FX Daily: Dollar lifted as search for terminal Fed rate continues

Financial markets are still coming to terms with the new inflationary environment and, prompted by Fed rhetoric, are now pricing the Fed terminal rate near 2.70% next year. This tough love from the Fed continues to drive the US yield curve flatter and the dollar higher. Expect more of the same over coming months. USD/JPY could push to 125

USD: Fed's tough love on inflation could send USD/JPY to 125

Hawkish comments from Fed Chair Jerome Powell yesterday have injected another wave of re-pricing into US rates markets. US 10 year yields are up 18bp to 2.33%, but the short-end has sold off more and the US 2-10 year curve has now narrowed down to 15bp. Expect much speculation over whether a flat or inverted US yield curve means recession - and certainly, this energy shock has increased the chances of a late 2023/24 US recession. Google searches on Paul Volcker are no doubt picking up as we remind ourselves of the Fed chair in the early 1980s who stamped out the inflationary effects of another oil shock, took rates to 15%, and sent the US economy into recession. Incidentally, the dollar went through the roof during this period.

As we discussed in our Fed review last week, USD/JPY is at the forefront of this adjustment and has pushed through 120 today. A sharply deteriorating trade position on the back of fossil fuel prices and a still dovish central bank leaves the door wide open for USD/JPY to trade up to 125 over coming weeks.

For today, look out for another batch of Fed speakers. And expect the DXY to continue pushing towards 100.

Elsewhere in the world, the importance of central bank support for currencies was evident in the Czech Republic yesterday. The governor of the Czech National Bank reiterated in the interview that the central bank is ready to use its massive FX reserves and will not allow the koruna to weaken. He also mentioned that the Board is likely to discuss further options for more active use of the FX tool at its March meeting. He added, however, that neither he nor his colleagues within the Board have a clear view at the moment and that the CNB does not want to significantly push the market and artificially create a higher value of the Czech koruna.

For the time being, we are not seeing a clear message from the central bank, but it is clear that the discussion within the CNB is escalating and record-high inflation is not leaving the board calm. Of course, a stronger CZK would be a quicker and safer medicine for the economy than further interest rate hikes. On the other hand, the CZK has recovered from the shock the most in the region and is not far from where it was before the Ukrainian conflict. From that perspective, it does not make much sense for the CNB to be more active in the FX market, unless the central bank's current approach to the FX instrument has completely changed. All this suggests the CZK may weather any renewed sell-off in the CEE space better than others.

EUR: Six ECB speakers today

EUR/USD has dipped sub 1.10 on the US rates move and could fall further. As Francesco Pesole discusses in his FX positioning review, speculative positioning long dollars or short euros is not particularly extreme at the moment. For today, we have six European Cental Bank speakers and the January eurozone current account data. Eurozone January trade data was terrible for the eurozone and, like Japan, Europe is on the wrong side of the fossil fuel surge.

Amongst the ECB speakers today, we have President Christine Lagarde (talking central bank policy in a digital world) and Chief Economist Philip Lane speaking at an event entitled '50 years of flexible exchange rates'. The flexibility of the euro now means that the eurozone is paying even more for its imported energy - a development the ECB is starting to brief against. Let's see if arch-dove Lane has anything to say about the current levels of EUR/USD. In reality, tighter monetary policy (not FX intervention) is the only credible tool available to the ECB to fight euro weakness. Let's see if they are prepared to use it.

Given the momentum behind the move in US interest rates, we could easily see EUR/USD pressing the recent 1.0800 low over coming sessions. And please read this piece by Francesco Pesole, where he concludes that EUR/USD may not be as cheap as it looks.

GBP: Hoping for some fiscal support

GBP has been outperforming in Europe. Its strength, despite last week's dovish hike by the BoE, is a reminder that continental Europe faces the same, if not worse pressure from the current energy shock.

In focus over coming sessions is the UK Chancellor's spring statement (tomorrow). There is much press speculation over support measures such as a cut in fuel duties, increases in national insurance thresholds, and more generous corporate tax breaks to encourage investment. That the UK's fiscal position has some room to support the economy may provide a little more room for the Bank of England to hike. Money markets have re-priced the BoE's Bank rate back to 2.20% for the 22 December meeting. The resilience of BoE tightening expectations should keep GBP bid versus the euro over coming months. 0.8305/10 looks the bias for EUR/GBP over coming sessions.

HUF: Hawkish central bank to help HUF below 370

The event of the week in CEE is today's meeting of the Hungarian National Bank. Our economist, Peter Virovacz, expects a hawkish 100bps hike in the base rate followed by a 50bp hike in the 1-week deposit rate on Thursday in line with consensus. However, market surveys show a wide dispersion of estimates indicating uncertainty associated with the board's decision.

From a macro perspective, the central bank will publish its March inflation report. GDP projections could remain unchanged. On the other hand, we expect the biggest change in the inflation forecast. We are expecting average inflation of around 9% for this year. In the last two days, the market has lifted pricing up again but we still see room, especially in the six to nine month horizon, to move market expectations closer to our terminal rate in the range of 8.00-8.25%. In any case, we expect a hawkish outcome of today's meeting, which we think should push Hungary's forint back below 370 per euro.

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com