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iFlow

MACRO MORNING BRIEFING

August 30, 2024

Soft-Landings and MXN/JPY

- **The ongoing risk for unwinding of carry trades extends through September**
- **Fed cuts will help investors reengage with emerging markets but will conflict with some holdings**
- **USD weakness remains more a hope than a reality**

Forecasts for September have been significantly affected by the volatility of August. The flip-flop of risk that started with the July 31 Bank of Japan hike and continued to August 5th with the largest one-day drop in shares globally since the Pandemic. The August 2nd release of US unemployment was also a trigger driving down US rates and pushing some analysts to call for an emergency rate cut. As we close out August, the unwind of some positioning stands out more than the actual price shifts. The September 6 unemployment report now seems more important than any other event this year, matching the November 5th election. The 1-week risk for FX shows this spike of fear clearly with JPY vol trading over 13.5%. EUR vol is less worrisome at 7.5%. We see European shares at record highs and our flows confirm that bias with another rate cut from the ECB fully priced for the month ahead. The moves in FX stand out with JPY up 3.1% on the month and MXN down 6.7% and that merits some further discussion of the carry trade and unwind risks ongoing while the VIX in the S&P500 is more sanguine below 15.5% and the short-term US rate market is evenly balanced between 25 or 50bps for September Fed Funds. The correlation to risk parity and carry holds and worryingly, carry has fallen back from its mid-month extremes. This shows that MXN/JPY and flows in August set up markets for more volatility across markets in September.

- **EM markets are seeing inflows** as the shift in Fed expectations dominants. Traditionally, investors put money into emerging markets when the Fed starts easing.
- **The role of emerging market debt over equity is interesting** to observe in the context of this expected money shift. The Fed easing in 1994 and 1998 is different than in other times – "soft-landings" matter and recessions are not all the same either.
- **The rise of local currency vs. hard currency debt is something to watch**, given the current flows into APAC and LatAm over the summer, have we reached a limit for local currency issuance.
- **The essential question that investors will be asking next week revolves around hard and soft- landing risks** in the US and the world.

The history of what happens to markets after the first rate cut one year later is a good place to start to understand what matters in the weeks ahead. The role of emerging markets in a portfolio and whether their equities or bonds with or without FX exposure will drive much of the month-ahead decision making for international investors.

