

## FX Daily: Volatility sinks across the board

Conviction is building that there is little to stand in the way of abundant USD and EUR liquidity this summer. Just next week's Fed meeting needs to be overcome as an event risk. Expect investors to continue their chase for yield, largely in emerging markets, while the dollar continues to soften in a low volatility world



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### 📌 USD: Whole world is looking for carry

Marketing the view that US inflation would hit 5% YoY in May, but that 10 year US Treasury yields would be declining to the low 1.40s% would have been a tough one earlier this year. Yet, it seems that [abundant USD liquidity](#) - and the promise of more - is dominating market thinking right now. This glut of liquidity is driving volatility levels lower across asset classes and driving the search for carry, including at the long end of yield curves. It even seems like there was interest to dip toes back into the TRY yesterday, where overnight implied yields are 18%+ p.a.

Next week's Fed meeting looks to be one of the big, final event risks before the market shuts up shop for the summer. The consensus clearly seems to be that though the Fed may hint that a tapering discussion may be closer than before, it will not be rushed into anything. So unless a Black Swan event comes along, it seems hard to argue with a further decline in cross-market volatility this summer.

As we have been repeating over recent weeks (and months), this environment should continue to see the dollar gently offered against those currencies with good stories (monetary tightening or commodity exposure) and a little carry. Carry can currently only be found in the EM world and as we discuss later, front-loaded tightening and implied yields of 5.5% p.a. make the RUB attractive.

We think this quiet period does see the dollar slowly sink across the board and is conducive for flows into emerging markets in general. That should probably mean that DXY sinks back to its lows near 89.50 - although today, it seems that some large FX option expiries after yesterday's 'Super Thursday' could keep DXY largely range-bound.

For today, look out for the Michigan Consumer Sentiment for June, with a key focus on whether sentiment has bounced back from last month's decline and the latest take on inflation expectations.

## 📈 EUR: One year implied volatility ready to crash through 6%

Probably one of the biggest talking points in FX markets right now will be whether one-year EUR/USD implied volatility crashes below 6.00% to hit a post-pandemic low. The likelihood is yes. The ECB [avoided any missteps yesterday](#) in its communication, and another quarter of above-average PEPP purchases adds to the story of a liquidity glut. Excess reserves parked at the ECB are now some EUR4.2trn and feed into the search for yield.

What does this mean for EUR/USD spot? With both the Fed and the ECB continuing to print money aggressively, a case is made that spot goes nowhere. Indeed today, there seem to be some large option expirations in the 1.2100-1.2200 area, which could keep the spot glued there for the 16CET expiries.

Yet European hard data for May should start to deliver on some of the bullish confidence indices, and we think will encourage further demand for Eurozone equities. Monday saw the single largest daily flow (\$1.1bn) on record into the Eurozone MSCI iShares ETF - a sign that US equity investors are interested in Europe. We think that could be a story that sees EUR/USD advance to the 1.25 area by late summer.

## ➡ GBP: Holding up well

GBP is actually holding up quite well. This morning's April GDP and industrial production figures were slightly disappointing, and the [hangover from Brexit](#) could still un-nerve GBP. Yet EUR/GBP is pretty steady near 0.86 and Cable bid near 1.42. Clearly, the USD and EUR liquidity stories are playing a role here - and actually, you can see the EUR offered against most European currencies.

We doubt today's G7 meeting in Cornwall has much impact on financial markets and would probably still think that Cable exits very tight ranges to the upside given our firm (if consensus) view that benign conditions mean a weaker dollar.

## 📈 RUB: CBR to tighten the monetary screws today

Russian policymakers meet to set rates today. Following a higher than expected [May CPI print of 6% YoY](#), most now expect a 50bp rate hike to take the policy rate to 5.50%. Markets currently expect this front-loaded tightening cycle to reach a terminal rate in the 6.00/6.25% area later this year. And what the CBR has to say about this may impact the Rouble today. Yet, the external

environment is benign, and [BoP trends](#) seem supportive for the Rouble in the short term.

A strong, front-loaded tightening cycle, with hints of a terminal rate, might also be welcomed by the local OFZ bond market, where 5-year yields near 7% may encourage some further foreign inflows. Investors also keenly await next week's Biden-Putin summit, and assuming the external environment remains benign, USD/RUB may make a run for the 70.50 area.

## Authors

### Chris Turner

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

[chris.turner@ing.com](mailto:chris.turner@ing.com)

### Francesco Pesole

FX Strategist

[francesco.pesole@ing.com](mailto:francesco.pesole@ing.com)

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