Brown Brothers Harriman

FOREIGN EXCHANGE

2024 SECOND QUARTER OUTLOOK

What's Ahead for the USD

Rally On

A cyclical USD recovery is underway.

Higher Treasury yields and U.S. economic outperformance underpin the dollar's uptrend.

U.S. economic growth outpaced that of other major economies during the quarter. At the same time some economies stagnated, while others entered technical recession and central banks took action that weighed on their currencies. The outlook continues to look promising for USD, for now at least.

Two things weigh on the currency's hopes of a mid-90s style rally: first, reserve managers' ongoing diversification away from dollar assets; second, our take on a valuation model suggests USD is overvalued against most major currencies.

Meanwhile the cyclical upturn in China bodes well for emerging markets as stronger demand for commodities should help these exporters. At the same time, however, carbon pricing's more central role in public policy could result in the U.S. using it as a tool to limit emissions and China's dominance of certain key industries.

CONTENTS

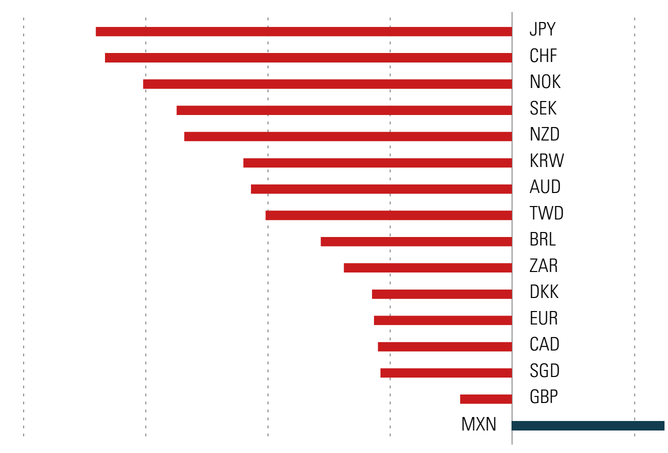
Powering Forward

By Elias Haddad

The U.S. macroeconomic backdrop bodes well for USD over the next quarter, but don't expect a sharp rally.

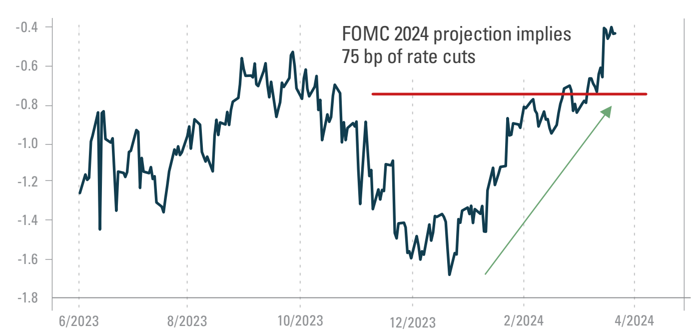
The dollar has rallied by almost 4% and outperformed nearly all major currencies so far this year. The upward revision to U.S. interest rate expectations and U.S. economic outperformance have underpinned the currency's uptrend.

% Spot Return Versus USD 12/29/2023 - 03/29/2024)



At the start of 2024, market-based measures of expected U.S. policy rates for the end of the year implied over 160 bp of cuts which was well out of line with the Fed's projection for 75 bp of easing. However, interest rate futures eventually adjusted higher in favor of USD, converging towards the Fed's forecast, as U.S. economic activity proved resilient and underlying inflation sticky.

Fed Funds Futures Dec 2024 (%)



What's more, cyclical growth divergences between the U.S. and other major economies supported broad USD strength. The U.S. economy grew at a quarterly pace of 0.8% in Q4 2023. Over the same period, the Eurozone economy stagnated, Japan managed to eke out 0.1% growth and the U.K. entered a technical recession.

Meanwhile, other major central banks took the following actions in March, which weighed on their respective currencies.

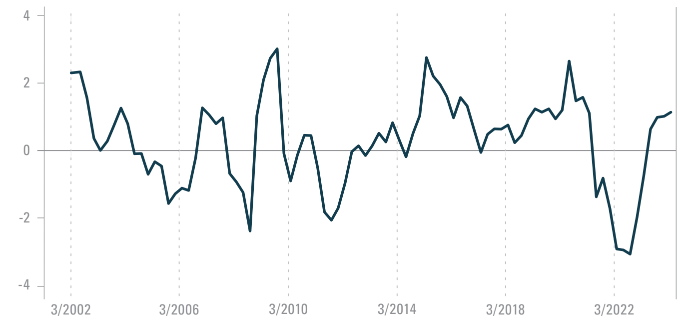
- The Reserve Bank of Australia left the cash rate target on hold but scrapped the tightening bias.
- The Bank of Japan raised the policy rate and ended yield curve control but tempered expectations that an aggressive tightening cycle was underway.
- The Swiss National Bank unexpectedly cut the policy rate and the updated inflation projections implied more cuts in the pipeline.
- The Bank of England held the bank rate steady but there was a dovish shift in the vote split.
- The Riksbank stood pat, but the policy rate path was adjusted lower.
- The European Central Bank (ECB) kept policy rates unchanged but slashed near-term inflation and GDP growth forecasts paving the way for looser policy settings.

The Fed has scope to hit the snooze button

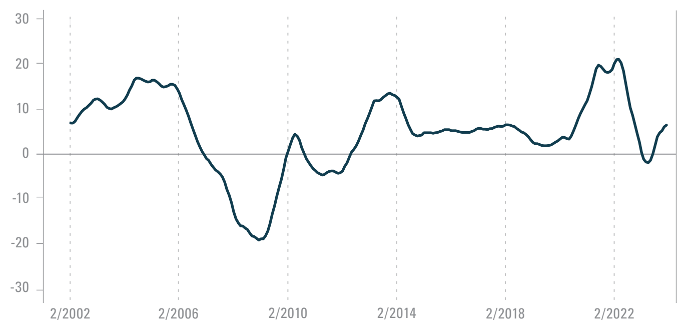
Going into Q2, we expect USD to benefit further from a reassessment in Fed funds rate expectations and U.S. economic outperformance:

- The U.S. economic growth outlook is encouraging. The Atlanta Fed GDP Nowcast model points to robust growth of 2.9% seasonally adjusted annual rate (SAAR) for Q1 and the New York Fed Staff GDP Nowcast for Q2 is tracking at 2.6% SAAR. Importantly, we expect consumer spending activity to remain resilient supported by positive real wage growth, higher house prices, and tight labor market *(see charts to the right)*.
- U.S. growth is on track to outpace that of its peers. The IMF forecasts U.S. real GDP growth of 2.7% in 2024. Over the same period the IMF projects the Eurozone, U.K., Japan, Canada, and other advanced economies to grow by 0.8%, 0.5%, 0.9%, 1.2% and 2.0%, respectively.
- Underlying inflation is sticky. Relatively high nominal wages suggest disinflation in the prices of core services excluding housing will remain slow. Indeed, the U.S. March CPI print suggests that progress on inflation may be stalling. The so-called super core CPI (core services less housing) increased 0.7% m/m after rising 0.5% in February and is up 4.8% y/y, the highest since April 2023.

