FX Daily: Fed foot-dragging and low volatility dominate

It has been a good night for the dollar. One of the Fed's most influential voices, Christopher Waller, delivered a mildly hawkish speech - firming up the view that the Fed will be arriving late to the rate cut party. At the same time, the S&P rating agency reaffirmed the US sovereign rating at AA+ with a stable outlook. Low FX volatility also dominates

Federal Reserve Board Governor Christopher Waller

USD: The dollar is in no rush to sell off

The dollar received some bullish news overnight in a speech from the Federal Reserve's Christopher Waller. He has been making influential speeches since late October, and last night's speech seemed to show slightly more concern over the early-year sticky inflation and strong jobs growth and what it would mean to the disinflation process. It sounds like he may well have recently shifted his own view on the Fed easing cycle to two cuts this year, and his message was one of shallower and later rate cuts. The speech will have been a disappointment to dollar bears who might have been hoping for some reassuring confidence on the disinflation process and some further discussion of the seasonal problems with the firm January inflation data.

In response to the speech, we saw some modest bearish flattening of the US yield curve (dollar positive), where short-dated yields rose about 4bp. The dollar got a brief lift on the news. The dollar also received some positive news from the S&P rating agency, which reaffirmed the US sovereign rating at AA+ on a stable outlook. There had been some quite high-profile interviews earlier this week on the unsustainability of the US debt profile but clearly, S&P read the debt trajectory differently to Fitch, which downgraded the US last August. In a way, this marginally diminishes or delays the risk of a US fiscal crisis, even though all investors appreciate that this will have to be addressed at some point.

As we head into the end of the quarter, one of the defining narratives remains the normalisation of monetary policy in the G10 space and the current signals that the Fed may be a late arrival. This follows last week's rate cut in Switzerland, yesterday's Riksbank meeting near-promising a rate cut in May or June, and overnight comments from the RBNZ Governor that New Zealand was preparing to normalise policy. As a result, short-dated interest rate differentials are moving in favour of the dollar.

Today's US focus will be on some revisions to 2023's fourth quarter US GDP and the March University of Michigan data. We will also see weekly initial jobless claims – though these refuse to budge higher and attest to Christopher Waller's remarks that perhaps there is some genuine pick-up in employment occurring after all.

It is hard to speculate against the dollar in the G10 space, and barring any significant quarter-end rebalancing (look out for flows at 5:00pm CET), it feels like the greater risks are DXY popping through 104.50 towards 105.00.

Chris Turner

EUR: Rate differentials move to the widest of the year

Two-year EUR:USD swap rate differentials are moving to the widest of the year near 138bp, following remarks from Christopher Waller. At the same time, some flash national CPI data for March (Spain data released yesterday) has come in lower on a core basis and firmed up market expectations that the European Central Bank will cut rates at the 6 June meeting. For reference, we see March inflation data from Belgium today and France and Italy tomorrow. The market now attaches an 85% probability to an ECB rate cut in June but only a 57% probability to a similar move that month by the Fed.

We suspect that if it were not for month-end portfolio re-balancing flows, EUR/USD would be trading below 1.0800 now. And that looks the risk heading into tomorrow's release of February core PCE inflation data for the US, which is expected at a sticky 0.3% month-on-month. Under 1.0800 support, we could see EUR/USD heading to 1.0780 and perhaps 1.0750. However, one month EUR/USD traded volatility below 5% suggests trading conditions will continue to be sticky.

Elsewhere, yesterday's speeches from Swiss National Bank officials reiterated that the SNB has no target for the Swiss franc and is also confident that CPI does not have to breach the SNB's 2% ceiling again. The market attaches an 80% probability to another 25bp SNB rate cut in June, and the low volatility environment also favours EUR/CHF grinding up towards parity.

Chris Turner

JPY: Higher US rates and low volatility weigh

Speculation over Japanese FX intervention remains high following yesterday's joint meeting of the Bank of Japan, the Ministry of Finance and the Financial Services Agency. We suspect Japanese authorities would pull the trigger were USD/JPY to burst through the 152 area, intervening perhaps somewhere in the 153-155 range. Recall that when Japan last sold FX in September/October 2022, it started off with about $15-20bn and, in total, sold around US$65bn of FX over the two months. What may be interesting this time around is if it leaves the intervention unsterilised – i.e., delivering a net drain of yen liquidity which can see some ripples in money markets. At least FX intervention from now on will be more consistent with the BoJ's new tightening bias for monetary policy.

With US interest rate volatility collapsing and much demand for the carry trade, it is, however, hard to see much of a market-led move lower in USD/JPY.

Chris Turner

MXN: The total return hero

The market's love affair with the Mexican peso continues. It has now delivered year-to-date total returns of 5.36% against the mighty US dollar and 13.1% against the yen. We had thought Banxico might push back against peso strength when it cut rates last week. Yet Banxico's statement (unlike the SNB's) did not single out a strong currency as an influential factor, and the market has been happy to press ahead with peso positions. We suspect the strong peso will enable Banxico to deliver a consistent path of rate cuts and expect more receiving pressure to emerge in Mexican two-year TIIE swap rates, which are now trading around 9.75%.

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