, w short term funding, or off-B/S exposure	≥$100bn to $250bn in assets	≥$50bn to $100bn in assets
CET1 capital	TLAC	-	-	-	-
	G-SIB surcharge	-	-	-	-
	Countercyclical buffer[1]	Countercyclical buffer[1]	Countercyclical buffer[1]	-	-
	Stress capital buffer (SCB)	Stress capital buffer (SCB)	Stress capital buffer (SCB)	Stress capital buffer (SCB)	-
	No opt-out of AOCI capital impact	No opt-out of AOCI capital impact	Opt-out of AOCI capital impact	Opt-out of AOCI capital impact	Opt-out of AOCI capital impact
Stress testing	Annual company run stress test	Annual company run stress test	Company run stress test every other year	-	-
	Annual CCAR	Annual CCAR	Annual CCAR	CCAR every other year	-
Leverage	Enhanced SLR	SLR	SLR	-	-
	Tier 1 leverage	Tier 1 leverage	Tier 1 leverage	Tier 1 leverage	Tier 1 leverage
Liquidity	Full LCR	Full LCR	Full / modified LCR	Modified / no LCR	-
	Full NSFR	Full NSFR	Full / modified NSFR	Modified / no NSFR	-

*Note: [1] Currently set at 0%. *FRC does not have a hold-co and thus not subject to LCR and NSFR until it's Cat 3*

Source: Goldman Sachs Global Investment Research

Source: Goldman Sachs Research, MGI Economics, 28 March 2023

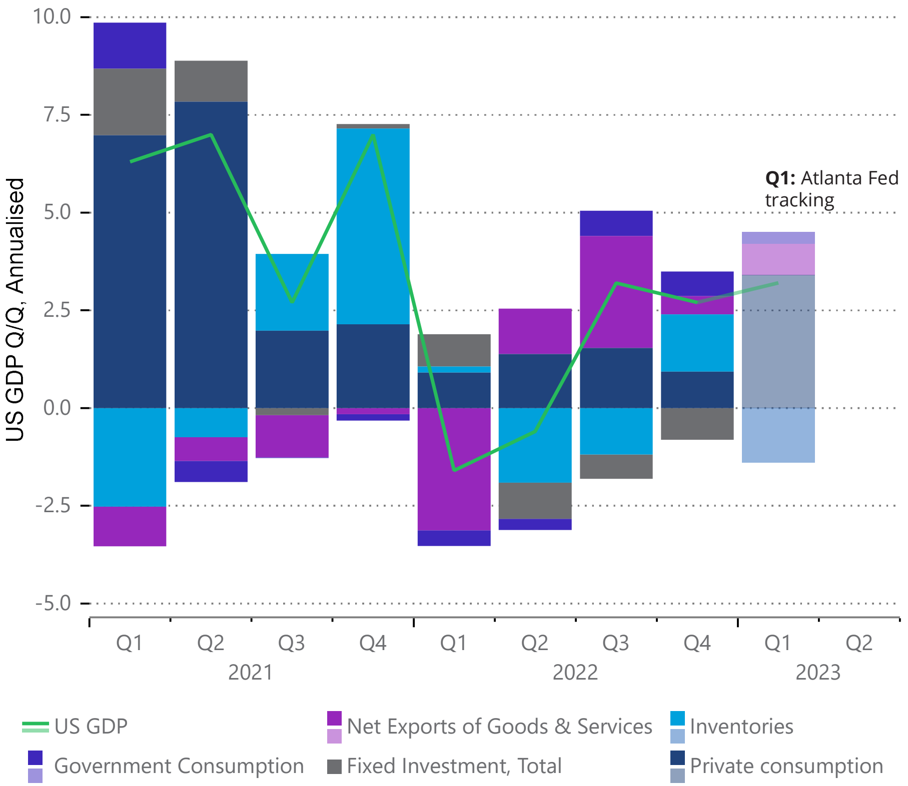
Importance of smaller banks



Source: Macrobond, MGI Economics, 28 March 2023

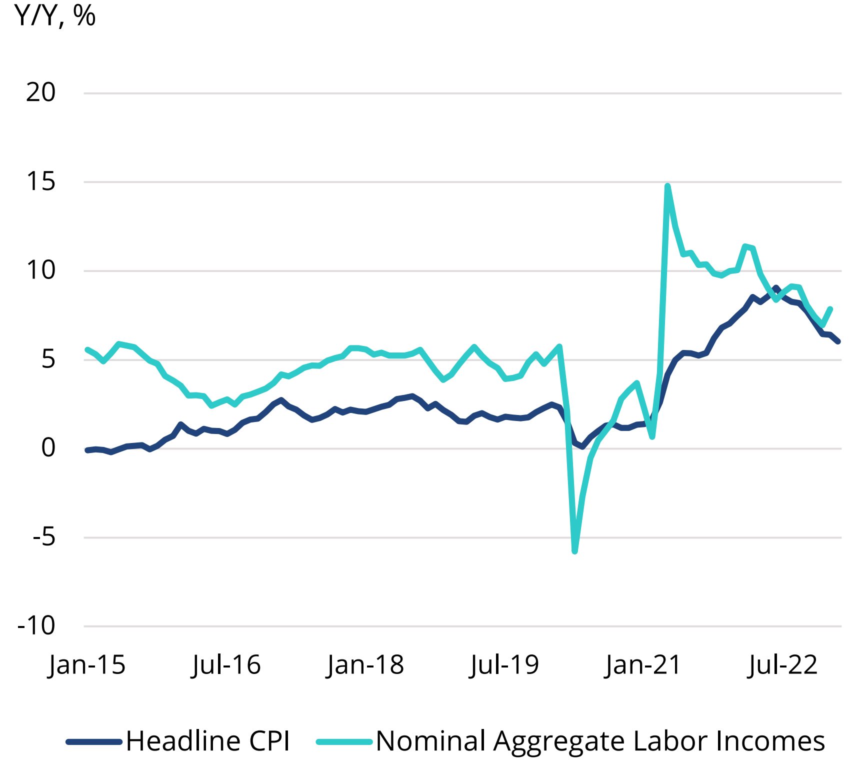
We expect growth to slow but no recession until later this year

Q1 GDP growth strong but narrow



Q1 from Atlanta Fed GDP tracking
Source: Macrobond, MGI Economics, Atlanta Fed, 23 March 2023

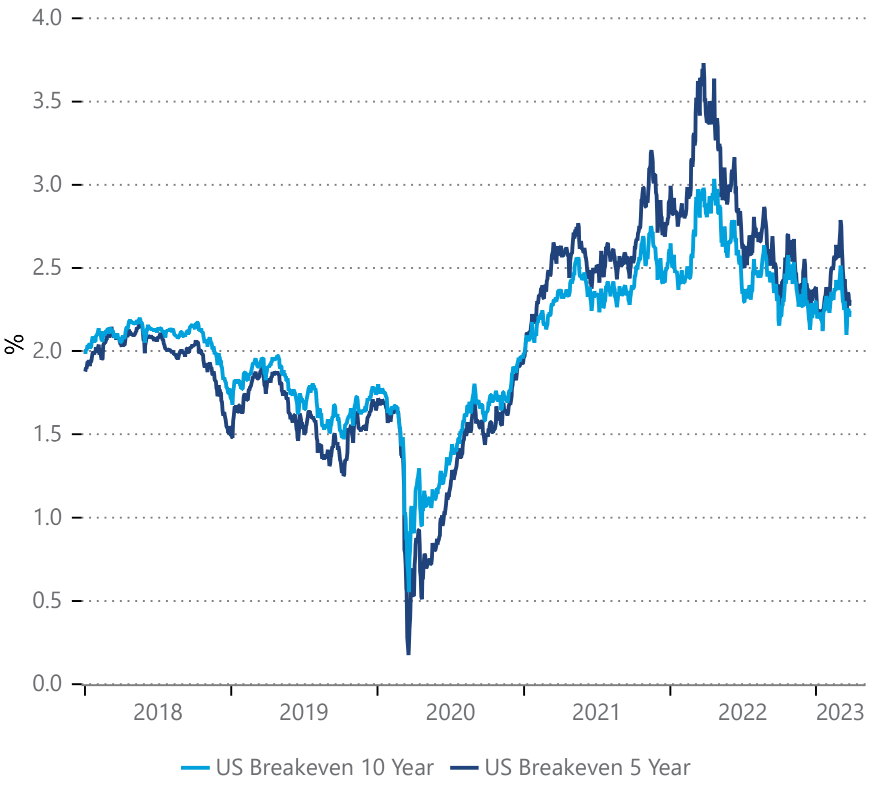
Aggregate income still strong



Source: Macrobond, MGI Economics, 23 March 2023

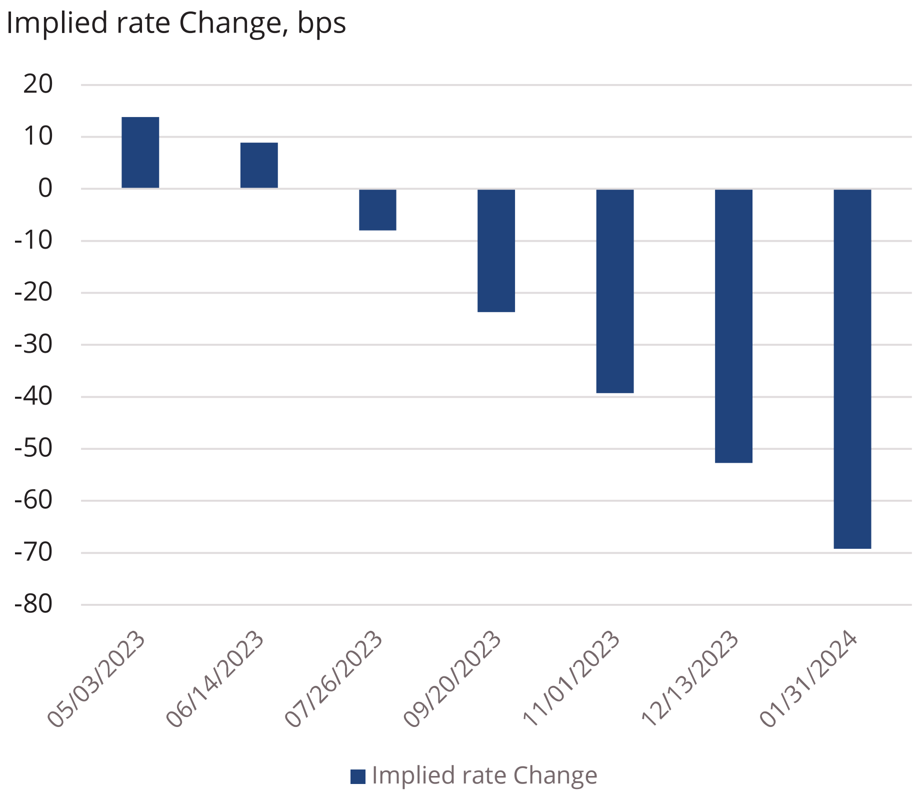
While Fed should pause, market too confident on cuts this year

