

Electing Goldilocks

“Your focus determines your reality.” – Qui-Gon Jinn, Star Wars, The Phantom Menace

- **Markets appear to have elected for Goldilocks interpretations of fraught French politics**, mixed *US jobs* and perhaps even *lingering China headwinds*.
- **Broad-spectrum “risk on”** prognosis has been squares with a **softer USD** (EUR ascendancy) amid **buoyant global equities** (ex-China).
- Arguably, CNY traction (below 7.30), despite softer China/HK equities, support Asia FX.
- But *focusing on relief* does **merely distracts from, but does not defuse, underlying risks**.
- **French Election: Averting the worst of French political risks** of *precipitously swinging far right or left* is the **low bar for relief**. But *wider French spreads* and *consequent EUR dent* is **par for a bumpier course ahead**.
- **US jobs: Unemployment nudged up** to 4.1% amid **softer wage gains** augmented by resilient jobs gains have **fired up bets** (>70% from ~50% end-June) of **“Goldilocks cut”** at the September FOMC.
- **Fed Chair Powell Testimony:** Powell’s testimony to the Congress this week, will support conditions for a **September (but not July) cut**, alluding to *encouraging but insufficient evidence of requisite disinflation*.
- **China Stimulus Hopes:** Evidence of bumpy industrial recovery and chronic confidence deficit, **hopes of bigger bang stimulus is growing but far from guaranteed**.
- **RBI’s Inflated Flexibility:** **Soft, sub-5% inflation** for India encourages, but does not emancipate. Not from the tyranny of underlying

volatility. This underpins latent rupee risks and inflates the RBI’s scope to ease.

- **EM Asia’s Hold ... Not Calm:** The **BoK and BNM are set to stay on hold** amid a “higher for longer” Fed. But this is *no guarantee of “Goldilocks” calm*; given stretched USD respite, the likelihood of EZ political bumps ahead and China risks looming large.
- **FX: No Room for Complacency:** Accordingly, **Asia FX may struggle to extend recent gains** (vs. USD). More likely are prone to profit-taking as **risk is liable to be re-priced**.
- **Rates: Watching Risk Premium:** **Despite softer UST yields, downside in EM Asia rates are far more constrained** as *risk premium* (both term and credit) are **re-priced**. This is **also reflected in underlying FX pressures**.

French Elections: What’s Left is Not Right

“Named must be your fear before banish it you can” – Yoda, Star Wars, Revenge of the Sith

- **A Goldilocks must be French. Unfazed by (French) elections shocks**, *first from the Right* (first round) and *now the Left* (run-off).
- **Far right related risks** from Marine Le Pen’s **National Rally (RN)** have indeed been **mitigated**, as hoped after the first-round shock.
- **But at the cost of far-left agenda**, which have **emerged** after shock win by the **New Popular Front (NFP)**.
- Especially as **NFP leader Melenchon promising to implement “nothing but its program – all its program”**.
- But the **conspicuous shortfall of a clean majority*** of 289 seats for the NFP (projected:

175-205 seats*) **checks the most imminent and devastating French political risks.**

- Specifically, the **overarching relief** of a **precipitous swing to the far-right or far-left** that has been averted.
- Admittedly, a **hung parliament could pose a problem.** More likely though is *a more muscular Far-Left that arm-twists its way into more public spending*, thereby accentuating French fiscal/debt vulnerabilities.
- So, what’s left (from far-Right risks being mitigated) is not quite right for unfettered risk
- **Widening OAT-Bund spreads is par for the course as fiscal slippage risks solidify.**
- So, **there is no excuse for complacency.** A **more extreme iteration** of these fiscal pressures (alongside those of Italy) **may highlight EUR “fragmentation risks”.**
- In which case, *EUR under-performance vis-a-vis real rate spreads against USTs could turn more pronounced.*
- For now, the (named) **foremost fear of French policies hijacked by extremist** (Right or Left) agenda is **assuaged, but far from banished.**
- Relief as such only narrowly buoys EUR above 1.08. Whereas optimism falls short of catalysts to extend EUR rallies (to 1.09).

