

FX Daily: Dollar floor crumbles as Fed terminal rate re-priced

Today's Asian session has seen another leg of position unwind. Equities are under heavy pressure and the carry trade currencies continue to surge. Instead of the orderly adjustment of rates to some kind of neutral level, it looks like the Fed might be bundled into some sharper adjustment of policy. The Fed's terminal rate being priced under 3% is \$ negative



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📉 USD: All eyes on the Fed response now

Global risk assets continue to correct sharply as investors fear that the Federal Reserve has left it too late to ease policy. This follows Friday's soft [US jobs data](#) and the now widely cited Sahm rule that points towards a US recession. That data provided a watershed moment for US rates markets, where short-dated US yields collapsed on the view that the Fed would have to slash rates heavily this year. The market now prices around 120bp of Fed rate cuts before year-end.

Importantly for the dollar, fears of a US recession mean that the market is no longer looking for an orderly adjustment in Fed policy towards some kind of neutral rate - say near 3.25%. No, the fear

of a recession is now bringing in the idea of stimulative monetary policy. This has seen the USD 1 month OIS rate priced two years forward priced sub 3.0%. Recall that 3% was seen as the floor for the Fed's terminal rate when US rates fell sharply late last year. Views of where the Fed easing cycle ends have now become unanchored.

It is no surprise to see low-yielding currencies now in the ascendancy as the rest of the world now starts to converge on their low interest rates. The Japanese yen, Swiss franc and Chinese renminbi are all outperforming and of course, aided by the across-the-board deleveraging of open positions this summer.

Where to from here? Presumably the Fed will have to offer some soothing words. Look out for a CNBC appearance today from Chicago Fed President Austan Goolsbee at 1430CET. But at the same time, the evidence against the Fed could build were the July ISM services index (16CET) not to rebound as expected.

We think the marked correction in equities is keeping high beta currencies under pressure and not allowing them to take advantage of much lower US rates. However, when asset markets stabilise, which they eventually will, we would then expect the dollar to come lower across the board given that the dollar yield advantage has been sharply pared. For the time being, however, expect the focus to remain on the likes of USD/JPY and USD/CHF - both of which could drop further. DXY looks biased to 102.00.

Chris Turner

EUR: When the dust settles, EUR/USD should trade higher

EUR/USD has finally found some support on the softer US rates story. EUR:USD two-year swap differentials have narrowed dramatically - from 113bp last Thursday to 83bp today. Weaker global growth is not good for the pro-cyclical euro, but the fact that the 'US exceptionalism' narrative could be coming back to earth with a bump should be EUR/USD supportive - assuming that the Fed is prepared to cut rates sharply.

Were it not for the heavy sell-off in equities, yield differentials would make a case for EUR/USD to be trading well above 1.10 now. We think this is the direction of travel once the risk environment stabilises. In terms of the risk environment, we are keeping our eye on measures of financial risks such as the three-month Ted Spread (Libor over US Treasury bills) and also on the three-month EUR:USD cross-currency basis swap. Particularly if there were any signs of stress in the latter, the dollar could end up going bid. Therefore the bearish dollar scenario we outline above assumes no financial institution runs into difficulty.

It is a quiet week for eurozone data. Look out for the August Sentix investor survey today - although that was taken before the recent rout in equity markets. Overall we think EUR/USD should be able to press the 1.0950/80 region and break above 1.10 - especially if the Fed starts to acknowledge that action is required.

Elsewhere EUR/CHF continues to be hit. Noticeably the market is not pricing the Swiss policy rate below 0.50% - seemingly the zero rate bound now. This means that lower interest rates in the rest of the world are converging on Switzerland. The Swiss National Bank will not like EUR/CHF at these levels and may well be intervening. But it is very hard to fight this current EUR/CHF bear trend.

Chris Turner

📈 JPY: New layers of buyers emerge

On Friday we published an article looking at the [many layers of the carry trade](#). We felt the unwind of the carry trade could extend beyond speculative positions among fast-moving accounts such as Commodity Trading Advisors and into banks and non-bank financial institutions funding operations cheaply in yen. We felt that the one-year FX options market would show whether this community was now hedging too. This does seem to be the case with the one-year USD/JPY risk reversal going very bid for yen calls.

It is hard to argue with USD/JPY extending this correction to the 140 area - which we had seen as the outside risk last week.

Chris Turner

➔ CEE: US jobs data once again shuffled the cards for FX in the region

This week we will see a [lot of hard data](#) from the economy that could give us a clue how the economic recovery is going in a region that has so far been rather disappointing.

The main focus today will be July inflation in Turkey. Our economists expect it to fall from 71.6% to 61.4% year-on-year mainly due to the base effect. In the Czech Republic, retail numbers for June will be released, which we expect to be below market expectations.

Tomorrow we continue with retail sales in Hungary and industrial production in the Czech Republic and on Wednesday industrial data in Hungary. The National Bank of Romania is scheduled to meet on Wednesday. [Our economists expect](#) rates to hold steady at 6.75% after the rate cut at the previous meeting, which is also the consensus but no doubt another rate cut will be on the table.

On Thursday in Hungary, we will see inflation numbers for June. Here we see an increase from 3.7% to 4.1% YoY, a tenth above market expectations, and higher core inflation as well.

On Friday, the Czech National Bank will release minutes from its last meeting when it cut rates by 25bp to 4.50%.

Despite the rich calendar in the CEE region last week, the story is clearly on the global side and that will very much be the story this week as well. CEE FX remains very mixed reacting differently to the global rally in the rates space. No doubt we will see reverberations of Friday's big move today which may change the picture significantly. However, the starting position points to a further strengthening in the Czech koruna, some stabilisation in Hungary's forint and a weaker Polish zloty. EUR/CZK continues to follow the rate differential closely. Although CZK rates did not have much chance of repricing up after the hawkish Czech National Bank last week, the interest rate differential is rising thanks to the rally in core markets and this should lead EUR/CZK lower this week. We see exactly the opposite story in Poland, where PLN rates reacted the most to Friday's US jobs data, which will be a problem for EUR/PLN to resist a return to 4.30. EUR/HUF is near this year's highs and Thursday's inflation numbers will be crucial, which may in fact decide further rate cuts in Hungary and the direction of HUF.

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