U.S. Real Private Sector Wage (Ann % Chg)

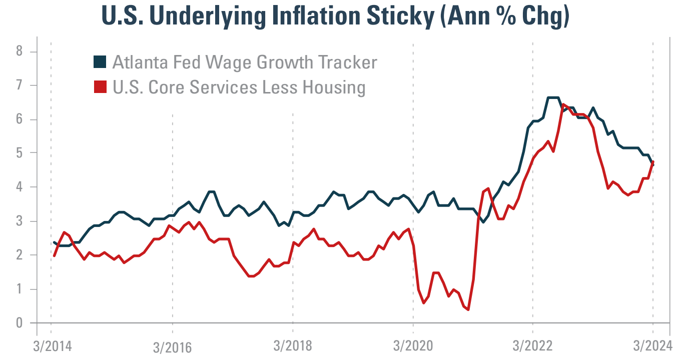


U.S. House Prices (Ann % Chg)



U.S. Labor Differential Index
(Jobs plentiful minus jobs hard to find)

U.S. Underlying Inflation Sticky (Ann % Chg)



Financial conditions are easy. The Chicago Fed financial conditions index is the loosest since January 2022 and U.S. nominal GDP growth exceeds 10-year Treasury yields.

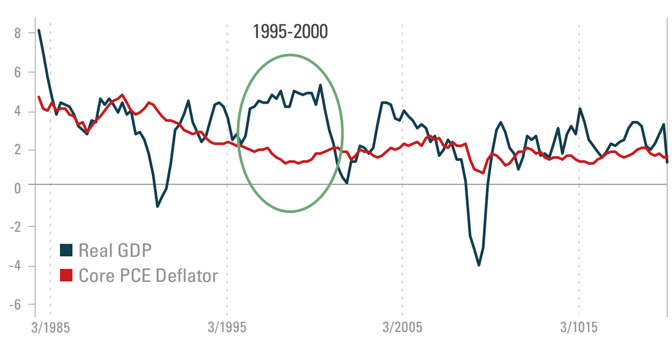
Chicago Fed National Financial Conditions Index

Is a mid-1990s USD rally underway?

U.S. Dollar Index (DXY)

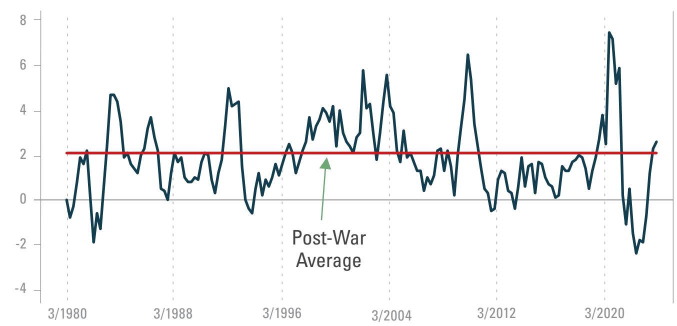
The 1995-2000 period coincided with a sharp appreciation in USD *(see above)*. At the time the U.S. had favorable macroeconomic backdrop of strong growth and easing inflation *(see below)*. The backdrop is quite similar today as the U.S. economy is expanding at a solid pace and inflation has eased notably over the past year. The other interesting similarity between the mid-1990s American boom and the current environment is the U.S. productivity landscape.

U.S. Macro Backdrop (Ann % Chg)



Nonfarm business sector output per hour averaged 2.7%/qtr between 1995-2000 as the internet revolution bolstered productivity. In Q4 2023, output per hour increased 3.2%/qtr to be up 2.7% on an annual basis. In the medium term, artificial intelligence could boost workers' productivity and lead to low inflationary economic growth if the U.S. manages to harness its potential like it did with the internet in the 1990s.

Labor Productivity, Nonfarm Business (Ann % Chg)



Overall, the U.S. macroeconomic backdrop bodes well for USD over the next three to six months. However, we don't expect a mid-1990s type USD appreciation and anticipate the USD index (DXY) to top-out around 110.00 for two reasons:

1. USD faces strong headwinds from reserve managers' ongoing portfolio diversification away from dollar assets. In a special feature, titled "King Dollar not ready to abdicate", we assess the dollar's dominance as an international currency.
2. Based on our adjustments to a well-known valuation model, we believe the USD is fundamentally overvalued against most major currencies. We explore this adjustment in the next section.

USD is Overvalued

By Elias Haddad

USD is overvalued versus most major currencies according to our adjusted Purchasing Power Parity (PPP) model.

Versus USD	BBH-PPP Value	% Over or Under (+/-)
CHF	1.0839	19%
EUR	1.1044	-4%
NZD	0.6636	-12%
CAD	1.1855	-16%
AUD	0.7847	-22%
GBP	1.5271	-22%
SEK	8.5618	-28%
NOK	7.6384	-43%
JPY	95.15	-62%

Valuation

The model is based on the classic theory of Purchasing Power Parity (PPP)[1] and adjusted with long-term economic variables to minimize some of the persistent PPP deviations. Here's the fundamental rationale behind each metric:

Personal Consumption Expenditure Deflator (PCED). Broad and comparable measure of prices. Derived from each country's national income account. A higher PCED should be offset by a depreciation in the currency to eliminate arbitrage opportunities between markets.

Term of Trade (TOT, export/import prices). General measure of a country's wealth. Derived from each country's national income accounts. A higher TOT should generate a positive net wealth effect on the economy which underpins a firmer currency.

Net International Investment Position (NIIP). Measures a country's overall financial health. Derived from each country's balance of payments report, as the gap between a country's stock of foreign assets and foreigners' stock of that country's assets. A higher NIIP typically leads to greater net interest income on the current account that should be offset by a deterioration in the trade balance via a higher exchange rate.

Unit Labor Cost (ULC). Measures a country's cost competitiveness. For simplicity and comparability, we use ULC from the OECD. A higher ULC tends to reflect lower levels of relative productivity, which generally leads to higher inflation and a depreciation in the currency.

A statistical overview of our PPP model is in the annex section. PPP models offer a good big picture view but are not useful investment tools. Indeed, exchange rates can stay under or overvalued for extended periods before mean-reverting. As such, we complement the readings from our adjusted PPP model with a qualitative assessment of the underlying business cycle and financial conditions. Our logic is that exchange rates are firmly grounded in economic reality, through the policies of monetary and fiscal authorities and international trade.

1. PPP asserts that the equilibrium exchange rate between two countries is determined by the ratio of the national price levels.

In most cases, USD overvaluation is justified by interest rate differentials (notably against JPY, CAD, NOK, and SEK). In other cases, there is scope for USD to correct some of its overvaluation (notably against GBP and AUD).

Let's look at each USD cross in more detail:

USD/JPY: Extremely overvalued and justified

We estimate long-term fundamental equilibrium for USD/JPY at 95.00, implying a 62% overvaluation relative to the current spot rate *(see figure 1)*. However, USD/JPY overvaluation is justified by wide U.S.-Japan real long-term interest rate differentials *(see figure 2)*.

Fig. 1 – USD/JPY & BBH-PPP

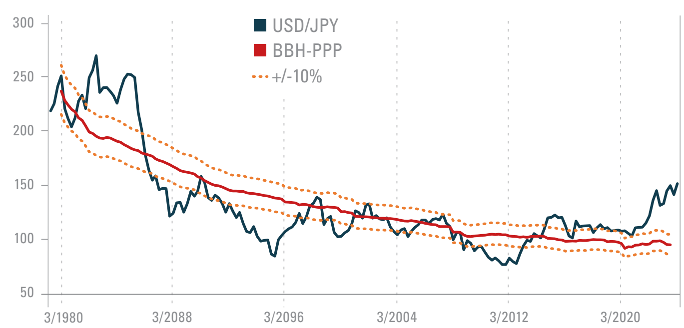
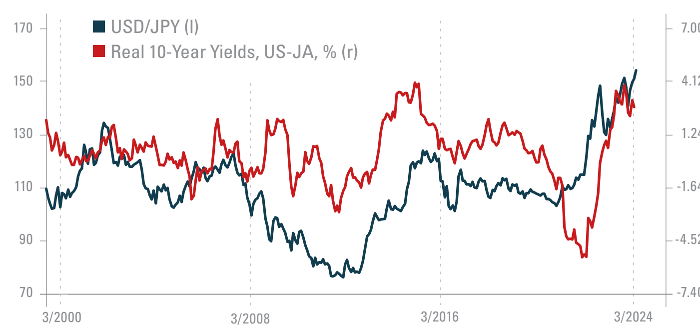


Fig. 2 – USD/JPY & Real Yields



GBP/USD: Undervalued with room to adjust higher

We estimate long-term fundamental equilibrium for GBP/USD at around 1.5300, implying a 22% undervaluation relative to the current spot rate *(see figure 3)*. Nevertheless, widening U.K.-U.S. real long-term interest rate differentials *(see figure 4)* and the U.K.'s narrowing current account deficit suggest there is room for GBP/USD to correct some of its undervaluation.

