

FX Daily: Fed's hawkish risk management to keep the dollar bid

The dollar continues to consolidate barely 1% off its highs of the year. Last night's release of the September FOMC continued to reveal a very hawkish Fed operating the risk management strategy that the 'cost of doing too little outweighed the cost of doing too much'. Today's US September CPI release should again be a major market mover. USD to stay supported



USD: September CPI to prove a major market mover

The message from IMF meetings in Washington this week has clearly been a [stagflationary one](#). Downside risks to growth and upside risks to inflation prevail and could be exacerbated by a deterioration in the energy crisis, further lockdowns in China, or the de-leveraging in the Chinese property sector leading to a Chinese-led financial crisis. Notably, the IMF backed central bankers in their fight against inflation and warned politicians against fiscal policy working at cross purposes to monetary (UK etc). The meetings have also been an opportunity for G7 and G20 central bank governors and finance ministers to get together. Support suggests that there will be no change in any of the key FX language in the communique, consistent with remarks from US Treasury Secretary Janet Yellen earlier this week that exchange rates should be market determined. We can

forget about a [Plaza 2.0 for the time being](#).

Last night saw the release of the [September FOMC minutes](#). Admittedly we are reading them through our hawkish Fed/bullish dollar lenses, but a few points stood out:

1. Fed staff 'significantly' revised down estimates of US potential output because of low productivity and weak labour force participation. The US economy is therefore seen operating above capacity until 2025. Arguably the Fed's battle against inflation became even larger.
2. A 'sizable portion of economic activity' has yet to react to higher interest rates. Housing and business investment have started to respond, but not much else.
3. The risk management approach was on display for all to see with the explicit strategy that the cost of taking too little action, outweighed the cost of taking too much

The Fed looks unlikely to pivot anytime soon. That brings us to today's main event, which is the US September CPI release. All eyes will be on the core measures, where last month's 0.6% monthly reading crushed bonds and sent the dollar higher. Consensus expects 0.4% month-on-month today, taking the core year-on-year back to the 6.5% cycle high. Our US economist James Knightley sees the risks evenly balanced here. Rents and used car prices make up nearly 50% of the core basket. There are some anecdotal signs of rents starting to soften, but the timing of this feeding through the official data is uncertain. While any sub-consensus number could see the dollar briefly dip, we doubt it would alter expectations that the Fed hikes 75bp in early November and dollar weakness should prove temporary. An above consensus number should send the dollar back to the highs and sink both Treasuries (already softened by the Gilt debacle) and global equity markets.

In practice, this should mean DXY losses are limited to the 111/112 area on a soft CPI print and test 115 on any above consensus number.

Chris Turner

➔ EUR: Becalmed at low levels

EUR/USD looks to be trading comfortably down at these low levels near 0.97. The three-month risk reversal, the price of a euro put option over a euro call option is still trading at 2% - reasonably bearish. As above, we're bullish on the dollar and would expect any gains on a soft US CPI today to prove unsustainable above 0.98. Equally, a high CPI print could tip US equities over the edge and send EUR/USD back to the 0.9540 low. [We have 0.92 targets for EUR/USD over the next two quarters](#).

Chris Turner

⬇ GBP: Cross purposes

As above, the IMF has warned that fiscal policy should not operate at cross purposes to monetary, risking financial stability. Of course, that is exactly what has been happening in the UK since late September, leaving the Bank of England (BoE) to pick up the pieces in the Gilt market. Reading between the lines of the BoE's Financial Policy Committee [summary released yesterday](#), the BoE seemed to point to oversight issues of the Liability Driven Investment (LDI) community by the pensions regulator and the FCA.

Gilts had a strong rally late yesterday on news that the BoE had bought all the Gilts on offer (£2.5bn). At present, the BoE's emergency buying scheme will halt at close-of-business tomorrow, whereby the BoE is pressuring the LDI industry to raise as much cash as it needs to manage its margin exposures in Interest Rate Swap (IRS) derivative contracts. The risk of a cliff edge in the Gilt market remains for Monday and in this environment, we doubt many investors would want to go near sterling.

Cable remains at risk of a move to the 1.08 area, while EUR/GBP could easily retrace all of yesterday's late losses from 0.8850.

Chris Turner

📌 HUF: Looking for support

EUR/HUF continues to plough ahead, having found no support from the National Bank of Hungary's (NBH's) [larger-than-expected](#) hike in late September nor its plan to remove excess HUF liquidity. Investors are probably concerned as to where the forint support is coming from given that the NBH has said that the tightening cycle is over at 13% (for both the base rate and the one-week deposit rate) and that it skipped a non-interest rate-setting meeting earlier this week.

The NBH's liquidity measures, such as central bank bill auctions and longer-term deposits, will take time to work, which leaves the forint waiting for some encouraging news on progress on EU fund disbursement. Hungary's Finance Minister Mihaly Varga even floated the idea earlier this week that Hungary could seek participation in ERM-2 after it has received its funds from the EU!

Until some concrete progress is made on the EU funds deal – or perhaps the NBH hugely surprises by continuing its tightening cycle – it is hard to see what is going to turn the forint around over the near term.

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