FX Daily: Confidence crisis sparks wrong kind of dollar rally

FX markets will be nervously assessing the overnight news that Credit Suisse has tapped a new Swiss National Bank facility for CHF50bn. Expect confidence to remain fragile - not least because pressure on US regional banks is unresolved. And the ECB faces a very difficult decision today, where market conditions are interfering with plans to hike 50bp

USD: Policy makers scramble to restore confidence

Despite much discussion of the unique problems facing the US regional banking system after SVB's failure, pressure in the banking sector did cross the Atlantic yesterday and asked questions of the European banking system. All eyes are on the health of Credit Suisse (CS) - one of the world's 30 Global Systemically Important Banks (G-SIBs). Late yesterday CS did receive the support it was looking for from Swiss authorities and overnight announced it had tapped a CHF50bn liquidity line from the Swiss National Bank (SNB). It also announced it planned to buy back some of its senior debt at 'attractive' levels.

The travails of CS are of a very different nature to that of SVB, but the trigger for yesterday's CS sell-off was a remark from one of its top investors over capital injections - SVB's problems crystallised last week when it struggled to raise capital. The SNB has made it clear that it believes Credit Suisse is appropriately capitalised for a G-SIB. And certainly, the Financial Stability Board's creation of G-SIBs was to avoid the kind of public sector bailouts seen through the global financial crisis. The question now is whether investors will be happier that CS has access to liquidity or will continue to focus on the CS business model and the trend in capital levels.

Pressure on a G-SIB has understandably unnerved global financial markets, which are clearly trading at stressed levels. Implied option volatility in the US Treasury market is now above that seen in March 2020 and dollar funding markets continue to show signs of stress. It seems unlikely that one single corporate finance event can put this genie of banking sector stress back in the bottle, but the market will be on the lookout for a series of supportive measures - perhaps some consolidation in the US regional banking sector under better-rated names?

Expecting another nervous day in FX markets, we suspect investors will want to hang onto defensive trades such as long Japanese yen on the crosses and probably long dollar balances in case financial conditions deteriorate further. The market will also take its cue from the European Central Bank today. Pushing on with a 50bp rate hike will prove difficult and we should expect more volatility immediately after the 1415CET decision.

Expect DXY to remain highly volatile in a 104-106 range - but the upside could come into focus (for the wrong reasons) if stress in the dollar wholesale funding market were to spike again.

Chris Turner

EUR: ECB will struggle to thread the needle

Today's ECB rate announcement will depend on a different set of factors than what the market – and the ECB itself – would have expected only a week ago. If recent inflation data clearly underpinned the ECB's pledge to hike rates by 50bp in March, the ongoing turmoil in the financial sector is casting doubts on whether policymakers will raise rates at all: the OIS curve is pricing only 28bps for today's meeting.

In our ECB cheat sheet, published on Monday, we analysed four different 50bp outcomes within the dovish-hawkish spectrum, based on the ECB's assessment of the inflation and growth outlook and above all the balance between data dependency and forward guidance. In light of yesterday's developments, those scenarios are possible only under the condition that the ECB can feel comfortable that going ahead with tightening will not come at the cost of excessive pain for the financial sector. In other words, the ECB will be monitoring the Credit Suisse news and by extension the environment for European banks before pressing ahead with its promised hike. The time window is very narrow, and while our call is for a 50bp hike, we wouldn't be shocked to see an ECB hold today. A 25bp move seems the least likely scenario.

What about the EUR impact? If the ECB 50bp hike comes in an environment where markets are scaling back concerns on the banking sector thanks to the support from the SNB, then this may actually be read as a signal of confidence by Frankfurt on the health of the eurozone banking system, and can ultimately lift the euro. Should the ECB force a hike in a still fragile environment for the European banking sector, the impact on EUR/USD may actually be negative, as investors see this as another major risk for the financial stability in the area, while the simple repricing higher in ECB rate expectations is statistically not enough to boost the euro (as discussed in this article).

Clearly, a tricky path for the ECB and we suspect EUR/USD will continue to be driven by the risk environment and the relative performance of the European financial sector.

Elsewhere in European FX, Norway's krone is emerging as the worst-performing G10 currency. This is far from surprising, as the krone is the least liquid G10 currency and generally performs very poorly during tumultuous times for markets, especially when the risks are concentrated in Europe. While EUR/NOK upside has been relatively capped by the EUR’s own weakness, the USD/NOK rally has been fierce. The pair is now close to a key level, the 10.8860 September 2022 high, after which NOK would default to the weakest since the 2020 pandemic shock, when a liquidity crisis sent it on an uncontrolled spiral to touch the 11.70 level. NOK weakness remains highly likely until central banks successfully restore market confidence.

Francesco Pesole

GBP: Budget overshadowed by banking sector stress

Chancellor Jeremy Hunt's budget delivered yesterday was generally seen to strike the right notes - albeit within the restraints he was given. It has been hard to pick out any sterling reaction to the budget given all the stress in financial markets. Instead, EUR/GBP seemed to come lower yesterday on stress in the Europan banking sector, recalling the weakness seen in EUR/GBP during the various eurozone crises of 2012-2015.

Once again, the performance of the European banking sector will probably determine the EUR/GBP performance over the near term - although should the ECB be able to credibly hike 50bp today without unnerving banking stocks, EUR/GBP can push back above 0.8800. Expect GBP/USD to bounce around in a 1.20-1.22 range until this banking sector crisis calms down.

Chris Turner

JPY: Remaining the outperformer

The return of financial crisis conditions has seen the Japanese yen return as the clear outperformer. The yen has normally played the role of safe haven currency during times like these because of Japan's large current account and net foreign asset position (years of surpluses). While Japan's current account surplus is smaller than it was because of the energy crisis, its large foreign asset position wins out.

The yen will also be winning from the macro side too. The US banking crisis stands to tighten US credit conditions, hit US growth, and accelerate the timing of the Fed easing cycle. The same is true for other major central banks and, in effect, will drag global interest rates closer to the rock bottom rates in Japan.

USD/JPY could easily trade under 130 should banking sector conditions deteriorate again and recent events on both sides of the Atlantic only give us greater confidence in our year-end USD/JPY forecast of 120.

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