Exhibit #1: What to do after a Fed cut rests on recession or softish landings

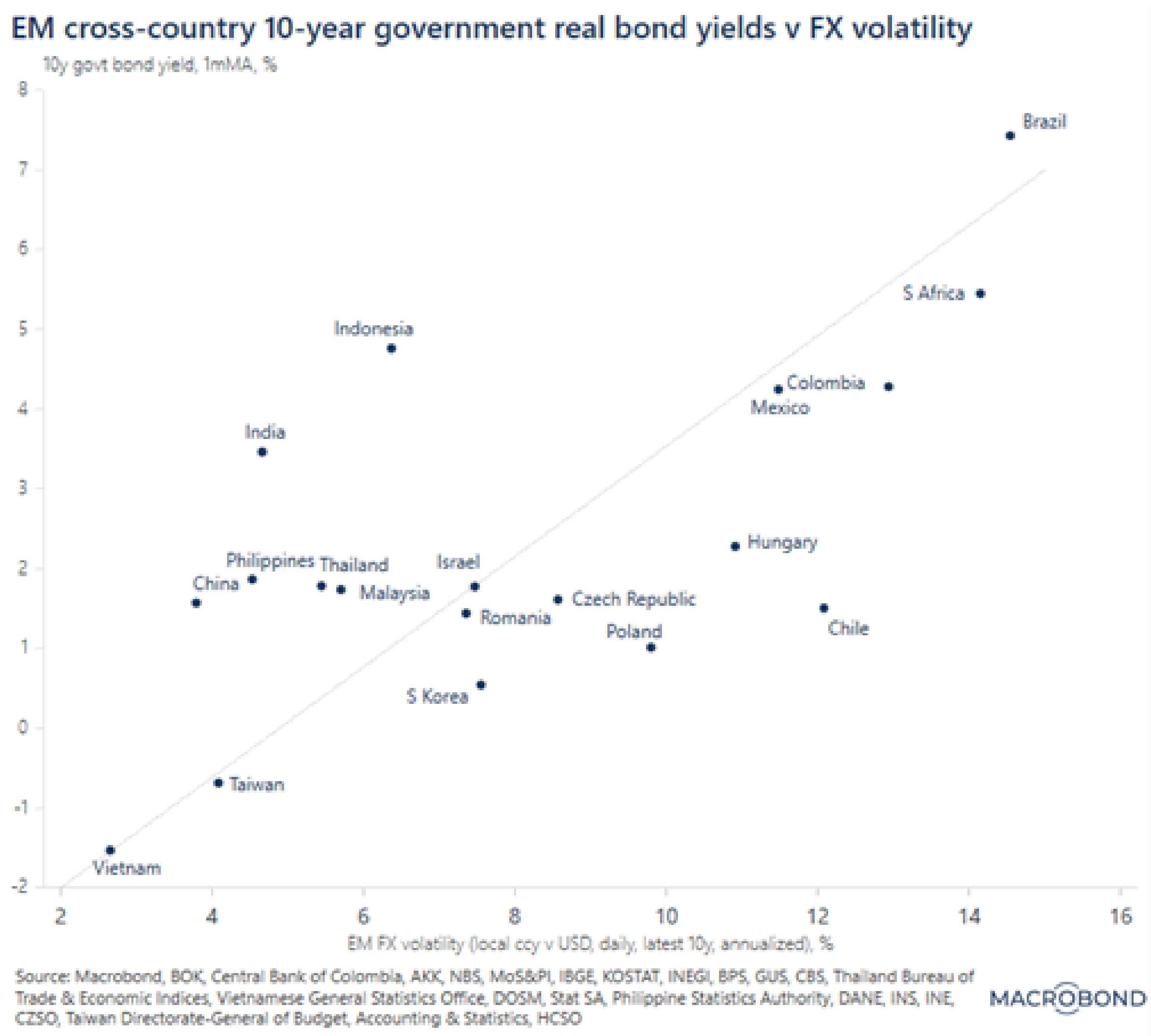
	FED CUTS and Asset Classes after 12 months				
	Jul-95	Sep-98	Jan-01	Sep-07	Jul-19
EMBI	31.78	29.27	1.42	5.37	2.96
Global HY	17.88	13.51	2.26	0.25	-1.97
US Bonds	5.02	0.8	8.44	5.86	8.74
Global Bonds	4.15	1.9	1.57	7.66	4.22
MSCI EM	-3.3	53.4	-15.5	-38.2	4.05
S&P600	12.38	20.97	-21.06	-31.54	20.74
MSCI AWCI	6.01	22.43	-27.44	-39.73	13.45

Source: Bloomberg, BNY

EM Debt nearly tripled in size since 2010 – from $10trn to $26trn in 2024 1Q. EM local currency debt has experienced the fastest rate of growth due to a shift away from external to local currency-denominated issuance. As a result, countries are less vulnerable than in the past to a depreciation in their exchange rates. While much of the growth in EM local sovereigns has been driven by China, the number of countries in the index has also increased to 20 from 12 since its inception. Following China's inclusion in the JPM GBI-EM Global Diversified Index in February 2020, India was included in the index from June 2024 with a final weight of 10% in April 2025. Given India's lower correlation to global bonds, the country's inclusion added diversification to the index and to broader fixed income portfolios.

In the last month, our iFlow data shows a resurgence in interest in EM bonds with focus on APAC region. Some of this reflects the balancing of FX volatility against real yields. The selling in Chile and Mexico bonds contrasts with the buying of Indonesia and India and tracks the regression line of the efficient frontier.

