FX Daily: Beware the pivot trade

FX markets were caught up in a broad risk rally on Tuesday. To what degree that owed to expectations of a slowdown in monetary policy tightening or just position adjustment remains unclear. However, we remain firmly on the side of the dollar, given that the Fed is unlikely to pivot early. Look out for rate meetings in Poland and Romania today

USD: Position adjustment dominates

Tuesday saw a tremendous rally in risk assets, where European equities led the pack by gaining over 4%, high yield credit spreads narrowed 30bp+ and emerging markets bounced back – Romania's 2051 USD-denominated bond rallied over 10%! In FX, European currencies fought back after recent losses.

Looking back on this period one could probably blame a variety of events such as i) central bank intervention to stabilise markets (Bank of Japan and People's Bank of China in FX, Bank of England in Gilts) ii) some slightly softer US data and iii) the Reserve Bank of Australia's smaller-than-expected hike, for contributing to the reversal of the unchecked stagflation trade. Position adjustment and new money being put to work in thin markets at the start of a new quarter may have also played a role.

On the subject of central bank intervention, investors may wait with interest to hear from the G20 on 12 October. We doubt G20 financial authorities will have too much to say about FX markets – but the communique is an event risk. However, we remain sceptical that the Fed is about to pivot on the back of slightly softer US data this week. Focusing on the tight labour supply challenge, the Fed told us in September that unemployment needs to rise from its current 3.7% to 4.4% next year to prevent the Fed funds from going any higher than 4.50-4.75%.

Instead, it looks like yesterday's outsized reaction was a function of market positioning. We are still multi-month if not multi-quarter dollar bulls and would see this dollar DXY correction running out of steam in the 108.50/110.00 area.

Chris Turner

EUR: Return to above-parity levels looks unsustainable

EUR/USD followed the stellar rally in risk assets yesterday, and is now pressing the 1.000 resistance. We struggle to see much more behind the pair's rally other than a position-squaring event and a broad dollar correction. Despite European assets rebounding quite sharply, it's hard to point to any material change in the eurozone's outlook that would warrant a significant return of market appetite for the euro just yet.

In our view, there is not enough bullish push to keep EUR/USD above parity on a sustainable basis, and we still forecast a drop to the low 0.90 area into year-end.

Today, the eurozone calendar is quite light, with only final PMI figures and France's industrial production to be highlighted, and there are no scheduled European Central Bank speakers.

Francesco Pesole

GBP: Fiscal event FX losses have been unwound

GBP/USD is now back to levels before the UK government's fiscal event on 23 September. What are not back to pre-fiscal event levels are the UK's sovereign credit default swaps (now 45bp vs 32bp) and the 10-year Gilt-Bund spread (200bp vs 155bp). The government's fiscal reputation has been tarnished and news that the chancellor may not after all bring forward his medium-term fiscal statement leaves sterling vulnerable.

Look out for comments from PM Liz Truss at the Conservative Party conference today. We suspect that the sterling rebound and the dollar correction may have come far enough and could easily see cable reversing to the 1.1200 area.

Chris Turner

CEE: Central banks try to end hiking story

Today we have two meetings of central banks in the Central and Eastern European region. We will hear from the National Bank of Poland on its reaction to the latest upside surprise in inflation. Our team in Warsaw expects a 25bp rate hike to 7.0%, in line with surveys. The latest statements from central bankers indicated that the hiking cycle is over and we cannot expect more. However, inflation has yet to peak and it will be difficult for the NBP to navigate the slowing economy. From a market perspective, the situation is very volatile. After the inflation release last week, the market moved to the hawkish side but has returned closer to our expectations over the last few days.

However, the record WIBOR levels indicate that the market is still tilted to the hawkish side. We see the NBP trying to end the hiking cycle, although we still expect further rate hikes. Overall, today's meeting will thus be negative news for the Polish zloty. Our view is also supported by the stronger levels achieved in the last two days due to the increase in the rate differential.

In Romania, the situation is a bit clearer. The National Bank of Romania already slowed the pace of interest rate hikes at the previous meeting and we expect this trend to continue. We expect a 50bp hike today to 6.00%. While the latest inflation developments have been rather on the upside of our central scenario, we maintain the view that we witnessed the peak headline in August at 15.3% year-on-year. Together with a slowing economy, this leads us to one more rate hike later in November, by 25bp to a terminal rate of 6.25%. On the FX side, the Romanian leu has moved back to 4.95 EUR/RON after a brief excursion to stronger levels and the NBR seems to have the situation fully under control, for now. We do not expect any changes in the short term, however, the global selling pressure on the CEE region is also affecting the RON market. Looking at the Hungarian forint and Polish zloty, we can assume that the NBR's FX defence costs have increased significantly over the last two weeks, indicating that stability cannot last forever. For now, we expect a shift higher in our forecast for the intervention level early next year. However, the winter months could bring increased pressure on FX and push the NBR to ease the pressure a little earlier.

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