FX Daily: Hard to put the tightening genie back in the bottle

This week's hawkish Fed shift and China's intention to intervene in commodities have proved a toxic combination for widely held dollar short positions. This correction may have a little further to run. These developments will emphasise trends towards backing currencies with policy normalisation cycles and leave the low yielders vulnerable.

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USD: It's been a tough week for dollar shorts.

Broad measures of the trade-weighted dollar have rallied around 1.5% this week. In the G10 space, the $ is firmer across the board - up as much as 2.5% against the commodity bloc and SEK and as little as 0.5% against the JPY. Speculators were already short JPY, hence the more limited response here.

The commodity bloc, in particular, has suffered on the toxic cocktail of the FOMC meeting and reports firming up that China is preparing to release strategic stockpiles of industrial metals to alleviate input price pressures. Effectively China is intervening in commodity markets. But as in FX, we suspect their intervention can only slow, not reverse underlying trends. So unless there are some more serious threats to global demand trends (such as new variants etc) or it looks like the Fed will be rushed into tightening, we doubt the commodity cycle goes fully into reverse and perhaps it is too early to say that the broad dollar index has put in a definitive low.

What we can say is that this week's events will emphasise the existing trends that those currencies backed with a path to monetary normalisation will out-perform. Norway is clearly at the front of the pack here and remains followed by Canada. This week's events, though, do suggest the dollar moves a little ahead in the pecking order as we suggested in the Fed review and the low yielders of EUR, JPY and CHF will remain the most vulnerable. For FX markets this suggests it will be the summer of 'cross trading' rather than merely dollar-funded carry trading. And if the dollar is to correct even higher, e.g. on the back of better US data or a more formal shift in Fed rhetoric, then those gains will largely come against the low-yielders.

Given that DXY is heavily weighted towards European low-yielders, the near-term bull trend may have further to run - initially to the 92.90 technical area - that's about 1% higher than current levels. Today will be quiet, however, with little on the US data calendar and US market trading calming in respect of the newly-signed into law Juneteenth public holiday.

EUR: ECB happy to distance itself from the Fed

The ECB will be looking to use this period of dollar strength wisely and be sure to insert a wedge between Fed and ECB expectations. ECB Chief Economist, Philip Lane, did this yesterday by suggesting at what seems to be a big ECB meeting in September the ECB may still not have enough data to make any changes to its dovish policy.

By inserting this wedge the ECB will a) hope to limit the fall-out in European bond markets and keep financing conditions loose this summer and b) try to encourage a weaker trade-weighted EUR. The ECB's trade-weighted EUR fell 0.5% yesterday and is not far from the cheapest levels seen since last July.

We doubt now EUR/USD can make it much above the 1.1950/80 area on any intra-day correction and momentum may well carry EUR/USD towards the 1.1835 area and potentially 1.1700 should any data/Fed commentary add to tightening fears this summer.

GBP: Bracing for the sausage wars

GBP has been an outperformer this week, losing just 1.5% against the stronger dollar. Again this is probably a function of where GBP sits on the monetary normalisation spectrum. Here the market prices the first 10bp BoE rate hike in August 2022 - ahead of the Fed. That is rare - normally the BoE cycle is priced somewhere between the Fed and the ECB.

Standing against GBP, however, is positioning but also European event risk. Here signs are growing that the UK government may want to unilaterally extend a grace period for processed meat exports (sausages) to N. Ireland that expires at the end of June. Brussels' patience with London's of having its cake and eating it is wearing thin. Indeed, there is a risk of protocols being triggered and tariffs being threatened more seriously.

The next few weeks could thus be a vulnerable period for Cable, where a break of 1.3890 opens up 1.3800/3810 - the last stop before an extension to the March/April lows of 1.3675.

BRL: Latest in a trend of hawkish hikes

With the Fed turning a little more hawkish, the $ will probably make gains against those currencies with the weakest monetary defences - e.g. EUR. JPY and CHF. But more resilient to dollar strength will be currencies backed by some quite impressive front-loaded tightening. Here Russia has already taken the policy rate to 5.50% and is expected to hike another 50bp in July. And the Czech National Bank should kick off its tightening cycle with a hawkish hike as well next week.

BRL should also be in a strong position to withstand dollar pressure - since the policy rate is now 4.25% after this week's rate hike and looks set to be taken to 5.00% at the next BACEN meeting in early August. Wednesday's hawkish hike from BACEN is firming up expectations that the policy rate may end the year well over 7% as BACEN tries to ride out the summer surge in inflation and get inflation expectations for 2022 back on track.

In an environment where selective carry is favoured, BRL may well out-perform its steep forward curve and funding out of EUR, rather than USD, may become the preferred strategy this summer.

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com