Exhibit #2: Real yields and volatility drive flows in August



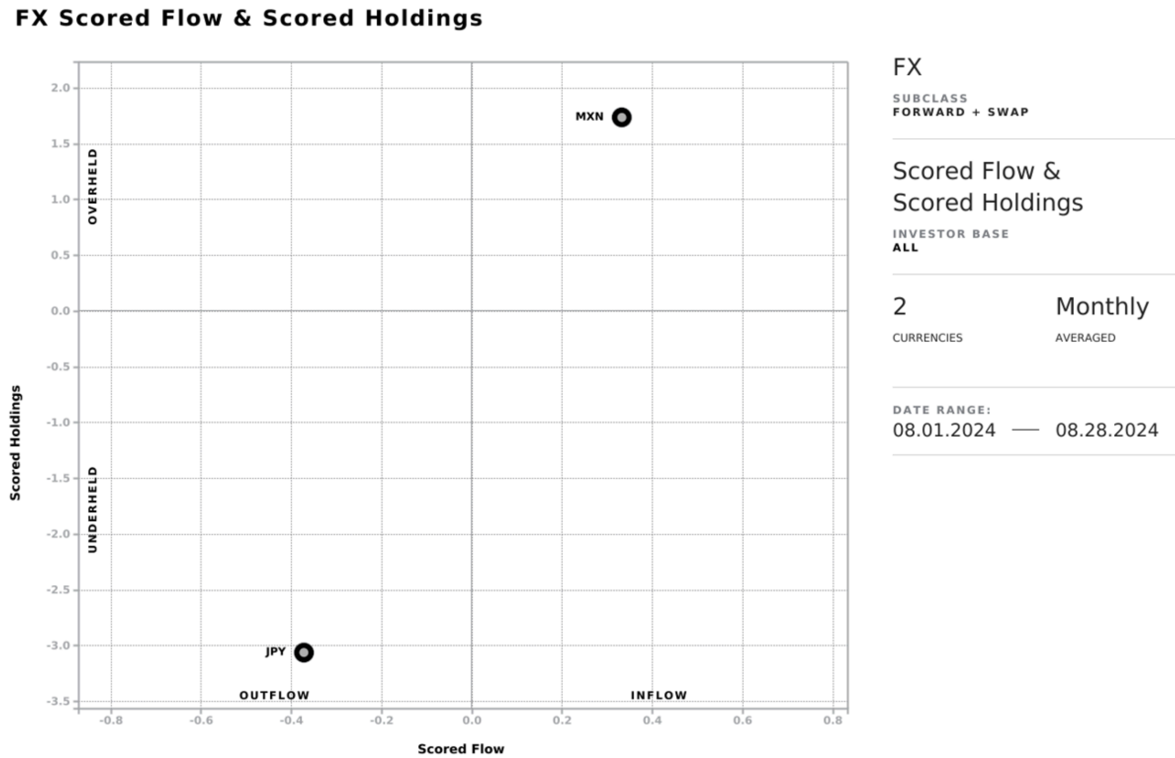
Source: Macrobond, BNY

Doing a deeper dive on Mexico and Japan flows in August reveals equity buying, bond selling against MXN and JPY selling. First is the Mexico fiscal outlook and the role of the current government fears linked to judicial reform on the market.

- As of June 2024, Mexico's national government debt was $918.3 billion. In 2022, Mexico's government debt to GDP was 49.4%, which is better than the Latin American average of 56%.
- This month Mexico sold ¥152.2 billion ($1.05 billion) of notes in five tranches, with the three-year part of the deal accounting for almost two thirds of the total size with the rest extending out from 5-7-10-20 years.
- Spreads on yen credit have inched higher in recent weeks, as market volatility climbed amid uncertainty about whether the Bank of Japan will raise interest rates again after doing so twice this year. We currently see the BOJ hiking again in October after the FOMC easing. The Mexican government paid a spread of 95 basis points on the three-year note. By comparison, Indonesia, which has similar BBB level debt ratings as Mexico, paid a yield premium of 50 basis points when it undertook a Samurai bond deal in May.

Mexico has issued Samurai notes every two years, Bloomberg-compiled data show. Yields on its 2042 bonds - the longest maturity outstanding - have climbed to about 3.57% from around 2.5% when they were sold two years ago. When you look at the FX flows in in 2024 you can see that our flows have tracked the price well since the election shock in Mexico.

