FX Daily: Dollar rally can pause, but should not correct

Key market factors continue to support the greenback. We could see some momentum fade today, but the balance of risks remains skewed to the upside into the US election. Elsewhere, markets are expecting a 50bp cut by the Bank of Canada today, but we think the chances of a 25bp move are underpriced

Governor of the Bank of Canada Tiff Macklem. Don't rule out a 25bp cut from the central bank today

USD: Still upside risks into the election

The dollar continues to benefit from a wide range of supporting factors. US 10-year Treasury yields have risen by 15bp since the start of the week, the 2-year USD OIS is inching higher again with only 37bp of Fed easing now in the price, oil prices are rebounding and the proximity to a closely contested US election can continue to favour deleveraging and defensive repositioning. On this last topic, we have published an overview of what polls and betting markets tell us about the swing state battle, and how we expect the currency market to trade into and around the US election result.

One of our key calls for the next two weeks is that implied 1M volatility in USD crosses has room to become increasingly expensive relative to historical volatility, following a path similar to the pre-election period in 2020 and 2016. Also, a potential dry-up in FX liquidity next week can lead to less liquid currencies (like NOK in G10) underperforming.

For now, the most interesting G10 pair remains USD/JPY. After clearing the 151.3 200-day moving average level, there is no clear technical resistance level into 155.0. The yen slump is both a function of higher USD yields and domestic political risk premium ahead of next weekend's election. The lack of verbal intervention by Japanese authorities so far has probably built speculative sellers' confidence, but we still think any threat of fresh FX intervention can lead to a material USD/JPY correction given the success of the latest Bank of Japan operations. If the Minister of Finance stays quiet on the yen, 155.0 becomes a very tangible risk before the US election.

In the US, the data calendar remains light, with only MBA mortgage applications and home sales figures released today. Expect some potential market impact from the Fed's Beige Book, which has grown in relevance lately. Four months ago, nine of 12 Fed banks reported growth, but by 4 September, only three did. This likely influenced the Fed's September 50bp rate cut, with further weakness expected to prompt more easing.

On the Fedspeak front, we'll hear from Bowman and Barkin today, with the former being arguably the most hawkish voice in the FOMC. We could see some mid-week loss of momentum for the dollar today, but the balance of risks remains skewed to the upside into the election.

Francesco Pesole

EUR: ECB hawks fly low

EUR/USD briefly printed below 1.0800 overnight. We could see the pair stabilise around current levels for a bit longer, but the chances of a sustainable rebound remain slim as the USD:EUR two-year swap rate gap is now at its widest since May (145bp) and it's hard to pinpoint any clear driver for a retightening in the near term.

One of the reasons that the gap will stay wide is that ECB speakers have followed a rather dovish script in post-meeting commentary. Even the most hawkish members like Austria's Holzmann decided not to push back against market pricing for back-to-back ECB cuts into mid-2025, and President Christine Lagarde reiterated her generally dovish tone at a TV interview yesterday.

Today, the eurozone calendar includes consumer confidence figures for October, and a bunch of other ECB speakers – including Lagarde again and Chief Economist Lane. The policy communication however appears quite clear, and markets may start to overlook some of those comments. If PMI fails to surprisingly rebound, the ECB should keep cutting, and EUR short-term swap rates will still remain capped. Our call remains for EUR/USD at 1.07 before the US election.

Elsewhere in Europe, we continue to see downside risks for sterling ahead of speeches by Bank of England Governor Andrew Bailey today, tomorrow and Saturday, as well as some potential risk premium being built before the UK Budget announcement next week. Cable can still move to 1.28 by month-end.

Francesco Pesole

CAD: Don't rule out a 25bp cut

Markets are pricing in 45bp of easing by the Bank of Canada today. The reasoning is that inflation has now slowed below target and a soft growth picture warrants a faster, 50bp, move to neutral rates.

It is a very close call, but we think 25bp remains slightly more likely. As highlighted in our BoC preview, the core measures of inflation did not slow further in September, and the labour market recently posted strong gains with the unemployment rate inching lower. The growth picture is incidentally showing some tentative signs of improvement, with the BoC Business Outlook reporting a recovery in future sales expectations in the third quarter. If the conditions for continuing to ease policy persist, those for an outsized rate cut may not.

The BoC's decision today is incidentally made more complicated by the recent hawkish repricing in Fed rate expectations, with some FOMC members now casting doubts on back-to-back cuts into year-end. The BoC has claimed its independence from the Fed, but an excessive gap with US rates may be undesirable, as it weakens CAD ahead of a potentially turbulent US election period, among other reasons. The currency isn't at the top of the BoC's concerns, but a persistent depreciation in CAD can lead to higher imported costs.

All in all, macro factors and the recent Fed repricing point to a 25bp cut. If the BoC goes ahead with 50bp, one of the reasons may be not to disappoint market pricing. In FX, we think the balance of risks is skewed to the upside for CAD. The loonie can take a hit on a rate cut, but Governor Macklem might not want to endorse expectations for back-to-back 50bp reductions, and the CAD curve does not have much more room to shift lower. We continue to expect CAD outperformance versus other commodity currencies into the US election thanks to the loonie's lower exposure to Trump-related risk.

Francesco Pesole

CEE: Bonds auction test market appetite for risk

Yesterday's National Bank of Hungary meeting brought no change in rates to 6.50% as expected. The central bank accompanied this with hawkish comments but tried to avoid commenting on rate hikes that circulated in the Q&A session.

The NBH seems to have done as much as possible while avoiding extreme scenarios in the current environment. The market also sees this and has taken hawkish guidance with a test of 400 EUR/HUF again but the 400-402 range seems to be here to stay. Of course, after the NBH meeting the focus shifts back to the global story and HUF is not under central bank control. At the same time, EUR/HUF is a key variable for the length of the pause in the cutting cycle and a possible return to the rate cuts discussion.

Paradoxically, it will now depend mainly on the outcome of the US election. We see HUF as the most exposed currency within the CEE region in case of a Trump victory, while relief in case of a Harris victory would be more visible in PLN and CZK. NBH will thus face a challenging following weeks. Overall, HUF may have found some new range, but it is not out of the woods yet and the coming weeks do not suggest calming. HUF recovery will thus take more time and will mainly depend on the global story.

Today the calendar in the CEE region is empty. However, rates markets saw signs of a turnaround and stabilisation yesterday after the aggressive sell-off over the past two weeks. Government bond auctions are scheduled in Poland and the Czech Republic, which should test the market's appetite for risk.

On the one hand, yields after the sell-off seem attractive, on the other hand, the market will remain risk averse at least until the outcome of the US election, which may reflect on weak demand and return the market to sell-off mode again. On the FX side, in the case of calm, the market may benefit from a significant increase in the rate differential. The CZK saw some gains yesterday and remains our favourite currency within the CEE region, which we believe has a chance to outperform CEE peers in the current environment.

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