

FX Daily: Between geopolitics and a position squeeze

FX markets are maintaining very high levels of realised volatility. Driving markets in the very short term is the stand-off between geopolitical risk in Europe and the powerful short squeeze in risk assets on the back of softer US price data. On the calendar today are US retail sales, industrial production, and a host of Fed and ECB speakers



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➔ USD: Buy-side wants and needs a weaker dollar

Realised levels of FX volatility remain near the highs of the year. For example, one-month EUR/USD realised volatility, at 14%, is back to levels not seen since April 2020. The dominant near-term theme is the aggressive position adjustment in FX, perhaps more so than in other asset classes, on the back of softer US price data. The dollar took another sharp leg lower on yesterday's release of [soft October PPI data](#). Clearly, US price data is the hottest commodity in the macro space right now.

Dollar price action does suggest the market is caught long dollars at higher levels and that corrective rallies in the dollar are tending to be relatively shallow. There is also a lot of buy-

side interest in expectations (and hopes) that the dollar has peaked. If so, that will release some handsome gains for emerging market local currency bond and equity markets. For example, were it not for the recent dollar correction, returns in the EM local currency bond index would be a lot lower than the current -10% year-to-date figures, and EM hard currency bond indices are down closer to 20% year-to-date.

Given the weight of long dollar positioning after a major 18-month bull trend, it looks too early to expect that this position adjustment has run its course. Yet developments in Poland late yesterday have somewhat clouded the picture. The market will await any announcement from NATO representatives today on the source of the explosion - although President Biden has partially defused the situation by suggesting the missile was not fired from Russia.

Beyond geopolitics today, the focus will be on US retail sales and industrial production data. Both should be reasonably strong, but less market-moving than price data. We will also hear from the Federal Reserve's John Williams and Mary Daly around 16CET.

For the DXY today, we did note that the dollar seemed to find a little natural buying interest after the PPI data, but before the Polish news broke. That might tend to favour a 106.00-107.20 DXY trading range today. In terms of the bigger picture, the question is whether 105 is a large enough correction for DXY.

Chris Turner

➔ EUR: Ongoing correction

EUR/USD turned from a high of 1.0480 yesterday - driven there by the softer US PPI data. By comparison, today's US data is second tier and might prove a weak dollar positive if retail sales and industrial production emerge on the strong side. Attention may also return to the energy markets given events in Poland. And this will also serve as a reminder of the upcoming embargo on Russian oil exports due to start in early December. This potentially is a downside risk to European currencies should energy prices take a leg higher.

On the calendar today are plenty of European Central Bank speakers. The ECB will also release its semi-annual financial stability report. Expect plenty of focus on the regulation of the non-bank financial sector after the recent debacle amongst the UK pension fund industry with its LDI hedges in the UK Gilt markets. Remarks earlier this week from the ECB relating to this report drew a conclusion that financial risks had increased.

We noted yesterday that EUR/USD seemed to turn naturally from 1.0480, suggesting the corrective rally might have run its course - at least for the very short term. But the bottom of the short-term range has now been defined at 1.0270 - pointing to a 1.0270-1.0500 range over coming sessions. This assumes no major escalation in geopolitics. Bigger picture, we are in the camp that something like 1.05/1.06 may be the best EUR/USD levels between now and year-end.

Chris Turner

⬇ GBP: BoE speakers in focus

Bank of England speakers will be in focus today after the release of the October CPI data. This is expected to be peaking around the 11% year-on-year level around now. BoE Governor Andrew Bailey and colleagues testify to the Treasury Select Committee at 1515CET today. We suspect the

message will be very much the same as that given at the policy meeting earlier this month - i.e. do not expect 75bp hikes to become common and that the market pricing of the tightening cycle is too aggressive.

GBP/USD briefly peaked over 1.20 yesterday. We think 1.20 is a good level to hedge GBP receivables. Equally, we have a slight preference for EUR/GBP staying over 0.8700. Tomorrow is the big event risk of the autumn budget - which on paper should be sterling negative.

Chris Turner

➔ JPY: Wild ride continues

USD/JPY continues to deliver 20% annualised readings in volatility (as do the high beta commodity currencies and those in Scandinavia). We suspect the next five big figures in USD/JPY come to the upside. We see this because the US 10-year Treasury yield typically only trades 50-75bp below the Fed funds rate towards the end of the tightening cycle. And given that our team is looking for the policy rate to still be taken 100bp higher, we think US 10-year Treasury yields will probably return to the 4.25/4.35% area before the end of the year.

Equally and once position adjustment has run its course, the yen rather than the dollar should become the preferred funding currency should market conditions begin to settle. Although that does seem an unlikely prospect right now.

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