Fig. 3 - GBP/USD & BBH-PPP

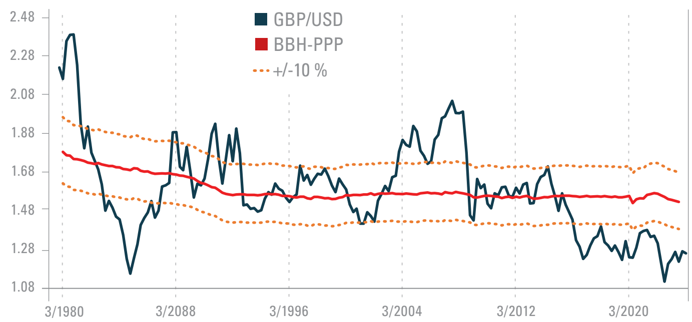
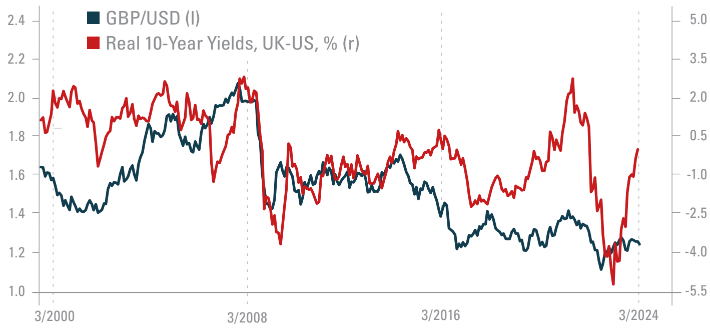


Fig. 4 – GBP/USD & Real Yields



USD/CAD: Overvalued and justified

We estimate long-term fundamental equilibrium for USD/CAD at 1.1900, implying a 16% overvaluation relative to the current spot rate *(see figure 5)*. However, USD/CAD overvaluation is justified as it's trading in line with the level implied by U.S.-Canada real long-term interest rate differentials *(see figure 6)*. Moreover, Canada's ongoing productivity underperformance versus the U.S. supports a higher USD/CAD valuation

Fig. 5 – USD/CAD & BBH-PPP

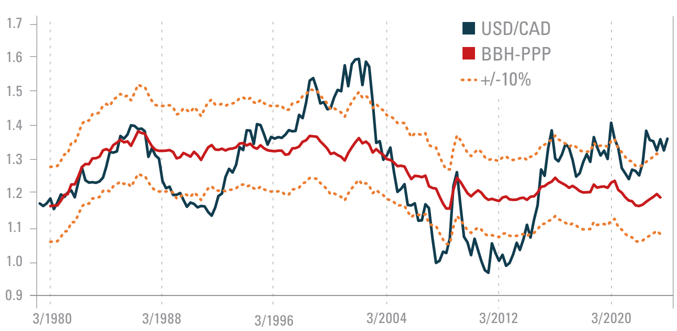
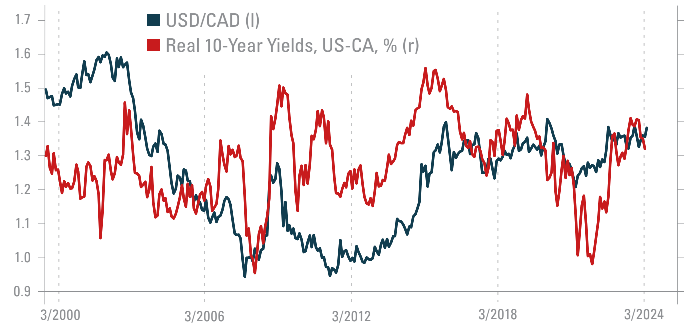


Fig. 6 - USD/CAD & Real Yields



USD/CHF: Severely undervalued with room to adjust higher

We estimate long-term fundamental equilibrium for USD/CHF at 1.0800, implying a 19% undervaluation relative to the current spot rate *(see figure 7)*. Widening U.S.-Switzerland real long-term interest rate differentials *(see figure 8)* suggests there is room for USD/CHF to correct some of its undervaluation.

Fig 7 – USD/CHF & BBH-PPP

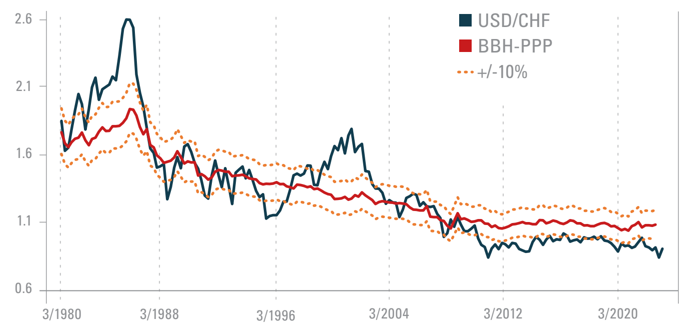
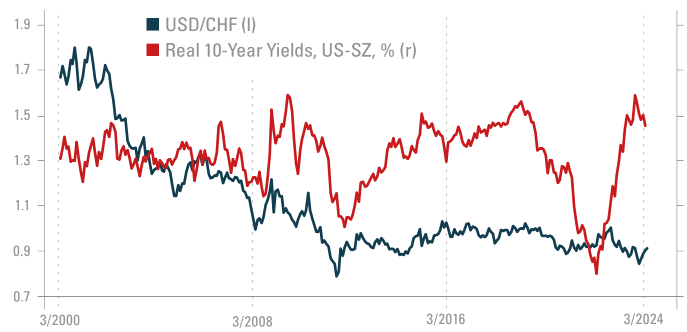


Fig. 8 – USD/CHF & Real Yields



USD/NOK: Significantly overvalued and justified

We estimate long-term fundamental equilibrium for USD/NOK at 7.6400, implying a 43% overvaluation relative to the current spot rate *(see figure 9)*. Norway's more favorable net international investment positions relative to the U.S. also favors a much lower USD/NOK. However, USD/NOK overvaluation is largely justified as it's trading in line with the level implied by U.S.-Norway real long-term interest rate differentials *(see figure 10)*.

