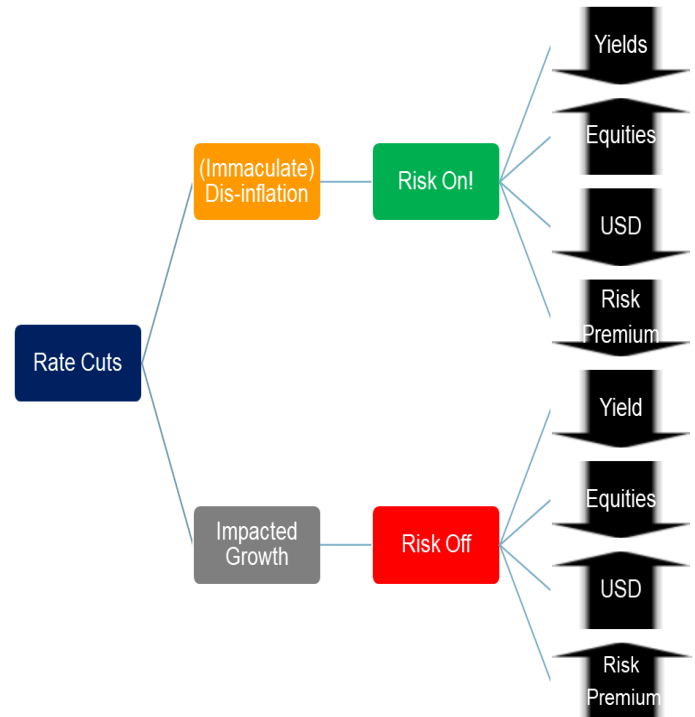


Sun-Kissed or Sun-Burnt?

- Arguably, the jury is out on whether markets, returning from the summer holidays to confront the aftermath of August turbulence, will **settle into sun-kissed glow or suffer sun-burnt pain**.
- To be fair, the **post-BoJ/NFP “risk off” convulsions** have subsided materially. In fact, with both UST yields and USD slumping, markets have by and large **tailed off into a climate more conducive for “risk on”**.
- But to maintain the sun-kissed, “feel good” “**risk on**” vibes, “**Goldilocks**” will be required to maintain not just *poise*, but *dominance too*.
- That’s to say, *dialled-up Fed cut bets* are necessarily *in conjunction with* (if not, confidence about) a “*soft-landing*”.
- Whereas if “**Goldilocks**” is challenged, and Fed rate cuts are in a desperate response to a sharp surge in US recession risks, then the threat of an initial descent into “**risk off**” cannot be ignored.
- In other words, the assumed **motivation behind Fed rate cut bets** is **critical in determining** if market outcomes on Fed rate cut bets will be **sun-kissed (risk-on) or sun-burnt (risk-off)**.
- And **switching between the two** (i.e. risk-on/risk-off) iterations of Fed cut bets entail **correlations flipped** and **risks re-priced**.

Figure 1. Risk On & Risk Off Fed Cut



Awkward Correlations

- Specifically, depending on Fed rate cut assumptions, **assumed correlations between USD, yields and risk appetite** (expressed as equity market exuberance as well as risk spreads) **could begin to fray, if not flip**.

Figure 2. Unstable Correlations

- **Drop in yields** – initially *led by 2Y* sensitivity to policy – is **consistent across** either iteration of rate cuts.
- But **USD, equities and risk premium** consequences may be starkly different.
- **USD**: To **ease on “risk on”** but **surge on “risk off”** amid haven demand.
- **Equities**: “Immaculate dis-inflation” rallies liable to sharp corrections on hard landing.
- **Risk Premium**: To surge (denting EM/risk assets) if economic outcomes sour.

- Notably, **familiar “risk on” pivot assumption** that Fed rate cuts will lead to **policy relief** from

looser financial conditions and *consequent economic alleviation* may be turned on its head.

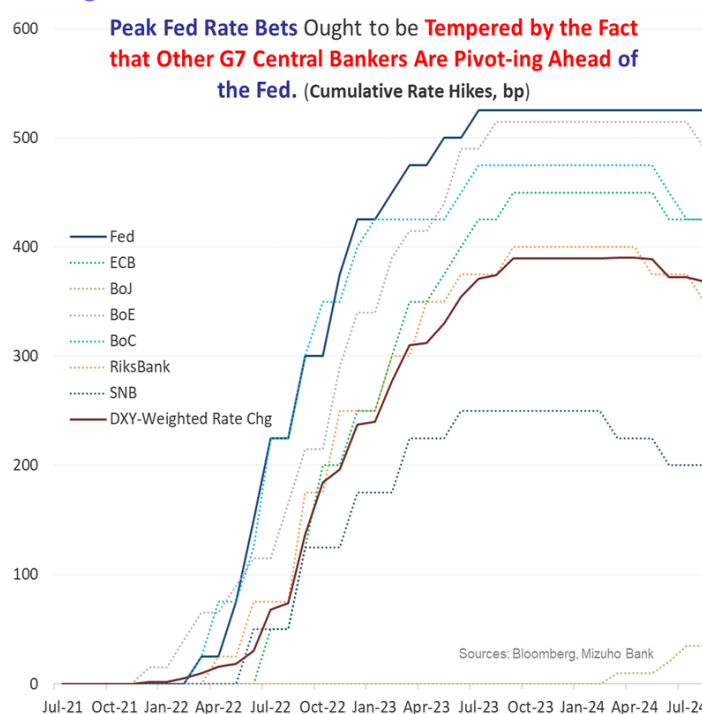
further* bearish pivot USD dynamics; *vis-à-vis* their respective currencies.

