

FX Daily: Dollar is on sure ground as Fed gets set to hike

We expect a 50bp rate hike by the Fed today and an announcement that the balance sheet will be allowed to shrink over the coming months. But the focus will mostly be on any endorsement of the market's hawkish tightening expectations. Any "sell-the-fact" downside risk to the dollar appears limited, also considering the USD-positive global environment



➔ USD: Limited downside risks as the Fed prepares to hike

With the exception of a modest recovery in some high-beta currencies at the start of this week (AUD is a stand-out after the [Reserve Bank of Australia hike](#)), dollar crosses have traded in some rather tight ranges in the run up to today's FOMC policy decision.

We discuss our base case ahead of the Fed meeting [in this article](#). In short, we think the FOMC will deliver a well-telegraphed 50bp rate hike, with a 75bp move (championed by arch-hawk James Bullard) not completely off the table but unlikely at this stage. The reasoning is well known: 8%+ inflation, tight labour market, rising wages. Against this backdrop, we think the Fed will simply overlook the 1Q GDP contraction and fully focus on fighting inflation.

We also expect quantitative tightening to be announced today after the latest minutes signalled widespread appetite across the board to let the balance sheet shrink. We expect the Fed to start with \$50bn being allowed to run off each month before increasing it to \$95bn by September.

All these measures should be broadly in line with market expectations. That, however, doesn't mean that there's no room for surprises on either side. Markets will look closely at whether the Fed will (also implicitly) endorse the next moves currently priced into the USD curve, which consist of around 260bp of tightening by year-end (including today's hikes).

The dollar is clearly embedding a good deal of positives related to Fed tightening expectations, and the possibility of a "sell-the-fact" reaction by the dollar is not unlikely. Still, we think that as long as the Fed doesn't push back against hawkish market expectations, the dollar is likely to face limited downside risks today, or any negative reaction may be short-lived. This is especially true considering the geopolitical risk in Europe tied to the war in Ukraine, lockdowns in China and portfolio outflows from emerging markets, which all point to a strong dollar.

Markets will also keep an eye on ADP payrolls today in the US ahead of Friday's official jobs numbers.

➔ EUR: Still no reaction to hawkish ECB comments

EUR/USD has been able to trade above the 1.0500 mark, but the risk of a decisive technical break lower remains quite high in the coming days. Yesterday, European Central Bank hawk Isabel Schnabel explicitly suggested a rate hike in July, following up on some comments by the more moderate Luis De Guindos who said this was a possibility but deemed it unlikely. We have recently discussed the euro's inability to materially benefit from hawkish comments by ECB members, and we continue to believe this mostly boils down to a market that is already pricing in a good deal of ECB tightening by year-end (around 90bp as of this morning), and official ECB statements that have so far fallen significantly more on the dovish side compared to out-of-meeting communication.

Today, it's going to be up to the FOMC announcement and the impact on the dollar to determine the direction for EUR/USD. The eurozone calendar only includes March retail sales data, and there are no scheduled ECB speakers.

➔ GBP: Playing the waiting game

GBP/USD broke below 1.2500 for the third time in three sessions this morning. Similar moves on Monday and Tuesday were, however, quickly reverted. Still, it looks like a matter of time now for the pair to make a decisive break lower: if not triggered by the FOMC announcement today, it could come as a consequence of tomorrow's Bank of England policy meeting, which we [expect to defy hawkish expectations](#) and add some pressure to the pound.

EUR/GBP may hold within the 0.8400-0.8450 range before tomorrow's risk event but is at risk of jumping into the 0.8450-0.8500 territory after the BoE announcement. There are no data releases to mention in the UK today.

⬆️ AUD: Upside limited despite RBA's hawkish shift

Yesterday's surprise 25bp rate hike by the Reserve Bank of Australia (here's our [economist's](#)

[comment](#)) pushed AUD higher against G10 peers. While the RBA offered some signals that it is now committed to a period of rising interest rates to fight inflation, markets are now pricing 270bp of tightening by the end of the year, which may have fallen too far on the hawkish side. In the coming weeks, the wage figures released on 18 May, and jobs figures released the day after will be key in directing policy expectations ahead of the June meeting.

For now, we think that an external environment that remains negatively affected by China's clouded outlook (Chinese PMIs tomorrow will be watched closely) will contribute to keeping AUD/USD capped to the 0.72-0.73 area in the coming weeks.

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