

FX Daily: ECB message may disappoint hawkish expectations

As discussed in our [market preview](#), we think the ECB meeting today may fall short of the market's hawkish expectations, as Lagarde may keep her options open in light of lingering uncertainty, despite opening the door to a 2022 rate hike. Elsewhere, the dollar correction may not have long legs after the re-pricing of terminal rate expectations



The US dollar's softish momentum may not have long legs

USD: Markets starting to price in a fast descent in US CPI

Markets have continued to scale back the Fed's tightening expectations after Tuesday's US CPI numbers seemed to indicate inflation may have peaked. The 2yr USD swap rate – which accurately mirrors policy rate expectations – has seen a 25bp pull-back since the 11 April high. The discussion does not concern the Fed's next moves this year, as markets continue to price in back-to-back 50bp hikes into the summer and around 200bp of total tightening by year-end. Instead, investors seem no longer comfortable with the notion of a terminal rate at or slightly above 3.00% and have scaled their expectations back to the 2.75% area.

Our perception is that markets are now probably embedding a rather fast descent in US inflation.

As our US economist [analyses here](#), supply-chain bottlenecks still suggest that descent will likely be long and slow, and ultimately should continue to advocate in favour of the Fed bringing rates to the 3.00% mark. In other words, we expect markets to gradually price back in the hawkish bets it pared in the past few days.

In FX, this means that the dollar's softish momentum (caused by shrinking rate differentials) may not have long legs, and the prospect of 50bp increases in May and June should also contribute to keeping the greenback in demand in the coming weeks. Today, the main focus in the US will be on the University of Michigan surveys as well as March retail sales and a few Fed speakers (Williams, Mester and Harker).

Speaking of 50bp hikes, the [Bank of Canada decided to accelerate tightening](#) also through balance-sheet reduction yesterday. The key take-away from an FX perspective, in our view, is how the Bank highlighted the combination of increasing inflationary pressures and reduced exposure of Canada to recession caused by the Russia-Ukraine conflict. This is a combination that – along with elevated commodity prices – should keep the Canadian dollar in demand and we still target sub-1.25 levels for USD/CAD for most of the remainder of the year.

📌 EUR: Some patience should still emerge in ECB message

EUR/USD has climbed back above 1.0900 ahead of today's ECB policy meeting. However, the move did not seem to mirror an increase in hawkish bets on ECB policy but rather followed the rebound in the ever-depressed EUR-USD short-term rate differential purely driven by a re-pricing of the Fed's rate expectations (as discussed above). That said, money markets continue to tell us that investors' expectations (120bp of tightening in the next 12 months) are surely falling on the hawkish side when compared to the most recent ECB rhetoric.

In our [scenario analysis ahead of today's meeting](#), we look at different options for the ECB to give some clarity on the policy outlook based on their risk assessment for inflation and growth. Most of the focus will be on any implicit (or explicit) rate guidance, any tweaks to the notion of sequencing (hikes only after the end of quantitative easing) and the details of further net purchases under the Asset Purchase Programme (APP).

Our base-case scenario is that the ECB will fall short of the market's expectations around a hawkish tilt in the message, as the uncertainty about the development and economic implications of the Ukraine conflict should encourage policymakers to keep their options open. In practice, this means that along with a well-telegraphed openness towards a 2022 hike, we may see a reiteration of sequencing and an unchanged APP purchase schedule.

This may translate into a weaker euro, which is still looking at an unsupportive external environment due to uncertainty around the French elections and the Russia-Ukraine conflict. EUR/USD may slide back towards the 1.0800 mark today.

Elsewhere, after a correction over the last three days, the rates market in Hungary is 30-40bps lower across the curve. Although we expect this to be a temporary pause in the hawkish market mood, this has not helped a Hungarian forint already under pressure. Thus, given the recent [restart of the Hungarian government's conflict with the EU](#), we may see the forint weaker for a longer period as the market waits for any progress in negotiations. The situation is thus starting to resemble the Polish FX mortgage saga, where the FX market is driven more by government and court decisions than macro and central bank news.

However, we believe that after the recent upward moves in EUR/HUF, the forint has the most potential for gains within the Central and Eastern Europe region, but also the most obstacles getting there. On the other hand, nothing changes our call that the April National Bank of Hungary meeting will bring a 100bps hike to 5.40% in the base rate and 30bps or more in the deposit rate to a minimum of 6.45%, which should be positive news for the forint.

➔ JPY: Nervousness around weak yen grows

Weakness in the Japanese yen is really starting to catch the attention of Japanese policymakers, with Finance Minister Shunichi Suzuki describing USD/JPY breaking to 20-year highs as "very problematic". Clearly, we have moved into the stage of heightened surveillance, which normally precedes FX intervention.

It would not be a surprise to see USD/JPY consolidate near the highs as traders process the risks of FX intervention, yet we suspect that the trigger for Bank of Japan's (BoJ's) own-account intervention would be a fast move closer to 130. Expect traded USD/JPY volatility to remain bid in this environment.

In the bigger picture, however, unless the BoJ is prepared to hike rates, FX intervention can only temporarily interrupt what should be a grind higher in USD/JPY this summer. 130 seems possible.

➔ CZK: The Governor's words do not change the CNB hawkish mood

Yesterday's Czech National Bank (CNB) interview with Governor Jiří Rusnok, who mentioned that he hopes the May rate hike will be the last, caused a drop in market expectations, especially in the 1-2y horizon. However, we believe the Governor's words do not alter the [hawkish tone we saw at the March meeting](#). Since then, we have seen an upside surprise in inflation, and furthermore, it is hard to imagine that the new CNB forecast for the policy rate path will show a flat or just a small increase when staff recommendations have typically been more hawkish than the CNB board view.

However, we can't expect many hawkish triggers in the coming days and market rates may remain at lower levels for several days. However, from the second half of next week or rather from the beginning of the following week, when the board will have a draft of the new CNB forecast in hand, we expect hawkish statements and fresh support for the koruna again. The May meeting itself, however, may be a dovish message for the market due to the aggressive rate cuts path at the end of the CNB forecast horizon. As we said earlier, the koruna is on a bumpy road, but we think it should stay within the 24.30-24.50 range of recent weeks.

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