- Whereby, **“risk off”** associated with **recession threats dominate** (and oppress) financial conditions. In turn, driving *yield, USD* and equity/risk pricing valuations/correlations.
- In other words, depending on the intensity of economic risks, **economic and attendant financial stress could overwhelm anticipated policy relief.**

1. USD-UST Correlation:

- In which case, the **assumed positive correlation between USD and UST yields need not hold up ubiquitously** across all currencies.
- Admittedly the *sharp drop in both UST yields and USD since July NFP* squares with *Fed rate cut-driven bearish pivot USD assumption.*
- Moreover, it boasts intuitive allure associated with USD being influenced by softer rates/yields associated with Fed rate cut expectations.
- But this **lacks nuance.** It is *not purely UST yields* dictate USD moves, *but more accurately, rate/yield spreads* that *determine where the USD goes.*
- What’s more, *shifts in real rate spreads* make for **more compelling** and *durable* sway on FX.
- Hence **other Major/EM central banks following Fed rate cuts may stifle**

Figure 3. Other G7 Rate Cuts Ahead of Fed



- **More so, if US dis-inflation outstrips dis-inflation elsewhere.**
- What’s more, **fear-induced risk retrenchment** ruling the roost could perversely **boost “haven demand” for USD**; *even if appreciably lower Fed rates/UST yields are assumed.*
- All said, **(positive) USD-UST yield correlations could be challenged** by not only any *flux in relative policy* and *inflation shifts*, but crucially, also *overarching risks sentiments.*

* Whereas current USD pullback is on account of Fed rate cut expectations being materially dialed up

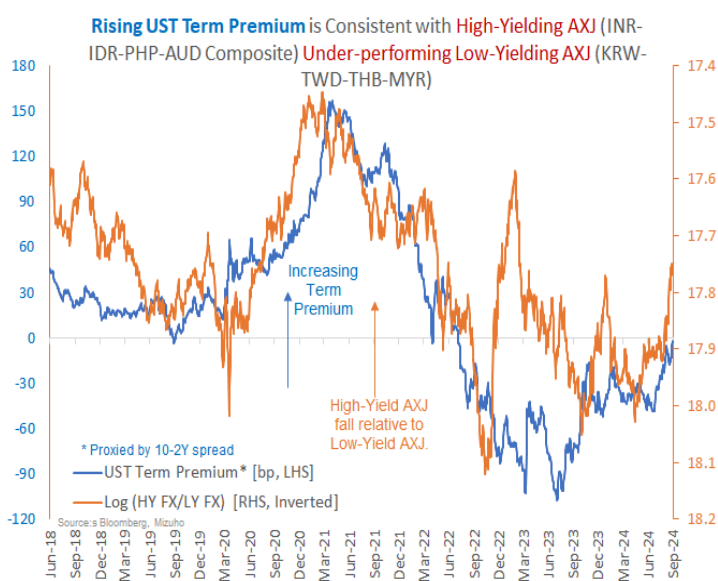
2. UST Steepener-AXJ Correlation:

- What’s more, **shifts in the shape of the yield curve** could arguably also have a non-negligible impact on EM Asia FX

(AXJ) over and above relief from softer yields.

- Specifically, a **steepening UST yield curve** that typically squares with rising term premium tends to be **less conducive for gains in AXJ**. And especially for **high-yielding AXJ**, which are liable to **under-perform low-yielding AXJ**.