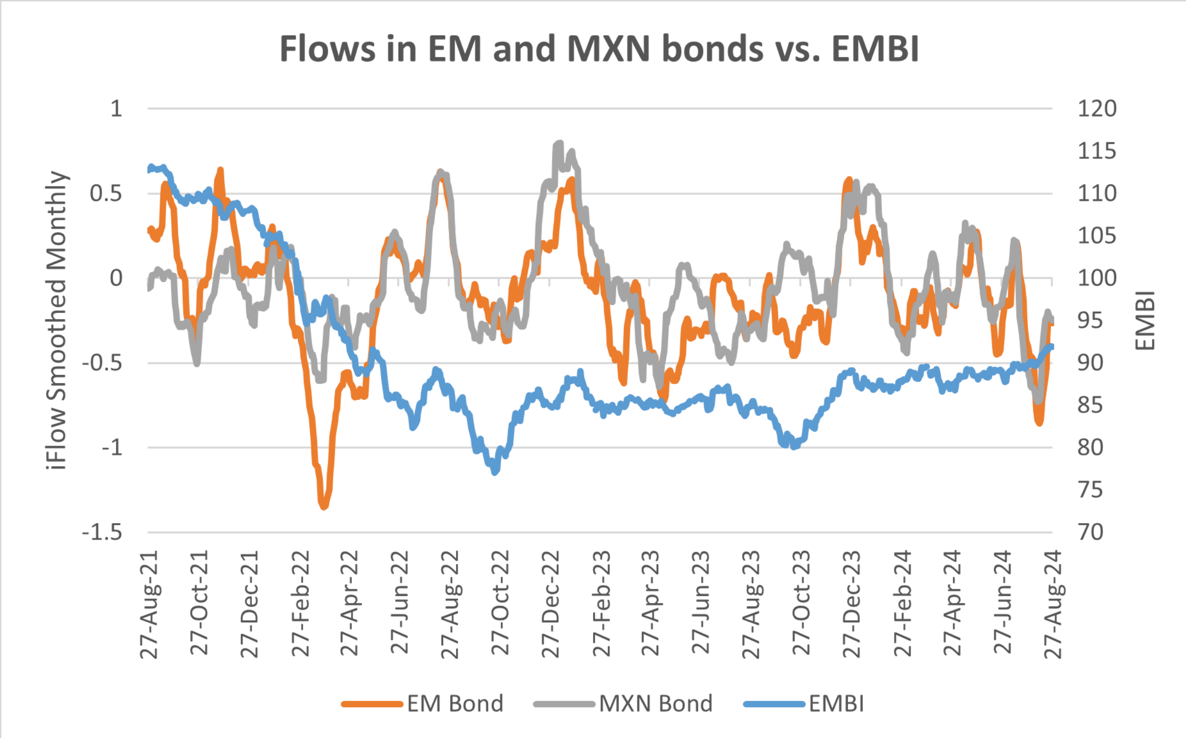
Exhibit #3: August MXN selling, JPY buying doesn't unwind holdings

