

## FX Daily: Corrective forces build

A reversal in UK fiscal policies, some stability in equity markets, and a dip in European energy prices point to a further corrective period in FX markets. The dollar could weaken a little further, but the core bull trend should remain intact



### ⬇️ USD: Corrective forces may dominate short term

Measures of the trade-weighted dollar index are around 2.5% off their highs of the year. The correction has nothing to do with any softening of Federal Reserve tightening expectations. Here the market firmly expects the Fed to hike 75bp on 2 November and prices a terminal rate as high as 4.90% next spring. Instead, we would say three factors are behind this current dollar correction.

The first is the reversal in UK fiscal policy. The much-maligned policy that garnered criticism at the IMF meetings has been largely reversed. This has brought some calm to global bond markets (Gilt instability had been dragging US Treasuries lower). Our rates strategy team does not see UK 10-year Gilt yields racing a lot further under 4.00%, though reports of the Bank of England delaying the start of its quantitative tightening Gilt sales programme should be helpful. Equally, it may be too early to expect US 10-year Treasury yields to drop back to the 3.75% or 3.50% area if the market is still searching for the top in Fed funds near 5%.

The second factor is global equity markets. It is very early days, but the MSCI world equity index is now 5% above last week's lows, with the S&P 500 rallying another 2.6% yesterday. Global asset managers, positioned very underweight equities and overweight cash, could be putting money to work and are wary of the seasonal factors, where the S&P 500 index has rallied in nine of the last ten Novembers. How far the equity rally continues remains to be seen - but so far 3Q US earnings have been encouraging (only 29% of those reporting so far have missed on expected sales numbers, with only 24% missing on earnings).

And the third factor is energy. European gas prices continue to sink on warmer weather and European gas storage facilities being largely full. Lower gas prices are allowing a drop in electricity prices, where German one-month forward power prices are just 50% above early June levels, compared to being three times higher in late August. The drop in energy prices is reversing the negative income shock that hit energy importers over the summer and reduces the dollar's advantage.

A quiet week for US data could see the dollar correction extend a little. High beta currencies which trade on higher implied volatilities, eg AUD, NZD, NOK, SEK and possibly GBP may outperform during this period. And the case could be made for DXY heading back to 110 (another 2% drop).

But a core view of not just the Fed, but other central banks hiking into a looming recession should mean that the core dollar bull trend remains intact.

*Chris Turner*

## **EUR: Terms of trade go into reverse**

EUR/USD went under parity in late August largely driven by the negative terms of trade shock of higher energy prices. That energy shock is temporarily going into reverse as European gas prices drop sharply on the warmer weather and European governments having largely achieved their gas storage targets. It would thus be churlish of us to suggest that EUR/USD does not need to rally.

A quiet week for US data (just soft US housing) and the conditions we outlined above, therefore, create a corrective window for EUR/USD, where an obvious target is the top of this year's bear channel at around the 0.9980/1.0000 area. We would assume that this continues to hold the correction.

Elsewhere today we have the German ZEW investor survey, which should continue to decline. And we also have some ECB speakers in Gabriel Makhlof (1540CET) and Isabel Schnabel (1900CET). The core ECB message at the moment seems to be the need to get the policy rate (deposit rate now 0.75%) as quickly as possible to 2% and then take stock from there.

*Chris Turner*

## **GBP: Don't chase sterling higher**

As new UK Chancellor Jeremy Hunt carefully claws back all the fiscal giveaways offered in late September, the question is how far should sterling now rally? Taking the UK sovereign credit default swap as a benchmark for levels of UK fiscal anxiety, one could mark out dates around mid-September (GBP/USD at 1.15) and the third week in August (1.18) as possible targets - representing brief periods of stability before Trussonomics hits home.

While there may be some more fiscal positives to come were the Conservatives to look at a windfall tax on the energy companies, we suspect cable will struggle to sustain gains over 1.15 this month. News that the UK government is shortening the period of the Energy Price Guarantee to six months from two years may not be greeted well by the consumer and also raises the prospect of UK inflation staying higher for longer.

Equally, the Fed terminal rate has been priced close to 100bp higher over the last month. We think higher US real rates have contributed to the size of the sell-off in UK asset markets. There are no signs that the Fed wants to reverse this rise in real interest rates anytime soon. And one month GBP/USD implied volatility (now at 16% versus a peak near 22% in late September) may struggle to return to pre-crisis levels of 12% - confirming that trust is hard won and easily lost.

*Chris Turner*

## **MXN: Interesting carry**

Given the prospects of a brief corrective period in the dollar, interest may return to the carry trade. The highest available carry in the FX space can be found in Eastern Europe (Hungarian forint one month implied yields pay a staggering 16.5% per annum) and also the Latam currencies. However, we think Central and Eastern European FX still carries a lot of risks currently.

The Mexican peso also has an attractive carry, with one-month implied yields are 10.2%. Banxico continues to move in lock-step with the Fed. Whilst investors could miss out on some larger nominal appreciation elsewhere, Mexican peso positions may have lower draw-downs if things went wrong. Spot USD/MXN could even make a run to 19.80 as well.

*Chris Turner*

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