Inflation expectations have fallen



Source: Goldman Sachs Research, MGI Economics, 27 March 2023

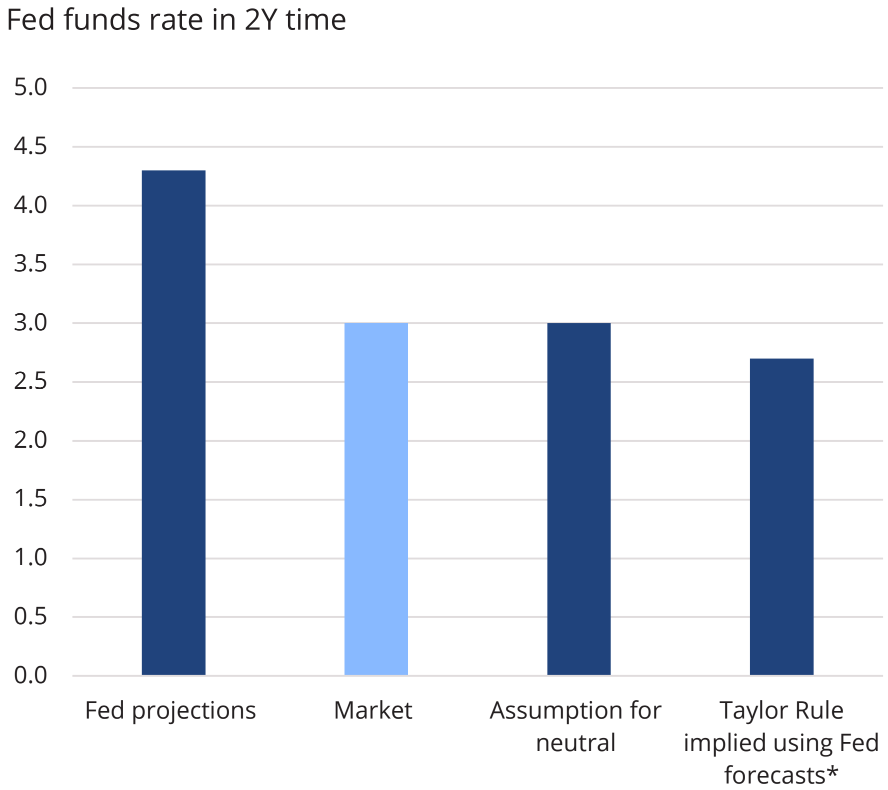
Market pricing 70bps of cuts this year



Source: Macrobond, MGI Economics, 27 March 2023

US 2Y pricing normalisation and little hard landing* risk

Fed own forecasts suggests deeper cutting cycle than market



Source: Goldman Sachs Research, MGI Economics, 28 March 2023

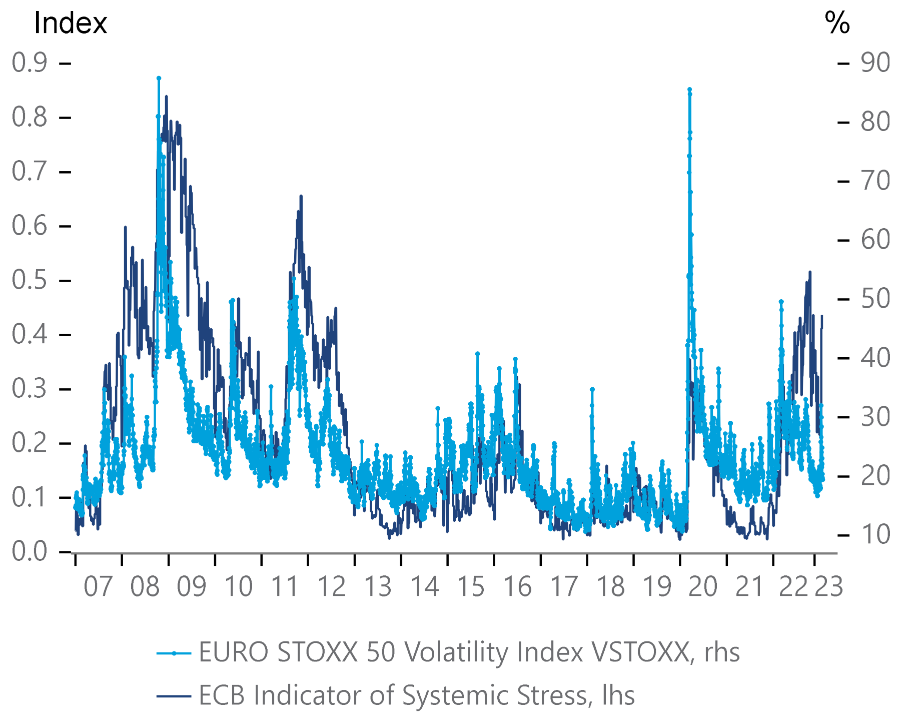
Implied Fed funds under various recession probabilities

Recession probability	Baseline Fed funds in 2Y		
	4.3%	**3%**	**2.7%**
10%	4.0	2.8	2.5
20%	3.6	2.6	2.4
30%	3.3	2.4	2.2
40%	3.0	2.2	2.0
50%	2.7	2.0	1.9
60%	2.3	1.8	1.7
70%	2.0	1.6	1.5
80%	1.7	1.4	1.3
90%	1.3	1.2	1.2
100%	1.0	1.0	1.0

**Hard landing defined as 6% unemployment.*
Source: Macrobond, MGI Economics, 28 March 2023

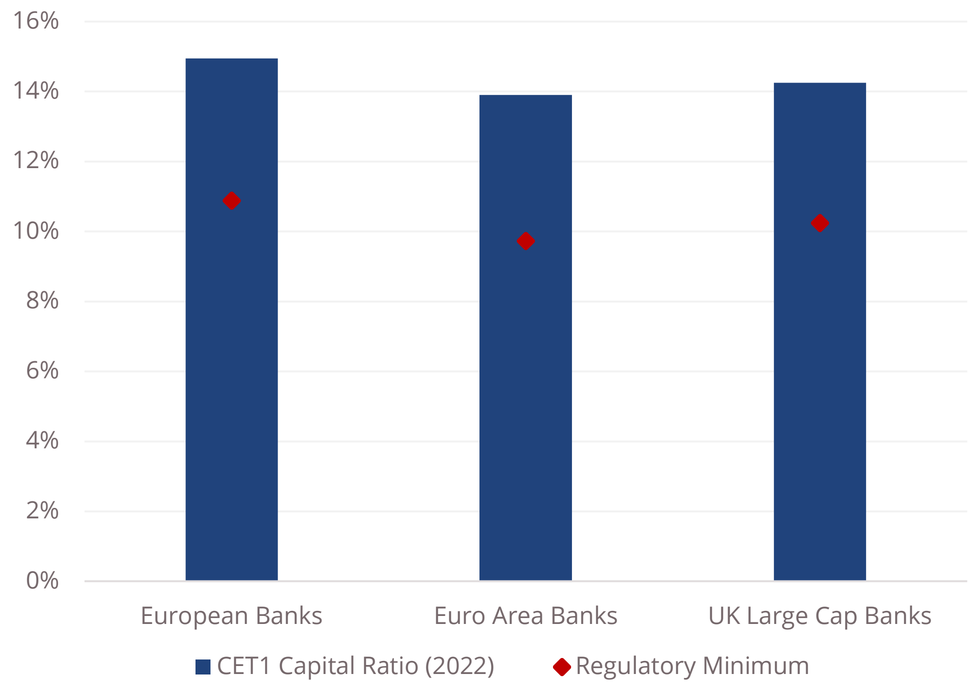
Despite increased volatility, European banking system sound

Market questions European systemic risk



Source: Macrobond, MGI Economics, 27 March 2023

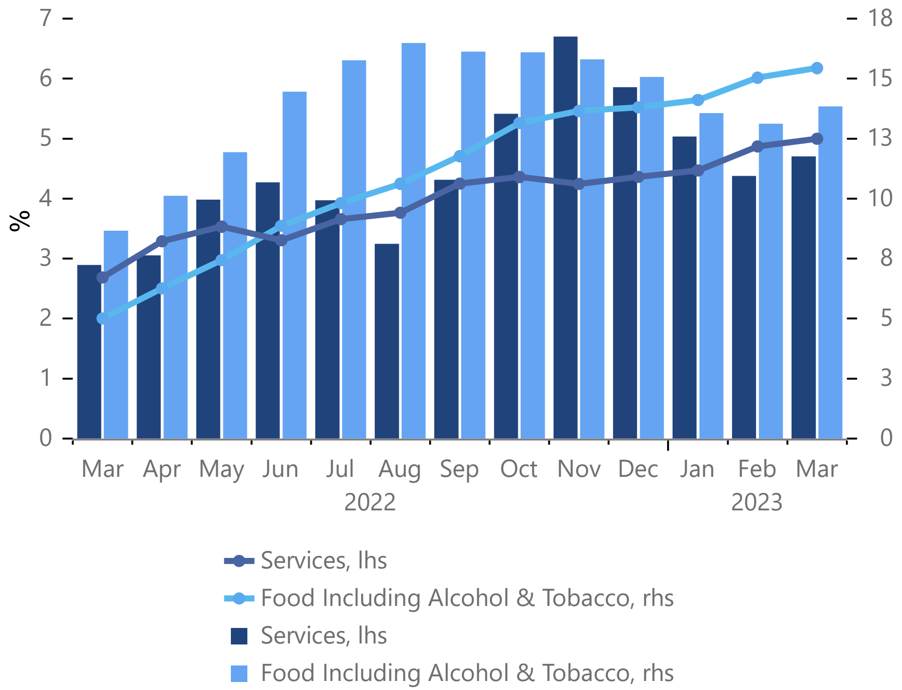
But resilient banking system denies fears



Source: ECB, Goldman Sachs, MGI Economics, 27 March 2023

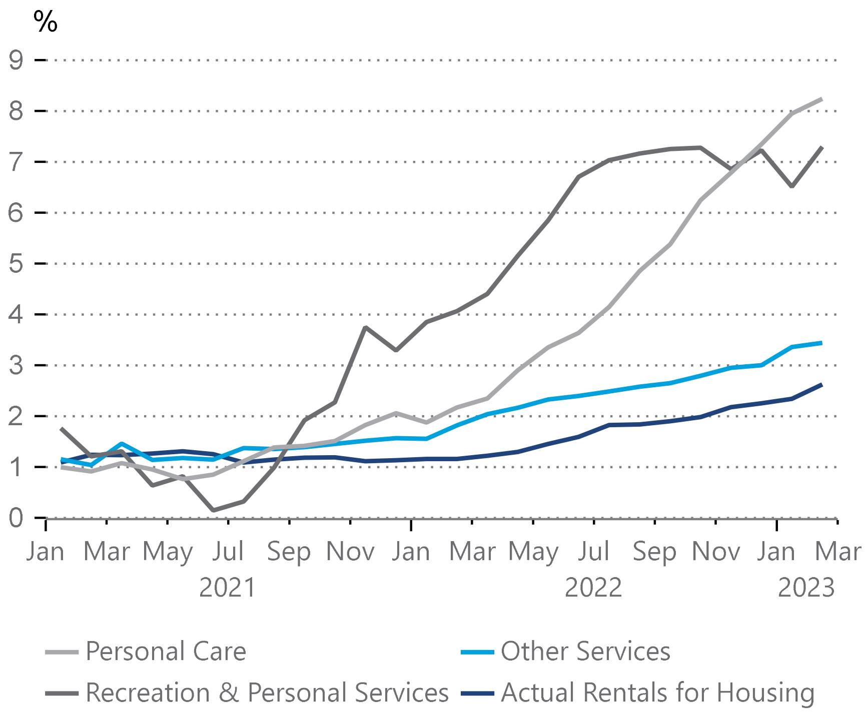
ECB likely to hike further as core inflation remains sticky

