

FX Daily: Data dependent or financial stability dependent?

The ECB pressed ahead with a 50bp hike but turned fully data-dependent on the back of higher financial market instability. This adds a new degree of uncertainty about the future path of monetary policy and leaves market pricing very sensitive to incoming news on the banking sector. However, EUR/USD remains primarily a risk-sentiment story



⬇ USD: FX hit the pause button

The turmoil in financial markets continues to follow two parallel tracks: news on distressed banks and central bank action. As we approach the end of the week, it's quite clear that the two epicentres of financial stability tumult – Credit Suisse in Europe and regional banks in the US – remain unresolved. In both cases, the respective central banks have stepped in with significant support: the SNB with a \$54bn loan to the troubled bank and the Fed with its two borrowing facilities which, according to data released yesterday, saw as much as \$165bn being used. The borrowing from the discount window reached a new high at \$152.85bn.

It is clear, however, that markets remain rather nervous about the banking story. First Republic Bank is under increased scrutiny as its share price experienced high volatility and it emerged that the bank will receive around £30bn in deposits from other banks. On the other side of the Atlantic, speculation about a potential acquisition of Credit Suisse by other institutions remains high (despite an official statement by UBS and CS opposing any forced consolidation). Despite the SNB intervention, Credit Suisse bonds continue to show elevated signs of distress. It appears that central bank action was a necessary but not sufficient condition to bring back markets to normality, so expect more turbulence into the weekend.

Meanwhile, speculation about the Fed's decision next week is very much open. Yesterday's ECB 50bp hike (more in the EUR section below) may suggest the Fed may follow suit with a hike (likely 25bp) of its own. Markets have crawled back towards this scenario in the past 24 hours and now price in 19bp for next week. Large rate cuts – around 90bp between May and January – remain embedded in the Fed Funds futures curve: regardless of whether the Fed will hike or not next week, the degree of pushback against monetary easing will inevitably drive a big deal of the market reaction, and potentially the implications for financial stability.

G10 FX took a big pause yesterday despite the still elevated volatility in the debt market. It does appear that currencies are the odd ones out among asset classes in recent market turbulence. This is partly due to the financial shocks being concentrated in the US and Europe, which implies that the dollar struggles to emerge as the straight-out safe-haven currency (Fed rate bets are scaled back) and high-beta FX that are far away from Europe's sphere of influence – like AUD and NZD – seem to have detached themselves from their canonical correlation with risk sentiment.

FX is the laggard now, so big moves and big pauses may be the norm for a little longer. We think a gradual dollar weakening – and we are starting to see moves in this direction this morning – is more likely in the near term, but the upside risks remain very tangible in such a volatile environment. Today's data calendar in the US includes industrial production for February and University of Michigan inflation figures (with a particular focus on inflation expectations).

Francesco Pesole

📈 EUR: A new kind of central bank dependency

The ECB defied some dovish speculation and [hiked by 50bp yesterday](#). The move appeared appropriate not just from an inflation-battling and credibility perspective but also given a pause might have sent a signal of mistrust to a market that is nervously assessing the contagion risk of the US and Swiss banking troubles. That said, it created a whole new set of communication issues for President Lagarde and her colleagues.

The heightened uncertainty related to financial market instability was – by Lagarde's own admission – a great incentive to abandon any trace of forward guidance in favour of a full data-dependent approach. This, in practice, means that the ECB is now both data-dependent and financial-stability-dependent. Lagarde clarified there is no trade-off between price stability and financial stability, although one could argue this is exactly what we are witnessing right now, considering how much the ECB and Fed narrative has changed in only a week: e.g. 3-4 members of the Governing Council actually wanted to keep rates on hold yesterday. The message, however, was clear: the focus remains on inflation. At the same time, one "hope" could be that instability in the financial sector does some of the monetary tightening itself, ultimately offering an economic reason to slow tightening. For now, our economists' base case is still two more 25bp hikes by the

ECB.

EUR/USD traded slightly lower after the ECB announcement, probably due to the adverse reaction in European bank stocks. The EUR-USD 2-year swap rate dropped yesterday, both as markets saw the ECB data-dependent approach as dovish and because a Fed rate hike was being priced back in. Short-term rate spreads are, however, a very marginal driver for EUR/USD (as discussed [here from a statistical standpoint](#)), especially when compared to equity dynamics. A de-escalation in the tension within the financial sector and stabilisation in sentiment continue to constitute the clearest pattern for a EUR/USD rally from the current levels.

Today, keep an eye on the announcement of the amount repaid by banks under the ECB TLTROs. It is looking increasingly likely that we could see smaller repayments as banks try to retain more liquidity as a precautionary measure. On the data side, there is the final read of the euro area inflation for February and the OECD interim Economic Outlook projections to watch for. We'll also continue to hear post-ECB comments from governing council members. This morning, Madis Muller made the first remarks after the announcement, saying that the inflation forecasts imply more hikes.

Francesco Pesole

➔ GBP: BoE hike looking slightly more likely now

The ECB hike may have slightly increased the chances of the Bank of England delivering a 25bp hike next week. Our base case is a hike, although it's admittedly a close call as we acknowledge it will depend on financial market developments and CPI numbers next week. The BoE is probably more relaxed than the ECB and the Fed, so the bar for pausing is lower.

For now, EUR/GBP is a thermometer of the Credit Suisse saga. Markets probably deem the UK banking sector less exposed than the eurozone one and are punishing the euro much more than the pound when risks to the Swiss lender escalate. A rebound beyond 0.8800 likely requires more improvement in European banking sentiment.

Francesco Pesole

⬆ CEE: Dose of relief

The region got a welcome dose of relief after yesterday. Declining risk aversion and a restart in market rates should support FX across the CEE region today. Despite the mountain ride in recent days, we still favour the Czech koruna and Hungarian forint as the best candidates for a recovery. Both currencies have lost the most in recent days, which in our view has significantly cleared heavy long positioning, opening up space for new buyers. Moreover, the recent moves confirm that both currencies are the most responsive to global sentiment within the region. Moreover, gas prices are again well below EUR 50/MWh. Of the pair, we prefer the Czech koruna, which additionally benefits from the Czech National Bank's hawkish tone and potential central bank intervention. In our view, the bank board continues to maintain its intervention mandate at 24.50-70 EUR/CZK and it cannot be ruled out that it would enter the market at lower levels in the event of further weakening of the koruna, which is not welcome in the fight against inflation.

In addition, next week we will see more statements from the board ahead of the blackout period before the CNB's March meeting, which should support koruna gains. Thus, for the rest of the week,

we expect the koruna to return below 23.90 EUR/CZK. In the case of the Hungarian forint, we expect a return to stronger levels, but the brake on the pedal may be the return of the EU money issue to the table and the potential renewed conflict with the European Commission in the coming weeks. For now, we could at least see the forint return below 395 EUR/HUF.

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