FX Daily: A nervous calm returns to FX markets

Measures of stress in financial markets have eased back from their spike on Monday - but remain elevated. Investors remain nervous over deposit flight from the less well-scrutinised US regional banks and whether any more of those banks will run into trouble. Expect another rangy session for FX markets and focus on today's UK 'budget for growth'

USD: Dollar takes a trip across its 'smile curve'

Financial market conditions have settled a little. Without any further public policy pronouncements yesterday, US regional banks reclaimed some of Monday's heavy losses, US bond yields reversed some of their enormous drop, and measures of money market stress such as the 3m FRA-OIS spread or the 3m EUR cross-currency basis swap partially eased back from stressed levels.

However, it seems far too early to sound the 'all-clear' on this topic. The genuine fear is that depositors in these less scrutinised and less regulated banks (the 2018 roll-back of regulation in the Dodd-Frank reforms is being blamed here) will choose to migrate deposits to more highly scrutinised, highly regulated, and better-capitalised banks. Overnight Bloomberg reports that

$15bn of deposits have flowed to Bank of America, one of the Financial Stability Board's 30 Global Systemically Important Banks (G-SIBs).

Investors will probably continue to monitor the stock prices of these US regional banks for signs of stress and might also gain some insights on deposit flight by Thursday's release of Federal Reserve borrowing data. Borrowing through the primary credit facility at the Fed's discount window will be scrutinised - last week's reading saw $4.4bn being borrowed versus a March 2020 pandemic peak of $50bn. Presumably, we might also get a read on Thursday evening of banks' use this week of the Fed's new Bank Term Funding Program. This offers funds for 90 days- one year at 10bp over one year USD OIS - currently at 4.68%. This is marginally cheaper than the 4.75% rate through the primary credit facility at the discount window. The size of any borrowing could have a say on market sentiment.

This brings us to the Fed and the dollar. As our US economist, James Knightley, wrote after the release of the February CPI yesterday, inflationary pressures are still evident but are expected to fall. The Fed must be praying that market pricing of the 22 March FOMC meeting moves back to a +25bp hike (+20bp now priced) such that it can deliver a no-fuss hike and, like an Olympic high-diver, adjust rates without barely making a ripple in the pool of financial markets.

For the dollar - more settled financial conditions should allow it to reconnect with softer rate differentials and leave the dollar slightly offered. Our concern is, however, that the dollar could easily cross its 'smile curve' should US banking sector stress re-appear and banks want to hoard dollars - that is why we should focus on the EUR cross-currency basis swap now. The idea of the smile curve is that the dollar does well when things are very good or very bad (e.g. start of the financial crisis in 2008 or the start of the pandemic in March 2020) and tends to gently sink at any conditions in between.

Expect a further day of consolidation in the dollar, although softer US retail sales figures at 1330CET could give it a gentle downside bias. DXY could nudge down to 102.75 should conditions allow.

Chris Turner

EUR: Settling in for the ECB

After the wild swings in short-dated bond yields this week, the two-year EUR:USD swap differential seems to be settling around the -100bp area - some 40bp narrower than last week. Should equities settle down a little, EUR/USD could start to reconnect a little with yield differentials and head up to the 1.08 area. As above, any severe signs of US money market stress could easily see these EUR/USD gains reverse. The mood in EUR/USD may also be subdued ahead of the European Central Bank's expected 50bp hike tomorrow.

Elsewhere, we have just seen an above-expected February CPI release for Sweden. This should cement 50bp hike expectations for the 26 April Riksbank meeting. This would take the policy rate to 3.50%. EUR/SEK has sold off 0.4% on the news, but we would be wary of holding the Swedish krona at the current time. The Swedish banking system is one of the more dependent on wholesale funding markets and also has sizable exposure to the Swedish residential and in particular commercial property sector. Ever higher rates in Sweden only stand to heap more pressure on the property sector, on the banks, and on the SEK.

Chris Turner

GBP: A 'Budget for growth'

At 1330CET today, UK Chancellor Jeremy Hunt will present what has been billed as a 'budget for growth'. At the heart of the budget seems measures to ameliorate the cost of living crisis (caps on energy bills), measures to address the decline in the UK labour force (childcare support and pension reform) plus perhaps some incentives on investment (new forms of tax breaks). While the UK's near-term growth forecasts may be revised higher, ING's UK economist James Smith argues that medium-term growth prospects will be revised lower. And we suspect that Chancellor Hunt may be saving more overt fiscal stimulus for the Autumn Statement or the Budget this time next year ahead of elections later in 2024.

We doubt anything in the Budget will be sterling negative - after all taxation levels are near the limit - but equally we do not see it as especially sterling positive either. With the Bank of England nearer to a pause than most, we think EUR/GBP can reclaim recent losses and head back to 0.89, while cable may struggle to break 1.22.

Chris Turner

CEE: First inflation reminder after SVB

Today, we will see an inflation test in the Central and Eastern Europe (CEE) region after the recovery of global markets. In the Czech Republic, PPI numbers will be released, which surprised massively to the upside in January. Although PPI has been falling since last July in year-on-year terms, surveys suggest that a significant drop is not in place, as already indicated by the CPI numbers.

In Poland, we will later see CPI numbers for February, the latest in the CEE region. We expect the February number to show a rise from 17.2% to 18.7% YoY, slightly above market expectations. The February CPI reading is highly uncertain due to the annual update of basket weights, however in any case it should be this year's peak. At the same time, core inflation is projected to remain sticky and elevated as the earlier energy shock should continue feeding into the prices of other goods and services. In our view, the path of core inflation will not allow the National Bank of Poland to start cutting rates this year and the easing cycle may start late next year.

In the FX space, yesterday we saw the CEE currencies find a floor and stabilise a bit. The Hungarian forint, the biggest underperformer in recent days, even posted a 0.7% gain yesterday. We believe that it is the Hungarian forint and the Czech koruna that should benefit the most in the region from the calming global markets. If the euro maintains its dominance over the US dollar we should see further gains for these two currencies, supported by a return of gas prices to previous lows and higher market rates. Thus, we expect a move to 385 EUR/HUF and 23.70 EUR/CZK for now.

Frantisek Taborsky

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

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