Inflation momentum still strong



Source: Macrobond, MGI Economics, 31 March 2023

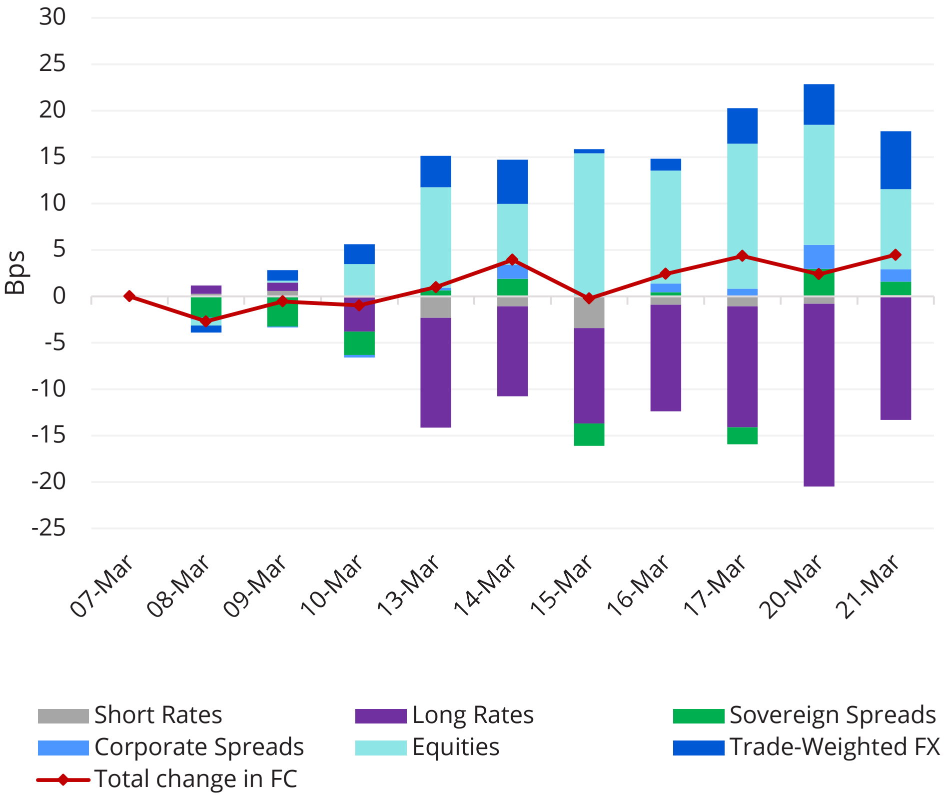
Inflation still building in services



Source: Macrobond, MGI Economics, 31 March 2023

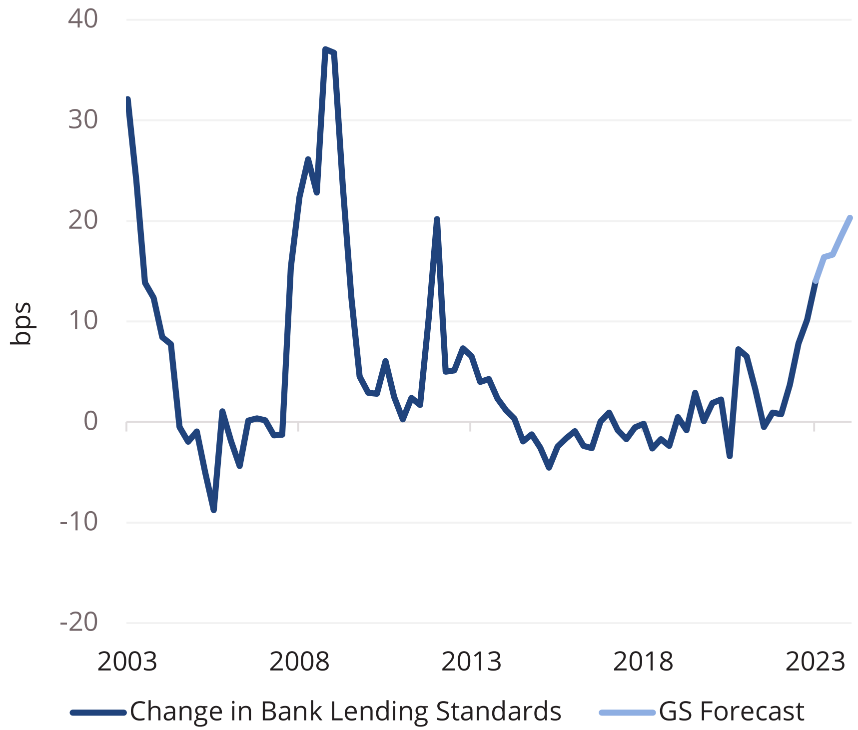
But be sensitive to credit conditions and lags of policy

Impact on financial conditions limited so far



**FC is Financial Conditions. Source: Goldman Sachs, 31 March 2023*

Rate hikes still working way through economy

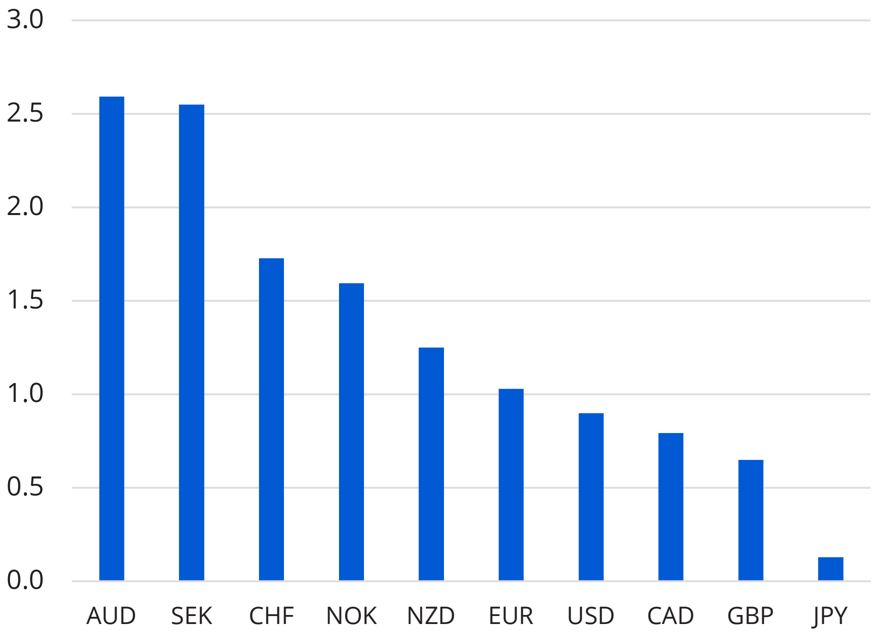


Source: Goldman Sachs, MGI Economics, 31 March 2023

Europe to play catch-up in hiking cycle

Fundamentals point to Europe being hawkish

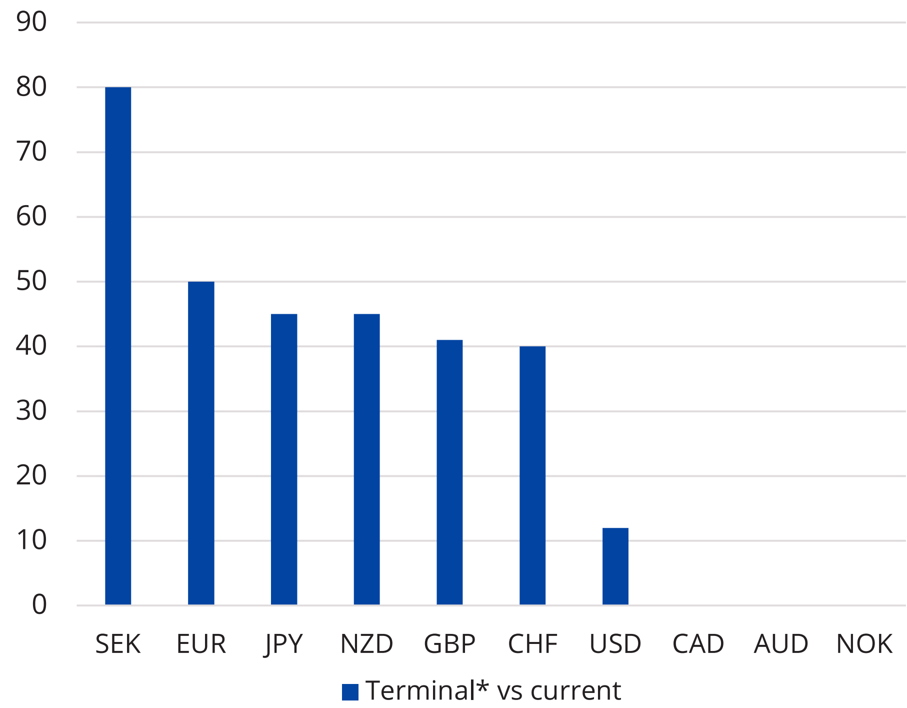
Taylor Rule implied policy rate less current policy rate, %



Source: Goldman Sachs Research, MGI Economics, 31 March 2022

Market expectations for terminal vs today

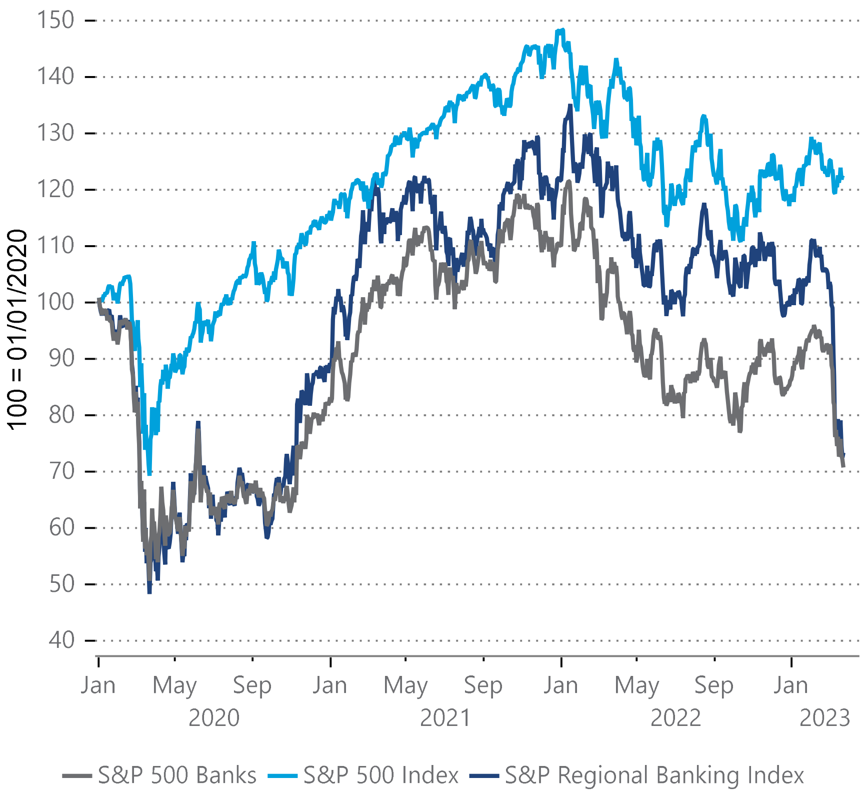
Policy rate, bps



Dashed line is trend line. Source: Macrobond, MGI Economics, 31 March 2022

Equities price lending stress but resilient growth

Equities price lending stress but resilient growth



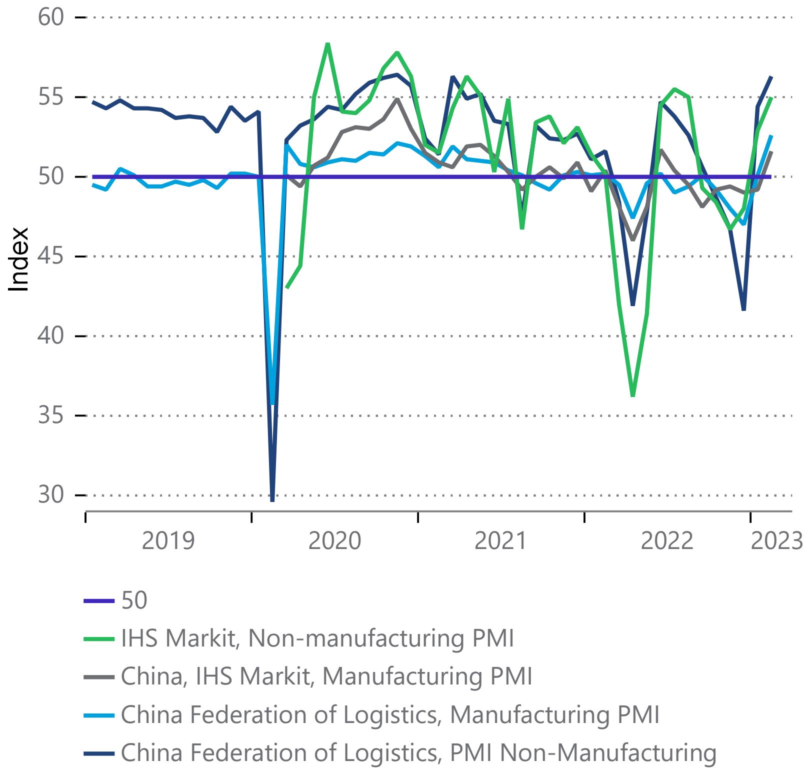
Source: Macrobond, MGI Economics, 23 March 2023

