TOPIC OF THE MONTH

How long can the Central Banks' divergence last

AUTHORS

MAHMOOD PRADHAN
HEAD OF GLOBAL MACROECONOMICS - AMUNDI INVESTMENT INSTITUTE

FEDERICO CESARINI
HEAD OF DM FX STRATEGY - AMUNDI INVESTMENT INSTITUTE

KEY TAKEAWAYS

The divergence of Central Bank policy rates is unlikely to significantly impact exchange rates, as other core currencies are not weak relative to recent history and market expectations of terminal rates in Europe are similar to those in the US.

Global financial conditions are strongly influenced by US long-end yields, and there is a risk of the term premium rising if US deficit and debt projections deteriorate.

Although not in our baseline scenario, an energy supply and price shock would weaken European exchange rates and rapidly transmit to domestic inflation.

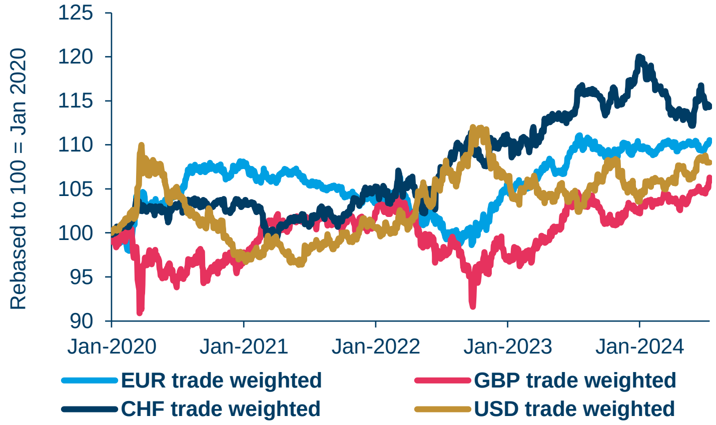
Central Bank policy rates can diverge.

The pace of disinflation in most advanced economies is following a similar path, albeit with differences in sticky components. **Central bank policy rates are unlikely to diverge significantly (our baseline), but this does not rule out the ECB and the BoE cutting rates faster than the Fed**, especially given their weaker growth outlook. The impact of this scenario would be steeper yield curves in the Eurozone and the UK, but not substantially weaker exchange rates, as some fear. A bigger risk to European exchange rates stems from (unanticipated) energy price shocks rather than lower relative interest rates. We explore why.

The US dollar has been exceptionally strong, but other core currencies (except the Yen) have also been strong in trade-weighted terms.

The global macro backdrop – inflation scares, geopolitical tensions and recession worries – together with US economic resilience, have supported the dollar versus core currencies, but the latter are not weak relative to recent history. Moreover, the difference in market expectations of terminal rates in Europe are now substantially higher than before the pandemic, and not materially different from expected US terminal rates. This should limit any sustained weakness in European exchange rates.

Core currencies outperformed in trade-weighted terms

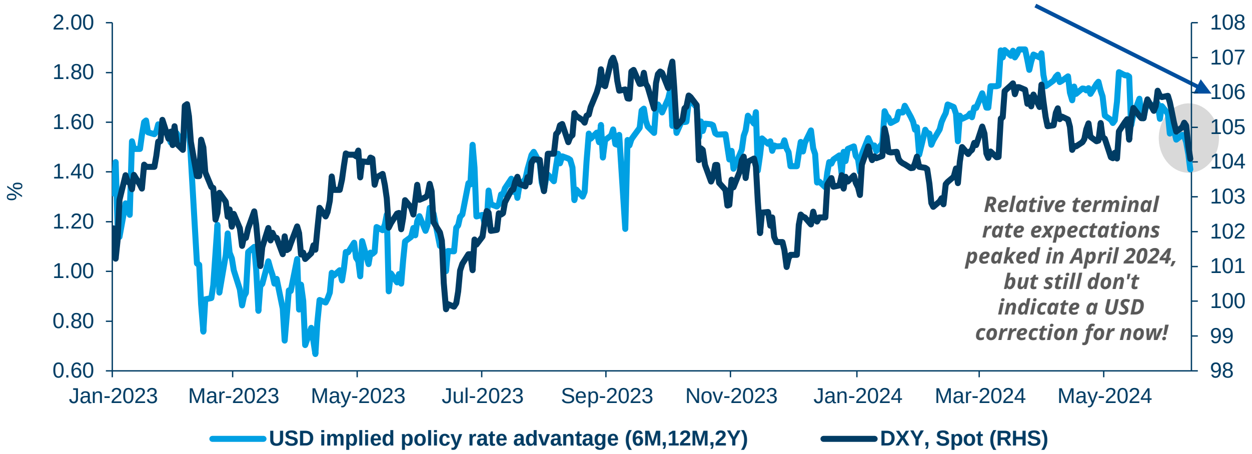


Source: Amundi Investment Institute, Bloomberg. Date as of 12 July 2024.

Fears about exchange rate depreciation are overdone.

When Central Bank policy rates diverge, there are typically two main risks that may make rate cuts unsustainable: **1) exchange rate depreciation and 2) inflation pass-through from exchange rate depreciation.** While monetary policy rate differentials matter, both risk factors seem less of a worry in this cycle. First, **exchange rate volatility has been unusually low**, despite the Fed becoming incrementally hawkish in 2024 relative to most other Central Banks. US disinflation has allowed the Fed to maintain its bias towards cuts, which has contained both the distribution of expected inflation and forward US rates.

