FX Daily: Central banks to the rescue, again

A liquidity injection by the PBOC and some tentatively encouraging news on Evergrande have helped contain the slump in Chinese equities this morning, to the benefit of global sentiment. We expect the FOMC to keep the tapering discussion open-ended, and as the median Dot Plot may end up being unchanged, some USD weakness may be on the cards later today.

Fed Chair, Jerome Powell

USD: Powell set to dodge the hawkish tone

Risk assets are navigating calmer waters this morning, as the re-opening of Chinese markets after a four-day holiday saw the PBOC pump extra liquidity (for a net CNY 90bn, similar to size of interventions on Friday and Saturday) into the banking system through reverse repurchase agreements. Also contributing to limiting losses in Chinese equities was the news that Evergrande has negotiated an interest payment for its 5.8% 2025 bond due tomorrow. As a consequence, US stock futures are pointing at a positive open, and the FX market saw a dominance of risk-on moves with commodity currencies gaining against safe-havens this morning.

Some special focus was also on the first CNY fixing this week, as the FX channel could be another way for the PBOC to ease the turmoil. The fixing (6.4693) was in line with model estimates this morning, but any fresh rally in USD/CNY might start to see the PBOC increasingly resist CNY depreciation.

While it still appears that the Evergrande saga holds the keys to any directional move in market this week, it is hard to attribute any secondary role to the FOMC rate announcement today (here's our FX preview and our economist's preview). Market consensus appears quite clear: the Fed will refrain from sounding too hawkish. This implies no tapering announcement just yet - with any reference to the plans to unwind asset purchases likely to be kept open-ended when it comes to timing - and a reiteration that tightening will not be an immediate consequence of tapering.

Should the Fed follow this script, the impact markets and the dollar should be neutral. However, where we think the Fed won't have a neutral effect is on the Dot Plot projections. Despite markets currently pricing very little tightening for 2022, we think there are some expectations that the Median Dot Plot will shift left to signal a first hike in 2022, from the current 2023. We think that such a change in the dot projections could be enough to dent the notion of de-linking between tapering and tightening that Chair Powell's has been championing, and ultimately push the dollar higher as it would leave considerable room for rate expectations to rise (and price even more than one hike in 2022).

We admit it is a close call, but we are inclined to think the median Dot Plot will still signal the first hike in 2023. Market pricing is indeed leaning towards this scenario, so the impact (in this case, negative) on the dollar should be more contained compared to a shift to 2022. Still, we think the dollar should come under pressure if the median Dot Plot is unchanged as that would provide a signal that Powell can count on some solid support within the FOMC for its tapering-tightening de-linking narrative.

We expect mostly high-yielding EM and G10 commodity currencies to benefit from an unchanged Dot Plot (and the overall lack of strong hawkish signals), and especially the likes of NOK and CAD that are not as directly impacted as AUD and NZD from the turmoil in Chinese markets. At the same time, it is highly possible that post-FOMC FX moves may be rapidly wiped by the spill-over of further swings in China-related sentiment.

EUR: Likely less impacted by FOMC than others

It is all very quiet in the eurozone's data and event calendar today, so all moves in EUR/USD will be driven by the dollar leg as markets weigh incoming Evergrande news this morning and the FOMC rate announcement later today. With regards to the FOMC impact, a policy message falling more on the hawkish side than expected should see EUR/USD weakening on idiosyncratic USD strength, but the low-yielding EUR should anyway perform better than higher beta currencies, as the impact may be mostly felt in riskier assets (equities and commodities).

As our base case is for a neutral/moderately dovish announcement compared to expectations, we could see EUR/USD climb back towards 1.1800 later today – assuming risk sentiment will remain broadly stable into the FOMC announcement. Gains in the EUR should however be more contained than in commodity currencies, as highlighted in the USD section.

GBP: Rising beta to risk sentiment

The pound is surprisingly the worst-performing G10 currency in the past five days (-1.4% vs USD).

Indeed, GBP has been cementing its pro-cyclical nature lately and the recent fluctuations in sentiment have been the main cause of weakness in the currency. At the same time, the underperformance compared to higher-beta currencies might suggest markets have turned less confident the BoE will be able to stick to its broadly optimistic tone as it announces policy tomorrow.

Today, expect GBP to move in line with the pack of pro-cyclical currencies again. Some post-FOMC USD weakness may put a floor below the underforming Cable, and potentially prompt a rebound to the 1.3700 area.

JPY: BoJ rings the alarm on the recovery

The JPY is the weakest G10 currency this morning. This is largely due to the lower than expected slump in Chinese equities, but it appeared that the Bank of Japan policy announcement overnight marginally contributed to JPY underperformance. While leaving all policy measures unchanged, as expected, the BoJ raised some concerns over the impact of supply chain disruptions and the recent Covid-19 wave in Japan, by cutting their forecasts for both exports and production.

Domestic factors are currently playing a secondary role for JPY compared to global risk/UST swings, but there is a chance that the upcoming LDP primary election in Japan may bring the attention to the local recovery story, which has taken a hit during the summer and may not prove very supportive for JPY.

Today, we expect JPY to stay under pressure if – as we project – the Fed remains cautious. The opposite scenario would likely see JPY being more protected compared to most other G10 currencies to USD appreciation.

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