Longer term weaker growth poses earnings risks

Source: Macrobond, MGI Economics, 23 March 2023

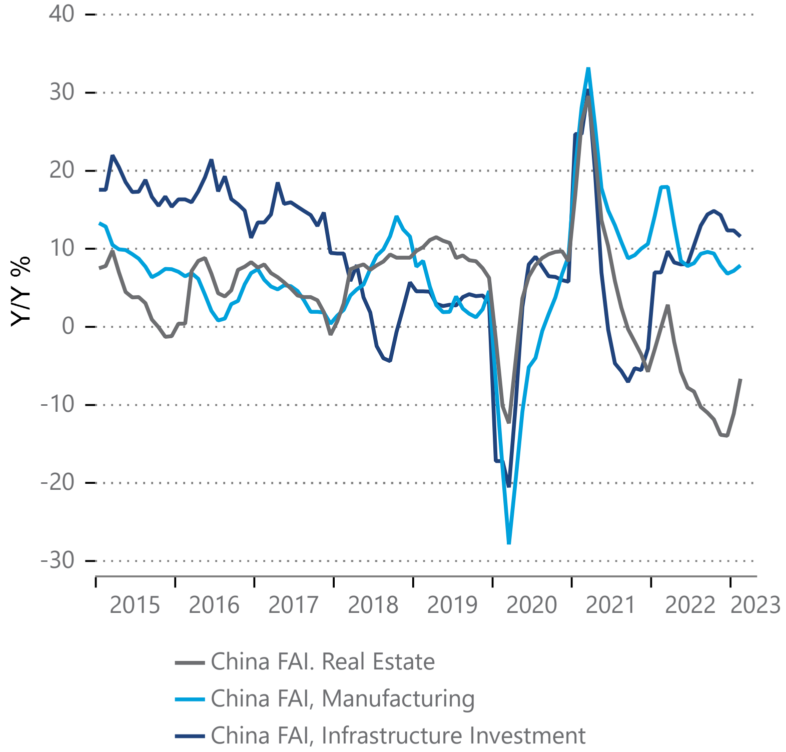
Reopening boosts domestic growth in China

PMIs point to strong rebound in Q1



Source: Macrobond, MGI Economics, 29 March 2023

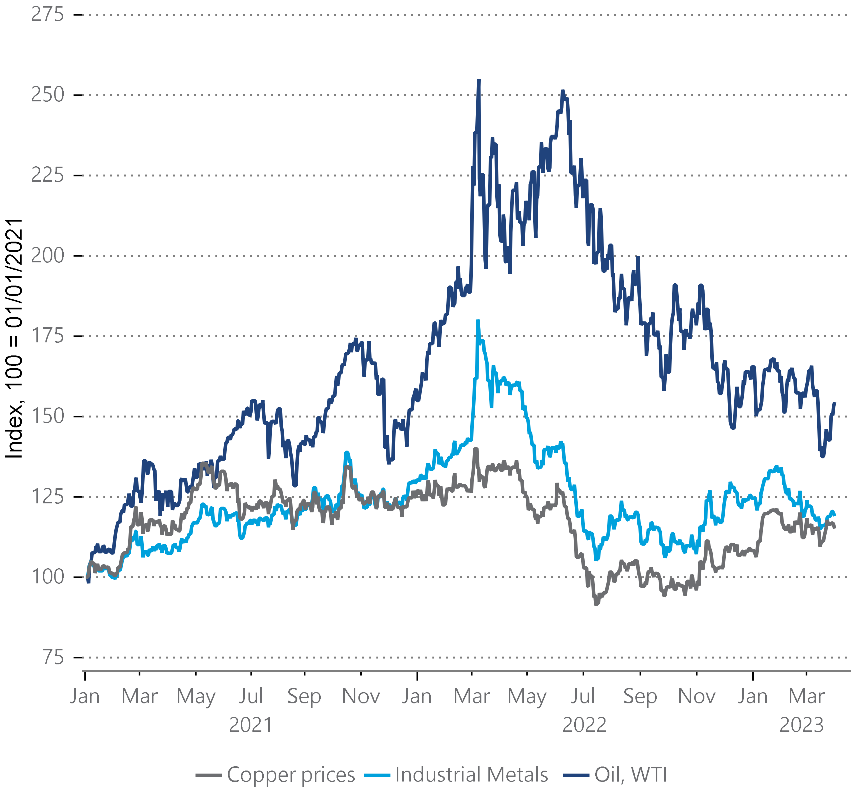
With less of a drag from real estate



Source: Macrobond, MGI Economics, 29 March 2023

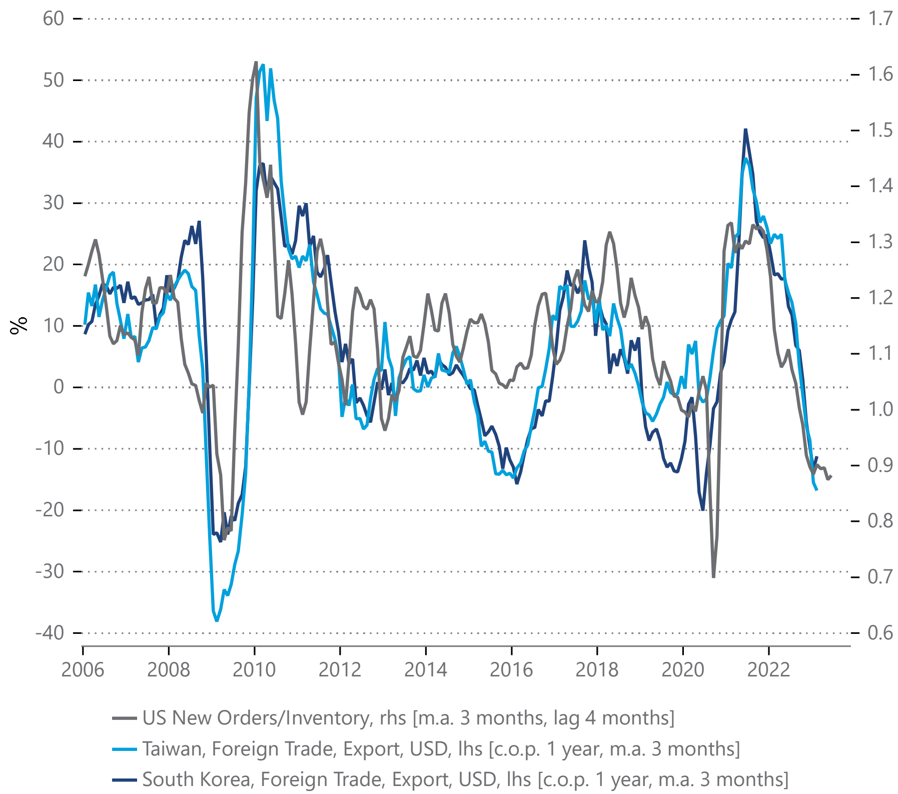
No global spillovers to commodities so far

Commodity prices well behaved



Source: Macrobond, MGI Economics, 29 March 2023

Global trade still weak



Source: Macrobond, MGI Economics, 29 March 2023

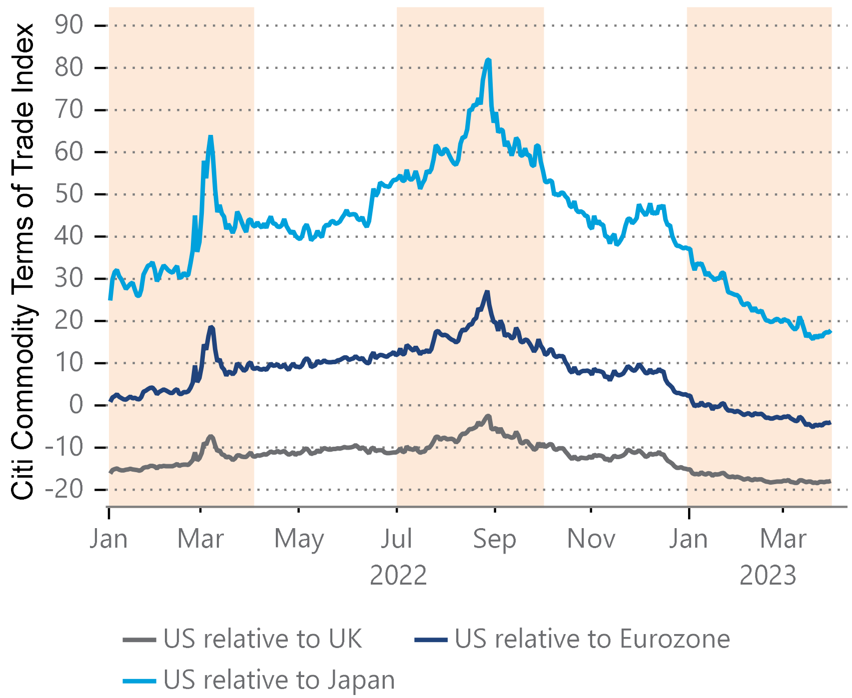
CURRENCY VIEWS

USD (-) US centric crisis accelerates US interest rate cycle

US vs ROW yield differentials

Shaded area is Q1 & Q3. Source: MGI Economics, Macrobond, 30 March 2023

Terms of trade shock recedes

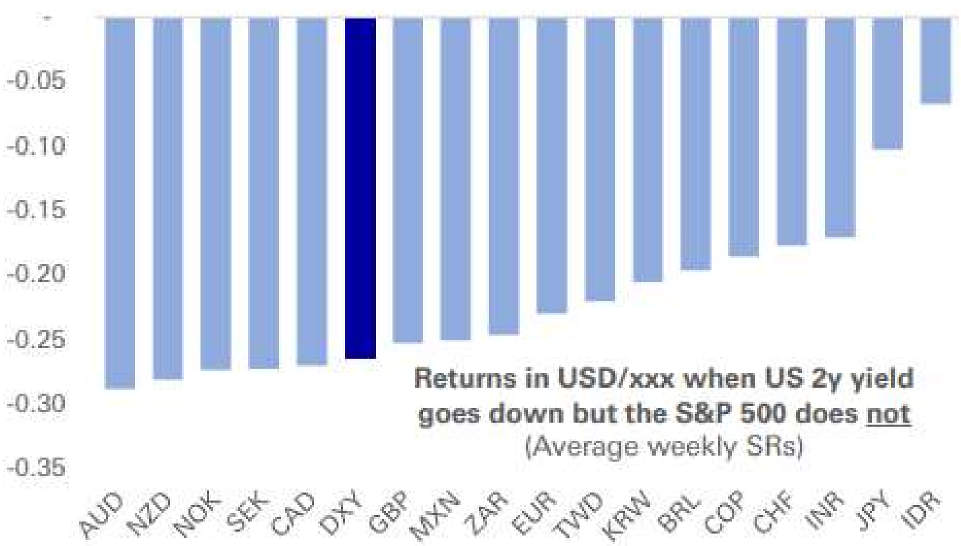


Shaded area is Q1 & Q3. Source: MGI Economics, Macrobond, 30 March 2023

Last quarter, we thought softer inflation would see a forward-looking Federal Reserve broadly navigate the end of its hiking cycle, while the European Central Bank played "catch-up" and the Bank of Japan geared up to an exit of yield curve control. Banking stress ultimately reinforces our view: we see credit tightening in the US accelerating the Fed tightening cycle by hurting growth and reminding the Fed there are lags to monetary policy. While it is too early to tell, the collapse of SVB may even result in a structural drag on US growth if regional bank model proves to be broken. This leaves our view of dollar weakness unchanged based on a view of interest rate convergence (US vs Europe and Japan), improved sentiment (inflation softening and China reopening) and a receding terms of trade shock, all in the context of significant overvaluation (see next page) .

