

FX Daily: Fed cycle now priced above the Dot Plots

Surging US inflation and some pretty hawkish commentary from many members of the Fed now see money markets pricing the terminal Fed Funds rate above 3.00% within a year. For the first time, market pricing of the Fed cycle is now above what the Fed has been telling us through its Dot Plots. Does that mean that the dollar rally has come far enough?



A hawkish Fed has kept the dollar reasonably well supported

➔ USD: Dollar should consolidate at these high levels

In our opinion, one of the most important factors driving dollar strength over the last nine months has been the market underestimating the scale of the forthcoming Fed tightening cycle. The dollar has been effectively bid since the Fed downplayed its average inflation targeting strategy at its meeting last June. Ever since then the market has struggled to believe that the Fed would undertake aggressive tightening and market expectations have lagged behind the Fed Funds rate profile presented in the quarterly Dot Plots. However, the sharp adjustment in market pricing over the last month now means the market prices the Fed cycle higher than the 2.80% levels presented in the March Dot Plots. Fed Funds futures contracts and the 1m USD OIS priced one-year forward point to a Fed Funds rate slightly above 3.00% next Spring. Does this mean that the Fed cycle is

priced high enough for the time being and that the dollar does not have to rally any further?

It probably does make the case that the dollar is moving into the 'hard yards' of its rally. Though, of course, Fed tightening expectations could overshoot (i.e. push well above 3%) over the coming months if US growth and inflation data stay strong and the Fed delivers a string of hawkish 50bp hikes in May, June, and July. Additionally, our financial fair value models see the dollar as a little under-valued after the big adjustment in short-dated US yields over the last month. Overall, it may well be that the dollar requires a strong impetus to rally much further - although equally, it should stay supported now that we are moving later into the business cycle - as evidenced by an inverted 2-10 US Treasury yield curve. If the dollar is to enter a period of consolidation at these high levels, which currencies might out-perform?

Look out today for the Bank of Canada (BoC) releasing its quarterly Business Outlook survey. Strong readings for sales, employment, investment, and inflation expectations could build expectations of a 50bp hike from the BoC next week - a 44bp hike is currently priced. Expect the Canadian dollar to stay well supported on the crosses (e.g. versus the Japanese Yen) and USD/CAD could retest strong support at 1.2430/50 if the Outlook survey is strong enough. DXY should stay bid within the 98.00-99.00 range awaiting Wednesday's release of the March FOMC minutes.

➔ EUR: Focus on sanctions

In Europe this week, the focus will be on whether politicians choose to escalate sanctions on Russia. Some in the EU (Poland and Lithuania) have already opted for unilateral embargoes on Russian energy, but so far the EU as a whole has avoided following suit given its heavy dependency on Russian crude. The very aggressive release of US Strategic Petroleum Reserves has taken the sting out of the crude oil price spike, but it still seems that the EU is some way from weaning itself off Russian oil. Presumably, any moves from the EU toward a Russian oil embargo would see crude prices spike higher again and the euro come under pressure via the Terms of Trade channel - plus the physical risks of rationing energy in the European industrial sector.

EUR/USD can probably consolidate in a 1.1000-1.1120 range over the coming days. For today look out for the Eurozone Sentix investor survey for April and later this week the eurozone highlight will probably be the release of ECB minutes on Thursday.

➔ GBP: Bank Rate still priced for 2.20% in December

Despite much focus on the heaviest cost of living rise since British records began (1950s), the market still prices the BoE Bank Rate at 2.20% at the December meeting later this year. That pricing of the BoE cycle is likely keeping GBP relatively well bid, although we do think the risks are growing of Cable breaking down to the 1.25/28 area over coming months. For this week, the data calendar is light and today we have two BoE speakers: Governor Bailey at 1105CET and dove Cunliffe at 16CET.

➔ RUB: Recovery 'is not sustainable'

The rebound in the Russian rouble is garnering much attention both sides of the Atlantic. Politicians in Washington and Moscow clearly see the rouble as the most visible sign of the performance of the Russian economy in the face of widespread sanctions. US Secretary of State, Anthony Blinken, over the weekend said the rouble's recovery was unsustainable and artificially supported by capital controls - e.g. restrictions on foreigners exiting Russian investments and for

Russian residents to buy FX.

In addition to capital controls and a collapse in Rouble liquidity, real sector flows are playing a role in supporting the rouble too. As long as foreigners, primarily Europe and Asia, buy Russian oil and gas, Russia will be receiving hard currency it can use to support the rouble. Notably, last week's decree from President Putin about 'unfriendly' countries needing to pay for Russian gas in roubles is playing a role too.

As we understand it, reading through the decree, consumers of Russian gas now have to open FX and Rouble accounts with Gazprombank onshore. Foreigners can still pay in FX according to their gas contracts, but Gazprombank will do the FX conversion to roubles onshore using onshore MICEX rates. In effect, this means that Gazprom - which previously had been mandated to sell 80% of FX revenues within three days, now has to sell 100%. That could be worth an extra \$2bn sales of FX into roubles per month. Presumably, Russian authorities are unlikely to lift capital controls any time soon and the fate of the rouble will very much be dependent on the continued Western purchase of Russian oil and gas.

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