Fig.9 – USD/NOK & BBH-PPP

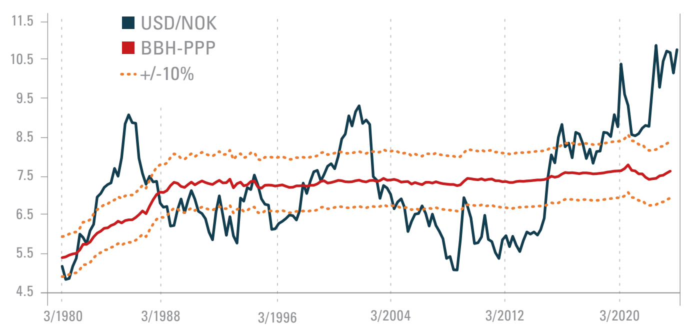
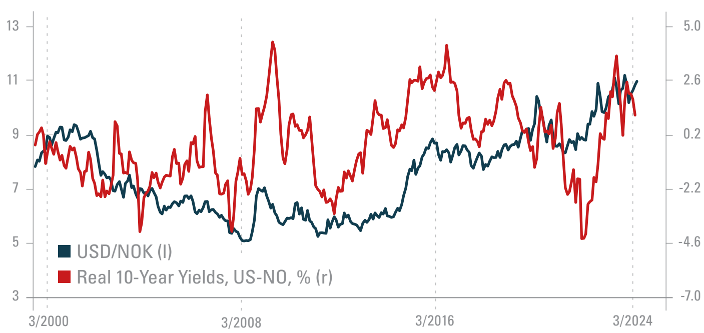


Fig. 10 – USD/NOK & Real Yields



USD/SEK: Significantly overvalued and justified

We estimate long-term fundamental equilibrium for USD/SEK at 8.5600, implying a 28% overvaluation relative to the current spot rate *(see chart 11)*. Sweden's more favorable net international investment positions relative to the U.S. also favors a much lower USD/SEK. Nonetheless, USD/SEK overvaluation is largely justified as it's trading in line with the level implied by U.S.-Sweden real long-term interest rate differentials *(see chart 12)*.

Fig. 11 – USD/SEK & BBH-PPP

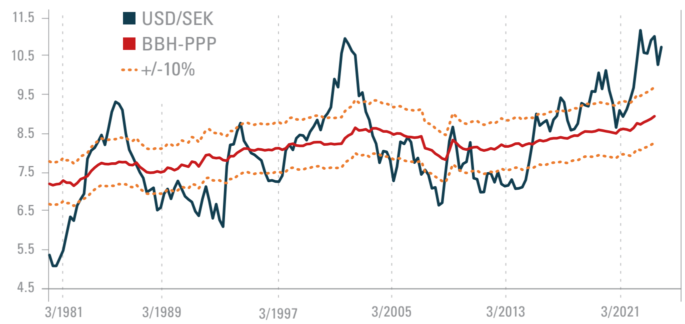
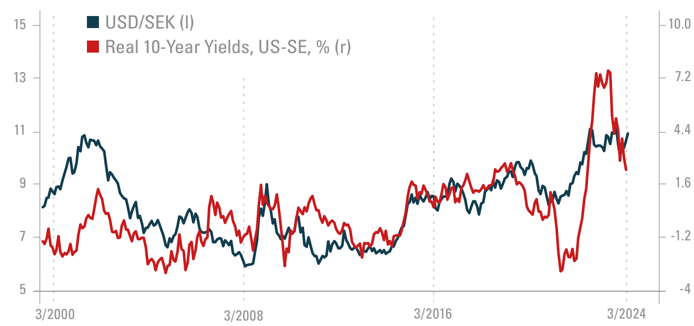


Fig. 12 – USD/SEK & Real Yields



AUD/USD: Undervalued with room to adjust higher

We estimate long-term fundamental equilibrium for AUD/USD at 0.7850, implying a 22% undervaluation relative to the current spot rate *(see figure 13)*. Nevertheless, widening Australia-U.S. real long-term interest rate differentials *(see figure 14)* and Australia's current account surplus suggest there is room for AUD/USD to correct some of its undervaluation.

Fig. 13 – AUD/USD & BBH-PPP

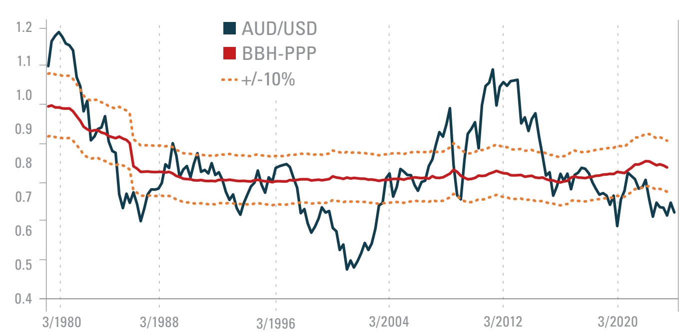
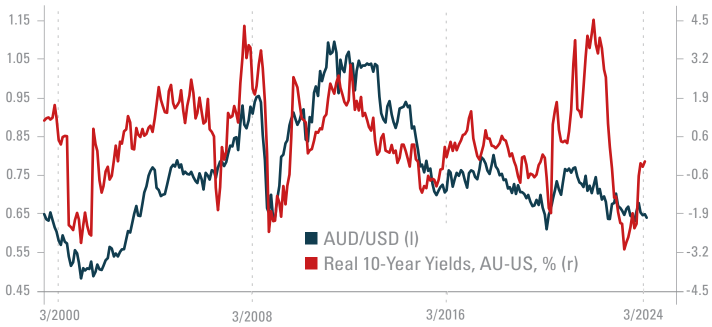


Fig. 14 – AUD/USD & Real Yields



NZD/USD: Undervalued and justified

We estimate long-term fundamental equilibrium for NZD/USD at 0.6640, implying an 12% undervaluation relative to the current spot rate *(see figure 15)*. NZD/USD is trading around the level implied by New Zealand-U.S. real long-term interest rate differentials *(see figure 16)*. However, New Zealand's balance of payments backdrop suggests NZD needs to keep trading at a discount to fundamental equilibrium to attract foreign investments and recycle the country's large current account deficit (6.9% of GDP in Q4 2023).

Fig. 15 – NZD/USD & BBH-PPP

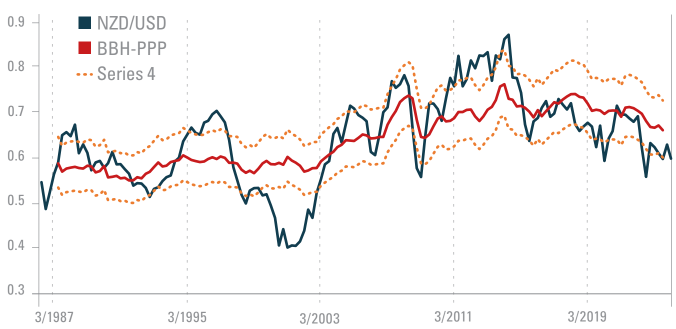
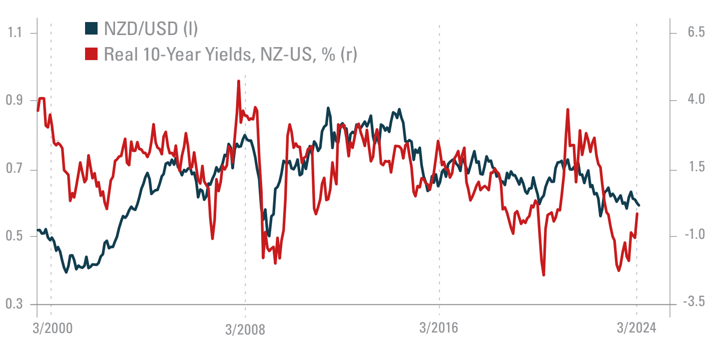


Fig. 16 - NZD/USD & Real Yields



EUR/USD: Slightly undervalued

We estimate long-term fundamental equilibrium for EUR/USD at 1.1040, implying a 4% undervaluation relative to the current spot rate *(see figure 17).* The Eurozone more favorable net international investment positions relative to the U.S. and Eurozone-U.S. real long-term interest rate differentials suggest EUR/USD undershoots beyond equilibrium should be limited *(see figure 18).*

