FX Daily: Payback time for the dollar

We expect benign conditions in FX markets to extend into next Wednesday's FOMC meeting. This will also allow greater scrutiny of Joe Biden's tax hike plans - potentially announced next week. Tighter fiscal policy may continue to diffuse US overheating fears and encourage the carry trade. Also, look out for a 25bp hike from Russia's central bank today

USD: Pay-back time

News of a possible doubling of the capital gains tax for Americans earning over $1 million per annum briefly hit US equities yesterday.

Tax hikes were always part of the Democrat election manifesto, although it seems they might be introduced a little earlier than most had expected. Of course, any tax hikes may well be watered down through Congress - especially at a time when US policy-makers are trying to re-employ 9mn or so of their residents. But a hefty capital gains tax hike potentially going into place at the start of 2022 will likely prompt a re-pricing of US equities - perhaps in 4Q21 - and perhaps for international investors encourage a further rotation away from the US in general and away from US tech stocks in particular. The FX implications of this would seem to be dollar negative.

A slightly tighter fiscal policy could encourage the Fed to keep monetary policy a little looser for longer and arguably further deflates fears of another tantrum in the bond market. This should be supportive of the benign dollar decline we are expecting through 2021.

Back to today, we have some April US Markit PMIs released and also March New Home Sales. We favour DXY to trade toward the lower end of a 90.85-91.45 range.

EUR: Advanced PMIs due today

We think the EUR really should be trading higher. It has been a good week for the EUR in terms of the Karlsruhe Constitutional court declaring that it would not delay the ratification of the EU's fiscal stimulus initiative and an array of business and consumer indicators (Belgium excluded) showing improving confidence in the region.

This latter point could be emphasised today with a robust set of flash April PMIs for the Eurozone, Germany and France. Those could be enough to send EUR/USD back to the 1.2080/2100 area. One slight risk here, however, could be the manufacturing segment of the PMIs, where chip shortages really seem to be impacting the automakers. Let's see.

Yesterday's ECB meeting had little bearing on the EUR, and the main event will occur in June when new forecasts are released, and the ECB has to handle the debate over whether to slow the above-average weekly PEPP purchases.

GBP: Strong March retail sales helps the re-opening narrative

Much better than expected March UK retail sales have just been released and position the UK and GBP well for a strong 2Q.

We think GBP strength is better played out against the dollar than the Euro over coming months, however, where the latter should enjoy a re-rating on opening prospects and the prospects of EU fiscal stimulus being released at the start of 3Q21. EUR/GBP to continue trading an 0.86-0.87 range, while Cable should return to 1.40.

RUB: Expect another 25bp hike from the CBR today

Russia's central bank meets today to set interest rates.

Our Russian economist, Dmitry Dolgin, expects a 25 basis point rate hike to 4.75%, although attaches a 25-30% chance to a more aggressive 50bp hike. Back-to-back hikes from the central bank, following a 200bp easing cycle last year, show that the Bank is taking the inflation threat seriously and stands out as one of the most independent central banks in the region.

The bearish flattening of yield curves associated with early tightening is normally seen as positive for currencies, although in Russia's case geo-politics has dampened investor enthusiasm for the Rouble. That said, investors have now received the news on formal sanctions from the US (and weathered it well), plus have already reacted to news out of Russia that troops would be returning to their bases and away from the Ukraine border by 1 May. Given that we like carry at the moment, the 5% p.a implied yields available through the 3m RUB forwards look attractive - equally, the RUB is an expensive sell - and suggests USD/RUB could make a run for the 73.80/74.00 area.

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