Relative terminal rates expectations support the USD



Source: Amundi Investment Institute, Bloomberg. Date as of 12 July 2024. USD implied policy rate advantage = US expected policy rate – G10FX policy rates (using DXY constituents' weights), where policy rate is the average between 6M, 12M, and 2Y.

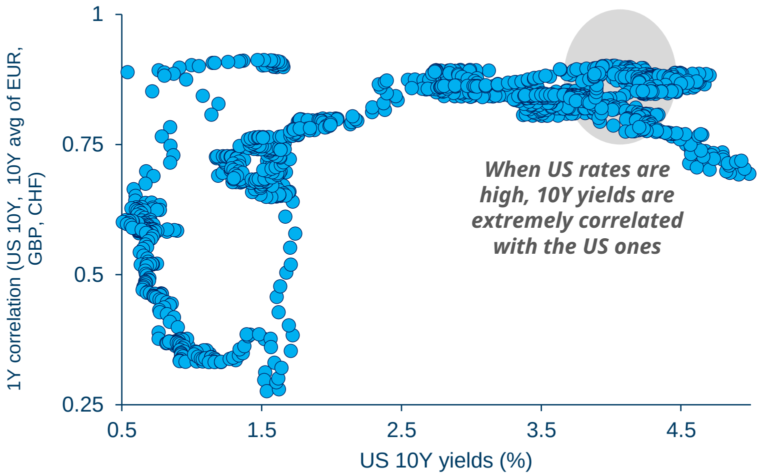
Second, **the inflation pass-through of exchange rate depreciation is estimated to be relatively low** (around 0.10 percentage points for a 1 percentage exchange rate point depreciation in the Euro Area). A related third factor is that **the ECB and the BoE are not easing their restrictive policy stances in response to a growth shock.** Such support for growth would, over time, strengthen their exchange rates. Fourth, the absolute level of yields matters. **Euro and UK terminal rates are expected to be substantially higher than pre-pandemic levels.**

Policy rate divergence would, however, imply steeper yield curves in Europe.

Global financial conditions at the long end are strongly influenced by US long-end yields (primarily reflecting the size of US markets), particularly since the pandemic.

Thus far, global markets have benefitted from the absence of any substantial term premium in the US because policy rates have been expected to fall (with inflation) and the US is continuing to attract foreign capital. But there is a **significant risk that the term premium could rise over the medium term**, possibly by a significant amount, **if the US deficit and debt projections continue to deteriorate.** This is the real risk that European Central Banks will have to manage: a much steeper yield curve than would materialise from going a little faster with rate cuts. Moreover, the absolute level of yields also matters.

European 10Y yields correlation with US 10Y



Source: Amundi Investment Institute, Bloomberg. Data as of 12 July 2024.

With the end of QE and the era of negative-yielding government debt outside the US, **higher US yield levels will likely have larger spillovers.** Any substantial and sharp rise in the US term premium, perhaps due to market concerns about debt issuance and fiscal paralysis in the US, could in turn also have **strong FX effects.** Here we would worry about low-yielding currencies, such as the Yen.

Although it's not our baseline, **another energy shock would also impact exchange rates.** Our baseline sees oil and gas prices on a gradual and slow downward trajectory. But an energy supply and price shock would weaken European exchange rates and rapidly transmit to domestic inflation. As most commodities are priced in US Dollars, the resilience of trade-weighted exchange rates would not help contain imported inflation.

AII* CONTRIBUTORS

SERGIO BERTONCINI
SENIOR FIXED INCOME STRATEGIST

POL CARULLA
INVESTMENT INSIGHTS AND CLIENT DIVISION SPECIALIST

UJJWAL DHINGRA
INVESTMENT INSIGHTS AND CLIENT DIVISION SPECIALIST

SILVIA DI SILVIO
CROSS ASSET MACRO STRATEGIST

PATRYK DROZDIK
SENIOR EM MACRO STRATEGIST

DELPHINE GEORGES
SENIOR FIXED INCOME STRATEGIST

KARINE HERVÉ
SENIOR EM MACRO STRATEGIST

SOSI VARTANESYAN
SENIOR SOVEREIGN ANALYST

CHIEF EDITORS

MONICA DEFEND
HEAD OF AMUNDI INVESTMENT INSTITUTE

VINCENT MORTIER
GROUP CIO

MATTEO GERMANO
DEPUTY GROUP CIO

EDITORS

CLAUDIA BERTINO
HEAD OF AMUNDI INVESTMENT INSIGHTS AND PUBLISHING, AII*

LAURA FIOROT
HEAD OF INVESTMENT INSIGHTS & CLIENT DIVISION, AII*

DESIGN & DATA VISUALIZATION

CHIARA BENETTI
DIGITAL ART DIRECTOR AND STRATEGY DESIGNER, AII *

VINCENT FLASSEUR
GRAPHICS AND DATA VISUALIZATION MANAGER, AII*

DEPUTY EDITORS

GIANLUCA GALLARATE
INVESTMENT INSIGHTS & PUBLISHING, AII*

FRANCESCA PANELLI
INVESTMENT INSIGHTS & CLIENT DIVISION SPECIALIST, AII*

* Amundi Investment Institute

Amundi Investment Institute

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