

FX Daily: Defensive positions advised

Equity markets are looking increasingly vulnerable as the risk-free rate rises and as businesses are finding their margins under pressure. A turn lower in core equity markets would like to keep the activity currencies under pressure and the dollar bid. The Japanese yen and Swiss franc could also win a few more friends



The main focus will be on UST auctions this week, beginning with the sale of \$48 billion in new 3Y notes tonight

USD: Margin pressure

Dominating global financial markets is the push in US 10-year Treasury yields very close to 5.00%. Arguably, the move could be a delayed reaction to some very strong US retail sales data earlier in the week. We note the incredible re-pricing in the two to three-year sector of the USD swaps curve. Investors now struggle to see 1m USD OIS swaps trading below 4.75% over the cycle.

However, the move in US Treasury yields does not wholly look like a function of a re-pricing of the medium-term Fed cycle. We note the US 10-year Treasury-OIS swap spread moving out to the widest levels in a couple of years near 40bp. This looks to embed some fiscal risk premium into Treasuries – perhaps not a surprise given rating agencies fears over an 'erosion of governance' and the startling developments in the US House of Representatives. Additionally, we note the continuous unwinding of US Treasury holdings by Chinese investors, whose holdings dropped by another \$16 billion in August. China's holdings of US Treasuries have dropped by \$235 billion since the start of 2022. At some point, there is a risk that the US Treasury yield to dollar correlation

briefly flips from positive to negative. We are probably not there yet, however.

We are focusing on equities today not only because they are under pressure globally, but last night's release of the [Fed's Beige Book](#) warned:

Sales prices increased at a slower rate than input prices, as businesses struggled to pass along cost pressures because consumers had grown more sensitive to prices. As a result, firms struggled to maintain desired profit margins.

This pressure on profit margins plus the rise in the risk-free rate of 10-year Treasury yields warn that equities will come lower. The S&P 500 rally has recently stalled at an upside gap near 4400 and the index looks primed for a retest of the 4216 low seen at the start of the month.

FX correlations with the S&P 500 suggest the dollar will hold gains in a sell-off, largely at the expense of the commodity and activity currencies. GBP/USD actually has one of the highest positive correlations with the S&P 500. Even though we think the Australian dollar is exceptionally undervalued from a medium-term macro basis, it could prove a high-beta victim to an equity sell-off. Here, we see a cross rate like AUD/JPY coming substantially lower if equities do finally drop.

A risk-off tone should keep DXY bid towards the top of its 106-107 range. In terms of today's calendars, look out for a host of Federal Reserve speakers, with Fed Chair Jay Powell's as the main event at 6:00 pm CET. Also, see how the dollar fares with the release of the weekly jobless claims at 2:30 pm CET, which so far have shown no signs of any lay-offs.

Chris Turner

EUR: Holding up surprisingly well

We would have thought EUR/USD would be trading a little lower given what has been happening to US yields this week. While there may be a tendency to conclude that long dollars is a very crowded trade and this week's EUR/USD price action is telling, we think the defensive global environment makes it hard to own the pro-cyclical euro. The eurozone data calendar is exceptionally light today and barring some surge in US jobless claims or some surprisingly dovish Fedspeak, we would expect EUR/USD to be pressuring support at 1.0500. We would be careful, however, if we are under-estimating the risk of indiscriminate down-sizing of open (long dollar) positions and would warn of a sharper correction higher should EUR/USD trade above 1.0600/0610 again.

Chris Turner

Elsewhere, Hungary's Minister for EU Funds will meet representatives of the European Commission in Brussels to discuss locked EU funds today. According to previous information from the Hungarian side, all the problems should be resolved by the end of November. However, today we could hear more details about the situation. The timetable has not been set but we will probably see some headlines on this topic. For now, it seems that the negotiations are moving in a positive direction, which should have been confirmed today. At the same time, HUF rates moved up again yesterday, which should offset the downside risk for HUF we mentioned yesterday after the core rate touched new record highs. If the progress in negotiations is confirmed, we could see EUR/HUF test new local lows below 384.

Francesco Pesole

⬆️ JPY: The intervention intrigue continues

Consensus assumes that the Japanese have not been selling FX in intervention to support the yen. Consensus has reached that conclusion since last year Japanese officials were quick to confirm their intervention during September-October 2020 when they sold about \$70 billion. However, overnight Japanese Vice Finance Minister Masato Kanda has said that real-time confirmation of intervention can become noise and that it is more normal not to confirm intervention.

These comments leave the door marginally open to the fact that Japan may actually have sold FX earlier this month. We will know for sure when the Ministry of Finance releases intervention statistics on 31 October. While the confirmation of the intervention will certainly not turn this USD/JPY trend around, it might add confidence to trades which favour Japanese yen out-performance on the crosses. A lower AUD/JPY is our focus near term with a target of 92.

Chris Turner

⬇️ Latam FX: Strong dollar derails local easing cycles

Quite apposite to the times is the well-worn phrase from a former US Treasury Secretary that the dollar is 'our currency but your problem'. This has relevance today around most of the world, but particularly in Latin America, where the strong dollar looks to be interfering with local easing cycles. For example, Chile's central bank yesterday said that the 'very important' depreciation of the peso recently (13% in three months) needs to be taken into consideration at next week's policy meeting. Two-year Chile swap rates jumped 17bp on the comments.

The current environment is a far cry from when Chile launched its easing cycle in July with a 100bp rate cut. The policy rate was taken down to 10.25%. At the time, investors read that as Latam firing the starting gun on deep easing cycles across the region. Since then, however, expectations of the policy rate in one to two years' time have backed up anywhere between 125bp in Brazil and 300bp in Chile. In short, the strong dollar and local currency weakness looks to be curtailing easing cycles.

Until we have much greater confidence that US Treasury yields are near a peak, the above trends look set to dominate over the coming months. We suspect that the Chilean peso looks the most vulnerable of the three, given that higher US rates probably stand to take the greatest toll on the commodity sector. We have a year-end forecast for USD/BRL at 5.25 and we think that the Mexican peso can outperform. [Banxico's unwind of its FX forward book was heavily front-loaded into September and October](#). The perennially more hawkish Banxico looks most likely to keep implied yields high given its preference for stability in the Mexican peso.

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