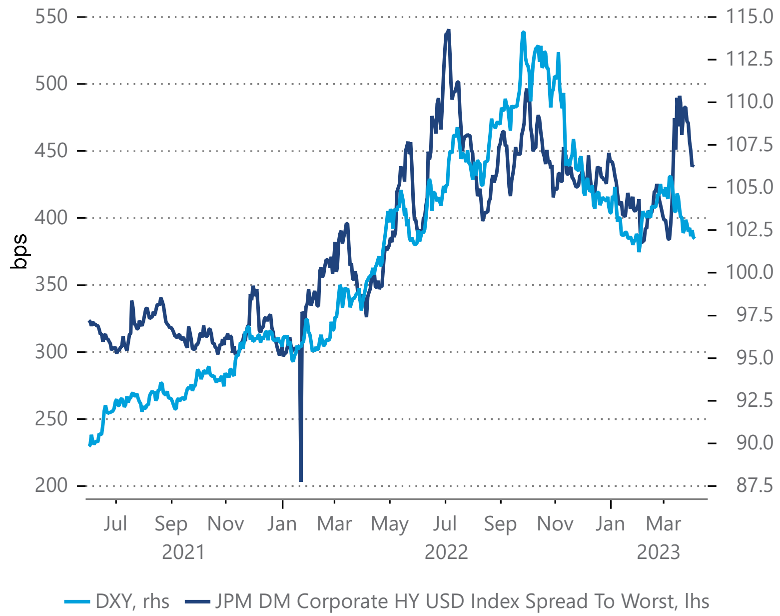
USD (-) Improving equity sentiment keeps dollar view broad

USD weakness is broad when yields are lower but equity is not



SR = Sharpe Ratio. Source: Deutsche Bank, 31/03/2023

DXY did not act as safe haven in March



Source: Macrobond, MGI Economics, JPMorgan, 31/03/2023

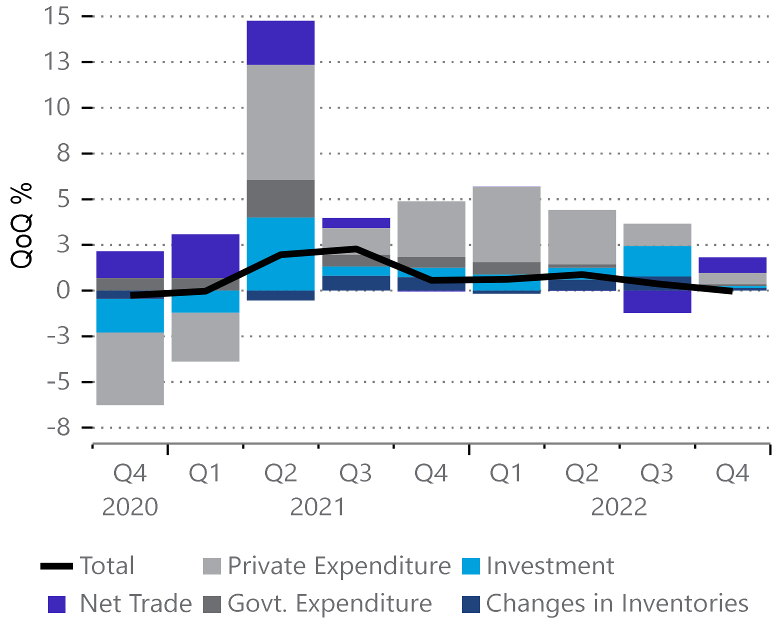
Our views do not express that US banking stress has eroded the dollars status as a safe haven, but reflect that the shock is a US centric one with limited spillovers to the rest of the world. Ultimately, low global systemic contagion risk via financial channels coupled with China reopening that helps boost global growth, should help avoid an environment where the dollar is bid from risk-aversion. Moreover, we see some “wiggle room” in our baseline scenario when comparing it to scenarios which provide a source of dollar strength. Uncertainty around credit tightening and the lags of monetary policy is unlikely to see the Federal Reserve raise interest rates meaningfully from here, while a US recession is likely to see the Fed cuts rates quicker than before the banking stress. Finally, our view that short term equity risk is likely to be boosted by China reopening and lower inflation is important as this tends to point to broad dollar weakness.

EUR (+) Financial stress not an impediment to rate hikes

Potential for European banks' stock to recover

Source: Bloomberg, MGI Economics, 04/04/23

Weak growth but no recession

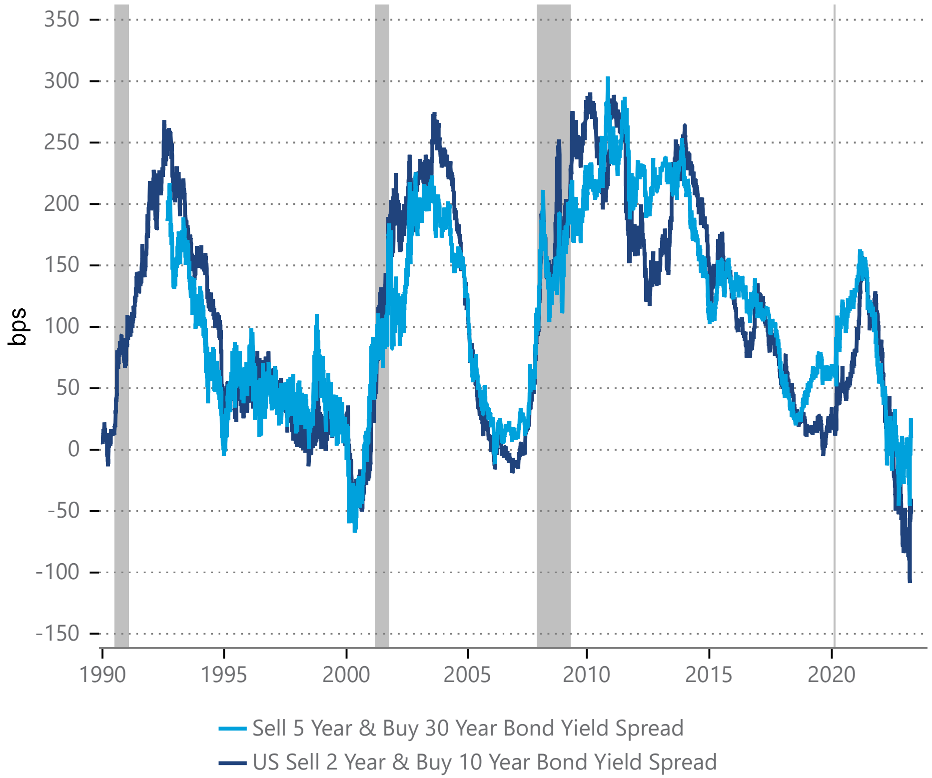


Source: Eurostat, Macrobond, MGI Economics, 31/03/2023

We think any fears of systemic risk to European banking should be faded, particularly after the takeover of Credit Suisse. Equity and credit markets in particular, point to room for a fading of pessimism. Meanwhile, still rising core inflation, a tight labour market and an improved growth outlook (from lower energy prices) should give the ECB room to remain hawkish. Warm weather and strong conservation efforts from Europe points to gas prices (while rising) proving somewhat contained. In the short term, this should broadly keep the current account on an improving trend. Additionally, fiscal policy should not be supportive this year and consolidation should be expected in the medium term, keeping BTP-Bunds spreads contained.

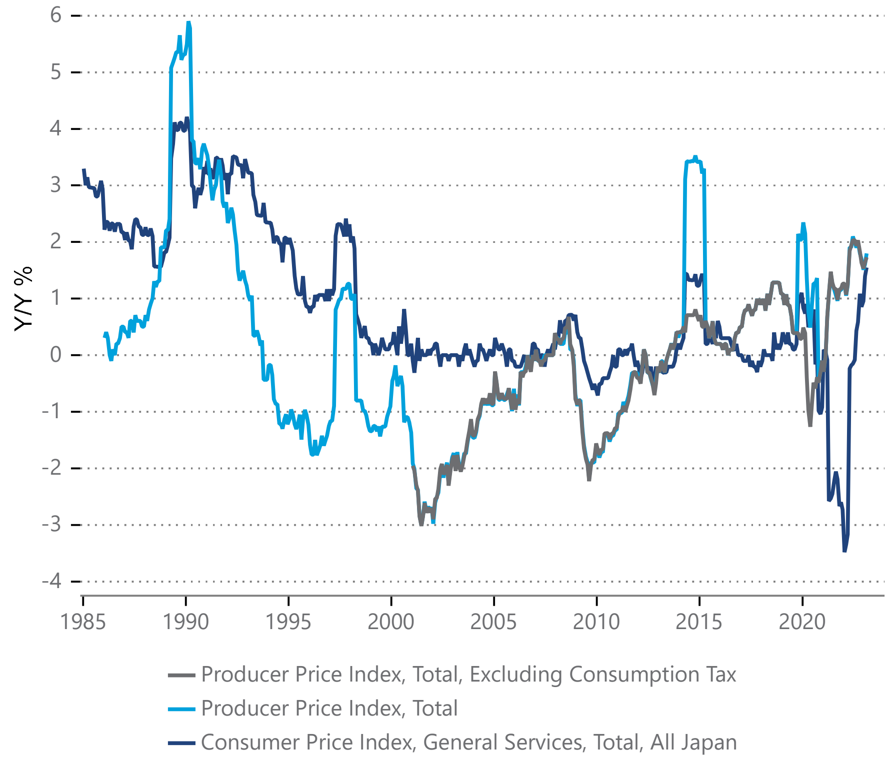
JPY (+) Good risk-reward as US economy reaches end of cycle