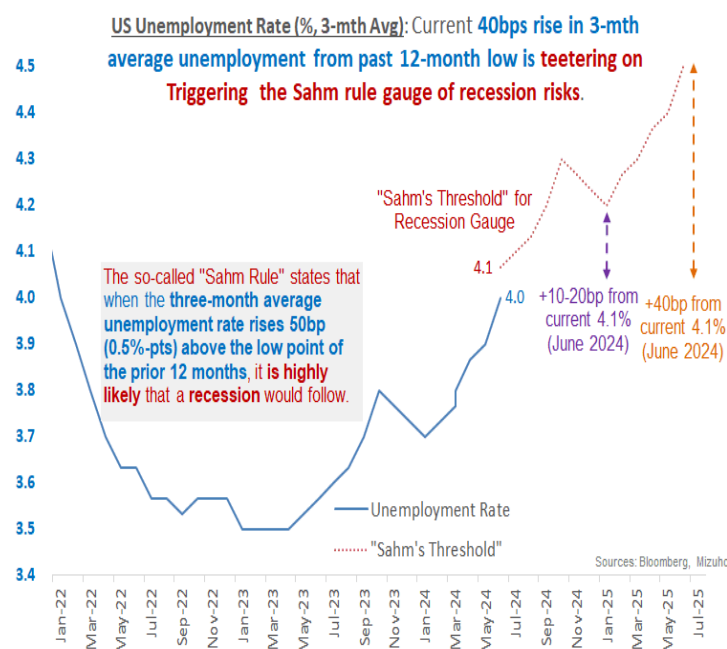
*Far Left NFP is poised for 175-205 seats, Macron’s Centrist for 152-180 and Marine Le Pen’s far-right (RN) for 130-152 in the 577 seat Lower House.

US Jobs: Sahm Thoughts

“Many of the truths that we cling to depend on our viewpoint.” – Obi-Wan Kenobi, Star Wars, Return of the Jedi

- Elsewhere, a **“Goldilocks” read of US jobs lent itself to optimism about markedly higher chances of a September rate cut**, and consequent drop in UST yields.
- This is *despite the coincidence of less rosy indicators.*

- That is markets now pricing in **~74% chance of rate cut in September, up from ~55% chance at end-June, overlook a not-so-soft landings.**
- Admittedly, headline jobs remained upbeat at 206K (vis-à-vis the 190K consensus) alongside softer but resilient wage gains.
- However, **111K downward revisions to job gains for April and May** alongside the **unemployment rate uptick** (to 4.1% from 4.0%) have induced *some dovish impulses to be incorporated into policy expectations.*
- Regardless, markets appear to have taken a **“Goldilocks” iteration of controlled jobs landing** that inspires supportive cuts; thereby boosting equities alongside softer yields.
- **Nonetheless, recession risks are rising by some measures, which in turn could challenge the “risk on” aspects of Fed rate cut bets.**



- Notably, **“Sahm rule” gauge*** that tracks dynamic jobs markets shifts as forewarning is **only fractionally shy of recession warning.**
- For sustained recession risks, it would **only take a durable (but gradual) 0.3-0.4%-pts pick-up in unemployment rate** to 4.4-4.5% (from 4.1% in June) by mid-2025 as per Sahm rule.

- In turn, this **flags risks of “Type-2” policy mistake** of “*too high for too long*” Fed policy as a matter of inherited policy bias.

*Sahm rule: If the 3-month average unemployment rate rises 50bp (0.5%-pt) above the lows for the preceding 12 months, a recession is likely.

Powell to Play it Cool to Congress

“Never tell me the odds.” – Han Solo, Star Wars, The Empire Strikes Back

- But with Fed Chair **Powell primed to signal patience** on commencing rate cuts to the Congress, the (rising) **odds of a recession**, and the *attendant policy inflection*, **implied by Sahm is overshadowed by Goldilocks**.
- Specifically, premising cuts on **further evidence of wider dis-inflation** intact. *Averting a re-acceleration in price pressures* the low bar while *confidence about less “sticky” services inflation* being the higher bar.
- But this may **temper, rather than accentuate, prevailing rate cut bets** (3-in-1 odds of a September cut).
- Especially as **Fed Chair Powell’s inclination to stress on data dependence** will *dampen implications of backward-looking jobs shortfall over volatility expected in inflation ahead*.
- Whereas the **incentive to maximize policy optionality** may *overshadow the sensibility of a tactical case for pre-election “insurance” cut*; especially as both inflation and jobs data soften.
- As such, **conditional policy cues** communicated to the Congress are *biased against growing odds of more cuts sooner*; especially given the baggage of “transitory inflation”.

China Stimulus Hopes

“Difficult to see; always in motion is the future” – Yoda, Star Wars, The Empire Strikes Back

- *Ahead of the Third Plenum* (starting 15th July) **hopes of “bigger bang” stimulus are elevated**.

