Daily FX: Now is the time to talk tapering

Confirmation from the Federal Reserve's James Bullard on Friday that Chair Jerome Powell has formally opened the tapering debate has extended the flattening in bond markets and is a clear dollar positive. Look out for a whole host of Fed speakers this week, warning that this dollar rally has further to run

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USD: FOMC speakers dominate this week's agenda

The fallout from last week's hawkish FOMC meeting is still reverberating around markets and received a nudge on Friday from the Fed's Bullard, who said Chair Powell had now formally opened up the discussion on tapering. This is a far cry from the April FOMC press conference, where Chair Powell calmed markets with a clean view that 'now is not the time to talk tapering'.

The hawkish turn from the Fed has many wondering whether its new strategy of 'Average Inflation Targeting' adopted last September was really just some elaborate form of forward guidance that would be dropped at the first sign of genuine concern over inflation. Bond markets seem to be reading it this way, with US Treasury yields rising at the short end of the curve on the view of early tightening, while long-dated yields are falling sharply - probably on the view that: a) the Fed may not be prepared to run the economy hot after all and b) early tightening could mean a lower terminal rate for Fed Funds after all. Currently, the market looks to be pricing the first Fed 25bp hike around November 2022.

Conventional Fed tightening, as we highlighted in our Fed review on Wednesday, looks to be a dollar positive against the developed market low-yielders, particularly those currencies in Europe and Japan which have not enjoyed the terms of trade gains of the commodity exporters.

As we discuss in the G10 Week Ahead, we think Fed communication will dominate markets this week. Today we should hear from the Fed's Bullard and Robert Kaplan at 15:45 CET discussing the US economic outlook at an OMFIF event. Bullard on Friday said his 2022 dot was for a hike.

For DXY, heavily-weighted towards European low-yielders, the backdrop looks positive. It has come a long way quite quickly, but after some consolidation may well break above resistance in the 92.40 area towards the late March high of 93.44 - equivalent to EUR/USD trading down to the 1.1700 area.

EUR: Lagarde testimony the highlight today

EUR/USD is consolidating after last week's heavy sell-off and we expect to see an environment of shallow corrections and new lows. The direction of travel looks to be to the March low at 1.1700, barring the Fed somehow rowing back on hawkish sentiment - the best chance of that perhaps being Powell's testimony to Congress tomorrow evening.

The eurozone data calendar is light today, although European Central Bank President Christine Lagarde speaks to European Parliament at 16:15 CET as part of her monetary dialogue. As we mentioned on Friday in this space, expect the ECB to encourage the wedge between US and eurozone monetary policy - such that the trade-weighted EUR cheapens up even more.

We would see something like the 1.1920 area as the best level for EUR/USD today and will be interested to see how eurozone manufacturing PMIs hold up in June - new releases come towards the end of this week - in the face of a myriad of supply bottlenecks.

GBP: Staying vulnerable near term

GBP has been underperforming even the soft EUR as the combination of dollar strength, rising daily Covid-19 case numbers and European politics have started to weigh. The highlight of the week - and GBP's best chance of a recovery - is Thursday's Bank of England rate meeting. However, no fresh forecasts will be released and the BoE may not want to encourage too many further expectations of an early rate hike. Currently the market prices the first 10bp BoE rate hike around August 2022.

We suspect GBP/USD will struggle to make it much above the 1.3870/3900 area through the early part of the week, before breaking down to the 1.3675/3700 area.

JPY: Having its day in the sun

Not many things have gone right for the JPY this year - but it is now enjoying a short term re-rating. Driving that are a couple of key factors. The first is that the commodity rally has temporarily burned out as Chinese intervention and a hawkish Fed take their toll on the industrial metals story. As a big commodity importer, Japan has been on the wrong side of this year's Terms of Trade adjustment.

The second factor is that Treasury yields at the longer end of the curve are falling and USD/JPY has consistently had the strongest correlation with US 10-year yields. Admittedly, it is not clear how much US 10-year yields can fall from their current very low levels of under 1.40%.

And finally, the JPY had been speculators' conviction short position. Current position-adjustment and de-leveraging, therefore, favours some JPY outperformance. A lower GBP/JPY could be the axis to express that view this week.

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