US curve has steepened



Source: MGI Economics, Macrobond, 29/03/2023

Inflation warrants an exit in yield curve control

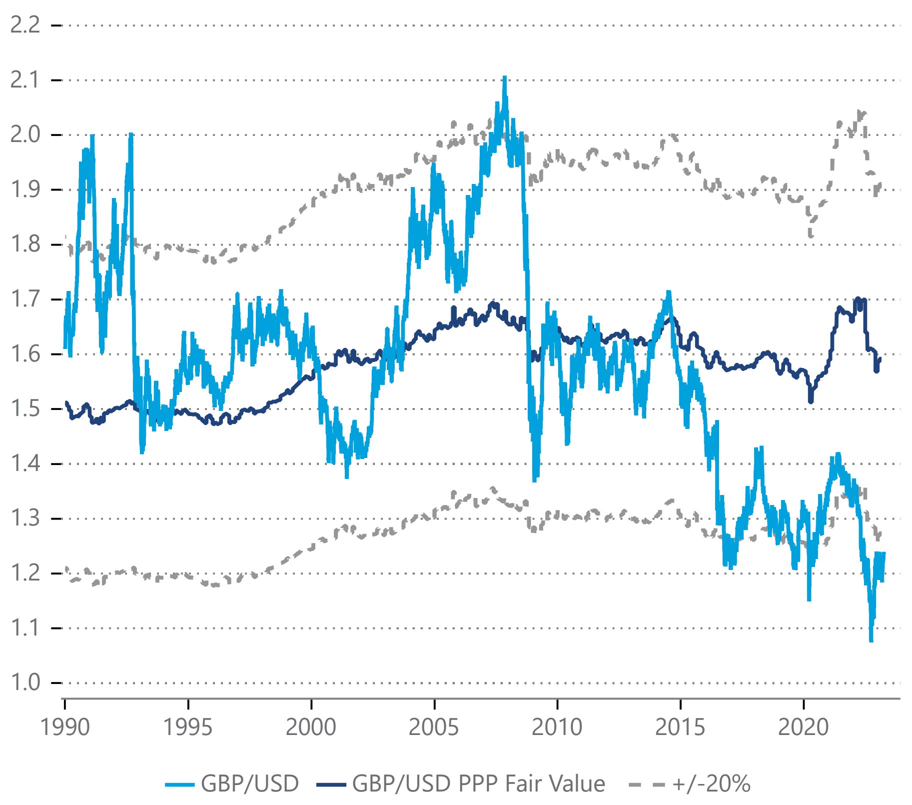


Source: MGI Economics, Macrobond, 29/03/2023

While a containment in banking stress is likely to see US 2-year yields moving higher, the yen should be resilient for two reasons. Firstly, this is likely to be accompanied by curve flattening (providing less upward pressure on US 10-year yields) and secondly, this is also likely to be the green light for an exit in yield curve control policy from the Bank of Japan. Inflation fundamentals combined with negative side effects of ultra-easy policy, warrant an exit in YCC, which we see in June. Meanwhile, the backdrop is one where lower energy prices is supporting an ongoing improvement in the current account. Net-net, the yen is still extremely undervalued (see appendix) and continues to provide good risk-reward as the US economy reaches the end of the economic cycle or the BoJ eyes a normalisation in policy.

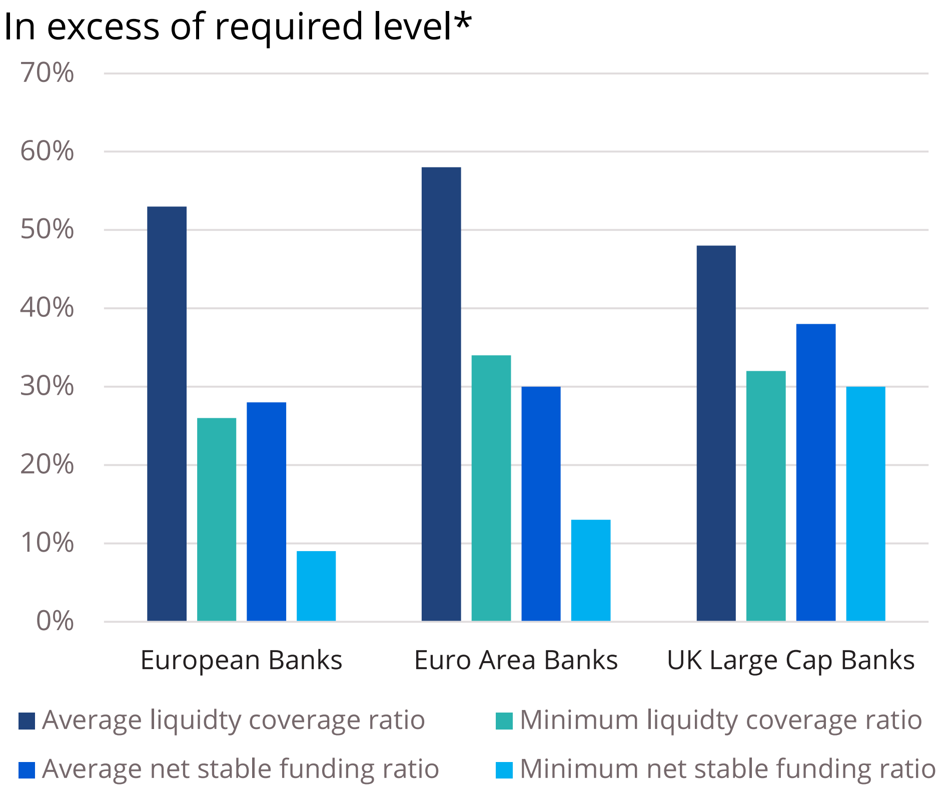
GBP (+) A pro-risk beneficiary of dollar weakness

Cable undervalued



Source: MGI Economics, Macrobond, 29/03/2023

Little systemic risk in UK banking system

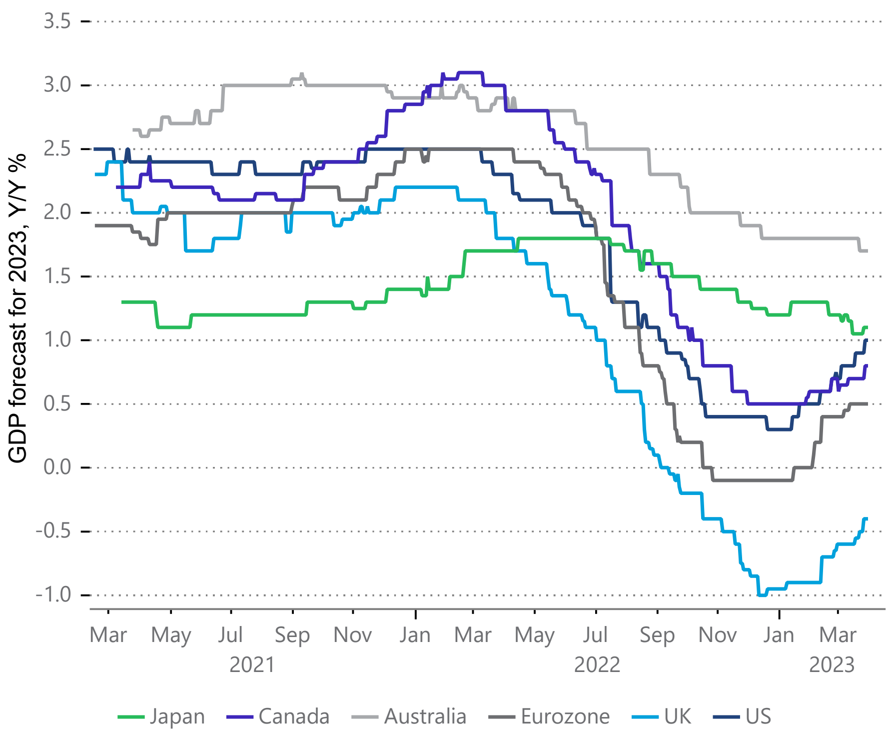


Source: MGI Economics, Macrobond, 29/03/2023

Taking a similar view to the euro, we see sterling as another beneficiary of dollar weakness. As a pro-cyclical and undervalued currency, sterling should be supported by an improvement in risk as banking fears are contained and global inflation slows. The UK banking sector itself is broadly resilient (well capitalised with strong liquidity and funding positions) and the rise in UK bank funding costs has so far been limited.

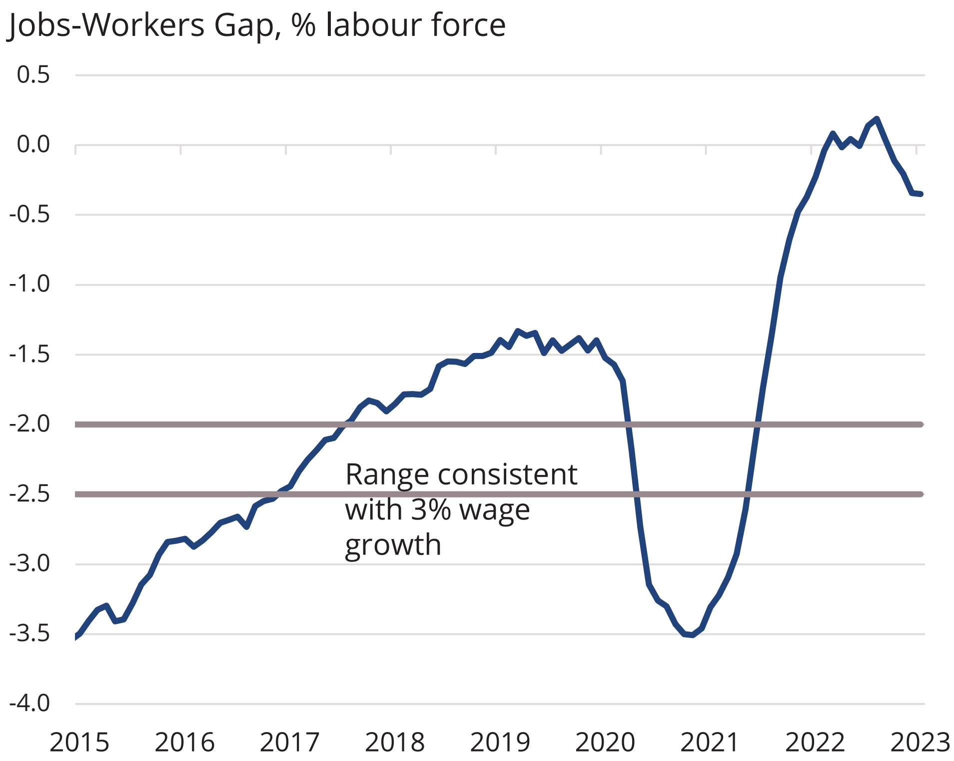
GBP (+) Growth outlook improves and rate support

Growth outlook continues to be revised up



Source: MGI Economics, Macrobond, 29/03/2023

Labour market still too tight

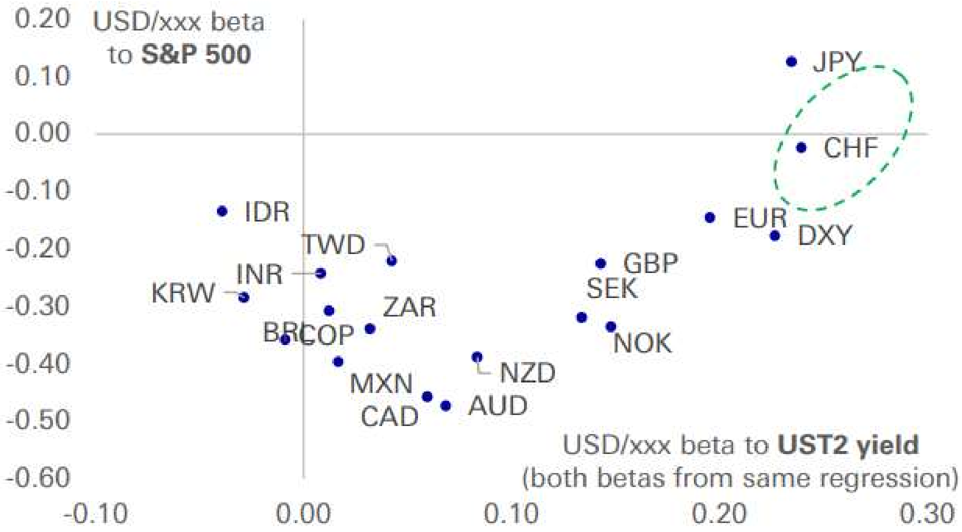


Source: MGI Economics, Macrobond, 29/03/2023

The fall in European natural gas prices improves the current account and the growth outlook. The growth outlook, which is also supported by further fiscal support, continues to be revised higher by both forecasters and the Bank of England. On monetary policy itself, while we remain slightly below consensus on the Bank of England's terminal rate, we do not expect disappointment in the short term. Ultimately, accelerating growth and sticky inflation in the context of a too-tight labour market tilts the balance of risks to one more hike in May from the central bank who retains a tightening bias.

