

FX Daily: Fed pause renews interest in the carry trade

Even though it was a hawkish hold, the Fed's decision to leave rates unchanged for a second meeting in a row has seen interest rate volatility drop and high-yielding currencies start to perform well again. This may be an emerging trend, especially if tomorrow's jobs data isn't too hot. The focus today is on rate meetings in the UK, Norway and the Czech Republic



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📌 USD: Investors look set to explore the Fed pause

The dollar has been a little weaker over the last 24 hours. Helping the move has likely been the rally in the US bond market, supported by a lower-than-expected quarterly refunding announcement, the soft manufacturing ISM and then the FOMC meeting. Despite the [Fed retaining a tightening bias](#), it seems investors are more interested in reading and trading a Federal Reserve pause. This has seen interest rate volatility drop and triggered renewed demand for high-yielding FX through the carry trade.

Calmer market conditions have gone hand in hand with the re-pricing of the medium-term Fed cycle. Recall that last month, the story was very much 'higher for longer' and rather incredibly, the

low point for the Fed cycle over the coming years was priced at just 4.50%. That pricing has now adjusted 60bp lower over the last few weeks and has even seen yields at the short end of the US Treasury curve start to move lower, e.g., sub 5% again. It may be too early to expect these short-end rates to go a lot lower just yet, but it does seem as though investors are a little more open to the prospect of weaker data knocking the dollar off its perch.

Without that confidence that US growth will decelerate this quarter, the Fed's pause can, however, see further demand for carry. In the EM space, it has been a good week for currencies in [Chile](#), South Africa and Mexico, while in the G10 space, the under-valued Australian dollar is doing well. We continue to see upside potential for AUD/CNH. This would normally be a weak environment for the yen as well, meaning that we cannot rule out USD/JPY retesting 152. US data will determine whether the dollar can generally hold steady in this carry trade environment or whether weaker US data finally triggers a more meaningful and broad-based dollar correction.

For today, the focus will be on the weekly jobless claims data – where any decent jump higher can knock the dollar – and the volatile Durable Goods Orders series. Do not expect big moves before tomorrow's US jobs report, but we would say the dollar's downside is vulnerable today. DXY to drift towards 106.00.

Chris Turner

➔ EUR: Global environment delivers a reprieve

EUR/USD is enjoying something of a reprieve as the global pressures temporarily abate. US yields have softened along with energy prices, and industrial metals are staying surprisingly bid, perhaps a warning that a modest re-appraisal of Chinese growth prospects is underway. The eurozone data has been nothing but euro-negative this week (weak growth and confidence, weaker inflation), but the calmer dollar environment warns that EUR/USD could creep higher again. 1.0520 to 1.0700 seems the new short-term range and EUR/USD could drift up to the 1.0650/75 area, with perhaps US jobless claims a possible trigger for the move.

The data calendar is light, but look out for a 12:00 pm CET speech from European Central Bank Chief Economist Philip Lane. He is speaking on monetary policy tightening. We presume he'll hold the door open for another hike in December even though money markets have now completely priced out any further ECB tightening.

Elsewhere, look out for the Norges Bank rate decision at 10:00 am CET. No one expects a hike today, but a re-iteration of plans to hike 25bp in December and the lower interest rate environment internationally probably favour krone outperformance today. Favour EUR/NOK to 11.74 and possibly 11.65 today.

Chris Turner

➔ GBP: BoE to keep rates high for 'sufficiently long'

"Monetary policy will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term" should be the key phrase to look out for in today's Bank of England (BoE) policy statement. The Bank Rate is widely expected to be left unchanged at 5.25%. The focus will also be on the vote split. 6-3 would seem to be the most likely as James Smith explains in our [BoE preview](#).

Assuming that the BoE does not soften its tone today – i.e., it does not provide fresh ammunition to pricing of rate cuts next year – we would expect sterling to stay relatively well supported. This could see GBP/USD push up the 1.2250 area, while EUR/GBP could press support at the 0.8670/80 area.

Chris Turner

📌 CZK: CNB to start its cutting cycle

We expect the Czech National Bank (CNB) to start the cutting cycle today with its first 25bp move. This seems fully in line with market pricing and economist consensus. However, surveys suggest it is a close call. And of course, upward pressure on commodity prices and tensions in the Middle East may be reasons to wait a little longer for the CNB. But we believe the new forecast plus weak economic data this week will be sufficient reasons to cut rates today. In addition to the decision itself, we will also see new numbers that should be revised towards a worse economic outlook, lower inflation, a weaker CZK and a faster pace of rate cuts.

However, for the markets, today's cut has become a done deal and the collapse in PRIBOR in recent weeks indicates that more than 25bp is priced in for today's meeting. At the same time, the entire curve has shifted lower, making essentially the entire cutting cycle already priced in 1y horizon. We see a significant deterioration in the risk/reward of being received in rates at current levels versus a scenario of no rate cut today. In the FX market, we see the situation getting a lot easier. In the event of a rate cut being delivered, we expect EUR/CZK higher in the 24.80-25.00 range supported by a new CNB forecast indicating levels above 25.00 and still room to price in further rate cuts in the longer term, which would lead to a deterioration in the interest rate differential. Otherwise, we think the potential for CZK appreciation is limited and EUR/CZK may touch 24.50 only temporarily.

Frantisek Taborsky

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

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