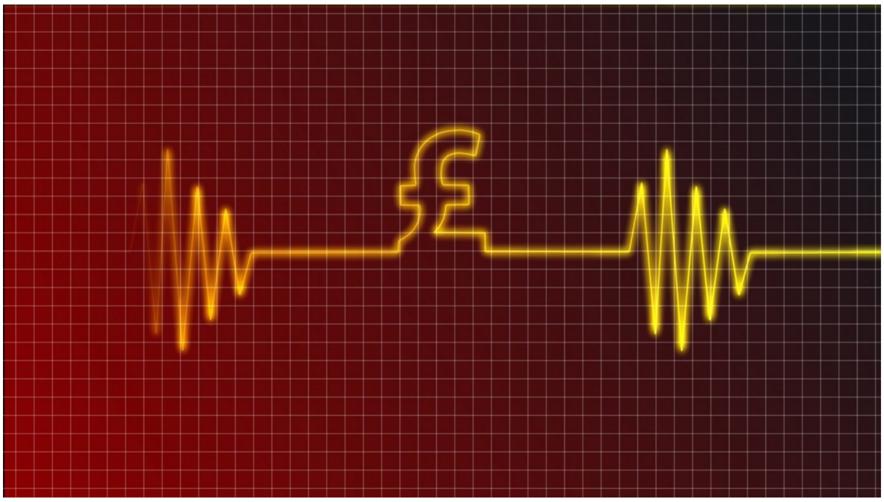
FX Daily: BoE exercises its financial stability remit

Events in the UK yesterday marked the first time this stagflationary macro environment risked evolving into a financial crisis. Fortunately, the Bank of England intervened aggressively in the Gilt market and market conditions have temporarily stabilised. However, there will be no room for complacency this autumn as volatility returns to 2020 highs



USD: Trying to avoid a crisis

Traded levels of volatility continue to rise in FX and debt markets. Remember these represent expected levels of volatility and are really being driven by the big swings we are seeing in spot FX and bond yields. Interestingly, equity volatility is a lot more subdued with perhaps equity investors already defensively positioned for late-cycle equity losses.

So far, this stagflationary environment and the aggressive response from central bankers - especially the Federal Reserve - have seen financial assets adjust as one would expect at this stage in the economic cycle. Up until recently, conditions in FX and debt markets had been reasonably orderly and there was no hint of financial stress in the system. Sadly the same could not be said of frontier markets, where the likes of Sri Lanka defaulted earlier this year.

Yesterday, however, saw the Bank of England's Financial Policy Committee take the decision to break the 'doom loop' at the long end of the UK Gilt market as margin calls on pension funds and the need to raise cash risked a downward spiral for long-dated Gilts. In effect, this is the first big intervention from a G10 central bank in this cycle to avert a financial crisis. It may not be the last. It serves as a reminder to policymakers around the world that any perceptions by the market of a policy misstep will be heavily punished. And with the Fed to keep hiking into a slowdown - probably taking rates to the 4.25/4.50% area into 1Q23 - these conditions may well be with us for the next six to nine months.

What does this all mean for FX? The dollar will continue to be favoured - especially if it is soon to be paying 4% on deposits. And tighter liquidity conditions as central banks battle inflation around the world mean still higher levels of FX volatility. This will discourage a return to carry trade strategies meaning that high-yielding FX and commodity currencies will not be given the benefit of the doubt. We, therefore, continue to favour defensive strategies in FX - which means backing the dollar and looking for the Swiss franc to outperform in Europe as the Swiss National Bank (SNB) guides it higher.

Out of interest as well, the US trade balance has narrowed back to levels last seen in October 2021 - meaning that the dollar's Achilles Heel - the trade deficit - does not look as vulnerable as it could. Expect there to remain strong demand for the dollar on dips - e.g in the 112.50/113.00 area for DXY.

Chris Turner

EUR: Gearing up for new highs in inflation

Beyond geopolitics, the short term focus in the eurozone is on inflation - where the September readings (Germany today, eurozone tomorrow) should mark new highs. The European Central Bank (ECB) is talking tough and will probably deliver on the 75bp of hikes expected for the 27 October meeting. We doubt this provides much support for the euro, however.

0.9500 has proved a good support area for EUR/USD after all and the BoE action did provide a brief reprieve to non-dollar currencies across the board. But we see nothing yet to reverse this powerful underlying downtrend in EUR/USD and expect any rallies above 0.97 to prove brief.

Chris Turner

GBP: Cable gets a reprieve

Aggressive BoE intervention in the UK Gilt market was firmly in the realms of financial stability and we would overlook the hyperbole of 'fiscal dominance' or 'monetary financing here. This was a necessary, temporary intervention to ensure the orderly function of the UK Gilt market - which our debt strategists describe as the 'bedrock' of the UK banking industry.

Yet there is only so much the BoE can do to support cable, since we think FX intervention and emergency rate hikes are not on the table. And we see no change in the strong dollar story over the next six to nine months. Instead, expect cable volatility to stay high (one week realised volatility is a staggering 34%) and be beholden to any fiscal updates. As we have been saying recently, trying to hold sterling together until the 3 November BoE rate meeting or 23 November fiscal update will be a tough challenge for policymakers. As we said in our reaction piece yesterday, we doubt cable holds gains to 1.08/1.09 and the bias has got to be for a 1.0350/1.0500 retest.

Chris Turner

CEE: CNB confirms end of hiking cycle

At today's Czech National Bank (CNB) meeting, we expect rates to be unchanged in line with surveys and market expectations. The main news in our view will be the confirmation of an end to the hiking cycle. We cannot expect a new central bank forecast today, but as always, we will see the governor's press conference. We expect the topic of FX intervention and the long-term level of interest rates, or the timing of the first rate cut, to be addressed. However, the CNB will mainly want to present unchanged rates as stability in uncertain times. From an FX perspective, it is evident from last week's data that the CNB has returned to the market for the first time since the August meeting, but intervention volumes have so far been minimal. We believe that part of the market is betting on an end to CNB intervention or a change in the central bank's approach again. However, we do not expect any change and so we can see them closing short CZK positions after the meeting, resulting in a stronger koruna.

In the rest of CEE, Tuesday's jump in the gas price translated to FX yesterday, as we expected, with the Polish zloty generating a loss of 0.4% and the Hungarian forint 1.5%. In Hungary, the move was supported by a further drop in market rates as a result of Tuesday's National Bank of Hungary decision. Unless we see a further rise in gas prices, we believe the forint has already taken its losses and should stabilise around EUR/HUF 412. The Polish zloty, on the other hand, still has room to move closer to 4.82 EUR/PLN. Moreover, in our view, the market is still too hawkish on Polish rates. However, Friday's inflation release from Poland will be crucial in this sense.

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