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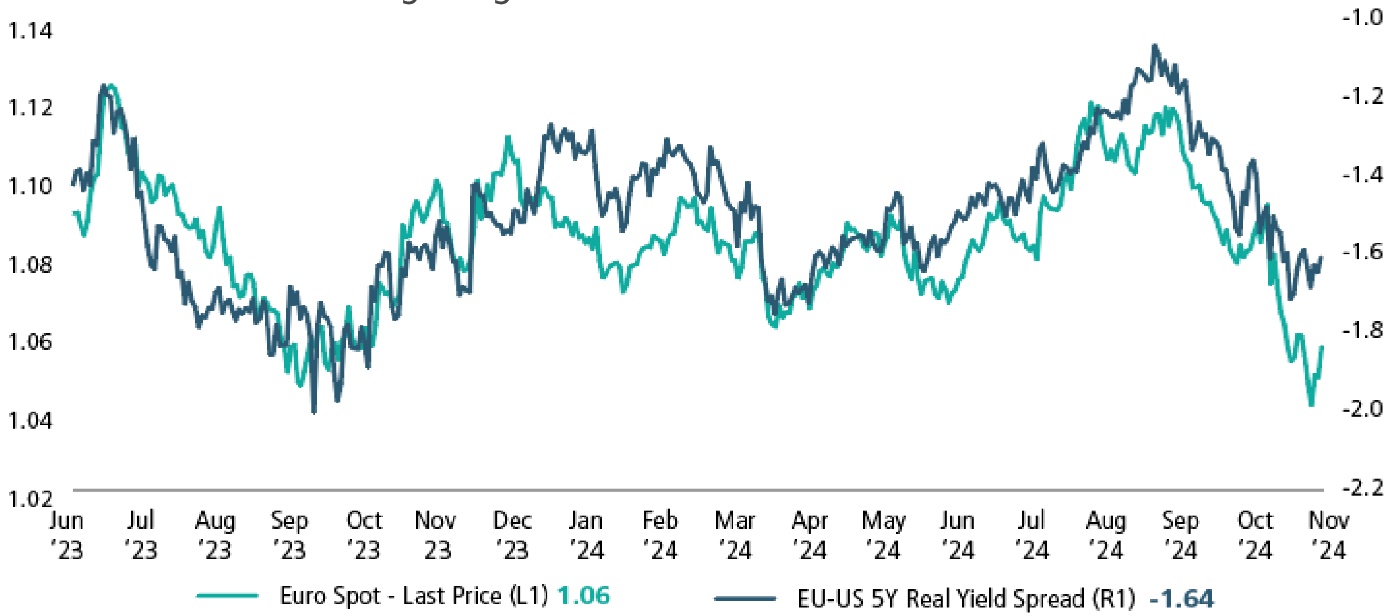
Neuberger Berman Multi-Asset Team

Monthly Global Macro Update

December 2024

CHART OF THE MONTH: Could FX Be Signaling a Breakout Year?



HIGHLIGHTS

With this month's Chart of The Month, the Multi-Asset Team highlights a recent development in the foreign exchange (FX) markets that is garnering little attention among investors: the disconnect of FX pairs from interest rate differentials. In our view, this may be due to investors' focus shifting from fundamentals to the next market-moving social media post. Whether this endures is an open question.

- The above chart shows the five-year rate differential between U.S. Treasuries and German Bunds versus the EUR/USD exchange rate. As can be observed, a large disconnect has developed relative to what has been a stable relationship for the past few years. Namely, the euro has fallen more than the relative rate differential.
- Why is this important? A few decades ago, FX pairs showed robust correlations to current account deficits, growth differentials and even trade flows. The rate differential was important, but not the sole driver we have become accustomed to in recent years.
- Aside from pursuing "carry strategies" where investors buy higher-yielding currencies funded by shorting lower-yielding currencies, the above-cited dynamic along with extremely low volatility has caused investors to largely overlook FX as an investment category.
- We believe this is about to change. As the market embraces the idea that short-term interest rate differentials no longer exert the same impact on growth and, therefore, risk assets, along with the potential dispersions in fiscal as well as trade policy, the non-interest rate variables that determine foreign exchange rates are likely to be more relevant in determining underlying FX trends.
- As a result, in the coming year we believe currencies could become a more fruitful source of return potential at a time when the market has understandably given up on the asset class as a source of non-beta returns.
- Despite not being able to find one sell-side research piece identifying "The Return of the FX Market" as a major theme of 2025, our team believes investors could find themselves surprised by the importance of this investment category in the coming year.

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