FX Daily: Banxico goes early with a hike

Emerging markets are leading the charge with tightening cycles. Mexico and Hungary have this week joined Brazil and Russia with early tightening. Even Korea said yesterday it will start its monetary normalization later this year. Expect these selected EM pairs to stay in demand this summer, although investors will have to be nimble around the Fed.

USD: Benign conditions allow select currencies to advance

DXY continues to very gradually hand back some of last week's 2%+ rally, but the move masks strong moves on the crosses. Most emerging market currencies are up anywhere between 1.5% and 4.5% against the JPY over the last week. And ex under-performing regional Asia, most EM currencies are up 0.5% to 3% against the EUR.

Effectively a flat dollar environment is allowing these selected cross positions to perform. This environment will probably continue today with global equity markets (including Asia for a change) pushing to new highs. US markets received a boost yesterday with news that there has been some progress on the US infra-structure bill ($559bn bi-partisan agreement from a Senate panel) and also healthy US banks stress tests. It's quite impressive really that the 23 banks stress-tested by the Fed showed CET1 capital ratios still double the minimum capital requirement when stressed by a scenario of a 4% GDP contraction and a 55% fall in equity prices.

This benign environment lasts until the next Fed shock comes along. Will that be today? Well, the consensus is already expecting quite a large increase in the May PCE inflation data - looking for 3.9% YoY headline and 3.4% YoY core. The bar may therefore be high for a nasty surprise and one that might push the Fed into early tapering and tightening.

Barring a surprise on the PCE inflation, we would say DXY continues to consolidate - perhaps drifting back towards the 91.50 area.

EUR: ECB happy to keep the EUR an underperformer

The ECB has done a good job of making sure the EUR will suffer the lion's share of any dollar appreciation. Unlike an increasing number of EM countries who feel the need to respond to the summer inflation spike, it seems the ECB is more than happy to position itself as not being rushed into premature tightening. That is why the EUR, the JPY and the CHF are the preferred funding currencies this summer. This could change should the ECB have to acknowledge the recovery even more in September, but for now the EUR should under-perform on the crosses.

The current environment should see EUR/USD continue to consolidate, although surprisingly strong Eurozone confidence indicators this week suggests EUR/USD could edge to the 1.1980/90 area over coming days.

Elsewhere, the RUB continues to perform well - backed by the hawkish CBR and high oil prices. We could see a little reduction of core RUB longs over coming days, however. Low vaccination rates in Russia have left it exposed to a new wave of Covid-19 cases. And the OPEC+ meeting of July 1st poses an event risk to the oil market should the alliance agree to increase supply in excess of 500k bpd.

GBP: BoE disappoints the bulls

GBP was an under-performer yesterday - hit by a BoE that was not quite as hawkish as traders had expected. The BoE was not particularly dovish, but it looked as though the market had got ahead of itself in pricing BoE hikes from summer 2022. The large 5 tick rally in December Short-Sterling contracts certainly suggested that was the case.

Expect EUR/GBP to continue to trade a low volatility 0.8535-0.8600 range, while a default Cable range looks something like 1.3890-1.4010.

MXN: Front-loaded tightening to keep MXN in demand

In a big surprise to markets Banxico last night hiked the policy rate 25bp to 4.25%. It was a three to two majority vote. This has been an amazing turnaround in Banxico, which in February would have liked to continue its easing cycle below 4.00%, but effectively had that door closed.

Banxico's statement showed concern that what had been considered transitory inflation could persist longer than expected and damage inflation expectations. Recall that inflation is running near 6.00% YoY and Banxico now estimates that it will not return to target until 3Q22.

Banxico joins the likes of Russia and Brazil (and this week Hungary too) in what could be a front-loaded tightening cycle - as EM central banks try to ride out the summer inflation cycle. The move shocked the local MXN rates markets, with some short-term TIIE rates moving up as much as 35bp on the day as traders move to price another hike at the August 12th Banxico meeting.

The move is a clear MXN positive, showing that Banxico is prepared to take no risks with the inflation cycle. MXN is also enjoying the benefits of $4bn in remittance inflows per month and could also stand to benefit from progress on the US infrastructure bill. The move could also see a return of foreign interest to the local MBONO market now that 10 year yields have pushed back above the 7% area and that Banxico looks to be taking no risks with inflation. Of course MXN is a high beta currency and will be hit should US yields spike higher - but during bouts of carry interest, such as we are currently seeing, MXN should out-perform the forwards and $/MXN should trade comfortably in a 19.50-20.00 range.

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