FX Daily: Dollar getting a lift from the short end

Amidst many cross-currents in FX markets, one that is gaining traction is that the dollar appears to be getting a lift from the adjustment higher in short-dated USD interest rates. Having laughed at the Fed Dot Plots last week, the market now seems to be taking them more seriously. This provides a bullish undercurrent for the dollar against the low-yielders

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USD: Short end support

Amidst the many cross-currents in FX markets right now - energy, Evergrande, US debt ceiling, Delta - one theme that seems to be gaining traction is that the market lies on the cusp of re-assessing the path for the Fed tightening cycle. In our review of the Fed meeting last week, we noted that the market did not seem to be buying into the Fed's Dot Plots that the policy rate could be taken as high as 1.8% by 2024. At the time we were looking at products like the 1m USD priced three years forward that was priced under 1.20%. Well, that is now trading at 1.37% and a move above 1.40% would mark a new cycle high - and arguably the market sinking its teeth into the Fed tightening cycle. This story is also playing out in two year US Treasury yields now trading above

0.30%.

A US short-end on the move is typically positive for the dollar against the low-yielders. Indeed, JPY and CHF have underperformed so far this week, although the JPY is also suffering as a large energy importer. 111.65 is this year's high in USD/JPY and a break above it could see an initial extension to 112.25/50, but potentially higher if momentum funds join the move. A big move higher in the short-end is the key reason why we are bullish on the dollar, particularly from 2Q next year, but we will closely monitor and re-assess whether that move needs to come earlier - largely a function of timing the take-off in short-end rates.

For today, look out from testimony from Powell and Yellen at 16CET in front of the Senate Banking panel. Both are a little pressured at the moment - Powell after two Fed officials had to resign for actively trading portfolios and Yellen for her oversight of the IMF, where the Chief is under pressure for alleged influence over China's ranking in a World Bank report.

US data includes trade, house prices and consumer confidence. We do note that ripples of US debt ceiling concern are starting to be seen in the US T-Bill strip (a small hump in yields in late October), but it seems the market expects the Democrats to secure Republican support in the Senate for a short-term funding bill into December. Let's see whether that can be secured by Friday.

Given the low-yielder prevalence of Europe and the Yen in DXY weightings, expect the short-end story to keep DXY bid. A break above 93.50/70 could encourage fresh entrants to the rally.

EUR: Sintra kicks off today

In past years the ECB's Sintra symposium had delivered some defining moments for the ECB. Think Draghi's very dovish comments at the 2019 event. That Sintra symposium is today opened by Christine Lagarde at 14CET today. Ahead of what should be another difficult round of inflation numbers later in the week (Eurozone September CPI rising to 3.3% YoY) the focus will be on ECB's view on inflation - likely still viewed as transitory - and any hints over how the end of the PEPP scheme will be handled next March.

As a low-yielder with an inherently dovish central bank (like the JPY) the EUR looks vulnerable to this run-up in short-dated US rates and EUR/USD support at 1.1665 looks vulnerable today. USD/CHF can also make a run at the recent high of 0.9330.

GBP: Rates markets getting excited

Even though we felt the BoE Bailey's speech yesterday was largely a repetition of what had been seen in last week's BoE communication, GBP interest rate markets are still moving higher. 1m GBP OIS priced two year's forward is now 0.82% - up 30bp this month already. We do not expect the BoE to deliver on the hawkish expectations priced by the market, but for the time being this theme may well pressure EUR/GBP back to the 0.8500 lows.

Look out for a speech from BoE's Mann at 1450CET today. Any support she gives to an early BoE rate hike would certainly add more strength to the pound.

HUF: Looking for support

The HUF has had a tough week. The softer risk environment and lower EUR/$ has hit CE4 currencies, but HUF has underperformed after the NBH delivered a shallower than expected hike last week. It seems as well that a very popular trade this summer, short PLN/HUF has been unwound recently, hitting the HUF.

But our local economist in Hungary, Peter Virovacz, thinks it would be wrong to conclude that the NBH has gone soft on tightening with a smaller than expected hike. Instead, we see the NBH lengthening the tightening cycle - we still like a 2.50% terminal rate in March 2022. Additionally, by reducing the amount of QE it undertakes and reducing HUF liquidity operations through FX swaps it looks like the NBH wants to take greater control of money markets - such that HUF implied yields trade much closer to the 1.60% base rate. Recall that 1 month HUF yields traded in negative territory just over two weeks ago.

While we do not rule out EUR/HUF approaching 360, our preference would be that a hawkish NBH means that EUR/HUF trades back to 350 over coming months.

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