FX Daily: Brazil to join Russia with 100bp hike

Despite bond markets priced for a late cycle slowdown, other asset classes are taking a less pessimistic view. In FX markets, this environment is allowing local stories to win through; Brazil's real should stay supported on a 100bp hike from the central bank today and New Zealand's dollar is enjoying gains as expectations grow for the first hike since 2014

Brazilian central bank president, Roberto Campos Neto

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USD: Focus on ADP and a 16CET speech from Fed's Clarida

Global financial markets typically take their cues from major benchmarks in asset classes. For bond markets, that is the US Treasury curve and in FX it's EUR/USD. Both may not be providing very useful signals at present.

As Antoine Bouvet discusses here, September should provide a better read of the US Treasury curve. Recent bull-flattening in the curve is normally associated with a late cycle slowdown ahead of likely central bank easing - not the start of monetary normalisation that seems likely for the Federal Reserve later this year. For EUR/USD, the European Central Bank's shift to a symmetrical inflation target has already, successfully, driven EUR real yields lower and weighed on the EUR. And thus a subdued EUR/USD may be more ECB-related than a typical association with slowing growth and global headwinds such as trade wars or a pandemic. In short, some major benchmarks may be painting too dark a picture on the global economy and some good local stories can actually win through.

One such story is New Zealand. Overnight, employment data for 2Q beat expectations, with the jobless rate falling to 4.0%, so exactly where it was in 4Q19 before the pandemic started. We had recently highlighted how we saw a 50% probability of an August hike by the Reserve Bank of New Zealand, and that jobs data would have been the deciding factor. We think the 2Q figures showed that the NZ economy has, by and large, recovered from the pandemic impact: when adding above-3% inflation and a housing market that has run very hot, we feel comfortable penciling in a first 25bp hike by the RBNZ on 18 August and see a good probability that another hike will come by the end of the year. This should further boost NZD’s rate attractiveness and allow the currency to be a key outperformer once global risk appetite stabilises.

For today, we will be focused on: i) the July ADP expected at around 680k and probably supporting a consensus for Friday's NFP at 850k and ii) a 16CET speech from Fed Vice Chair Richard Clarida. He's a dove, but any indications on the start and end of tapering (James Bullard thinks tapering should be concluded by March 22) will be interesting for markets.

For the dollar, we do note that the expected pricing of the Fed tightening cycle has eased by a large 25bp since the start of July (using 1m USD OIS rates two years forward as a guide) and do see scope for US short rates to rise. Any dollar strength on less dovish remarks from Clarida should largely be played out against the low yielders of Japan's yen and the euro. We are not really big subscribers to the safe haven flow story at present.

EUR: ECB will be pleased with EUR weakness

The ECB will be pleased that the market has turned its attention to very low real interest rates in the euro area - being blamed for example in the current decline in EUR/CHF. (We'll have more on that story later today.) The large decline in real EUR interest rates points to the market believing that the ECB will be successful in reflating the economy - but will keep EUR subdued for the near term. The ECB's trade-weighted euro is now about 3% off the highs of the year and ECB policy now makes a EUR/USD rally quite difficult - barring a U-turn in Fed policy.

EUR/USD looks set for further range trading - perhaps in the 1.1850-1.1910 area - and implied volatility staying under pressure even though we have the event risk of the Fed Jackson Hole symposium on 26-28 August.

GBP: Positioning ahead of the BoE

Sterling is trading on a mixed to firm footing ahead of tomorrow's Bank of England meeting. The soft EUR environment is certainly making EUR/GBP look offered, but we may also be seeing some position adjustment ahead of the BoE potentially discussing tapering strategies tomorrow.

EUR/GBP faces major support in the 0.8470/8500 area, which may be a tough nut to crack unless the BoE feels the need to move the needle on tightening expectations - though this seems unlikely while case numbers are still high and the impact of ending furlough schemes will not be known until September/October.

BRL: BACEN to accelerate its tightening cycle

Having hiked by 75bp at each of its last three meetings, Brazil's BACEN is widely expected to hike by 100bp today - taking its selic policy rate to 5.25%. Market expectations are that this will be work-in-progress in terms of tightening, where the policy rate is priced well over 8% into early 2022. Like Russia's central bank, which also hiked 100bp at its last meeting, BACEN is taking no chances with inflation which is currently running at well over 8%.

As usual with recent BACEN meetings, the focus will be on whether it effectively pre-commits to further aggressive tightening - the next meeting is on 22 September. And with President Bolsonaro looking to test the boundaries of Brazil's fiscal headroom in advance of elections next year, we suspect BACEN will want to stay hawkish as a means to keep inflation expectations in check.

Expect another large hike to keep USD/BRL trading within its recent range of 5.05-5.30 - even though a 100bp rate hike is widely expected today.

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