

FX Daily: From trading war to trading monetary restraint

Yesterday's trading session was a good example of the futility of trying to pick a top in the rates markets. It seems too early in the cycle to be doing that, especially with so many central bankers ready to stamp on the brakes to prevent inflation from getting out of hand. Aggressive tightening and perhaps a more difficult risk environment will dominate FX now



Federal Reserve
Chairman Jerome
Powell

USD: Powell's homily to Paul Volcker reminds us that the dollar can soar

We are currently seeing tremendous volatility in interest rate markets, where the kind of 10-15bp daily swings at the short end of the yield curve was unthinkable just a few years ago. Driving those swings are both the commentary and actions from central bankers who look prepared to take action to prevent inflation expectations from getting out of hand. Mexico's central bank, Banxico, describes the issue quite nicely as acting to prevent inflation expectations from becoming 'contaminated'.

In a week of IMF meetings, we have heard from quite a few central bank speakers and the

message from the likes of the Federal Reserve and the Bank of Canada is that the policy rate needs to be taken to neutral as quickly as possible. Even the Bank of England's Catherine Mann hinted at the need for a quicker pace of tightening. Expectations of central bankers hiking in 50bp or even 75bp increments are now contributing to the volatility in rates markets. This theme looks set to be with us over coming months and may well become the dominant market driver instead of the war in Ukraine which, away from the human tragedy, has largely been treated as a commodity supply shock.

What does this potential shift in focus mean for FX markets? The war in Ukraine and its implications for commodity prices had seen FX trade through the terms of trade lens - or winners and losers in the commodities war. That is why USD/JPY has nearly traded to 130. A shift to almost involuntary adjustments in monetary policy - i.e. inflation dominating growth concerns - could start to see a more difficult risk environment emerge. An extreme example here remains Paul Volcker's time at the Fed in the early 1980s - lauded by Fed Chair Jerome Powell yesterday. Volcker 'slayed the dragon of inflation' by taking rates to 15%, sending the US economy into recession and the dollar soaring. Could that be the 2022 story? The jury is out on how high the Fed will take rates, but with the terminal rate for Fed funds being priced higher each day (now at 3.35%) it seems far too dangerous to try and pick a top. And equally, that is why we see the dollar staying strong for most of the year.

If we are to shift to a more difficult risk environment on the back of what we call involuntary tightening (where real yields go more deeply into positive territory) we could start to see some of the pro-risk commodity pairs hand back some of the war-inspired gains. We are thinking here of a pair like AUD/JPY. Having rallied 15% since the war broke out, a quick 3-5% snap-back lower could be on the cards over the next month. Equally, CNH/JPY could correct sharply lower too, seemingly putting in an important top this week.

For today's session, we have some US April PMIs, though we suspect that the market is far more interested in price than activity data right now. Do not try to fight the strong dollar bull trend and DXY can probably hold above 100.

➔ EUR: Decreasing marginal hawkishness

The euro has failed to find much lasting support from an increasingly hawkish set of commentary emerging from the European Central Bank this week. The problem is that rates lift-off from the ECB this year looks to be overshadowed by aggressive tightening cycles from elsewhere. The core message from the ECB regarding monetary policy of 'optionality, **gradualism** and flexibility' means that the ECB will not be in the camp of racing to neutral.

For today, look out for the April PMIs across the eurozone. French business confidence actually held up pretty well when it was released yesterday. Importantly, let us not forget that the euro OIS market looks to be pricing 95bp of ECB rate hikes this year already - limiting the scope of the euro to react to any further hawkish rhetoric. We favour EUR/USD continuing to trade heavily near the 1.08 area - and any deterioration in the risk environment will generally see the dollar favoured.

Elsewhere, the onshore and offshore USD/RUB rates are diverging again. Offshore being quoted at 80, onshore at 75. Onshore sales of FX energy proceeds are keeping the rouble bid here, while offshore flows remain very light. In terms of capital controls, domestic measures have been softened. Earlier this week, Russian exporters were told that they had 60 days instead of just three to sell FX proceeds. Capital controls on foreigners look to be unchanged - a situation unlikely

to be adjusted in the foreseeable future.

➔ GBP: 25bp or 50bp at the 5 May BoE meeting?

The Bank of England's (BoE's) Catherine Mann put the cat amongst the pigeons yesterday by suggesting the BoE could accelerate its pace of tightening if the economy withstood the cost of living crisis. Today's soft UK March retail sales release is a notch against such an outcome. But importantly the market is now pricing a 38bp adjustment at the 5 May meeting and it may be hard to put the 50bp genie back in the bottle.

Sterling also faces some political risks again where the Financial Times [today reports](#) that the UK is (yet again) threatening to rip up parts of the Northern Ireland protocol, agreed as part of the Brexit deal. Markets have come to ignore this, although it could add to some downside risks to cable - where we think 1.2850 beckons.

➔ MXN: Banxico needs to keep pace with the Fed

Speaking in Mexico yesterday, the new Banxico governor, Victoria Rodriguez, said that Fed rate hikes were a challenge for Mexico. The issue here is that Banxico normally targets USD/MXN stability through keeping a 600bp policy spread of the Fed funds rate. The Mexican policy rate is now 6.50% and the market indeed prices it at 9.50% next year on the back of a 300bp Fed tightening cycle. Failure of Banxico to follow the Fed could see the Mexican peso (MXN) coming under pressure.

There are no signs as yet that Banxico is ready to forego USD/MXN stability. And Mexico's dependence on a strong US economy puts Mexico's economy on more solid ground than South Africa, which has greater ties to China. Both the MXN and the rand (ZAR) are high beta emerging market currencies. Both will be challenged by the developed world quickly taking real rates into positive territory. But the Mexican peso should outperform the rand and has a 280bp per annum positive carry via the three-month implied yields. 1.25 seems a target for ZAR/MXN in 2Q22.

Authors

Chris Turner

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

chris.turner@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

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