FX Daily: Dollar showing texbook overbought behaviour

Powell's speech yesterday was perceived as dovish and left the dollar a bit weaker. The greenback continues to draw smaller benefits from strong US data and high rate advantage than it should, likely due to its overbought status, but upside risks remain predominant in our view. Riksbank hedging figures will be in focus again today

USD: Still many upside risks

Markets have continued to receive evidence of US economic resilience, this time in the jobs sector as initial jobless claims surprised again to the downside and broke below 200k. However, the dollar weakened across the board after Federal Reserve Chair Jerome Powell said the central bank was treading carefully and that policy was at quite a restrictive level. The comments by Powell do not sound excessively dovish when looking at the market pricing for more Fed tightening (only around 10bp priced in before his remarks) and the recent narrative by other Fed officials that higher market rates mean lower chances of additional hikes.

However, the dollar is displaying the textbook behaviour of an overbought currency. We have long suspected that the CFTC figures are underestimating the real market's long positioning on the dollar. New numbers will be released today, but the latest figures from 10 October indicated the net long positioning was above 10% of open interest.

In this week's commentaries, we have also discussed some alternative views that can help explain the dollar's recent underperformance in light of a rates environment that would otherwise scream a rush to the greenback. The spread between 10-year UST and swap yields touched multi-year highs, a sign that markets may start to price in some fiscal-related premium into US yields. Also, we have recently seen a tentative recovery in the eurozone and Chinese data flow. A market that may feel the peak of pessimism has been priced into USD rates could be placing some forward-looking long positions on EUR/USD as the bearish growth narrative for non-US major economies is seen abating.

On the other hand, the dollar has also struggled to effectively draw safe-haven flows as geopolitical turmoil escalated. The conflict in the Middle East has, so far, had a surprisingly limited impact on markets as a whole. The rise in oil prices has not been huge, and equities appear to be holding up relatively well, especially considering the parallel spike in the risk-free rate. Barring a rapid de-escalation in the conflict, there is a lingering risk of a lagged impact on asset classes. That is another upside risk for the dollar – which is positively correlated with oil prices now, and historically negatively correlated with equities – along with what the rise in both front and back-end USD rates already suggests.

On balance, the dollar still looks more likely to rise in the short term than fall further. The US calendar is quiet today, we have two Fed speakers to monitor: Patrick Harker and Loretta Mester.

Francesco Pesole

EUR: Idiosyncratic support remains limited

EUR/USD has continued to enjoy pockets of support on the back of negative USD swings. The euro still appears to be lacking the strong idiosyncratic bullish narrative that can drive the pair sustainably above into the 1.0650/1.0700 range. Markets will likely await cues from the European Central Bank next week, and a few more data out of the eurozone, but the chances of a rapid upturn in euro bullish momentum aren't too high.

This means that EUR/USD should remain almost entirely driven by the USD leg for now. The two-year EUR-USD swap spread rate spread tightened by 10bp after Powell's speech yesterday but remains too wide at -118bp to justify a sustainable rebound.

More swings within the 1.05/1.06 range may remain the norm for now, but we see the balance of risks as slightly tilted to the downside.

Francesco Pesole

GBP: Soft data

We saw some rather soft UK numbers this morning. Weak retail sales and a noticeable drop in consumer confidence, though both are among the most volatile UK data releases.

In better news for the government, borrowing was a bit lower than expected which means that, following some similarly brighter readings in previous months, borrowing is running roughly £20 billion lower than expected in this fiscal year so far. But the rising cost of borrowing means this probably won't translate into much extra "fiscal headroom" for the Chancellor to spend in the budget next month.

We have seen EUR/GBP rally above 0.8700 recently, which starts to look slightly overdone as market expectations for Bank of England tightening at the 2 November meeting have dropped to almost zero.

Francesco Pesole

SEK: Two key questions as new FX sales data are released

EUR/SEK touched the upper bound of the trading band that has held since 27 September, two days after the Riksbank started FX hedging operations. That upper-bound level is slightly above 11.65. While it is too early to call it a line in the sand – especially because FX hedging isn't officially FX intervention – we have now observed two instances where the pair was rejected at the 11.65 resistance. We cannot know for sure, but there is a possibility that Riksbank will get more active with SEK purchases around that level.

This morning, we'll see the release of FX hedging figures by the Riksbank for the second week of operations (2-6 October). The USD sales figures for the first week matched our central estimate for a scenario where daily sales were spread equally across five months (an average of the 4-6 month window indicated by the Riksbank). Here's what we'll be on the lookout as new numbers are released today:

- Whether the USD sales were kept at the same level in the second week. That should be SEK-positive as it shows that the Riksbank did not counter the drop in SEK with more aggressive purchases.
- Whether EUR operations were started, via exchanging EU payments or directly in the market. The first time EUR/SEK was rejected at around 11.65 was on 4 October. If euro buying numbers come in high, then speculation of a line in the sand around that level would be fuelled.

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