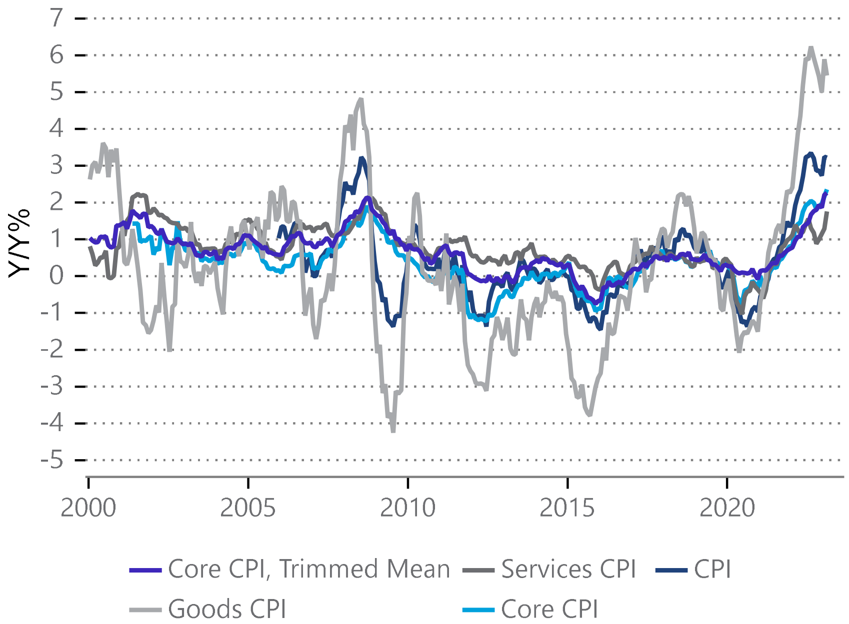
CHF (+) Risk agnostic duration exposure with SNB "help"

CHF is fairly risk agnostic when repricing US



Source: Deutsche Bank FX Research, 31/03/2023

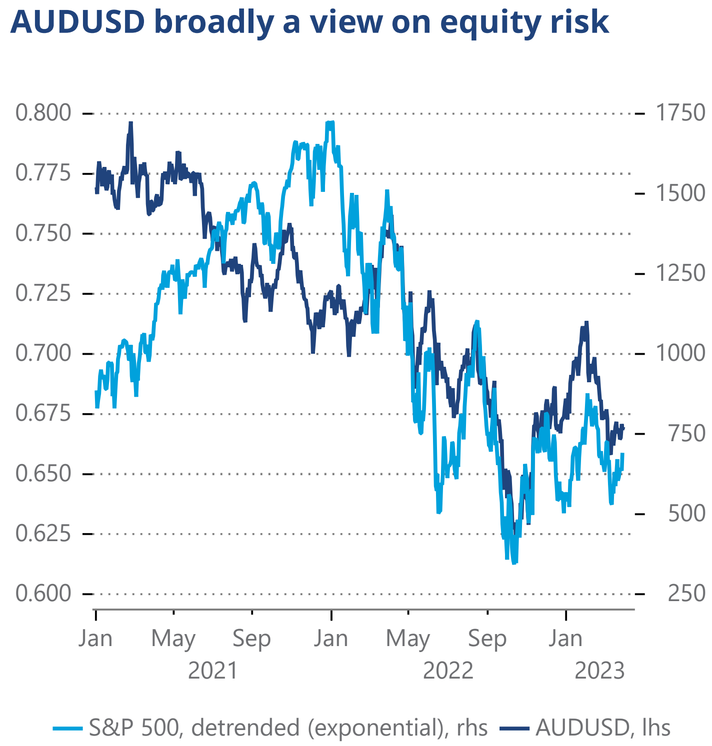
Inflation keeps SNB avoiding FX weakness



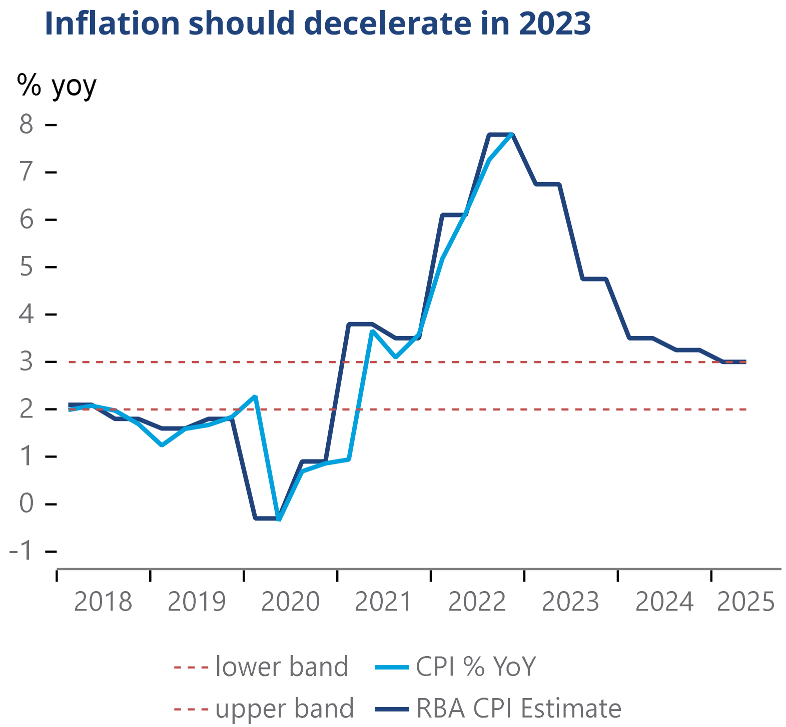
Source: MGI Economics, Macrobond, 31/03/2023

Our views on US interest rates clearly support exposure to currency pairs exposed to duration including the swiss franc. Importantly, the swiss franc is also fairly agnostic to why yields are going down or the broader risk backdrop (more than the yen). We like this characteristic, given we expect equity risk to do well short term (as US banking fears prove contained and US inflation softens), but are more cautious on longer term (given our expectation that US growth is likely to slow raising downside risk to earnings). Moreover, strong swiss inflation keeps the SNB not only hiking but also avoiding a weak currency. This helps keep the risk-reward asymmetric.

AUD (+) Equities supportive with hawkish risks to RBA



Source: Macrobond, MGI Economics, 30/03/023



Source: Macrobond, MGI Economics, 30/03/2023

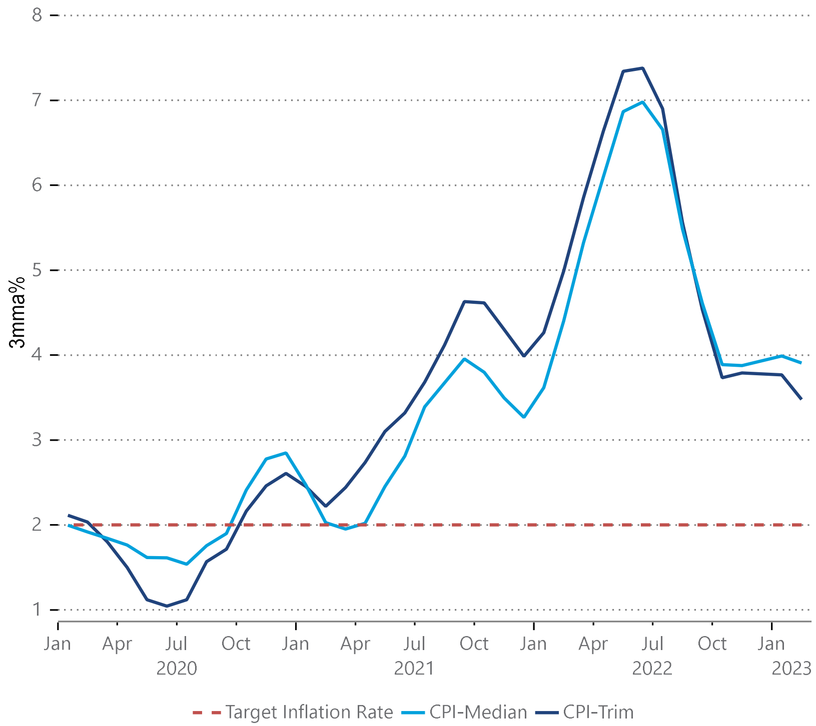
Correlations suggest that the Australian dollar remains a view on equity risk as well as yield differentials. In the near term, our top down views suggests equity risk should be supported by resilient US growth in the near term. In the medium term, we see risk of recession in the US weighing on equities. Meanwhile, domestic developments will likely push the RBA to pause its hiking cycle and assess the data. Inflation has probably peaked in Q4-2022 while growth has slowed as a result of the monetary tightening. Nevertheless, we have an hawkish bias to the RBA as upside risks to inflation remain both domestically and related to China reopening through tourism. Consequently, we overall have a positive view on the currency vs USD.

CAD (0) Little support as the Bank of Canada remains on hold

Commodities should not be supportive of CAD

Source: MGI Economics, Macrobond, Citigroup, 31/03/2023

While the BoC is on hold amid ongoing disinflation

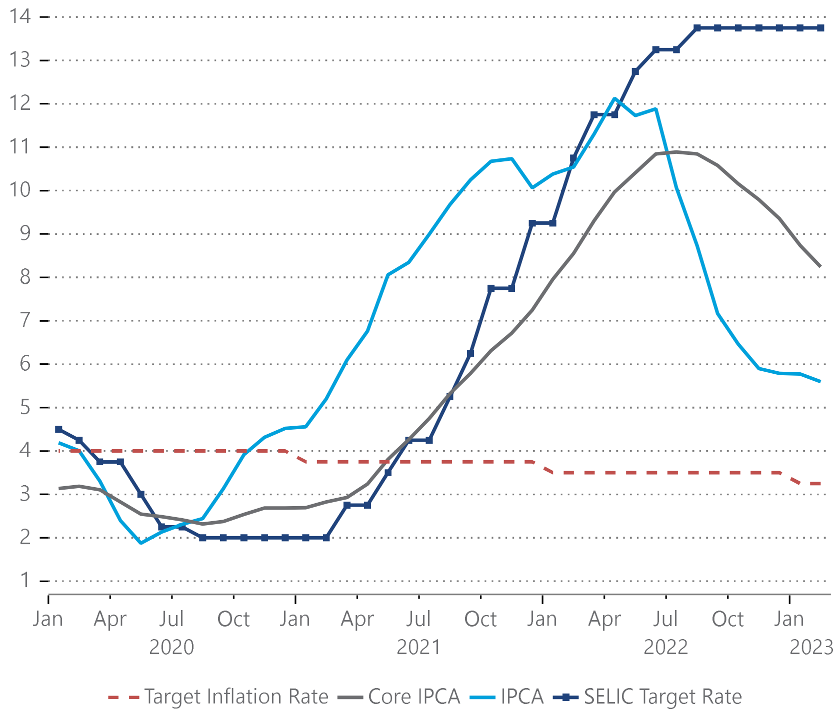


Source: Macrobond, MGI Economics, 31/03/2023

The contained level of commodity prices, which is the main driver of the Canadian dollar, should remain unsupportive of CAD. Additionally, the Canadian economy should slowdown further as the tightening of monetary policy has now started to take effect. The Bank of Canada (BoC) announced a conditional pause in January, as inflation has clearly peaked. While core measures remain above the BoC mid-target for inflation, disinflation is ongoing. Additionally, spillovers from a slowing US economic cycle could weigh further on the Canadian economy. Consequently and in line with market pricing, we see the BoC on hold this quarter as data should come in line with their projections. Overall, we see no domestic nor global support for the currency which leaves us neutral CAD in the short-term.