Fig. 17 – EUR/USD & L-T Equilibrium

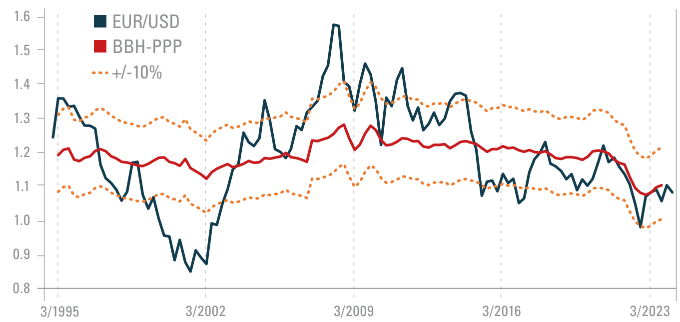
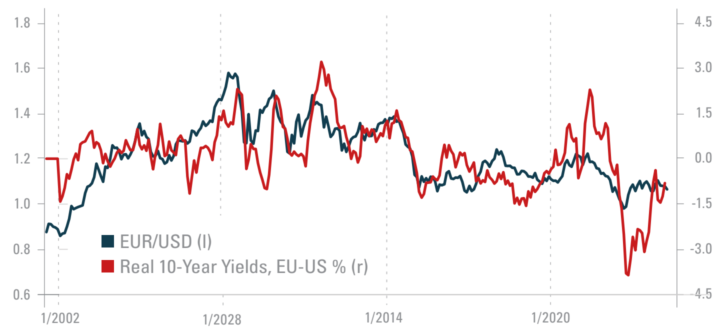
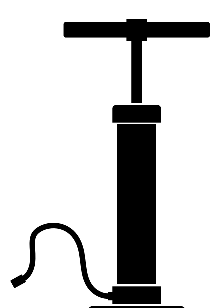


Fig. 18 – EUR/USD & Real Yields



For more insight on our BBH-PPP model, please contact **Elias Haddad** or **Win Thin** in the Currency Strategy team.



ANNEX

AUD/USD BBH-PPP

Average of 4 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) AUD/USD versus relative PCED (U.S./Australia). Sample range Q1 1980 to Q3 2023. (ii) AUD/USD versus relative TOT (Australia/U.S.). Sample range Q1 1980 to Q3 2023. (iii) Output from (i) versus relative ULC (U.S./Australia). Sample range Q1 1980 to Q3 2023. (iv) Output from (ii) versus relative NIIP % of GDP (Australia-U.S.). Sample range Q1 1989 to Q3 2023.

NZD/USD BBH-PPP

Average of 2 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) NZD/USD versus relative PCED (U.S./NZ). Sample range Q2 1987 to Q3 2023. (ii) NZD/USD versus relative TOT (NZ/U.S.). Sample range Q2 1987 to Q3 2023. Relative NIIP and ULC are excluded as independent variables because they are not statistically significant.

USD/CAD BBH-PPP

Average of 3 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) USD/CAD versus relative PCED (Canada/U.S.). Sample range Q1 1980 to Q3 2023. (ii) USD/CAD versus relative TOT (U.S./Canada). Sample range Q1 1980 to Q3 2023. (iii) Output from (i) versus relative NIIP % of GDP (U.S.-Canada). Sample range Q1 1989 to Q3 2023. Relative ULC is excluded as an independent variable because it is not statistically significant.

USD/JPY BBH-PPP

Average of 4 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) USD/JPY versus relative ULC (Japan/U.S.). Sample range Q1 1980 to Q3 2023. (ii) USD/JPY versus relative TOT (U.S./Japan). Sample range Q1 2008 to Q3 2023. (iii) Output from (i) versus relative PCED (Japan/U.S.). Sample range Q1 1994 to Q3 2023. (iv) Output from (i) versus relative NIIP % of GDP (U.S.-Japan). Sample range Q1 1996 to Q3 2023

USD/CHF BBH-PPP

Average of 4 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) USD/CHF versus relative PCED (Switzerland/U.S.). Sample range Q1 1980 to Q3 2023. (ii) USD/CHF versus relative TOT (U.S./Switzerland). Sample range Q1 1980 to Q3 2023. (iii) USD/CHF versus relative ULC (Switzerland/U.S.). Sample range Q1 1990 to Q3 2023. (iv) Output from (iii) versus relative NIIP % of GDP (U.S.-Switzerland). Sample range Q1 1990 to Q3 2023.

GBP/USD BBH-PPP

Average of 2 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) GBP/USD versus relative PCED (U.S./UK). Sample range Q1 1980 to Q3 2023. (ii) Output from (i) versus relative ULC (U.S./UK). Sample range Q1 1980 to Q3 2023. Relative TOT and NIIP are excluded as independent variables because they are not statistically significant.

EUR/USD BBH-PPP

Average of 3 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) EUR/USD versus relative TOT (EU/U.S.). Sample range Q1 1995 to Q3 2023. (ii) EUR/USD versus relative PCED (U.S./EU). Sample range Q4 1995 to Q3 2023. (iii) Output from (ii) versus relative ULC (U.S./EU). Sample range Q4 1995 to Q3 2023. Relative NIIP is excluded as an independent variable because it is not statistically significant.

USD/SEK BBH-PPP

Average of 3 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) USD/SEK versus relative TOT (U.S./Sweden). Sample range Q1 1981 to Q3 2023. (ii) USD/SEK versus relative ULC (Sweden/U.S.). Sample range Q1 1980 to Q3 2023. (iii) Output from (ii) versus relative PCED (Sweden/U.S.). Sample range Q1 1990 to Q3 2023. Relative NIIP is excluded as an independent variable because it is not statistically significant.

USD/NOK BBH-PPP

Average of 3 simple linear regression results. The regression and independent variables are all statistically significant at 95% confidence interval.	(i) USD/NOK versus relative PCED (Norway/U.S.). Sample range Q1 1980 to Q3 2023. (ii) Output from (i) versus relative ULC (Norway/U.S.). Sample range Q1 1995 to Q3 2023. (iii) Output from (i) versus relative TOT (U.S./Norway). Sample range Q1 2006 to Q3 2023. Relative NIIP is excluded as an independent variable because it is not statistically significant.

SPECIAL FEATURE

King Dollar Not Ready To Abdicate

Central bank reserve managers’ actions result in other currencies gaining a more prominent role.

The U.S. dollar's unrivalled 80-year reign as an international currency is intact. But other currencies are gaining a more prominent role, which will limit USD strength over the long term. The euro and gold stand to benefit the most.

What is an international currency?

An international currency is one that is used outside its home country and satisfies the classic three functions of money: store of value, medium of exchange, and unit of account. By all measures the dollar is the dominant international currency and plays an outsized role relative to the U.S. shares of global GDP and world trade *(see chart below)*.

USD dominates as a store of value

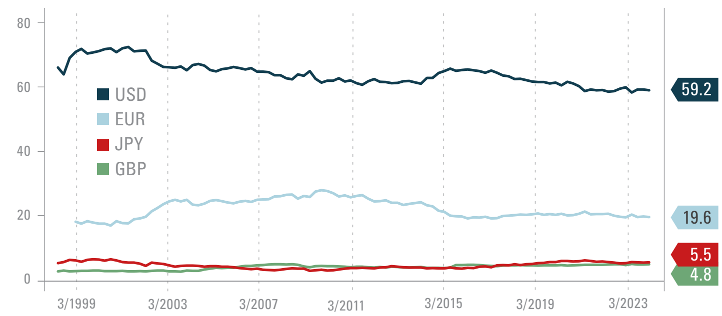
The share of reserves held in U.S. dollars by central banks has averaged 64% since 1999 reflecting confidence the currency can be saved and retrieved in the future without a significant loss of purchasing power. Other currencies lag far behind, with the euro the undisputed second averaging about 22% of global foreign exchange reserves since its launch in 1999.

