FX Daily: Hawkish 75bp Fed hike can keep dollar bid

We expect a 75bp rate hike by the Fed today, accompanied by a hawkish tone and Dot Plot projections which may show a terminal rate around 4.25-4.50%. We think this could keep risk sentiment fragile and offer further support to the dollar. Elsewhere, SEK is struggling to benefit from yesterday's 1% hike by Riksbank, and UK policy plans remain in focus for GBP

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USD: Fed can keep offering support

The dollar has retained good momentum so far this week, largely benefiting from safe-haven demand as risk sentiment has remained quite fragile. The performance across G10 currencies continues to follow a textbook reaction to an inverted US yield curve (the 2Y10Y currently oscillating around -40/-45bp), with pro-cyclical commodity currencies getting hit particularly hard.

Yesterday, markets had a chance to look at the last bits of data before today's FOMC announcement, with a specific focus on housing figures. Housing starts surprisingly spiked in August, while building permits dropped. On the one hand, this continues to raise concerns around this sector, as the rise in housing starts points to more supply at a time when high mortgage rates are set to curb demand. On the other hand, falling building permits suggest this may be the last big wave of construction and supply should ease next year.

In terms of today's big event, the FOMC announcement, concerns about the housing market will likely play a marginal role. The above-consensus inflation reading in August and recent Fed communication have left little doubt among investors and economists that the Fed will hike by another 75bp today. This is also our call, as discussed in our Fed preview, where we also explore different scenarios and potential market implications.

With somewhat limited scope for a surprise on the size of the rate hike today, all eyes will be on the updated projections, and especially on the Dot Plot estimates. We expect another revision higher in the median Dot Plot so that the terminal rate should now fall in the 4.25-4.50% area in 2023. Revisions to other economic forecasts should show some signs of a worsening economic outlook, but the notion of broad resilience in the US economy should remain the baseline scenario.

Looking at FX implications, we think that a hawkish hike today by the Fed will keep front-end rates supported and a very inverted yield curve should continue to endorse the dollar's good momentum for now, largely to the detriment of pro-cyclical currencies. With the relationship between short-term rate dynamics and most G10 pairs having waned lately, expect a big chunk of the market reaction to be driven by the reaction in global equities – here a still hawkish Fed may not be read as good news, and that is another reason why we expect the safe-haven dollar to remain bid.

Francesco Pesole

EUR: Empty calendar, all eyes on the Fed

With such a large risk event on the calendar, it's hard to see EUR/USD being driven by anything else than the Fed today. This is especially true considering the lack of market-moving data releases in the eurozone today and only one scheduled ECB speaker: Luis de Guindos, this morning.

What is sure is that the overall environment for the euro remains quite challenging, and the latest reports that Germany is going ahead with a full nationalisation of Uniper - the largest buyer of Russian gas – are working against any relief rally in European sentiment at the moment.

We think the early-September 0.9900 lows can be tested in EUR/USD after the Fed announcement, and a break below that level may unlock further downside for the pair into the 0.9800 support.

Francesco Pesole

GBP: Truss tax cut proposals in focus

While some wait-and-see approach would normally prevail in GBP crosses ahead of tomorrow's big Bank of England announcement, the FOMC and incoming news on domestic policy proposals mean that the pound may remain volatile today. In line with our view for a positive response by the dollar to the Fed announcement, we think cable could set new lows today (a move below 1.1300 possible), and the pound's higher sensitivity to a potentially adverse reaction in equities compared to the euro suggests some upside risk for EUR/GBP (which could re-approach 0.8800).

Prime Minister Liz Truss's policy plans remain very much in focus too, and recent reports that her government may push for tax cuts – including the stamp duty on home purchases – may ease some concerns about the clouded UK economic outlook, but also fuel doubts about the sustainability of expansionary fiscal policy while delivering a mammoth energy bill support package.

Francesco Pesole

SEK: A tough lesson for the Riksbank

Yesterday, the Riksbank surprised on the hawkish side as it hiked by 100bp (expectations were for a 75bp increase). We discuss the move and market implications in our Riksbank review note.

One important point from an FX standpoint is that the Riksbank might have chosen a larger hike not only because of high inflation and because it has fewer meetings than other central banks (which in theory encourages front-loading), but this may also be read as an attempt to lift the battered krona and offset the increased sales of domestic currency for FX reserve build-up purposes. We are not surprised this attempt has blatantly failed. As discussed in a recent note on SEK, the correlation between monetary policy dynamics and EUR/SEK has faded of late and markets clearly retain a bearish bias on European high-beta currencies in the current environment.

EUR/SEK broke the 2022 highs yesterday, with the next key resistance found in the 2020 Covid crash peaks (all above 11.00). We do admit that SEK has quite a lot of negatives in the price at the moment, and a move above 11.00 in EUR/SEK is still not our base case at this stage, but we acknowledge downside risks have mounted for the krona due to the challenging economic and market conditions, and there is not much the Riksbank's monetary policy can do to help in the near term. If anything, a U-turn (which was however ruled out by Governor Stefan Ingves yesterday) on FX purchases would likely ease some pressure on SEK.

A return below 10.50 in EUR/SEK in early 2023 is still possible in our view, as the krona should be at the forefront of any recovery in global and European risk sentiment. But the timing and likelihood of such a scenario are surely uncertain for the time being.

Francesco Pesole

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

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