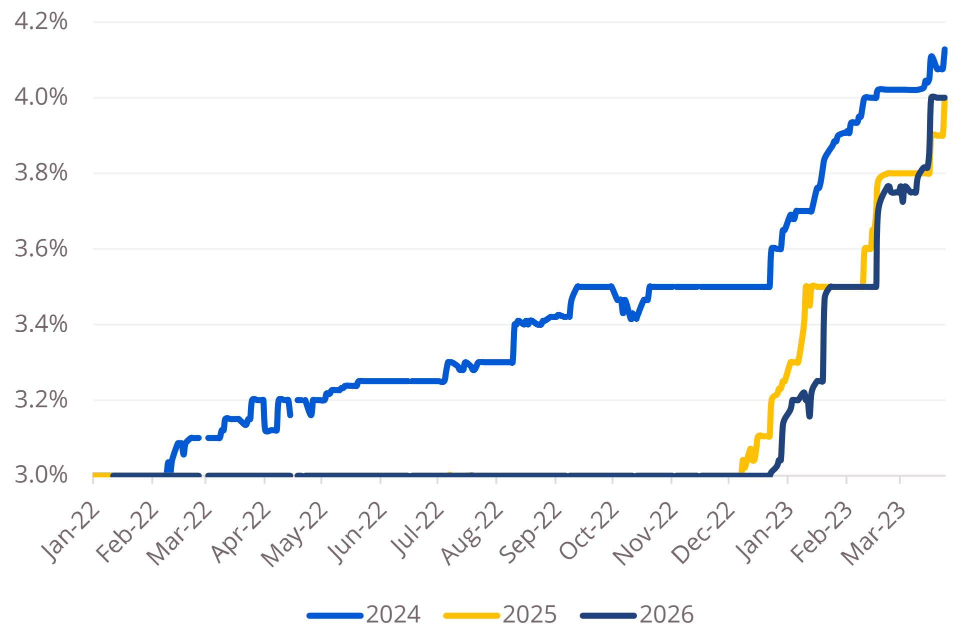
BRL (+) BCB to remain hawkish despite disinflation

Ongoing disinflation amid restrictive policy



Source: BCB, Macrobond, MGI Economics, 31/03/2023

But fiscal uncertainty weighs on outlook

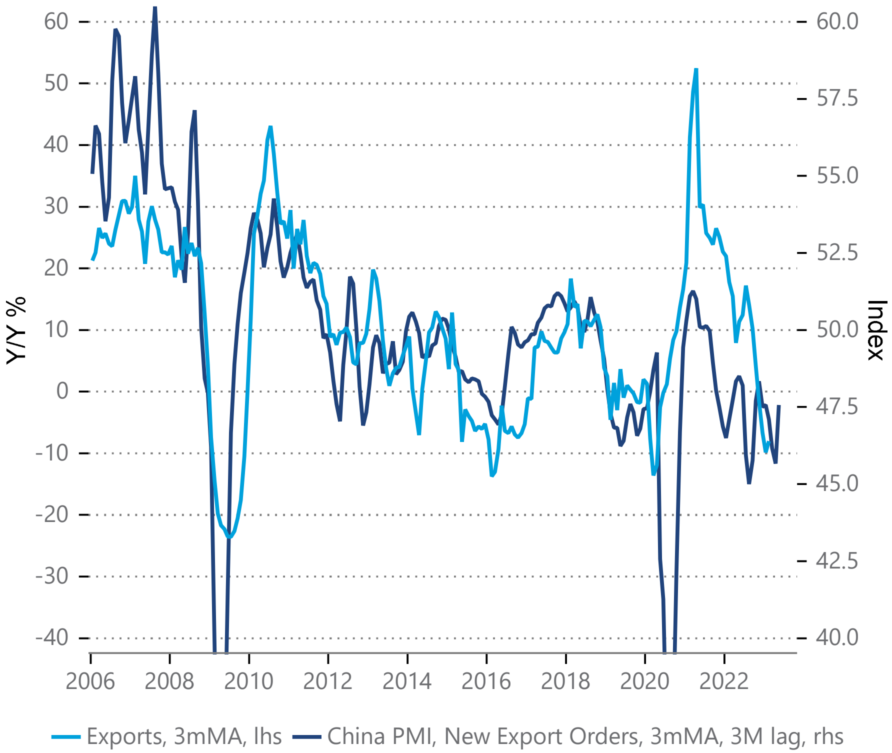


Source: Focus Survey, MGI Economics, 31/03/2023

A combination of restrictive monetary policy and a fall in commodity prices has driven the disinflation process. Additionally, the economy has contracted in Q4-2022 and is expected to remain weak. Despite these developments, inflation expectations have overshot recently, responding to the fiscal turmoil and adding pressures on the BCB to keep rates unchanged. Fiscal uncertainty has soothed but subsists until the New fiscal Framework is released. We expect the BCB to remain focused on still elevated core inflation and unanchored inflation expectations and keep the Selic rate unchanged. We take a positive view on BRL versus USD amid ongoing high carry and less fiscal turmoil.

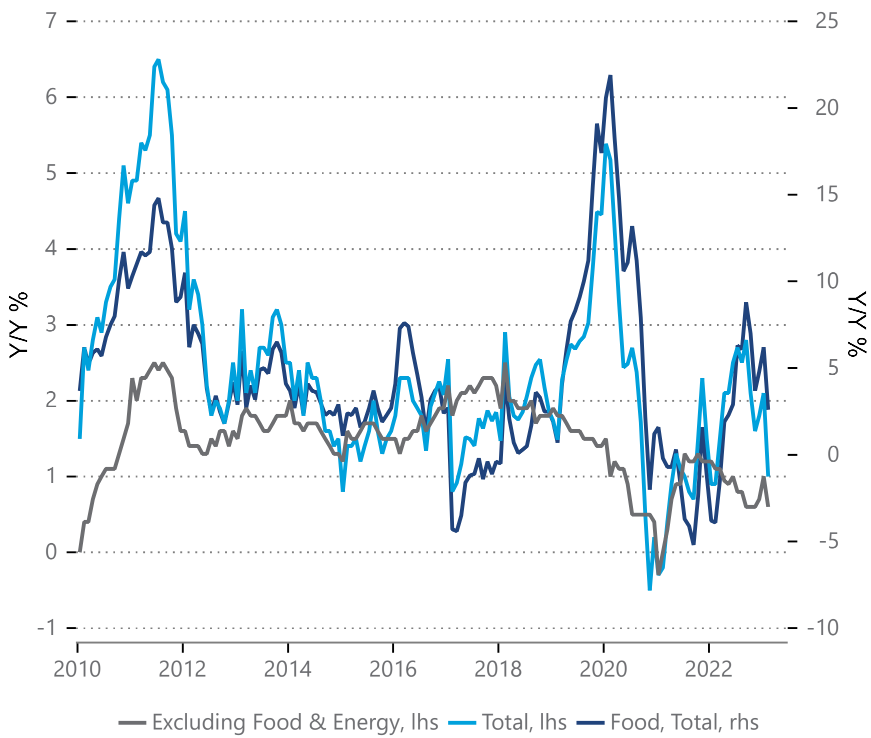
CNH (0): Difficult to translate growth boost into currency gains

Weak exports to weigh on current account



Source: MGI Economics, Macrobond, 29/03/2023

Inflation provides high hurdle for tightening



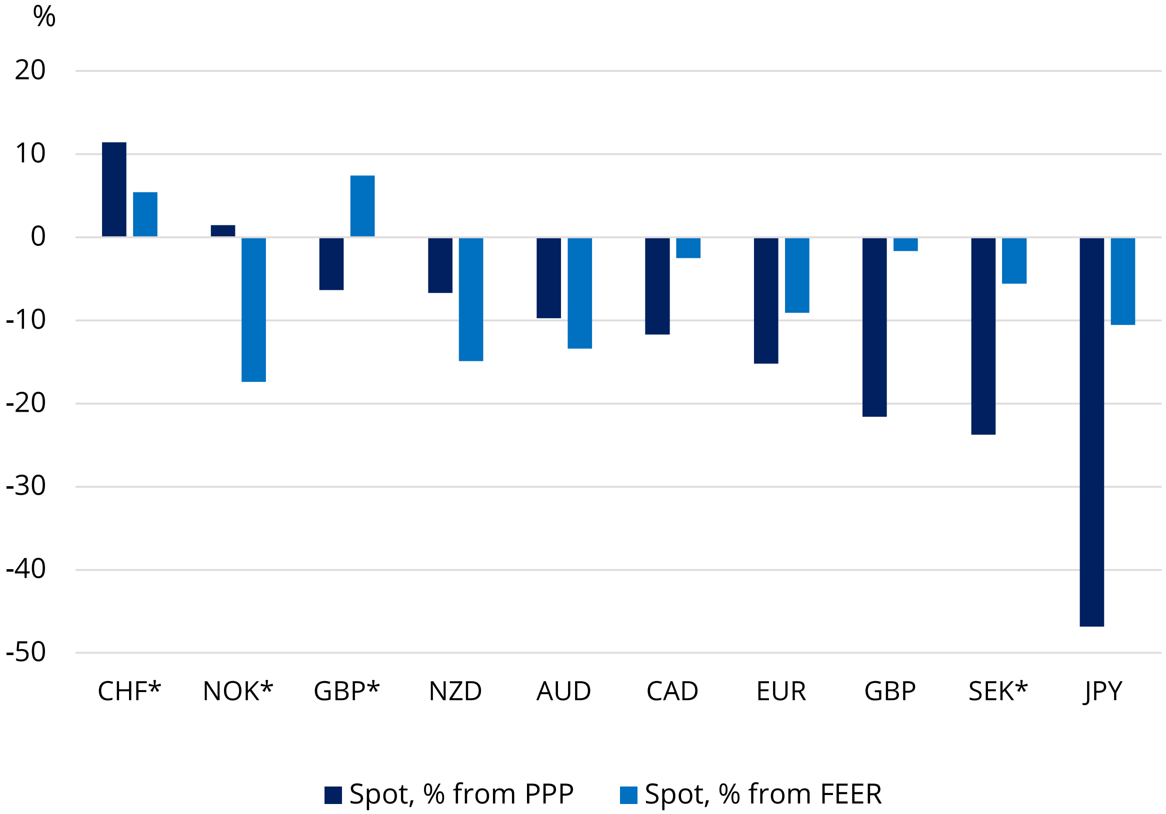
Source: MGI Economics, Macrobond, 29/03/2023

The domestic nature of the Chinese rebound in some ways provides a necessary condition for the currency to do well via a weaker dollar axis. Namely, the lack of spillovers to commodity prices (all else equal) provides a more benign environment for US inflation, and the reopening boost helps reduce the probability of a global recession. However there is little on the domestic side to help the currency itself. Weaker export growth in China should erode the current account and a still weak property sector combined with slack in the labour market is likely to leave the PBOC with a high hurdle for the policy tightening needed for significant rate convergence. Given Chinese Government Bonds (CGBs) still have lower yields than US Treasuries – in other words, the FX trade has negative carry – we stay neutral on the renminbi.


FX VALUATION
MEASURES
MILLENNIUM GLOBAL
INVESTMENTS

Valuation opportunity in G3

G10 Valuation measures



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.

**is vs EUR. Otherwise vs. USD. Source: Macrobond, MGI Economics (PPP), GS Research. Data as of 03/04/2023*

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