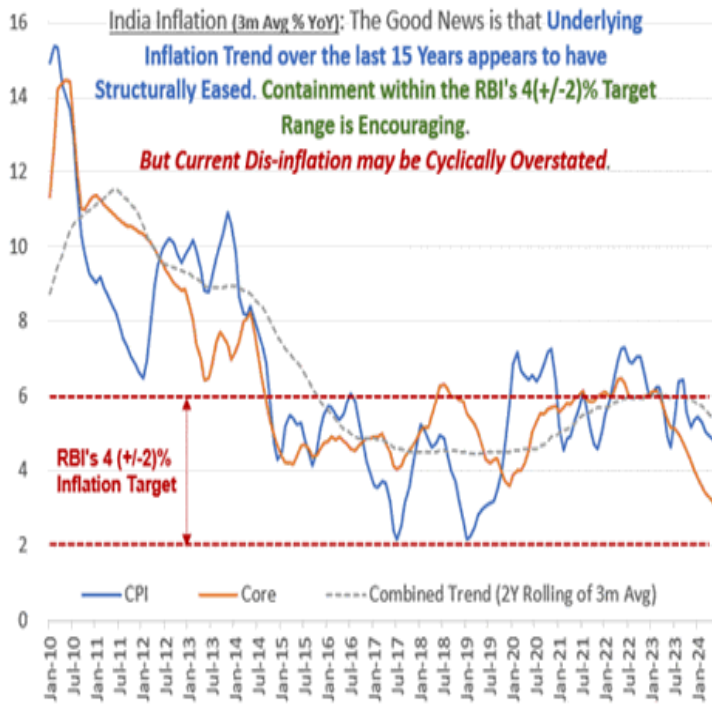
- For one, **in-coming evidence of consumption and credit data have been under-whelming**, underpinning chronic confidence deficit hobbling hopes of domestic demand drivers.
- Meanwhile, **prospects of industrial rebound have been hobbled** by elevated geo-political risks; the latest iteration being tariffs targeting China’s industrial “over-capacity”.
- The **bigger picture** is that *while manufacturing recovery is likely to remain broadly intact*, the **ability to engineer broad-based demand recovery is compromised** by *binding policy constraints* and *attendant trade-offs*.
- On-going efforts to arrest CNH pressures are **at the expense of broader policy stimulus**.
- Preventing a bond market bubble is admittedly at odds to stimulus. But nevertheless, reflects financial stability as overarching policy priority.
- This leaves **hopes grasping at fiscal boost** rather than a monetary silver bullet that risks shooting itself in the foot by exacerbating self-reinforcing CNH pressures.
- But the **risk** is that policy stimulus revelations will turn out to be a **damp squib**. Point being, the **Plenum’s economic policy initiatives may be tilted to structural plans, not cyclical fillip**.

India’s Inflated Policy Flexibility

“There’s always a bigger fish.” – Qui-Gon Jinn, Star Wars, The Phantom Menace

- Elsewhere, India’s **sub-5% inflation continues to be a gift for the RBI**.
- But this is *in terms of not overly pressuring the rupee*, to the detriment of policy independence,
- And **not in the sense of bona fide policy flexibility that allows the RBI to comfortably front-run the Fed’s rate cuts**.
- For one, **underlying inflation remains uncomfortably subject to volatility**.
- Which is to say, **exaggerated (but unsustainable) dis-inflation may be**

misleading flattering in terms of the implied real rate support **for the rupee**.

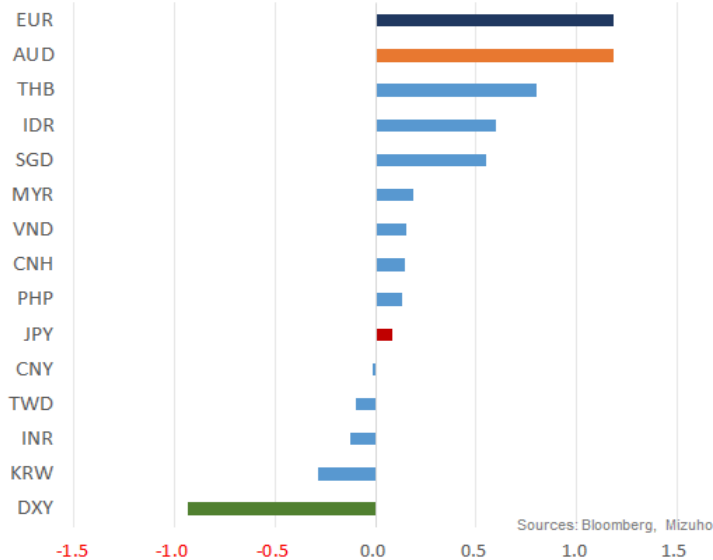


- More importantly, the **cost-free reduction in India’s yield pullback** (led by narrowing risk spreads) may also be exhausted as near-term ratings upgrade prospects are on hold.
- And that means rupee support for the same yield spreads may be diminished as risk is re-priced.