Nonetheless, there has been a steady erosion of the dollar's dominance in international reserves largely because of active portfolio diversification by central bank reserve managers.

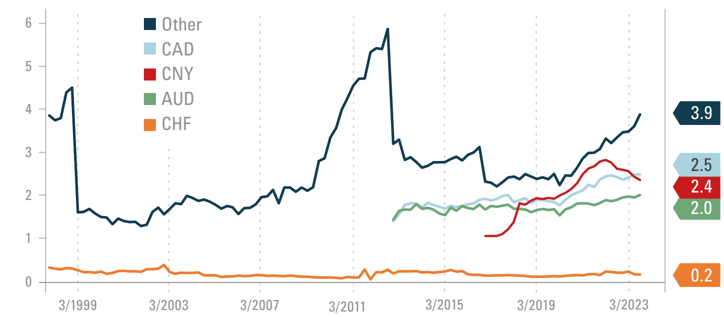
The dollar accounted for 59% of official foreign exchange reserves in the third quarter of 2023, down from a high of almost 73% in 2001. The decline in the dollar's share of central bank reserves is mostly due to the shift into the Australian dollar, Canadian dollar, and other currencies (namely the Korean won, Singapore dollar, and Swedish krona) rather than the euro, the British pound, and Japanese yen *(see chart 1)*.

World Currency Composition of Official FX Reserves (%)

– Chart 1 –

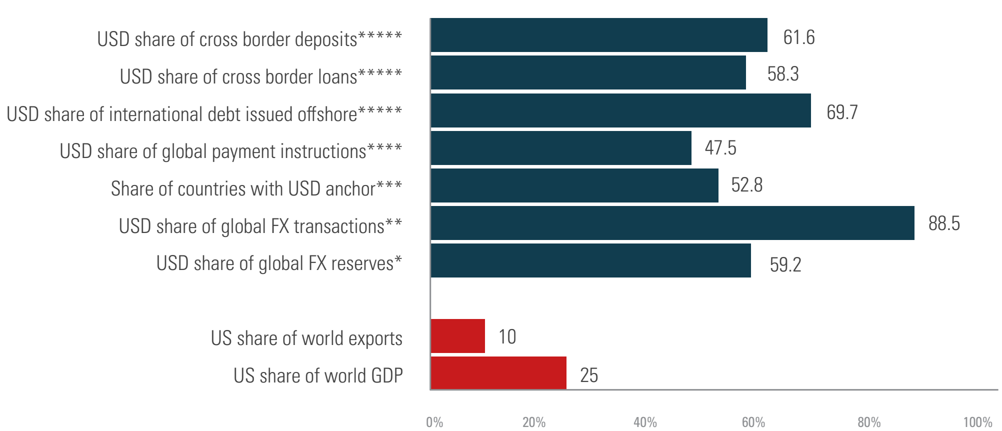


– Chart 2 –

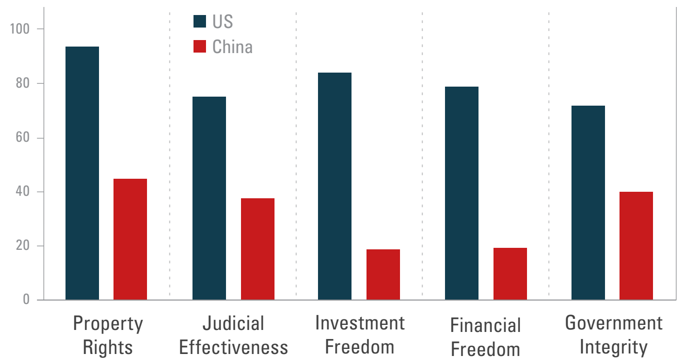


The Chinese renminbi's role has increased but accounts for only 2.4% of global reserves *(see chart 2)*. China will likely have to solve key challenges before its currency gains more importance in other countries' foreign exchange reserves. China's capital markets are not perceived as deep, liquid, and transparent. Additionally, China's political system lacks credible checks and balances that are often critical for reassuring foreign investors.

USD Hegemony (%)



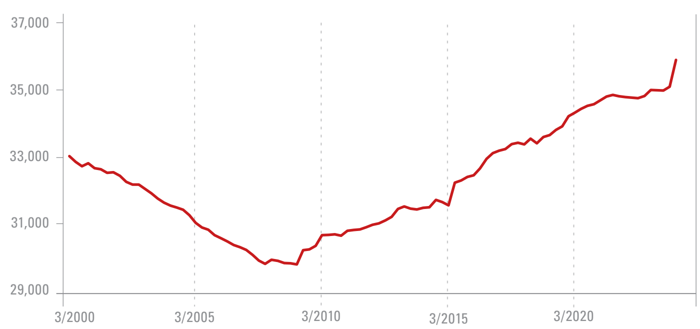
Economic Freedom Index



Instead, there is room for the euro to have a stronger weight in the share of foreign exchange reserves held by central banks as European Union (EU) integration deepens and boosts liquidity in its financial markets. Common EU debt issuance surged by over €350 billion since 2020 and the European Commission plans to raise €75 billion in EU-Bonds in the first half of 2024.

Gold, the traditional store of wealth, can also gain greater importance in central banks' reserves because of the unfavorable geopolitical landscape. For example, sanctions imposed on Russia's FX reserves by the U.S. and its allies can affect a government's willingness to hold international reserves in U.S. dollar assets. This is where gold can further prove its value.

World Central Banks Gold Reserves (Tonnes)

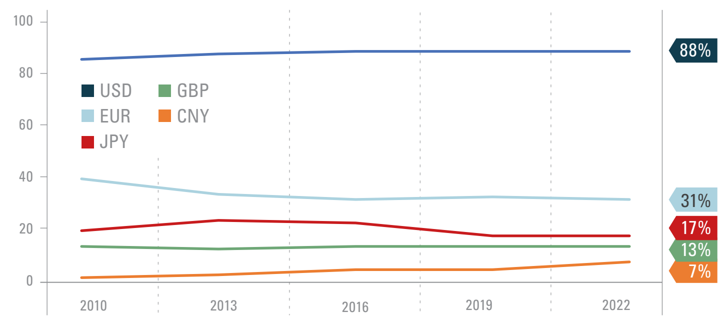


Meanwhile, inflation around the world will likely remain sticky to the upside as a shrinking labor force raises the bargaining power of employees and the levelling-off in globalization increases businesses input costs.

USD dominates as a medium of exchange and unit of account

The U.S. dollar was involved in more than 88% of daily global FX transactions in 2022, highlighting its status as the world's most frequently used currency in global trade and international banking.

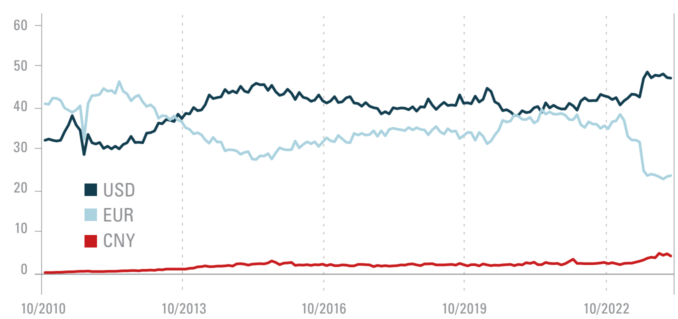
Foreign Exchange Daily Turnover (%)



In fact, since October 2022, more than 40% of global payment instructions have been in dollars *(see chart 3)*; over 52% of countries have their currencies anchored to the dollar; the share of foreign currency debt denominated in U.S. dollars is around 70%; 58% of cross-border banking claims (loans) are denominated in dollars; and 62% of cross-border banking liabilities (deposits) are denominated in dollars *(see chart 4)*.

