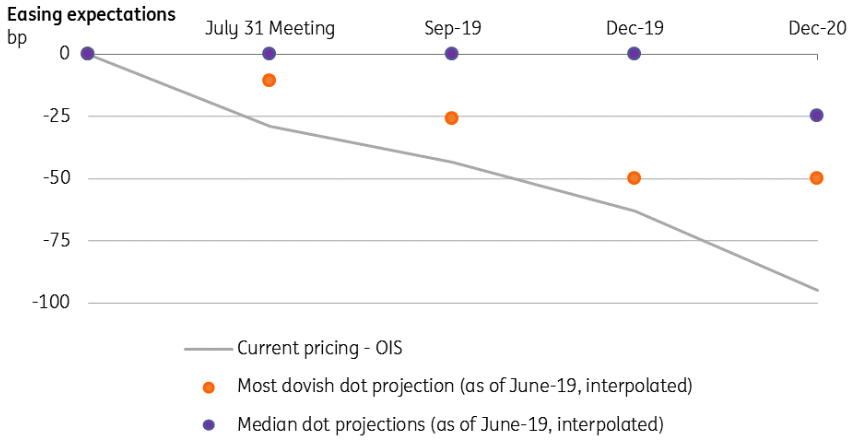
Fed meeting: beware the dollar’s resilience

The bar is high for the Federal Reserve to meet the market's dovish expectations, suggesting the FOMC will struggle to push the dollar lower. However, the Fed will be loath to disappoint markets and we think the high yielders (especially the Canadian dollar) could outperform

Source: iStock

Market expectations may be overly dovish

The past few weeks have been dominated by a single question, will the Fed cut by 25bp or 50bp? As the FOMC announces policy today, only a few market participants are still betting on a 50bp cut (16% implied probability), as the recent constructive data flow has helped to cement expectations of a quarter point reduction. This is also our call and we find it hard to believe that the Fed will surprise in this regard. All eyes will therefore be on the language that the FOMC uses to support its decision to ease monetary policy. Our economists believe that Chair Jerome Powell will highlight the downside risks stemming from trade tensions and slowing global growth, including the risk of softer inflation, which supports the need for an insurance cut. While we see room for another quarter point rate cut by the end of this year, market pricing has been much more aggressive on the dovish side. Currently, the OIS curve is showing 63bp of easing ("two-and-a-half cuts") by year-end, with two more cuts priced in for 2020. As shown in the chart below, this is more aggressive than the most dovish dots in the June FOMC projections. It suggests that, rather than an insurance move, markets are pricing a full-fledged easing cycle by the Fed.



Source: Federal Reserve, Bloomberg, ING

Historical evidence: a (selectively) resilient dollar

Many market observers have been comparing the expected "insurance" cuts to those delivered by the Fed in 1995-96 and 1998 as fears of an economic slowdown spiked. The 1995 analogy seems particularly apt: inflation had faced a benign decline and global growth was sending warning signals, although the labour and stock markets were fairly robust. At that time, Chairman Alan Greenspan delivered three rate cuts between July 1995 and January 1996.

The first cut in 1995 caused a 21bp drop in the US 2y swap rate in the 48 hours around the meeting. Nonetheless, in the same time frame the US dollar strengthened (+0.625% on a trade-weighted basis), massively outperforming safe havens (Japanese yen and Swiss franc), although losing ground against risk-sensitive high yielders (Australian and New Zealand dollars). The table below shows that this pattern (lower rates, broadly stronger dollar, weaker havens, stronger high-yielders) was followed in other instances when the Fed delivered the first cut after a period of pause. The only exception seems to be 2007 when, however, the move was triggered by growing fears of a crash in the housing market and actually was the first step in an aggressive easing cycle.

Performance versus USD in the 48h around the Fed's meeting

	06/07/1995	29/09/1998	03/01/2001	18/09/2007	Average
EUR	-0.43%	0.54%	-0.23%	0.65%	**0.13%**
GBP	-0.02%	-0.70%	-0.11%	0.31%	**-0.13%**
JPY	-2.10%	-0.45%	-1.18%	-0.83%	**-1.14%**
CAD	0.59%	-1.39%	-0.40%	1.22%	**0.00%**
CHF	-1.22%	0.68%	-0.34%	0.23%	**-0.16%**
AUD	0.62%	0.56%	0.71%	2.77%	**1.17%**
NZD	0.80%	0.76%	-0.16%	4.07%	**1.37%**
SEK	-0.27%	-0.24%	0.38%	1.44%	**0.33%**
NOK	-0.74%	0.22%	0.09%	0.90%	**0.12%**
USD TWI	0.63%	0.28%	0.25%	-0.63%	**0.13%**
2y US swap rate (bp)	-21	-16	-12	-16	**-16**

Source: Federal Reserve, Bloomberg, ING

This time, it may be different

There are at least two major caveats that suggest today's meeting may have a different impact on the FX markets compared to these previous instances.

1. During the 1990s the statements were much shorter and provided little to no forward guidance. Given that the cut is a sure thing, according to almost all market participants, it will actually be the language used by the Fed that will steer the market's reaction.
2. Even if the Fed does not pare the market's aggressive easing expectations, it is hard to visualise a drop in the 2y swap rate similar to the one seen in the meetings shown above – or indeed delivering a repeat of the drop in rates seen at last month's meeting, where the use of the Dot Plots helped. Instead, today there is the risk of an upside correction in front-end rates, which may translate into a bearish flattening of the yield curve, rather than a steepening as happened in most of the previously mentioned Fed meetings. Should this be the case, the overall impact on the dollar should still be broadly supportive, but a sell-off in safe haven currencies such as CHF and JPY may be unwarranted.

From a tactical point of view, Powell will have little interest in delivering a disappointing message for the markets, prompting a fall in equities and even more pressure from the White House going ahead. In turn we suspect that the Fed will likely tweak its forward looking language in a way that keeps the door open for new cuts (without necessarily setting a timeline). Nevertheless, we still believe that a marginal upside correction in rates and the USD can occur, given what was previously said about excessive market pricing.

CAD may be the outperformer

All in all, we believe that high-yielding currencies will hold their ground better than their G10 peers in the aftermath of the meeting. This may be especially true for the Canadian dollar, given that the Bank of Canada's on-hold stance is keeping the currency particularly attractive from a rates perspective, and the upcoming ratification of trade deals with the US

(USMCA) and the EU (CETA) could offset fears about a re-escalation in US-China tensions.

Conversely, AUD and NZD may show more limited resilience given that their outlook remains affected by the prospects of more central bank rate cuts. Among the "losers", we suspect that the euro may actually weaken more than other low-yielders (namely, CHF and JPY), given that investors could take the chance to price in the ECB's dovish message from last week by sending EUR/USD below 1.1100. Should the Fed put even more emphasis than expected on the trade war and slowing economy risks, we would expect the Swedish krona to be a major underperformer too.

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