FX Daily: 5% USD deposit rates are hard to fight

Last night's release of the May FOMC minutes has seen the dollar push further ahead as expectations for another rate hike from the Fed this summer firm up. Given USD overnight rates now at 5%, shorting dollars is an expensive proposition. Until hard US data makes the slowdown case, the dollar can hold gains. Keep an eye out for a big hike in South Africa

USD: FOMC minutes has little for dollar bears

US yields and the dollar have edged higher after last night's release of the May Federal Open Market Committee (FOMC) minutes. ING's James Knightley discusses those minutes in this article. There were very few crumbs of comfort for dollar bears in the minutes, apart from some comments that it was uncertain what additional tightening would be necessary. Otherwise, the tone of the minutes was pretty hawkish – inflation remaining unacceptably high and slowing less quickly than expected, plus uncertainty as to how tighter credit conditions would impact the economy and prices. The uncertainty here seemed to stem from fears that the regional banking crisis may not slow inflation after all. And the minutes presented a core view that there were upside risks to the baseline view for US prices and activity.

That leaves the market well on its way to pricing another 25bp hike by the July meeting. That has seen the US 2-10 year Treasury curve invert further – a key factor supporting the dollar. As we discussed on Tuesday, lower levels of volatility are generating more interest in the carry trade and keeping the negative-yielding Japanese yen under pressure. 139.50/140.00 is quite strong technical resistance for USD/JPY, and a break above there can cause a deeper short-squeeze.

The dollar has also shaken off news late yesterday that Fitch has put the US AAA sovereign credit on negative watch. This should not be a surprise given the proximity of the 'X' date – but so far financial markets are trading like a deal will be done. That may not be the case if there has been little progress in a week's time.

For today, we will see revisions to first quarter US GDP and the weekly initial claims data. With overnight USD deposit rates now a very dear 5.00%, the burden of proof for dollar bears will have to be very high – and there is not just enough of it at present. Above 104.00/104.20, there is an outside risk that DXY needs to trade all the way back to the 105.88 high seen in early March.

Chris Turner

EUR: Re-pricing of China is not helping the euro

EUR/USD continues to edge lower – largely on the back of the stronger dollar. Not helping either is the re-pricing of China's growth prospects, as evidenced most starkly with 'Dr Copper' breaking back below USD8000/MT. Additionally, the focus is on the People's Bank of China's money market operations, where generous liquidity adds are raising speculation over possible rate cuts. As we've highlighted in various scenario pieces, the euro tends to do well when China is doing well, given the large share of manufacturing in the Eurozone economy.

Doubts over Chinese growth prospects and growing views that there remains unfinished business in the Fed's tightening cycle are weighing on EUR/USD. It has some decent support around the 1.0715/25 area, below which there is not much support until 1.0500/0515. That is the risk unless tomorrow's US April core PCE deflator shows a sizable fall.

For today, look out for plenty of European Central Bank speakers – probably unlikely to move the needle on market expectations that the ECB has a further 50bp of hikes to be done.

Chris Turner

GBP: 90bp of further Bank of England tightening now priced

Yesterday's surprise release of April UK inflation at 8.7% YoY certainly set the cat amongst the pigeons in the UK gilt market. Our debt strategists think the Gilt curve should invert further. While this is not welcome news for UK growth prospects, in the past we have found inverted yield curves positive for currencies. That means our summer target for EUR/GBP near 0.8800 may be hard to achieve after all.

The EUR/GBP bias is probably now for a retest of the 0.8650 area, and we'll definitely have to see some softer wage/price data over the coming weeks for the Bank of England to be diverted from what looks like another 25bp hike on June 22nd.

For GBP/USD, the 1.2340/50 area seems decent support below which the downside could open up to the 1.2200 area.

Chris Turner

SEK: Krona's pain continues

We've just published our latest update on the krona: Sweden: Hard to pick to a bottom for the unloved krona. Our view is that there are not enough elements convincing us that the tide can turn for the battered SEK at the moment. As we'd already discussed last week in our more in-depth SEK and Riksbank analysis – where we had called for SEK underperformance – the communication missteps of the Riksbank have essentially left the krona without any real floor in this rather unfavourable environment for high-beta currencies. And now, the lack of a strong technical resistance for EUR/SEK until the 11.68 historical high (May 2009) means that upside risks are significant.

A move to the 11.50/11.60 area remains our base case unless the market turns decisively more favourable towards high-beta and European currencies in general. Levels in the 11.60/12.00 region could be seen just with a further deterioration in risk sentiment, without having to witness a material worsening of domestic news out of Sweden.

Such levels may, however, see the Riksbank step in with some verbal intervention without waiting for the 29 June meeting, potentially threatening FX intervention. The Riksbank can find some ways to offer some support to SEK, but that would probably be limited in scope and duration after the recent dovish turn. It's up to the market to trigger a SEK recovery, and we think this can happen in the second half of this year – but this is not guaranteed. Expect a bumpy road ahead for the krona.

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