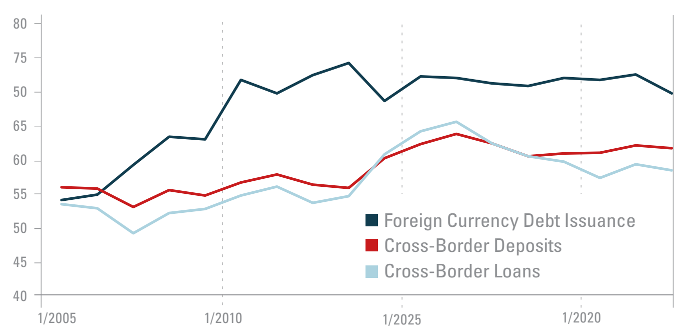
Share of Payments via SWIFT (%)

– Chart 3 –



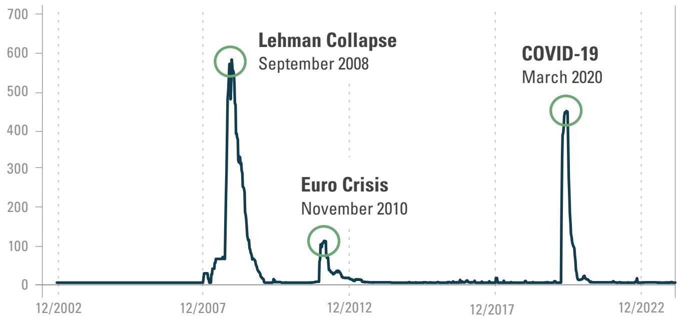
USD Share (%)

– Chart 4 –



The large take-up of Federal Reserve (Fed) swap lines facilities during periods of financial market turmoil highlights how crucial dollar funding is in the operations of many internationally active banks. The Fed's swap lines act as a relief valve in periods of stress by providing foreign central banks with the capacity to deliver U.S. dollar liquidity to financial institutions in their jurisdictions.

Fed Swap Line Provisions (Billions of USD)



China takes steps to shore up RMB

China has made significant progress to increase the international usage of the renminbi in international trade. Indeed, the renminbi became the fifth most traded currency in 2022 with a market share of 7% (up from 0.9% in 2010).

Chinese authorities are encouraging foreign importers to make payment in renminbi and recipients of Belt and Road loans to borrow in renminbi. It has taken the following steps to shore up the use of its currency in international trade:

- Built a Cross-Border Interbank Payments System (CIPS), which offers clearing and settlement services.
- Rolled-out a central bank digital currency to simplify cross-border transactions in renminbi.
- Negotiated a network of central bank swap lines to persuade foreign regulators to permit their banks to borrow and lend renminbi.

However, significant roadblocks remain to more widespread use of the renminbi on the financial front. China maintains capital controls that limit the quantity of inward and outward foreign investment, and the renminbi is not freely exchangeable.

Bottom line

The U.S. dollar is not about to lose its dominant international currency status. But other currencies, notably the euro, are gaining a more prominent role, which is a structural headwind for the USD.

Rate **Hikes** and **Recovery**

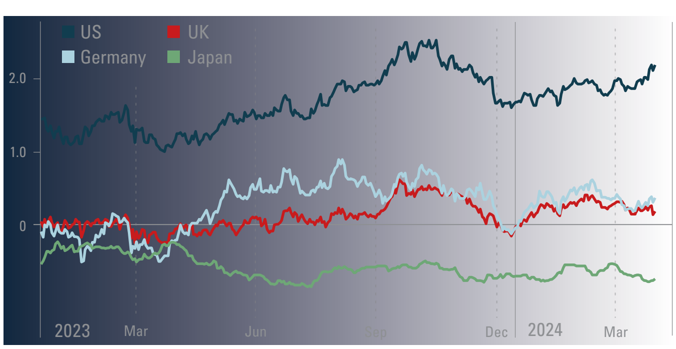
By Win Thin

Japan hikes rates

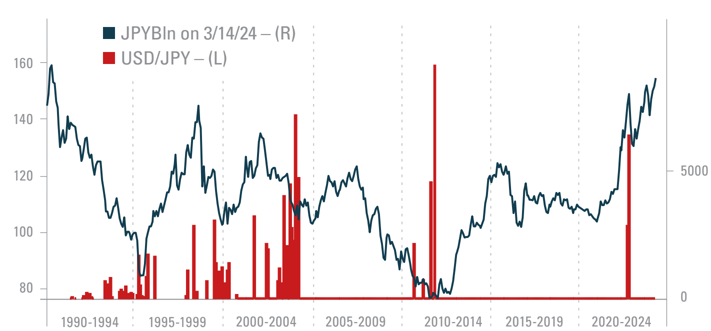
The Bank of Japan (BOJ) hiked rates in March for the first time since 2007. So far, Japan has avoided the undesired side effects of a stronger yen and higher Japanese Government Bond (JGB) yields. It has done so by giving very dovish forward guidance, stressing that policy will remain accommodative for quite some time yet. The market has taken this message to heart and is pricing in only 50 bp of tightening over the next three years. With the Fed keeping rates higher for longer, the monetary policy divergences between the U.S. and Japan remain wide and so there is scope for the yen to continue weakening.

To prevent a freefall in the yen, Japanese officials have already increased their jawboning on the exchange rate. When jawboning didn't work, senior officials from the Bank of Japan, Ministry of Finance, and the Financial Services Regulator moved another rung up the intervention ladder and held a special meeting in March to discuss the exchange rate. Now that USD/JPY has broken above 152, we believe intervention risks become quite high. The BOJ has not intervened since October 2022, when the yen was trading near 152. Intervention would introduce more two-way risk in the FX market, but we do not think the move higher in USD/JPY will be reversed until the Fed pivots more dovish. To us, that is an H2 2024 story, at the earliest.

10-Year Real Yields, %



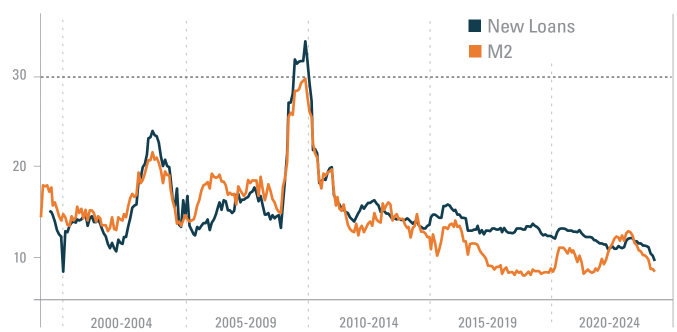
BOJ FX Intervention



China enjoys modest recovery, but may struggle to meet growth targets

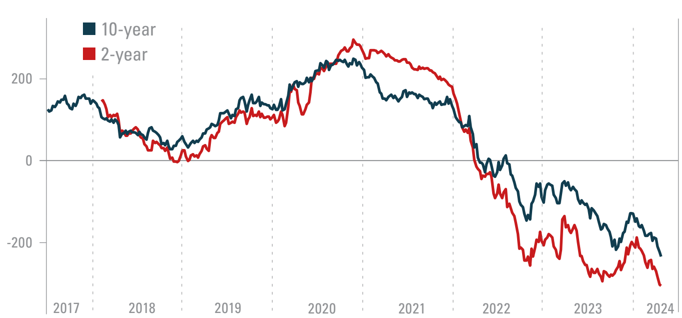
China continues to enjoy a modest cyclical recovery. March Purchasing Managers' Index (PMI) readings suggest the economy may have bottomed in late 2023. The official manufacturing PMI is in expansionary territory for the first time since September and is the highest since March 2023. However, we continue believe China may struggle to meet its 2024 growth target of "around 5%." That's because policymakers can no longer rely on massive debt-fueled stimulus to prop up the economy when debt/GDP is running close to 300%. This can be seen by slowing new loan growth, which at 9.6% in March was the slowest since 1999. We also learned that much of that stimulus went into the housing sector, which has become overbuilt and non-productive.

