

FX Daily: A textbook reaction to yield curve inversion

Markets have continued to push their Fed peak rate expectations further, and now see 4.50% in March 2023. A more inverted yield curve has triggered a textbook reaction: fears of slower demand have hit oil and commodity currencies and offered a floor to the dollar possibly into Wednesday's FOMC. Today, the focus will be on Uni Michigan surveys and Lagarde



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Monday 19 September will be a national holiday in the UK, the next FX Daily will be published on Tuesday 20 September.

➔ USD: Hawkish re-pricing continues

Despite some mixed data out of the US yesterday, markets have continued to push their hawkish bets on the Fed tightening further, and with 75bp fully priced in for next week's meeting, March 2023 Fed Funds futures now trade at around 4.50%. This marks a 50bp+ increase in peak rate

expectations since the start of September, which has translated into a 40bp rise in two-year Treasury yields.

Ultimately, we're observing a textbook FX reaction to the US yield curve inversion: a supported dollar, and heavily impacted pro-cyclical/commodity currencies; dollar-bloc currencies are down 1.6-2.1% in the week, and only NOK has performed worse (-2.5%) versus the USD. Slumping oil prices (third consecutive weekly drop) are all part of the equation and are mirroring how markets are factoring in a more aggressive tightening by central banks materially hitting global demand.

In such an environment, risk sentiment is struggling to recover and this is just another factor delaying any correction in the dollar. Today, University of Michigan sentiment and inflation surveys will be watched (especially the latter), but we may need to see some significantly below-consensus reads to dent the ultra-resilient hawkish Fed expectations at this stage. We see the dollar staying on solid ground into Wednesday's FOMC announcement.

Francesco Pesole

➔ EUR: How will Lagarde address the energy bill caps?

Today's final CPI numbers for August in the eurozone are expected to confirm the preliminary 9.1% print, and there are no other data releases to watch meaning all attention will remain on: a) developments in the Russia-Ukraine conflict; b) gas prices and EU measures to cap energy bills; c) ECB speakers.

About this last point, we'll hear from ECB President Christine Lagarde, who will speak with Governing Council member Francois Villeroy at a student event in Paris this morning. So far, post-meeting comments by ECB officials have stayed on the hawkish side of the spectrum and we see no reason for Lagarde to derail from this narrative today. What we'll be watching closely is how the recent measures by EU members to cap energy bills will be embedded into the ECB's policy assessment, and this is a factor that may cause a further divergence between the doves and hawks within the Governing Council. We'll also hear from Olli Rehn this morning.

Either way, the euro has displayed a reduced sensitivity to ECB communication recently and the unstable risk environment mixed with a strong dollar may keep EUR/USD upside capped for now despite the recent decline in gas prices. The 1.0000 level could remain an anchor over the coming days.

Francesco Pesole

➔ GBP: A last (grim) piece of data before the BoE

This morning's retail sales in the UK continued to show a deteriorating consumption picture in the UK, which emerged more from the continuation of a steady downtrend from last summer rather than the single grim data point in a rather volatile series. This has been the last important piece of data before the Bank of England meeting on Thursday and has hit the pound this morning.

Despite the seemingly unstoppable re-pricing higher in Fed rate expectations, the BoE's pricing has stalled, now around 65bp for the September meeting. We currently see a relatively high chance of a 75bp move next week, which could lend sterling some help, despite a general environment that remains rather unwelcoming for pro-cyclical currencies, and domestic growth fears that is likely set to keep a lid on a large GBP recovery. This morning's EUR/GBP jump may struggle to extend

beyond the 0.8750 mark.

Francesco Pesole

➔ CEE: Polish core inflation hitting new record

Today's calendar features core inflation in Poland and PPI in the Czech Republic. Our Warsaw team expects core CPI to jump from 9.3% to 10.0% YoY, the highest level since 2000, which could make for some headlines. In the Czech Republic, confirmation of the slowing trend of year-on-year numbers is expected, and moreover, it will be the last number before the September Czech National Bank meeting. However, we believe that even an upward surprise would not change the expected stability of rates.

On the market side, the number one theme remains Hungary and the forint, which lost another 0.7% yesterday and nearly 3.0% for the week, reaching its weakest levels since late August. Of course, the main reason is the issue of EU money and negotiations with the European Commission. Moreover, yesterday we couldn't even blame gas prices, which fell again. As we mentioned earlier, we expect the forint to still have a tough time. The next deadline is on Sunday and in the second half of next week when we should hear more from the European Commission.

Elsewhere in the CEE region, the Polish zloty and the Czech koruna remain strictly driven by the price of gas, which helps them overcome the negative impact of the EUR/USD below parity and the unfavourable development of the interest differential in both markets. On the other hand, their development makes it more unpredictable, and we must continue to closely monitor the next steps of the European Union in the gas story.

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