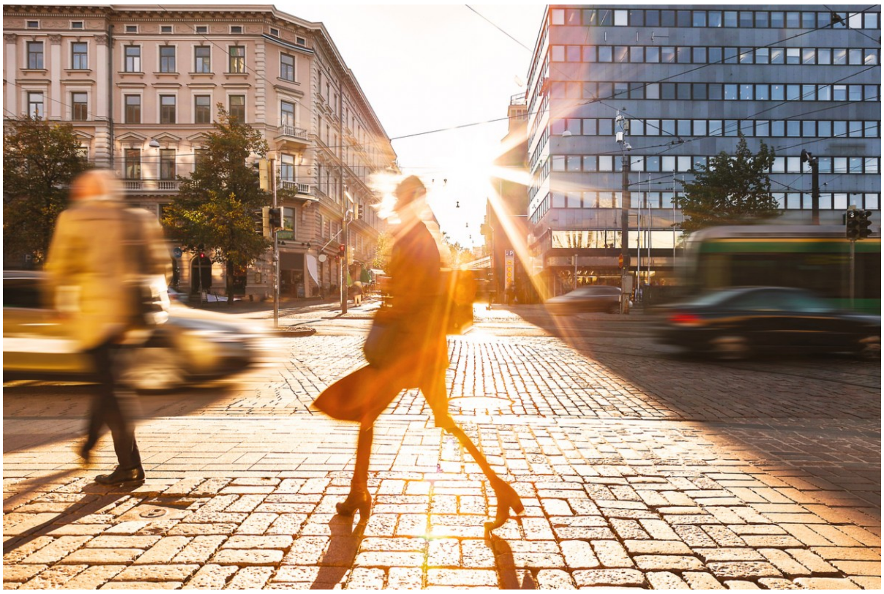
FX Daily: FX market heats up

As central bankers around the world try to battle inflation, currency policy is also being dragged into the fray. Now both the SNB and CNB will be selling some of their chunky FX reserves to keep their currencies stable or stronger. The BoJ remains the odd man out, but friction around the USD/JPY 135 levels looks set to keep volatility levels very high



Source: iStock

USD: US economy can best handle higher rates

FX volatility levels remain very high as central bankers battle with high inflation and investors try to position for their next move. The dollar was briefly lower yesterday after the Swiss National Bank's (SNB) surprise hike raised expectations that the Bank of England (BoE) and Bank of Japan (BoJ) would follow suit with 'more forceful' (that phrase has cropped up a lot recently in central bank circles) monetary policy.

We discuss the BoE later, but barring a surprise announcement from BoJ Governor Kuroda at his press conference today (due at 0830CET) it looks like the BoJ is sticking to its guns and still printing money. This suggests that USD/JPY will be pressing 135 again, above which a disorderly move could prompt BoJ FX intervention. The alternative is that the Ministry of Finance instructs some state actors (buy-side) to sell a lot of dollars near 135 if Japanese authorities have failed to secure permission for intervention from the US Treasury. A relevant point here is that substantial FX intervention could add to woes in the US bond market, where US securities could be sold to raise the dollars to intervene.

We mention the subject of intervention since news that the SNB could be selling from its substantial FX reserve stockpile seemed to spook European bond markets yesterday - especially the five-year sector which seems to be the average duration for central bank bond portfolios. The Czech National Bank (CNB) is already selling from its FX reserves - perhaps as much as EUR10bn over the last month as it fights Czech koruna weakness after the installation of a new dovish board. FX reserve sales and higher bond yields are not particularly helping the equity environment this summer and should maintain levels of FX volatility near the recent highs.

In all of this, we would prefer to back the dollar. The US economy went into the current inflation shock operating above capacity. Regions like the eurozone were still running output gaps and the ECB is merely reacting to a supply shock. We think the pricing of the Fed tightening cycle has the longest staying power - keeping short-end US rates and the dollar bid this summer.

For today, the only US data is May industrial production and we may see some further position adjustments on June contract expiries and ahead of Monday's Juneteenth public holiday in the US. Expect DXY to find continued demand under 104. Also, look out for opening remarks from Fed Chair Jerome Powell at a conference at 1445CET today.

EUR: Official selling

The European Central Bank (ECB) may not take too kindly to their Czech and now Swiss counterparts potentially selling a lot of euros. A weaker euro will not help the ECB's battle with inflation. EUR/USD, however, did see a good rally yesterday as investors bought Rest of World currencies against the dollar on expectations for tighter monetary policy outside of the US. Yet that looks more a function of position adjustment and we do not see any reason for EUR/USD to embark on a sizable rally this summer - perhaps the only cause for such a move could be 8-10% declines in equity markets such that the Fed cycle is substantially re-priced.

Expect volatility to remain high and EUR/USD could well bounce around in a 1.0400-1.0600 range for the near term.

On the SNB, we reiterate the view that the central bank wants to manage the nominal trade-weighted CHF some 4% higher over the next year, offsetting low Swiss inflation and keeping the real CHF stable. The SNB has the firepower to achieve this. A low volatility EUR/CHF decline would seem to be the call here.

GBP: Crazy day in UK markets

UK markets saw some wild gyrations yesterday. As we understood it, sterling rallied after the SNB hiked by 50bp and declined when the BoE only raised by 25bp. The pound then rallied when the market re-read the MPC statement about some 'forceful' adjustment in policy. Despite only hiking 25bp yesterday, market pricing of the Bank rate at year-end rose to 3.00% from 2.84%!

It seems the BoE is not in the mood to fight this market pricing at present and the next big opportunity only comes at the 4 August MPC meeting. That said, we do have two MPC speakers today, Silvana Tenreyro at 1030CET and Chief Economist Huw Pill at 16:30CET. As a more dovish MPC member, let's see how much pushback we get from Tenreyro today. Cable could sink into a 1.22-1.23 range for the time being.

HUF: National Bank of Hungary bundled into emergency hike

In and amongst high FX volatility, the National Bank of Hungary raised its one-week deposit rate by 50bp yesterday to 7.25%. This had not been expected this early and looked to be a reaction to EUR/HUF trading at 400. Given that Hungary does not have a lot of FX reserves at its disposal, we assume that defence of the 400 level will come more through the rate side than the FX intervention side. 6 by 9 month HUF FRA now price HUF 3m rates as high as 9.75% towards this end of this year. Currently, we see the policy rate heading up to 8.25% later this year.

How central banks react to local currencies should be a theme for central and eastern European FX currencies in general - i.e. none of the local central banks will want weaker currencies right now. We would probably back the Polish zloty to hold its value the most, given plenty of scope for rate increases and the prospect of converting EU funds into zloty on the open FX market.

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