FX Daily: Can markets push the Fed to cut 50bp?

Remarks from former FOMC member Bill Dudley and some media reports pointing to a close 25bp-50bp decision have triggered a fresh round of dovish Fed bets ahead of next Wednesday's meeting. The risks appear skewed to increasing speculation on a half-point move and higher EUR/USD, especially after a cautious ECB meeting

USD: Markets might hold keys to a 50bp cut

The currency market has cemented its view that the Federal Reserve's focus has shifted away from inflation this week. The dollar is trading on the soft side after two above-consensus inflation prints (CPI and PPI), with the impact of the former proving to be rather short-lived. The swap market is currently pricing in 37bp of easing for next week's FOMC meeting, implying equally split chances of a 25bp or 50bp cut.

Helping the dovish case overnight were some remarks by former FOMC member Bill Dudley, who explicitly said he would push for a 50bp cut were he still in the committee. One part of his speech that particularly struck us is this: "It's very unusual to go into the meeting with this level of uncertainty – usually the Fed doesn't like to surprise markets". One possible interpretation is that markets themselves can tilt the balance towards a half-point move should their dovish bets be pent up into Wednesday's meeting. There were also some media reports suggesting it would be a close call between 25bp and 50bp, which contributed to the dovish repricing.

We recently called for subdued dollar performance into the US election. Unless the Fed surprises with a hawkish cut, we think even a dovish 25bp move (i.e., signalling large easing and perhaps 50bp cuts ahead) can prevent a sustainable dollar recovery. Investors will also monitor the direction of US election polls in the coming days. Kamala Harris is openly calling for another debate, but Donald Trump has ruled it out. Remember that Harris is seen as a more dollar-negative candidate, and if her good momentum extends from the debate into the polls, we would really need some data/a Fed surprise to take the dollar higher.

Today, the only event in the US calendar is the University of Michigan survey, where inflation expectations are expected to have flatlined in September. If actual inflation data didn't help the dollar much, we doubt some tier-two indicators will. With Fed members in the pre-meeting "blackout" period, there is no real way to tone down the market's dovish bets after Dudley's comments, so the chances of more dovish repricing into Wednesday – and further dollar underperformance – have increased substantially. DXY could retest the 100.5 recent lows into the FOMC.

Francesco Pesole

EUR: Data dependency helping the euro

EUR/USD is eyeing 1.11 again after the combined support of a not-dovish-enough European Central Bank and rising dovish bets on the Fed. Our economics team discusses yesterday's ECB rate cut here. It is abundantly clear that President Christine Lagarde is fine with keeping communication quiet and predictable at this stage, offering little to no guidance. At the press conference, she merely admitted the direction for policy rates is "pretty obvious" (i.e., more cuts), but what truly resonated with markets is the firm reiteration of data dependency.

The EUR OIS curve is now pricing in some 5-6bp higher year-end deposit rate compared to yesterday: 3.10% from the current 3.50%. A 50bp move by the Fed can surely convince markets to price in 50bp of easing in the eurozone too this year, but the net impact on the EUR:USD swap rate gap would be neutral, so that support for EUR/USD from a rates perspective should remain intact.

We have two ECB speakers to keep an eye on today amid an otherwise light eurozone calendar. Lagarde speaks again at an event in Budapest, and before her Finnish central bank chief Olli Rehn (a neutral member) will participate at an event. Comments from Germany's Joachim Nagel overnight were quite cautious and merely justified the rate cut with recent data.

We can see EUR/USD breaking above 1.110 in the next few days on the back of USD weakness. There is no strong technical resistance before the 1.120 August highs.

Francesco Pesole

GBP: Strength into the BoE

Sterling remains in a strong position. The Bank of England is deemed unlikely to cut rates next week, and while the Sonia curve pricing can be affected by the Fed's dovish rerating, the data has so far prevented the sterling market from making the kind of dovish pivot we saw in USD swaps. The 1.3250 August highs in GBP/USD appear well within reach at this stage.

Looking at EUR/GBP, a tentative bounce earlier this week proved to be quite short-lived. The ECB-BoE and eurozone-UK growth outlook divergence continues to weigh on the pair, and while the pound is starting to look expensive in relative terms, a sustainable recovery to the 0.85+ levels likely requires some strong dovish hints by the BoE.

The next big event for GBP is the CPI figures released on Wednesday, one day before the BoE announcement. Until then, global FX dynamics will dominate, and the pound should remain broadly supported.

Francesco Pesole

NOK: More room to recover

Earlier this week, we pointed out how EUR/NOK was substantially expensive close to the 12.0 mark, and that the risks of a correction lower were very high. That correction has materialised, and it is clear that the key engine for a NOK recovery at this stage is more dovish bets on the Fed.

At 11.85, EUR/NOK remains expensive, but we still have to stress how the risks of speculative dynamics (favoured by slimmer NOK liquidity) will keep volatility on both sides quite elevated. We believe Norges Bank will remain focused on helping the krone and refrain from sounding dovish at next week's meeting.

Ultimately, that can favour a further EUR/NOK depreciation to 11.60-11.70, and potentially to even lower levels if the Fed cuts by 50bp.

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