FX: Don’t Get Carried Away

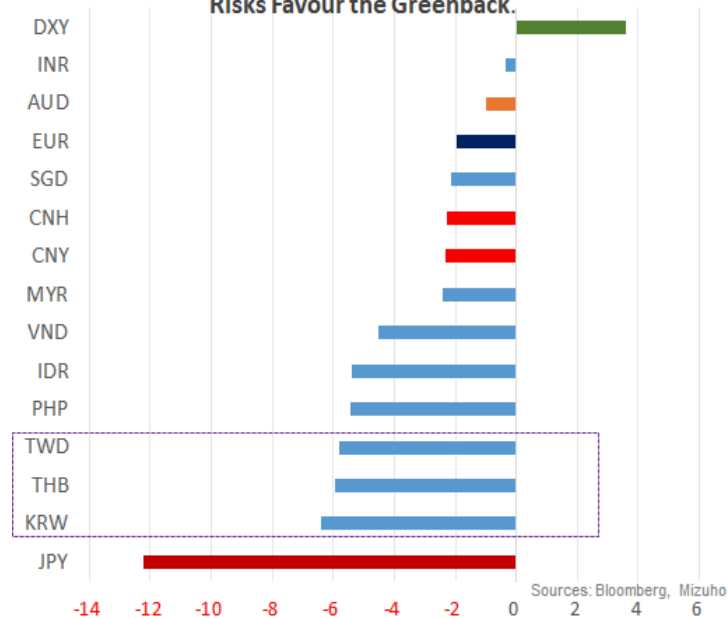
“Great kid! Don’t get cocky.” – Han Solo, Star Wars, A New Hope

Weekly (% Chg, since 28th June 2024): EM Asia FX mostly Higher. But Broad-based USD Pullback Not Uniformly Exploited as Wider Risks Watched.



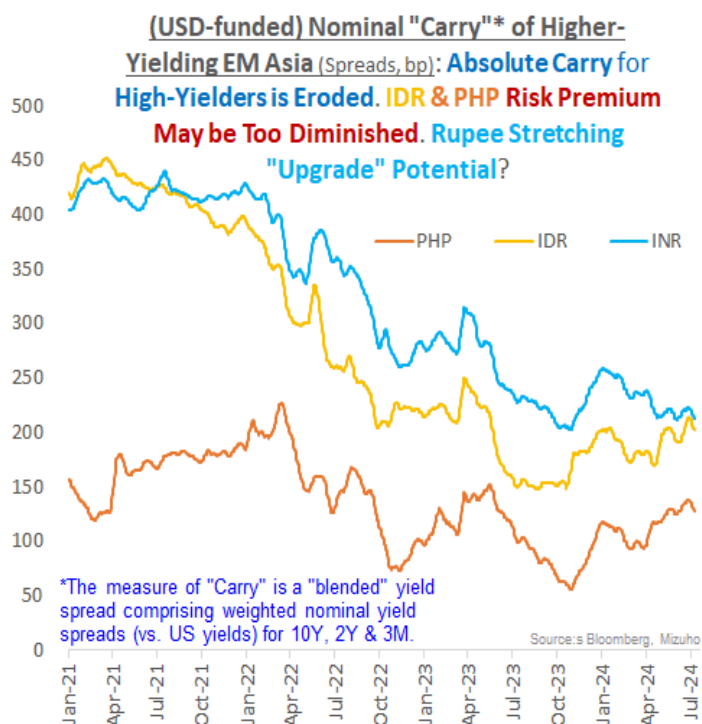
- Admittedly, **USD has slipping** appreciably last week has resulted in Asia FX gains.
- But this is against a backdrop of **relief of worst-case scenarios averted**, and *not on exuberance built on sustained and scalable “risk on”*.
- Instead, conditions for persistent USD strength, both from relative US exceptionalism as well as bouts of haven refuge, remain firmly intact.
- And so, it would be **cavalier over-confidence to get carried away about sustained AXJ rallies derived from unremitting USD weakness**.

YTD (End-2023 to 8th July 2024): But EM Asia FX are Remain Compromised More Broadly amid Persistent JPY & CNY Pressures. As a **Conspiracy of Risks Favour the Greenback**.



- In particular, if **relief from the French elections fade**. Worse yet, uncertainties associated with an untested French coalition government and the pitfalls of fiscal profligacy and debt burden **could undermine EUR**.
- Inevitably, a softer EUR giving up relief gains as the realities of political uncertainties and associated “fragmentation risks” re-emerge will **reversing broad-based USD declines**.
- And this will be **to the detriment of currency gains elsewhere. Asia FX included**.
- And **more so if China risks resurface** in soggy data, led by underwhelming credit and uninspiring domestic demand.

- Finally, **longer-term erosion in Asia FX “carry”** means that the underlying “carry” support for Asia FX is stretched, if not increasingly compromised.
- Especially as **rising term premium** alongside the *risks of wider credit/risk premium* from **risk re-pricing undermine Asia FX currency valuations corresponding** to prevailing levels of “carry” (on risk-adjusted basis).



BoK & BNM On Hold

- Elsewhere, the **BoK and BNM** are expected to be **on hold** this week ahead of US CPI.
- *Even if* the expected **policy hold has hawkish accents**, this is likely to be a **pre-condition for KRW and MYR backstop** and not a catalyst for rallies in the respective currencies.

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