China Money and Credit, y/y



That said, the People's Bank of China is likely to continue cutting interest rates modestly this year as deflation risks persist. This means that U.S.-China spreads should continue to move in the dollar's favor, with USD/CNY likely to test last fall's high near 7.32.

China-U.S. Spreads, bp



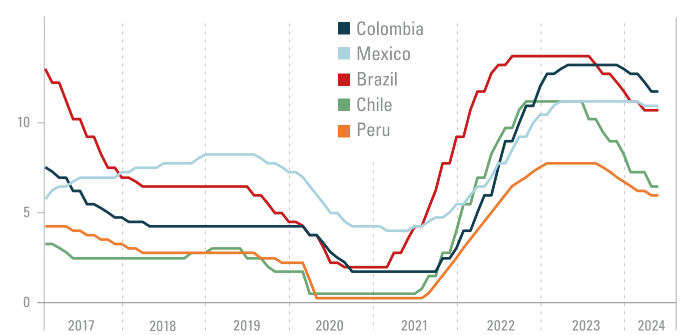
Longer-term, China is facing a long slog to address its huge debt overhang. More companies in the property sector will likely go bankrupt, putting more pressure on the financial system as local banks would be forced to take huge losses on their loan books. A banking sector bailout may become necessary. If so, it will be a long and painful process, but China's policymakers will have a pretty good roadmap for what must eventually be done. It took Japan decades to fully recovery from the bursting of its property bubble back in 1989. We think China can recover more quickly, but it should begin the process as soon possible.

Emerging markets could benefit from stronger commodities demand

The cyclical upturn in China will be positive for Emerging Markets (EM). Many major EM countries are in recession and so stronger demand for commodities will help these exporters. However, we expect most EM central banks will continue to cut rates to boost growth further. With the Fed staying higher for longer, however, most will have to recalibrate their easing cycles lest their currencies come under withering pressure.

High carry will insulate some currencies, but others will pay the price for narrowing interest rate differentials with the U.S. MXN is the top performing EM currency YTD, due in large part to the hawkish Banco de Mexico. It only started its easing cycle in March and has signaled a very cautious rate path ahead. PEN and COP are the next top EM performers and their central banks have also been cautious. On the other hand, CLP is the worst EM currency YTD and we see this as a direct result of a very dovish central bank. We expect EM FX weakness to continue this year, but will see divergences due largely to monetary policies.

Latam Policy Rates, %



DISCLOSURES

This material is provided solely for informational purposes by Brown Brothers Harriman & Co. and its subsidiaries ("BBH") to recipients who are classified as institutional or sophisticated investors, or as Professional Clients or Eligible Counterparties if in the European Economic Area ("EEA"). BBH is an independent FX research provider and this communication should not be construed as a recommendation to invest or not to invest in any country or to undertake any specific position or transaction in any currency, security, other asset class or any particular investment strategy. This material does not constitute legal, tax or investment advice. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code or for promotion, marketing or recommendation to third parties. This information has been obtained from sources believed to be reliable that are available upon request. This material does not comprise an offer of services. Any opinions expressed are subject to change without notice. Unauthorized use or distribution without the prior written permission of BBH is prohibited. This publication is approved for distribution in member states of the EEA by Brown Brothers Harriman Investor Services Limited, authorized and regulated by the Financial Conduct Authority (FCA). Please be advised that any analysis of individual countries, currencies, securities or other asset classes contained herein, including, but not limited to, rankings contained in BBH Country Risk Ratings, FX Risk Rankings and Equity Risk Rankings, should not be considered sufficient information upon which to base an investment decision. Such analysis is intended to serve as a preliminary screening tool, which should be supplemented by additional research.

This material contains "forward-looking statements" which include information relating to future events, projected future performance, statements regarding intentions, strategies, investments, expectations, the competitive and regulatory environments, predictions, and financial forecasts concerning future foreign exchange activities and results of operations and other future events or conditions based on the views and opinions of BBH. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time the statements are made and/or BBH's good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in, or suggested by, the forward-looking statements. Actual results of activities or actual events or conditions could differ materially from those estimated or forecasted in forward-looking statements due to a variety of factors.

There are risks associated with foreign currency investing, including but not limited to the use of leverage which may accelerate the velocity of potential losses. Foreign currencies are subject to rapid price fluctuations due to adverse political, social and economic developments. These risks are greater for currencies in emerging markets than for those in more developed countries. Foreign currency transactions may not be suitable for all investors depending on their financial sophistication and investment objectives. The services of an appropriate professional should be sought in connection with such matters.

BBH, its partners and employees may own currencies discussed in this communication and/or may make purchases or sales while this communication is in circulation.

Information has been obtained from sources believed to be reliable and in good faith. Sources are available upon request. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Any opinions expressed are subject to change without notice. This material has been prepared for use by the intended recipient(s) only. Unauthorized use or distribution without the prior written permission of BBH is prohibited. Please contact your BBH representative for additional information.

All data, statistics and direct quotations are sourced from Bloomberg April 2024, unless otherwise noted.

Brown Brothers Harriman & Co. ("BBH") may be used to reference the company as a whole and/or its various subsidiaries generally. This material and any products or services may be issued or provided in multiple jurisdictions by duly authorized and regulated subsidiaries. This material is for general information and reference purposes only and does not constitute legal, tax or investment advice and is not intended as an offer to sell, or a solicitation to buy securities, services or investment products. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code, or other applicable tax regimes, or for promotion, marketing or recommendation to third parties. All information has been obtained from sources believed to be reliable, but accuracy is not guaranteed, and reliance should not be placed on the information presented. This material may not be reproduced, copied or transmitted, or any of the content disclosed to third parties, without the permission of BBH. Pursuant to information regarding the provision of applicable services or products by BBH, please note the following: Brown Brothers Harriman Fund Administration Services (Ireland) Limited and Brown Brothers Harriman Trustee Services (Ireland) Limited are regulated by the Central Bank of Ireland, Brown Brothers Harriman Investor Services Limited is authorised and regulated by the Financial Conduct Authority, Brown Brothers Harriman (Luxembourg) S.C.A is regulated by the Commission de Surveillance du Secteur Financier, and Brown Brothers Harriman (Hong Kong) Limited is regulated by the Securities & Futures Commission in Hong Kong. All trademarks and service marks included are the property of BBH or their respective owners.

FOREIGN**EXCHANGE**

BROWN
BROTHERS
HARRIMAN

NEW YORK BEIJING BOSTON CHARLOTTE CHICAGO DUBLIN GRAND CAYMAN HONG KONG HOUSTON JERSEY CITY
KRAKÓW LONDON LUXEMBOURG NASHVILLE PHILADELPHIA TOKYO WILMINGTON ZÜRICH WWW.BBH.COM