Figure 4. HY AXJ to Underperform on Steepening

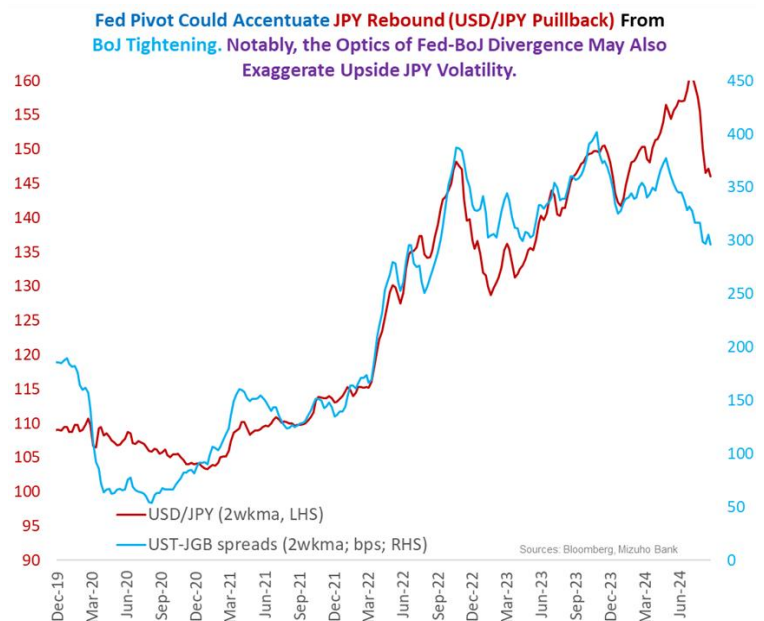


- This reflects inadvertent risk re-pricing as investors are able to get **higher returns** by “going out” a steeper (risk-free) UST yield curve rather than “going down” the credit curve.
- And so, the **required price equilibration** process will involve some **sell-off in AXJ bonds** to lift yields adequately.
- Which in turn **results in interim AXJ weakness** during this **risk re-pricing** (involving not just the bond, but also associated FX sell-off)

3. JPY-AXJ Correlation:

- In addition, whilst acute JPY-carry unwind following BoJ/NFP has subsided, there could be **further unexpected episodes of JPY carry unwind** remains a **non-negligible threat for AXJ bulls**.
- Only this time, the trigger is far more likely to be the Fed, not the BoJ. And is likely to involve “risk off” associated with US recession and/or financial shocks.
- Especially insofar that sharp Fed shifts could still set-off intense JPY squeeze, which compound into an adverse loop between JPY-funded “carry” unwind and wider “risk off”.

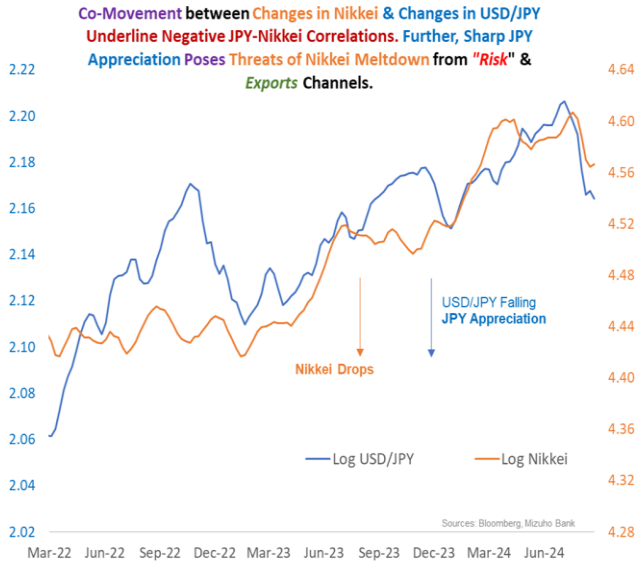
Figure 5. Other G7 Rate Cuts Ahead of Fed



- This is but the **other side of the coin** of excessive JPY depreciation being a BoJ problem with a Fed solution.
- Whereas **excessive JPY appreciation** from the aggressive “Fed (cut) solution” is a tragic case a cure worse than the disease.

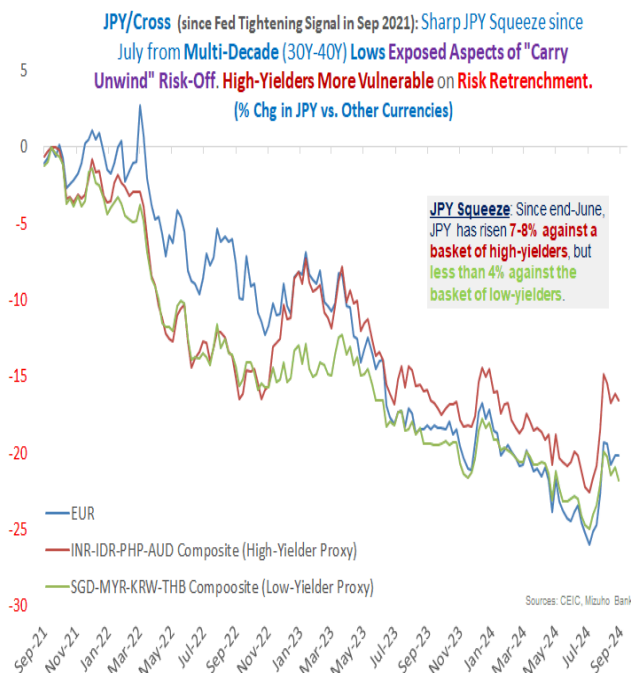
- Such an **acute JPY appreciation** not only *hammers exporters*, indirectly *hurting already fragile households*, but also *threatens a destabilizing meltdown in Nikkei*.
- “**Carry unwind**” from such sharp JPY squeeze typically **bodes worse for high-yielding AXJ**.

Figure 6. Nikkei Risks from Sharp JPY Squeeze



- In which case, **ordinarily positive JPY-AXJ correlations will flip negative**; such that sharp JPY strength will result in AXJ downside pressures ... and **economic gloom all around**.

Figure 7. JPY Carry Unwind Hurt HY AXJ More



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