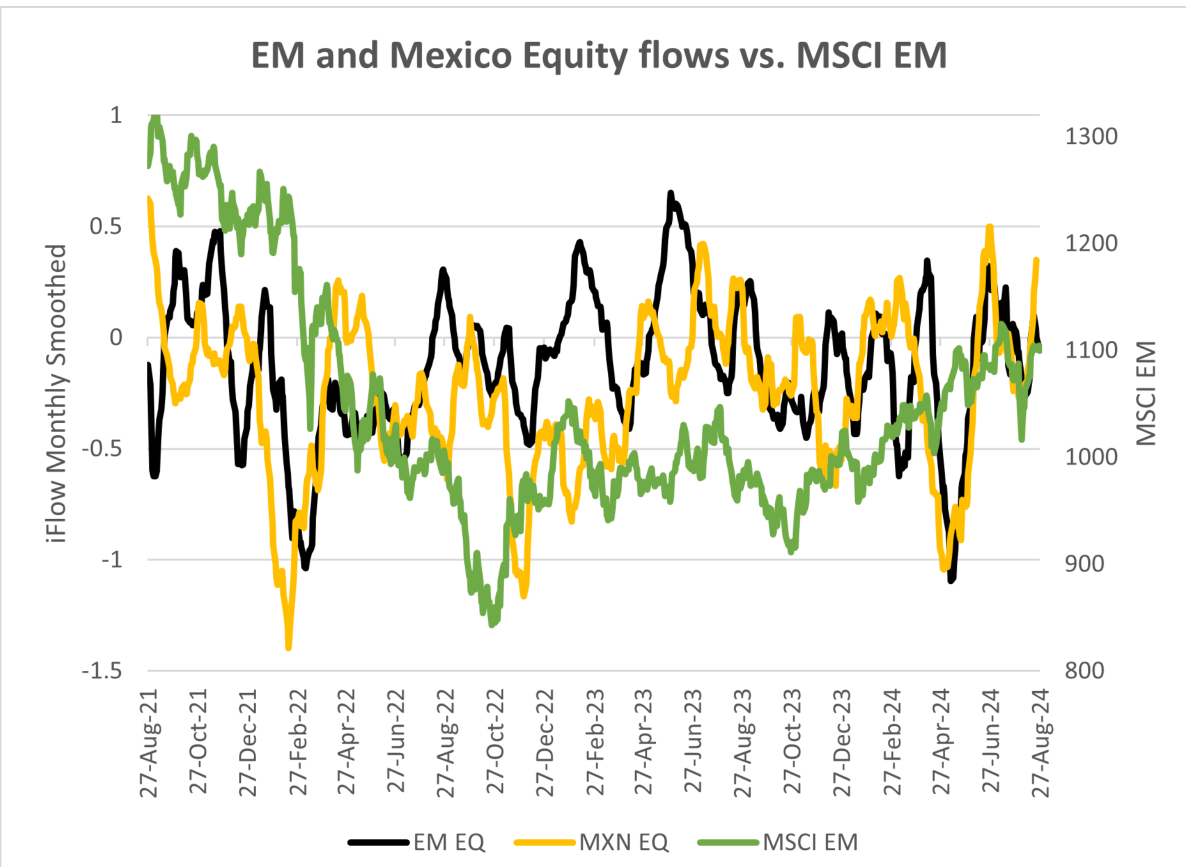


Source iFlow, BNY

What is notable about the Mexico flows in August in Bonds and Stocks is how much they correlated to the rest of the EM world. In 2024, we have seen Mexico match and lead much of the flows into and out of stocks and bonds. The liquidity offered by the MXN as a hedge against all emerging markets has been one factor to consider in this connection, while the role of high real rates stands out as the other. The credit spread of Mexico to other sovereigns is last factor to consider with the entire region paying a premium for fiscal dominance worries. Should the world see a US hard-landing, expect such concerns to rise faster.

Exhibit #4: Mexico and broader EM flows in stocks and bonds





Source: iFlow, Bloomberg, BNY Mellon

Bottom Line :

Mexico remains at a crossroads in September as the economic slowdown and the link of Mexico to the US economy drives some doubt about the sustainability of carry covering the other risks wrapped around politics. The US election and the super-majority push of the new Sheinbaum government in Mexico are chilling some flows into the Autumn. The JPY and risk of 140 will track the US rate cut expectations vs. the FOMC guidance in September and how that plays out against global financial conditions. August saw a global easing of financial markets despite the bad start with the Nikkei and JGBs. The recovery in EM assets is something that could continue into September but requires a perfect set up for the US soft-landing.

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNY.com

Bob Savage
HEAD OF MARKETS STRATEGY AND INSIGHTS

CONTACT BOB

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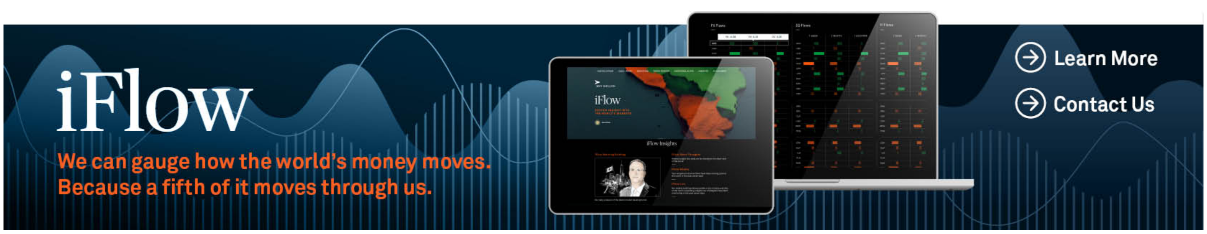

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