

## FX Daily: From Fed dependence to Fed divergence

The dollar momentum is consolidating after the ECB and Bank of Canada have signalled a desire to diverge from the Fed. That can place the market on a path of de-linking Fed rate expectations with those of central banks – a dollar-positive development. In Sweden, low inflation and a weak krona are making pricing for a May cut increasingly tricky



We think the case for a growing divergence between an immobile FOMC and a bunch of dovish central banks is getting stronger

### ➔ USD: Stronger backing from other central banks

At the start of this week, the dollar looked cheap, but we thought it would have taken something on the US side or in other key developed markets for it to realign with its strong rate profile. Come Friday, both the US and rest of the world's story have turned more positive for the greenback.

The hot US CPI was the trigger to a substantial dollar rally, but the dovish (even if moderate) shift in the European Central Bank and the Bank of Canada messaging has now made that rally more sustainable. Both banks have given a nod to market bets for a rate cut in June, and rightly so given the considerably more encouraging domestic inflation outlook than in the US. As things stand now, the Federal Reserve looks unlikely to match that same dovishness, and the case for a growing divergence between an immobile FOMC and a bunch of dovish central banks is getting stronger.

That implies a stronger dollar. We argue that there is plenty of evidence now for markets to break the link between the pricing for Fed and other central banks (which ECB President Christine Lagarde said loud and clear yesterday), but we also understand the assumption of “Fed dependence” in rate expectations could last until we actually see cuts in those other major economies. That hardly means dollar downside risks, but if anything, a more gradual or delayed USD appreciation.

Any real downside risks for the dollar seem to be stemming almost only from US data now, and yesterday’s PPI was a case in point. The below-consensus 0.2% month-on-month headline print sent the dollar lower across the board, even though core at 0.2% MoM was expected. Deteriorating sentiment and a slightly delayed ECB impact offered new support to the greenback shortly after, but there are still two points we want to make about March’s PPI. First, the inconsistencies with CPI have been particularly marked this time. For example, medical services PPI was flat versus 0.6% MoM in CPI and car insurance PPI rose 0.1% vs 3% MoM (!) in CPI. Second, a lot of PPI components feed into the core PCE deflator – the FOMC’s favourite measure of inflation. If we have to point to a moment where USD strength risks of being unwound, the PCE release on 26 April is surely a big one.

Today, the US calendar includes the import price index for March and April’s University of Michigan surveys (markets normally move on the inflation expectation component). The Fed’s agenda includes Susan Collins, Jeffrey Schmid, Raphael Bostic and Mary Daly.

Geopolitics has played a seemingly secondary role for FX for a while now, but rising tensions between Iran and Israel can spill into even higher oil prices – all to the benefit of the dollar in the near term. DXY can comfortably eye 106.00 now, but today may be too early for a move to that level.

*Francesco Pesole*

## ➔ EUR: ECB on a clear path to June cut

The ECB announcement and press conference did not rock markets, as President Lagarde offered only a cautious transition to rate-cut wording. It is not irrelevant that, for the first time, the policy statement included a specific reference to lowering rates – but the whole communication package delivered yesterday in Frankfurt seemed tailored to minimise impact on a market already positioned for summer cuts. Our economist Carsten Brzeski thinks the ECB will deliver a “hawkish” cut in June, [as discussed here](#).

As FX analysts, a couple of things caught our eye. First, Lagarde stressed during the press conference that inflation is expected to fluctuate in the coming months, but also that if projections give confidence on reaching the target, rates will be cut. We might be overspeculating here, but that could be a way to prepare markets for a period of cuts and inflation volatility (on the upside). We may well hear this message reiterated in the future to try and anchor rate expectations and avoid the kind of hawkish repricing the Fed is dealing with now, which would be an undesirable development for eurozone economies struggling with wide deficits (e.g., France and Italy) and high interest payments.

Secondly, Lagarde said the ECB does not target the exchange rate, but if we indeed see Fed rates unchanged for multiple months and cuts in the eurozone, then the inevitable pressure on EUR/USD would need to be accounted for in the economic projections. A weaker euro is both positive for the eurozone’s struggling export machine and is potentially inflationary. But the ECB has been more

concerned about inflation than growth (as per its mandate), so we cannot exclude that a return to a 1.00/1.05 area in EUR/USD – which is possible in an extreme Fed-ECB divergence scenario – triggers some concerns in Frankfurt. Whether that will be enough to stop the ECB from easing is a different question, and one that can only be answered by inflation data. However, the way the ECB communicates with markets about FX and rates could be more easily impacted.

As usual, the days after the ECB meeting offer a chance to Governing Council members to fine-tune the policy message. This morning, Yannis Stournaras said clearly that “now it’s time to diverge” from the Fed. He is one of the most dovish members and probably one of those who asked for a rate cut yesterday. We are more interested to hear what more neutral members have to say in the coming days. Looking at EUR/USD, the momentum still looks tilted to the downside. A break below 1.0700 can come at any moment and further downside risks extend to the 1.0600 support in the near term.

Francesco Pesole

## ⬇️ SEK: Inflation adds to May cut dilemma

Inflation in Sweden surprised again on the downside in March. Data released this morning shows CPIF declining from 2.5% to 2.2% (expectations were for a rebound to 2.6%), with Riksbank-preferred CPIF excluding energy inflation slowing to 2.9%, markedly faster than expected.

Considering these figures and stable inflation expectations at 2.0%, the Riksbank should cut in May in line with their latest policy announcement. But markets are not pricing in a May move aggressively (around 13bp at the time of writing) due both to the hawkish repricing in Fed expectations and the recent weakness of the Swedish krona. Comments by Sweden officials have endorsed this Fed/SEK conditionality. Yesterday, Per Jansson admitted that the Riksbank’s ability to cut next month depends on other central banks’ rate-cut plans and that a further weakening of the krona remains a key concern.

The external environment for SEK remains unwelcoming given higher US rates. The lower chances of the Riksbank cutting in May with a weaker SEK mean that the downside risks for the krona are less pronounced than those for NOK, for example. At the same time, a turn higher in high-beta currencies can easily see SEK lag peers as Riksbank easing is priced back in. In the near term, a re-test of the 11.619 highs in EUR/SEK looks very possible, while a move to the 11.70+ area would seriously hinder the chances of a May cut in Sweden and would potentially encourage the Riksbank to restart FX sales.

Francesco Pesole

## ⬆️ CEE: Global sell-off as opportunity for FX

Following yesterday's inflation numbers in [Romania](#) and [Hungary](#), this morning we saw industrial production and labour market numbers in Romania. Later today, current account numbers in Poland and the Czech Republic will also be published. After the close of trading, the rating review in Romania by S&P will also be published. We do not expect any changes here.

Yesterday's selloff in the rates space following core rates and reflecting the impact after the US inflation numbers at the end of the day led to widening interest rate differentials in favour of CEE FX. While we do not believe these rates will remain at current high levels – especially in the Czech

Republic and Hungary – we believe this will support FX in the short term. The CZK could benefit the most from this perspective, where the interest rate differential has reached the highest levels since early February when the Czech National Bank cut rates by 50bp. EUR/CZK should therefore head below 25.20. We still see HUF as overvalued as we mentioned earlier, but due to temporarily higher rates, the correction might not be that significant – if it materialises at all. However, we still see rather an upward move in EUR/HUF above 392.

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