

FX Daily: Geopolitics may start to take over

Yesterday's US inflation figures triggered a rebound in the dollar, but markets are endorsing the more dovish Fed stance, so the dollar may not rally much more on rates only. Geopolitical volatility can, however, favour defensive currencies. Elsewhere, the Riksbank published key hedging data this morning. Watch for SEK downside risks



📈 USD: Looking beyond the post-CPI bounce

The September US CPI report turned out to be the tipping point for the dollar correction, as we had expected. As discussed in our [US economist's note](#), it was mostly the “super core” measure of service inflation (ex-shelter, ex-energy) that surprised on the upside, coming in at a hot 0.6% month-on-month. The bump was mostly due to hotels and motor insurance prices, which will subside, but it still complicates the disinflation narrative.

Despite the understandable bearish reaction in bonds and rebound in the dollar, markets for now remain very cautious when it comes to pricing in more Federal Reserve hikes. The implied effective Fed Funds rate in the futures market for December is almost unchanged; it was 5.40% on Wednesday and 5.42% this morning. The narrative pushed by Fed officials that “higher market yields will do the tightening” appears to be well cemented now.

This new Fed stance probably means that there will be some reluctance to follow yesterday's dollar rebound much further for now – at least if only the rates aspect is considered. Geopolitics appears to have played a rather secondary role in global FX developments despite the ongoing conflict in the Middle East. This morning, the Israeli government warned UN staff to evacuate Gaza and notified Palestinians living in the northern part of the Gaza Strip to head south within the next 24 hours, raising the perceived chances of an imminent major ground offensive. Yesterday, Syrian media reported that Israeli airstrikes hit the airports of Damascus and Aleppo. Meanwhile, the US has reportedly stepped up diplomatic efforts to avoid the conflict spreading to other fronts in the Middle East.

The situation clearly remains too volatile for a prediction on the market impact, but it is fair to assume that the start of an Israeli ground offensive in Gaza may encourage more defensive trading and favour currencies like the dollar, the Swiss franc and the yen, as some investors price in a greater risk of the conflict spreading to other fronts. The commodity market impact has been contained so far, but more upside pressure on oil prices can also favour the dollar.

There are also potential risk-off implications from the protracted stand-off in the US House Speaker bid, as Representative Steve Scalise abandoned his campaign to become the new Speaker after only a few days. That could have repercussions not only for domestic fiscal funding but also for military aid to Israel and Ukraine, which President Biden has promised to deliver but is now set to face approval hurdles.

We suspect political and geopolitical events will start taking centre stage in the FX market into the weekend. The US calendar includes University of Michigan surveys today, and the focus will as usual be on the inflation expectations gauges, which are expected to have held steady. Patrick Harker is the only scheduled Fed speaker.

Francesco Pesole

EUR: Downside risks from geopolitical tensions

EUR/USD plunged below 1.0550 yesterday, and remains entirely driven by the dollar leg and non-eurozone factors for the moment. As discussed above, from a rates perspective and given the market's endorsement of the Fed's more dovish narrative, there is a chance of a rebound for the pair (i.e., back to 1.0600/1.0650). However, the escalation in Middle East tensions can keep the upside capped for pro-cyclical pairs like EUR/USD. A pair like EUR/CHF should remain a common short position for markets amid the volatile geopolitical environment. A move below the 0.9530 September lows looks quite likely.

The eurozone calendar only includes industrial production figures for August and some final regional CPI prints. There will be some focus on European Central Bank President Christine Lagarde's speech at an IMF panel this afternoon at 2:00 pm BST, although the ECB's speakers' ability to influence the euro has been quite limited recently.

This morning, markets will monitor Bank of England's Governor Andrew Bailey's speech at the IIF. This will be followed by a speech from Deputy Governor Jon Cunliffe. Still, it seems unlikely that BoE officials will offer strong guidance considering the lack of key data releases since the last meeting. Markets are pricing in about 40% implied probability of a hike before year-end in the UK, and our view is that that will have to be fully priced out as price dynamics subside. For now, however, EUR/GBP volatility should remain muted.

Francesco Pesole

📌 SEK: Aggressive hedging not good for SEK

It is a big day for the Swedish krona. This morning, Sweden released the inflation report, which should headline and underlying price pressures were hotter than consensus in September. The Riksbank effectively focuses on two main inflation indicators, the CPIF – which decelerated from 4.7% to 4.0% (expected 3.7%) – and the CPIF excluding energy – which slowed from 7.2% to 6.9% (expected 6.7%).

The figures, and especially the stickiness in core inflation around 7%, warn against ruling out more monetary policy tightening in Sweden. Remember that in the latest projections the Riksbank implied a close-to 50% probability of another rate hike. Yesterday, Governor Erik Thedeen spoke at an interview and said it was “fairly likely” there were more rate hikes on the way. Markets have scaled back bets of another hike given the rebound in the krona, but we think the probability of another increase is higher than what markets are currently implying (around 15bp priced in to the peak).

Crucially, the krona will have to pass a big test this morning, as the Riksbank releases the data for the first week of FX reserve hedging at 09:30 am BST. We published our estimates on what today's figures may look like and the potential FX impact [in this note](#). We estimate that a hypothetical equally weighted daily SEK buying would equate to somewhere between US\$400 million and \$660 million weekly, given the four to six-month window mentioned by the Riksbank for hedging operations. Anything in the upper end of this range or above would mean the Riksbank started buying quite aggressively – possibly because SEK was weaker. That has implications from a sustainability standpoint (Riksbank would run out of firepower earlier), and if the markets are forward-looking enough, a high SEK buying number for the first week may well not be a positive for SEK.

Francesco Pesole

📌 CEE: Last trading day before general election in Poland

We have some second-tier data on the calendar today across the region. In Poland, the final estimate of September inflation will be published. We will also see current account data in Poland, the Czech Republic and Romania. And after the close of trading S&P will release reviews for the Czech Republic (AA-) and Romania (BBB-). In both cases, we think the rating and outlook will remain unchanged.

Today is the last trading day in Poland before the general elections this weekend. EUR/PLN is hovering near its lowest levels since early September, and some may see a stronger zloty as a bet on the outcome of the election. However, we see the hawkish surprise from the National Bank of Poland's decision to cut rates by only 25bp as the driver of the current move in recent days, with FX simply following higher market rates. Hence, we believe PLN positioning is not necessarily tilted towards one election outcome, and we therefore do not expect a significant reaction to the election result on Monday. However, given the strong likelihood of a close result or a deadlocked parliament leading to a prolonged period of political uncertainty, we are leaning more towards a negative view of the PLN as an election outcome if we have to pick a side.

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